Sarbanes-Oxley and the Outsourcing of Accounting

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Abstract

The following paper analyzes the outsourcing, offshoring, and offshore outsourcing of accounting following the passage of the Sarbanes-Oxley Act of 2002 (SOX). The outsourcing of accounting services is growing at a phenomenal pace and is affecting firms of all sizes, regardless of industry or market capitalization. This is leading to a strategic shift in what, where, and by whom accounting services are performed. The outsourcing of accounting following SOX is analyzed in five areas: First, the initial impact of SOX on onshore and offshore outsourcing of accounting, in particular, the emergence of India as a major destination for offshore outsourcing. Second, the outsourcing of accounting services in small and medium sized firms; in addition, the application of outsourcing theory as a metric to gauge sourcing decisions. Third, accounting pronouncements which impact the desirability to outsource accounting following SOX. Fourth, transaction cost economics and its application to the outsourcing of accounting. Last, the emergence of global accounting standards and the future of accounting outsourcing. These five areas provide a comprehensive outlook towards the impact of outsourcing on the accounting industry.

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I. Introduction

For the past two decades, the outsourcing and offshoring of professional services has grown phenomenally. Of particular interest is the growth of off-shore Business Process Outsourcing (BPO) to the growing markets of Australia, China, Hong Kong, India, Ireland, Mexico, the Philippines, Poland, Russia and New Zealand. Among one of the fastest growing sectors of the BPO market and outsourcing of professional services is the outsourcing of finance and accounting (FAO). According to an Everest Research Institute Study, the global FAO sector has grown by 30% in 2007 alone. The market for FAO has grown by 45% since 2005 and has reached expenditures in the United States of $2 billion. The United States has accounted for close to 50% of the FAO market.

The growth in the FAO market is primarily due to a larger trend of off-shore BPO. According to a Gartner report as cited by Bhatnager (2005), the global offshore BPO market will grow to $24 billion by 2007, of which India will capitalize on $13.8 billion. Today, FAO is emerging as a significant player in the overall growth of the global BPO market. In conjunction with the emergence of a robust Information Technology Enabled Services (ITES) industry in India, the FAO market in India will continue to expand over the next decade. This growth in the Indian FAO market has even affected markets outside of India. For instance, the growth of FAO in Europe is accelerating. Over the past three years the number of FAO deals in Europe has grown from 15 to around 45 to 50. Often these deals are through major business process sourcing agreements and long term partnerships in India.

Although many FAO deals began as an expansion of smaller BPO projects, FAO still carries many privacy and data protection issues which concern the accounting profession. For instance, FAO is unique due to compliance and regulatory risks dealing with network security, knowledge expertise, and the professional or ethical conduct of accountants. Numerous restrictions and legal requirements are necessary to outsource accounting related services. One such barrier to outsourcing accounting is the strict and prohibitive data protection agreements required by national governments. A few examples are the EU Data Protection Directive of 1995 and the Gramm–Leach Bliley Act of 1999.

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4 Gramm-Leach Bliley Financial Services Modernization Act repealed part of the Glass-Steagall Act.
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Although the Indian outsourcing industry already complies with WTO-TRIPS\(^5\), many concerns still persist. The Data Security Council (DSC) of India has responded to this sentiment and will be implementing a data protection bill within the next 12 months that mitigates many concerns over data security.\(^7\) Nevertheless, without robust regulation and enforcement procedures, many legislative efforts will be undermined.\(^8\)

In addition to regulation, outsourcing accounting-related work poses many ethical and regulatory problems for practitioners. One such topic is outsourcing accounting-related work unbeknownst to the client. The American Institute of Certified Public Accountants (AICPA) has issued guidance dealing with outsourcing and the relationship between clients and third party service providers. Guidance with regard to these topics has concerned issues ranging from computer processing of client returns\(^9\) to ethics rules on conducting outsourcing business with third party service providers.\(^10\) Nevertheless, CPAs, accounting firms, and companies have expanded their use of FAO as a means to capitalize on labor arbitrage rates in developing countries, enter new markets, recruit talent, and expand services.

**Labor Arbitrage**

FAO is currently focused on cost savings for organizations’ internal accounting functions. In terms of labor arbitrage, why pay an accountant or auditor an average annual salary of $54,630 in the United States in 2006\(^11\) when you could pay an equally competent chartered accountant elsewhere significantly less? According to Mercer consultants, the average accountant in China earns £4,677 ($9,214) while in India £2956 ($5,823).\(^12\) According to Anderson and Vita (2006), Indian knowledge workers can expect salaries 10-20% lower than their American counterparts, while Chartered Accountants (CA) in India

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\(^5\) World Trade Organization-Trade Related Intellectual Property Agreement (WTO-TRIPS)


can be hired for as little as $8 an hour.\textsuperscript{13} The labor wage differences often become a compelling case to outsource accounting-related functions. The incentives to outsource accounting become even more desirable during a recession and when profit margins narrow.

\textbf{Shift from Transactional to Specialized Accounting Services}

According to Sulakshana Patankar, an executive at WNS Global Services (major FAO provider), businesses that outsource simple and discrete tasks can only save 30-40\%, while outsourcing the full range of internal accounting-related functions can save businesses up to 60\%.\textsuperscript{14} For this reason, companies are shifting from only outsourcing transactional-related services to more specialized or idiosyncratic services. The reason for the shift to higher level accounting services is that simple transactional-focused processes reap lower cost savings than do more complex accounting processes. According to NASSCOM, high-end accounting work now makes up 30-40\% of the market.\textsuperscript{15} Figure 1 presents this shift in specific accounting tasks, along with a timeline of the expansion of accounting services capable of being outsourced.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{outsourcing_diagram.png}
\caption{OUTSOURCING AND ACCOUNTING MOVING BEYOND TRANSACTIONS}
\end{figure}

(Data Reproduced and Presentation Augmented from http://www.nasscom.in/Nasscom)

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Given the trend towards higher level accounting processes (specialized functions) in conjunction with the digitization of firm proprietary files/processes, it is only a matter of time before most accounting functions are capable of being outsourced. Save direct contact with the client, the ability of outsourcing firms to provide high level services is being met by the reality of paperless business transactions.

**SOX and Outsourcing**

A defining point in the analysis of the outsourcing of accounting related services is the passage of SOX. Also known as the Public Company Accounting Reform and Investor Protection Act of 2002, SOX is considered to be the most significant business legislation since the securities acts of 1933 and 1934\(^{16}\). In the wake of accounting fraud and corporate scandals at companies such as Enron, Adelphia, and WorldCom, SOX was passed almost unanimously in the House of Representatives by a vote of 423-3 as well as in the Senate by a vote of 99-0.\(^{17}\) The passage of SOX implemented the most stringent compliance regulations for company’s internal controls, financial statement reporting, and firm/personal liability. Although SOX has had both detractors and proponents, its significance for firms that outsource accounting-related functions is unprecedented. In the academic world, SOX is seen first as a benchmark from which prior accounting research and trends can be compared. Second, SOX is a factor which has augmented outsourcing risk and exacerbated accounting practitioner uncertainty. Nonetheless, companies continue to outsource accounting-related services at a growing pace.

The following paper analyzes the outsourcing of accounting following the passage of SOX. The impact of SOX is analyzed according to five separate areas: First, the initial impact of SOX on onshore and offshore outsourcing of accounting. In particular, the emergence of India as a major destination for offshore and offshore outsourcing. Second, the outsourcing of accounting services in small and medium sized firms. In addition, the application of outsourcing theory as a metric to gauge sourcing decisions. Third, accounting pronouncements which impact the desirability to outsource accounting following SOX. Fourth, transaction cost economics and its application to the outsourcing of accounting. Last, emergence of global accounting standards and the future of accounting outsourcing. From these five perspectives, the outsourcing of accounting can be ascertained in its entirety on accounting firms, internal audit functions, and the internal control infrastructure of firms.

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Antecedent to SOX: US TAX Return Preparation

The FAO market began in the 1970s when processing firms such as ADP and First Data Corporation began to process payroll and repetitive transaction processes for companies looking to reduce costs. From the 70s until the mid-90s, the scope of the accounting work being outsourced was primarily lower-level or transaction-focused, and outsourcing service providers operated on a relatively small scale. This all changed during the early to mid-90s when accounting firms such as Deloitte and Touche and Arthur Anderson, among others, established partnerships with foreign accounting firms and service providers to process tax compliance work in India. Despite the fact that major accounting firms now embrace outsourcing tax compliance-related work, many tax professionals have maintained that the scope and scale of work capable of being outsourced is prohibitive given the sensitive nature of client personal information.

Tax executives from the beginning have felt conflicted about the impact of outsourcing on the profession. On one hand, the outsourcing of routine, tax-related tasks to countries such as India or the Philippines eases the workload of the tax professional. These professionals are often over-worked and/or time constrained, and they view outsourcing as a natural outgrowth from the current business environment. Conversely, some tax professionals have felt as if a “Trojan Horse has been brought into Troy.” The later perspective is intimately linked with the concerns over protecting client information and the responsibilities of CPAs. Specifically, outsourcing tax returns brings up a series of ethical issues dealing with whether clients should be notified that work is not only being outsourced but offshore outsourced as well. Regardless of the sentimentalities toward the issue, the current phenomena of the outsourcing of accounting began much earlier than SOX.

Almost 15 years since these humble beginnings, the tax return segment of the outsourcing of accounting is now significant and growing rapidly. According to research by ValueNotes, an estimate of 360,000 tax returns were prepared in India in 2006, with the potential to grow to 1.6 to 22 million by 2011. With offices in Bangalore, India, large accounting firms such as Deloitte and KPMG have even established “captive centres” which process thou-

sands of tax returns at an accuracy rate of 99.5%.22

Part of the drive for outsourcing tax return preparation in India is twofold. First, there is a shortage of accountants and qualified CPAs to complete the growing demand for tax compliance work.23 Second, CPA firms have found the offshoring of tax compliance work such as 1040s24 creates faster turn-around times and can be done 40-60% cheaper.25 According to ValueNotes CEO, Arun Jethmalani, “The industry will quickly move beyond 1040s. Both the vendors and buyers are at an inflection point on the maturity graph, and we expect tax returns preparation will drive penetration into a wider range of offshored professional accounting services.”26 This has led to the expansion of accounting service providers beyond the “big four”27 that facilitate the transfer of tax return preparation. Four of the most prominent of these companies are Commerce Clearing House (CCH), Outsource Partners International (OPI), SurePrep, and Xpitax.28

Although this paper will not further analyze the impact of tax return preparation on outsourcing, it has made a significant first step in reducing the perceived risk of other accounting related outsourcing. Tax return preparation has laid the foundation for the future of accounting outsourcing post-SOX and continues to influence the outsourcing of accounting for both service providers such as accounting firms as well as industry firms.

II. Initial Impact of Sox on Outsourcing of Accounting

Early Fears

During the first year following the passage of SOX, there was conjecture that companies would face a similar scenario to Y2K, where much of the conversion programming was outsourced. For accounting, this can be seen as outsourcing of internal control related compliance. The rationale behind this early concern was that just as companies were understaffed and unprepared in their IT departments for Y2K, accounting departments lacked the staff and expertise to be fully compliant with SOX. There were two variations of this line of thinking. First, just as companies faced an immovable deadline before

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24 United States Individual Income Tax Return Code
25 NewsWire Today, Ibid.
26 NewsWire Today, Ibid.
27 “Big Four”: Deloitte and Touche, Ernst and Young, KPMG, and Price Waterhouse Coopers.
January 1, 2000, companies would face a rush to be compliant with SOX on a yearly basis. Second, becoming compliant with SOX would be a onetime fix that major software manufacturers such as Oracle or SAP could fix with a single purchase.

In retrospect, these fears were promulgated by a misunderstanding of what SOX meant for a business and its internal controls. Although Y2K forced companies to consider outsourcing as a viable solution, SOX requires a more long-term strategic partnership in terms of outsourcing accounting. According to James Carlini (2008), an adjunct professor at Northwestern University, people misunderstood the impact of SOX. They did not realize it was going to be an ongoing change in culture and practice for most accounting departments.29 Thus, both the uncertainty among firms concerning SOX’s implementation and the early predictions by analysts were off the mark.

**Market Reaction**

The passage of SOX in this instance did not solely encourage the outsourcing of accounting related functions immediately. In fact, many companies became apprehensive of what they would outsource and what they would keep in-house because of SOX. Overall, the more compelling factor contributing to the impact of SOX on outsourcing of accounting is that the market was going through a recession when SOX was passed.

The market immediately reacted to SOX since it raised the cost of capital for most firms, especially those that would have to revamp their entire internal control infrastructure. SOX raised the cost of capital for many firms because many corporate firms that previously outsourced accounting related functions now faced greater perceived risk, in addition to regulatory penalties for non-compliance. For example, the cost of capital of a firm already takes into account the additional risk perceived from outsourcing in-house transactional accounting work to a third party. Under new and uncertain legislation, many risks that were originally accounted for in a firm’s estimate of cost of capital are augmented by the possibility of regulatory penalties. Both personal and companywide penalties were now tied to management’s ability to meet and comply with the demands of SOX.

According to research by Zhang (2005), the passage of SOX caused a $1.4 trillion loss in the value of the stock market. Zhang’s research looked specifically at how the market would value the restructuring of non-audit services, requirement of corporate responsibility, and the forfeiture of incentive pay and insider trading. While considering these three factors, Zhang used

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cumulative abnormal returns\textsuperscript{30} as a measure of the market valuation of the passage of SOX. Empirical results showed that the cumulative abnormal returns were negative. The market weighed the costs of SOX negatively, and this was reflected in the expectation that earnings would be lower for future periods. In this scenario, when profitability goes down and the cost of capital goes up, companies look to reduce costs. Therefore, outsourcing of accounting related functions, which are often seen as non-core, become more desirable.

\textit{Section 404}

With the prospect of tightening budgets due to a recession, the added costs of complying with SOX compliance such as section 404 became a reality. Section 404 of SOX is management’s assessment of the internal control infrastructure of a company. Specifically, managers must “acknowledge their responsibility for maintaining controls and procedures that pertain to financial reporting.”\textsuperscript{31} For many firms before SOX, it was almost impossible for CFOs to be certain of every aspect of their company’s internal controls. With SOX, both criminal and legal liability issues forced companies to expand their accounting budgets to meet this new demand. In order to deal with this issue, many companies began to outsource accounting related services which were traditionally done in-house.

The recent growth in outsourcing of accounting related functions would not be growing as fast as it is without the passage of SOX and concern over compliance difficulties dealing with Section 404. Nevertheless, the impact of the 2001 recession exacerbated these additional compliance costs. One significant factor of this recession was the passage of SOX and, as Zhang’s research demonstrates, the markets negative response to its passage. Either factor alone, being the economic recession of 2001 or new SOX internal control compliance regulations, are insufficient to fully explain the growth of FAO over the past five years. But, in conjunction, they provide a convincing incentive for firms’ management to consider outsourcing as a long-term strategic decision. This long term strategic decision is most often tied to cost reduction and, in the instance of professional services, capitalizing on labor arbitrage rates.

\textit{Labor Arbitrage, Information Technology, and SOX Outsourcing}

For the past two decades companies have sought to minimize costs through labor arbitrage in many developing nations such as the popular outsourcing destinations of China and India. This trend developed into the cur-

\textsuperscript{30} Cumulative Abnormal Returns: Actual Returns-Expected Returns
rent emphasis on BPO for the purpose of focusing a firm’s resources on its core competencies. One area of the business process outsourcing trend which resisted pressures to outsource was the field of accounting. Following the passage of SOX, companies were forced to comply with stringent and complicated compliance issues demanding a new emphasis on technology and real time data. SOX opened the way for the outsourcing of the accounting industry. This is especially true in terms of IT related compliance and information system management. As cited in the *Wall Street Journal*, AMR research found that companies will spend an additional $5.8 billion on Sarbanes Oxley compliance in 2005 (up from $5.5 billion in 2004) and a quarter of this will be related to new technology and systems.\(^{32}\) It is this quarter (new technology and systems) which many Indian outsourcing firms will be competing for. Countries such as India have an advantage for servicing FAO work for two reasons. First, they are the world’s leader in outsourcing information technology related work. Second, the cost of labor in India is still considered low in terms of the quality, knowledge, and reliability of services provided. Moreover, the ability of firms to capitalize on the cost savings attained through labor arbitrage is dependent not only on the ability of service providers to provide safe, secure, and reliable networks but also the idiosyncratic needs inherent in a firm’s specific industry.

**Outsourcing of Accounting by Industry**

Following SOX, certain industries have found it more desirable to outsource accounting related functions then in the past. According to a Nelson-Hall\(^ {33}\) research survey sampling 520 firms, telecommunications, pharmaceutical, retail, consumer-packaged goods, and transport industries are the industries that are most likely to outsource accounting-related functions.\(^ {34}\) The following table, FIGURE 2, from this research survey presents these findings:

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33 Nelson Hall is a BPO analyst firm focusing on market analysis and industry reports.

For the transport/logistics and telecommunications industries, the desire and ability to outsource accounting related functions are significantly higher than for other industries. This is due to these industries focus on cost savings, deregulation, and experience with BPO. The telecommunications industry, in particular, views outsourcing of business processes as a “mature and prevalent practice in the industry.”35 Although outsourcing of accounting is often seen as the last area to outsource,36 for industries that have experience with BPO, FAO becomes very desirable. In addition, as an industry becomes more specific and focused on its core competencies, it will get rid of functions which do not add value to their core services. As noted by Jones, Bowonder, and Wood (2003), the problem with determining core competencies is that they are usually determined by a particular industry or shared marketplace. As shown in FIGURE 2, as firms move closer to the dotted line, they become more specific or customized in their service offerings. Moving up or down along the line simply shows scales of production.

The outsourcing of accounting following SOX increased the propensity for firms to outsource due to a lack of knowledge in compliance measures; moreover, industries such as local government, utilities, and insurance will

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slowly move towards outsource accounting. The caveat is that when competi-
tors begin to outsource accounting, then not outsourcing accounting may be-
come a major disadvantage. Thus, as more firms embrace FAO, it will create a ripple effect throughout the entire industry.

The major accounting firms have already begun to pick up on this pro-
gressing trend and have already begun to outsource their own work to captive centers across the world.

**Accounting Firms**

In addition to firms outsourcing accounting based functions to service providers both onshore and offshore, accounting firms are outsourcing portions of their work as well. One global accounting firm which outsources is Deloitte. Since the late 1990’s Deloitte has looked to outsourcing as a means to capitalize on accounting skills around the world, reduce work turnaround time, cut costs, and enter new markets. Deloitte has partnered with Mastek to help attract companies to outsource business processes to India. With centers in Hyderabad and Mumbai, the joint venture, Deloitte Consulting Offshore Technology Group, is growing fast and taking on more U.S. clients.\(^{37}\)

In addition to consulting related services, Deloitte has ventured into traditional accounting based services such as auditing and taxation. In the late 1990’s Deloitte started region “10,” now formally referred to as Deloitte India, as a means to capitalize on talent and labor arbitrage rates in India. This decision before the passage of SOX has paid off tremendously and has given Deloitte access to world class talent in India.

Post SOX, the flood of compliance related, IT related, and a host of other accounting related tasks have encouraged the major accounting firms to grow significantly. For example, Deloitte is able to capitalize on this increased demand due to the establishment of a safe, reliable, and redundant service information technology infrastructure. This allows Deloitte to transfer work abroad to captive subsidiaries or regional partners without compromising client data. According to a presentation by Neeraj Goenka and Steve Covel, auditors at Deloitte, Deloitte now leverages the world-class talent of Indian accountants and finance professionals in India to decrease work turnaround time by up to 40%.\(^{38}\) In this global accounting framework, teams in India would work alongside teams in the U.S. and partition work according to the specialty or strengths of the Indian practice versus the American or International practice. Under this paradigm, both work that is horizontal in nature (partitioned tasks)

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and vertical in nature (individual tasks being shared and handed off overnight) are sourced back and forth between Deloitte in the U.S. and Deloitte India. According to the Deloitte auditors, this relationship has been especially beneficial in terms of compliance work that often have hard deadlines.

Accounting firms outsourcing portions of their work post Sarbanes Oxley makes a lot of sense. If secure networks can be made and clients are demanding accounting related services that few would have thought necessary to be competitive just ten years ago, then why not outsource as a means to ease workload and costs? In terms of accounting skills necessary to complete such work, accountants abroad face comparable standards and just as rigorous certification requirements as CPA’s in the United States. A good example of this is the notoriously difficult exam requirements to practice accounting in India as a Charted Accountant (CA). The pass percentage rate to become a chartered accountant of the Institute of Chartered Accountants of India (ICAI) is between 7-8% and this amount almost never reaches double digits. Lastly, the number of accountants in India is significant. There are currently 140,000 practicing CAs in India and an additional 350,000 pursuing a CA certification.

In addition to traditional CAs, the ICAI is also instituting a new certification known as an Accounting Technician (AT). This is a natural outgrowth from the specific accounting expertise demanded by accounting software companies and the growth of BPO. Individuals with a base level of accounting expertise are necessary to fill the global sourcing phenomena in India. With the growth of variations of accounting certifications, Deloitte along with other major accounting firms have benefited from the growth of the industry, the development of new certifications, and the leveraging global talent. The growth in these sub-specialties within the traditional accounting background is strongly linked to the increasing demand for higher-level accounting services by large firms. These large firms seek consulting services/contracts with sourcing providers for specific accounting related tasks to be performed systematically and on a regular basis.

Large Industry Firms and Outsourcing

In the wake of the SOX, many large firms were uncertain of how to comply with new regulations and business process documentation. Specifically, the requirement of Section 404: Management Assessment of Internal Controls

has been a particular concern of many companies in terms of full compliance costs. According to a survey by Financial Executives International, the average first year compliance costs of SOX “alone average $4.36 million per company, and large companies with more than $5 billion in revenues spent more than $10 million per company”. For large multi-national firms, the pressures from shareholders to reduce costs and increase profitability are tremendous. Coupled with an increase in costs due to SOX is the lack of knowledge in internal controls that even large corporations may lack. According to Karen Ikeda, a partner and global practice leader at TPI, many companies should consider outsourcing or offshoring as a means to transfer the worries and concerns of SOX to specialized service providers. This can be especially true since internal control certification is an ongoing process which cannot be met with a onetime expenditure.

Nevertheless, large firms, and specifically the Fortune 500, are outsourcing, offshoring, and offshore outsourcing accounting related work. According to research by the Center for International Business Education and Research at Duke, 60% of companies offshore either finance or accounting related work. Of this 60%, 70% of the work is done by “captive” offshore subsidiaries. This is high considering the fact that only 10% of offshore work is “captive” for IT vendors such as call centers. With the onset of SOX compliance related work, this is not surprising since many companies may want to expand accounting departments but are adverse to increasing costs. In addition, accounting related functions may be seen as too risky because they involve valuable corporate data.

**Large Firm Outsourcing Example**

Although not a Fortune 500 company, one large company which has decided to offshore outsource their accounting department is Church’s Chicken. Church’s is a major chicken restaurant diner based in the United States. During 2006, Church’s decided to offshore their entire IT department to India. This initial step opened the door for the company to consider offshore outsourcing other portions of their company. It was with the success and reliability of outsourcing IT related work that Church’s decided to offshore their entire IT department...
accounting group to India in 2007. While considering whether to stay with their current outsourced partner Convergys or outsource to WNS Global Services, cost savings played a critical role. According to Dusty Profumo, CFO of Church’s Chicken, “Economics clearly played a role in deciding not to pursue bringing it back-in house.”46 Upon review of the facilities, when deciding on a service provider, the company saw the quality of services were comparable and sometimes better than their U.S. counterparts. Ultimately, this choice has lowered the cost of Church’s accounting related functions by half.

With the success enjoyed by large firms to outsource accounting related functions, such as Church’s, smaller firms in the wake of SOX have considered the same options. Specifically, small and medium sized firms with much smaller and less sophisticated accounting departments may have even more incentive to outsource accounting functions than large firms may.

III. First Years Following Sox: Small and Medium Sized Firms

Following the passage of SOX, many companies which previously considered outsourcing accounting related functions were unsure of whether to outsource. On one hand, strict legislation had come about that few people completely understood. While on the other hand, the US economy was going through a recession and the pressures to cut costs were enormous. This dilemma was not simply played out in the conference rooms of large Fortune 500 companies, or large scale manufacturing companies, but at small firms as well. A great example is the restaurant industry. The restaurant industry which is one of the first industries to feel the impact of a recession, advocated the outsourcing of accounting to deal with this issue.

According to Michael Kaufman, the CEO of Metromedia Restaurant Group, his company is adapting its corporate structure to “navigate better through uncertain economic times and position itself for the future.”47 Many restaurants and small businesses alike have embraced this attitude because of the perceived benefits of cost savings. In addition, many small businesses recognize that although accounting information supplemented the business process at restaurants, it did not differentiate their business; it was not a core competency.

SMEs and SOX Costs

Of particular interest to smaller firms is the impact of SOX on accounting work. Since its passage, small and medium enterprises (SMEs) have dis-

proportionately borne the weight of Section 404 specific compliance costs as compared with larger firms. According to United States Representative Nydia Velásquez, Chairwoman of the Committee on Small Business, small businesses are indeed being impacted, and I call on the SEC to delay implementation of SOX 404(b) until the needs of small ventures are taken into account.48 In addition, Chairwoman Velásquez alluded to a recent survey which found that the cost of compliance for nearly half of small companies (non-accelerated filers) was 3% of net income, and close to 60% have contracted with an outside auditor to provide compliance related services.

The additional costs of SOX compliance are a major cost driver for firms to consider when deciding whether to outsource accounting. Part of the reason for this is due to the disproportionate impact of compliance costs on small firms in terms of their ability to absorb these costs. Although all firms, regardless of firm size, found few internal control experts immediately following SOX, large accounting departments can proportionately absorb additional work and have access to better technical knowledge. Where large firms have accounting departments with proportionately larger budgets, highly structured accounting departments, and more CPAs, small firms often have fewer accounting professionals and informal management structures.49 Despite SOX’s passage in 2002, it has been just over the past year or so that the SEC has commented on this controversy and issued new guidance.50 Unfortunately, following the passage of SOX, many accounting firms immediately recognized the burdensome costs of full compliance. This immediately led many small firms to reevaluate their core competencies, department efficiencies or inefficiencies, and reconsider whether to outsource or keep accounting functions in house. These considerations are all tied to the long term economic considerations facing a firm.

Small and Medium Firm FAO and Application of Theory

On the flipside of the growing trend of large firms outsourcing accounting-related functions to vendors abroad, the outsourcing trends for small and medium sized firms pose different questions. In order to analyze this scenario, Everaert, Sarens, and Rommel (2006) utilize the Transaction Cost Economics (TCE) framework in conjunction with Resource Based Theory (RBT) in order

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to analyze outsourcing for small firms.\textsuperscript{51} In this study, the authors gauge outsourcing by “outsourcing intensity,” which is the product of the percentage of work outsourced by the degree to which the outsourced tasks are outsourced. An outsourcing intensity of 0% would indicate no outsourcing while 100% would indicate every portion of the accounting function was operated externally by a service provider.

Their research points to three main factors of small to medium sized firms; first, that outsourcing intensity on average was 87%; second, a resource deficit in accounting-related skills leads to firms looking to outsource accounting-related functions; third, firms that do not have a CEO with a background in economics or a separate CFO function will outsource accounting related work. Although their study focused specifically on Belgian firms, its insight provides context for the knowledge deficit inherent in implementing SOX compliance and overall transaction costs for small and medium sized firms.

Following SOX, many firms that had small internal auditing functions immediately looked for outsourcing of accounting-related functions following the passage of SOX. Many of these firms lacked the knowledge or capabilities to be compliant with SOX. This led to an increase of costs, and these have dipped into company profitability. The costs of compliance with SOX for smaller firms are significantly large. Since 2001, SOX compliance for firms under $1 billion in revenues has increased from $1.7 million to $2.8 million.\textsuperscript{52} Nonetheless, these additional costs for firms have not necessarily encouraged a universal embrace of FAO.

\textit{Accounting Department Expansion and Lowering SOX Costs}

Just as many companies have immediately looked to outsourcing for compliance with SOX, many firms see SOX compliance in a different light. In particular, many small and medium sized companies have discontinued contracting with independent IT consultants or other SOX compliance consultants. According to Geoff Zodda, a Director of SOX Compliance at the Glenmont Group, SOX has created two trends: the emergence of SOX departments and the growth of audit departments at firms (2006). According to Zodda, although outsourcing and consulting were seen as a viable option during the first few years following the passage of SOX, many companies have begun to consider long-term solutions besides outsourcing. Specifically, bringing accounting functions previously outsourced for efficiency purposes back in-house due to prohibitive costs associated with additional risk. Overall, it is

\textsuperscript{51} Small firms in this study are firms with less than 250 employees.  
primarily smaller firms which often lack the accounting expertise or know-how who are more inclined to outsource their key accounting related services to foreign service providers. Nevertheless, under the pressures of paying high consulting fees or finding few positive returns for contracting these services, many of these companies are bringing accounting work back in-house and establishing larger accounting departments.

An interesting finding is the slowdown in the cost originally anticipated in the field of SOX compliance. Of particular interest is the effect of compliance with Section 404 for small businesses that have argued over the past five years that SOX compliance disproportionately affects these companies profitability as compared to large sized firms. According to a report by Lord & Benoit LLC, as cited by Search CIO midmarket.com, the average first year cost of compliance with Sarbanes Oxley related cost are 13.8% less for non-accelerated filers (market cap below $75 million) than previously estimated by the Securities and Exchange Commission. The reduction in anticipated costs for small business could signal that a state of normalization is setting in with respect to internal control compliance with SOX. Companies that are just starting out seem to immediately understand how to comply with SOX and what to look for. This could inadvertently lead to a slowdown of the outsourcing of accounting due to the traditional focus on labor arbitrage in markets such as India. With many costs of SOX decreasing, many companies’ internal audit committees may reconsider their plans to outsource if long-term contracts and potential security concerns exist. Of particular interest is the possible methodology embraced or complementary decision making metric utilized for making these decisions.

**DEA Theory and Small and Medium Firms**

Similar to research by Everaert, Sarens, and Rommel (2006), Barrar and Wood (2002) analyze the choice to outsource for small and medium firms by looking at organizational structure, efficiency, and whether accounting functions for firms are either non-core or core. In their research, firms first evaluate their business processes as a starting point to decide whether to outsource. The reasoning behind this evaluative approach is that, following SOX, companies have to consistently evaluate their core competency and strategic aims. According to Stainer and Stainer (1998), this can be summed up by the following, “those who have never effectively measured their performance cannot seriously claim to know their business might progress.” Barrar and Wood

Sarbanes-Oxley and the Outsourcing of Accounting

provide the following diagram, FIGURE 3, to evaluate a decision framework once processes are well understood:

![Diagram](image)

**Figure 3**  
(Reproduced from Barrar and Wood 2008)

With this framework in mind, firms looking to outsource their accounting functions have the following four scenarios:

1. **Low Efficiency and Non-Core**: In this case, firms that are not efficient in their business processes, whether this is due to a lack of technical knowledge or scale factors in comparison with other firms (i.e. large or specialized accounting firms), should outsource their accounting functions. Following SOX, lack of compliance knowledge in SOX could drive firms to outsource or alternatively contract with consulting firms to improve efficiency.

2. **Low Efficiency and Core**: Firms that have low efficiency but whose accounting functions are core to the business should re-engineer these very functions. Although a firm could not persist in this scenario for very long, this could be solved by developing new software, changing how accounting functions are operated companies, or a host of other changes.

3. **High Efficiency and Non-Core**: Firms that have accounting functions that are high efficiency but non-core could consider insourcing. A good example of this scenario was the formation of the company ‘Tasco’. ‘Tasco’ is a joint venture between Shell and Ernst and Young in which the efficiency of accounting related work, which was non-core to its business, became so high that it partnered with a major accounting firm to attract additional work. Spe-

4. High Efficiency and Core: Firms that operate accounting functions at high efficiency and are Core to the business will simply keep accounting processes in-house. They will look for alternatives to outsourcing that reduce costs for an accounting department, function, or service.

For the majority of small firm and medium size firms, the first scenario (low efficiency and non-core) is probably the most realistic evaluation of a company’s accounting department or functions.\footnote{For Large Firms, this analysis will continue with section V: Service Agreements, Transaction Cost Economics, and Outsourcing of Accounting.} With this framework in mind, Barrar and Wood utilize a non-parametric linear programming methodology called data envelopment analysis (DEA) to analyze how resources are utilized in relation to volume and complexity of the work done by an accounting department. Within this framework the traditional make or buy decision is analyzed. In this scenario, “make” alludes to keep accounting functions in house where as “buy” alludes to outsource. The researchers look to service providers in the UK and Italy for the focus of their analysis.

By utilizing decision making units (DMUs) to weigh multiple inputs and outputs\footnote{Inputs and outputs are comparative resource variables.}, the researchers find that accounting service providers offer a more efficient platform for small firm accounting functions. Given that the majority of firms fall into the first category of low efficiency and non-core accounting departments, these results are not surprising. Furthermore, the efficiency matrix of FIGURE 3 in context of a firms choice to make (in-house) or buy (outsource) provides a compelling case to consider outsourcing accounting. The only remaining questions then are, why, in the midst of improvements in network security, digitization of imaging technologies, and new cost effective communications, would some companies be reluctant to outsource? Despite the growth in FAO, why would small companies, which have the greatest incentive to outsource, not do so? What are some of the factors beyond Section 404 impacting the outsourcing of accounting? The answer to these questions are specific rules and regulations tied to SOX, contract restrictions between firms, and auditing standards promulgated in the practice of accounting.

**IV. Sections 302,404 and SAS 70, 94: Impediments to Outsourcing**

One major impediment to the outsourcing of accounting related services is Sections 302 and 404 of SOX. Under Section 302, company executives such as the CEO, CFO, or other managing executives are held accountable for any material weakness in internal controls at a company. In addition, they
must report any fraud whether it be material or not to shareholders. Section 404 requires management’s assessment of internal control in every quarterly or yearly report. Both of these sections of SOX impede the ability or desirability of a company to outsource accounting related services. Any service or process which is outsourced from the company, although external to the traditional internal control framework, is considered to be an extended portion of the company wide internal control structure. Ultimately, it is the company itself and not the service provider that is liable.

**SAS 70**

In order to mitigate the concerns with outsourcing and internal controls, many companies now require service providers to provide certification by an external auditor on the reliability and robustness of a company’s internal controls. This certification is known as a Statement of Auditing Standards (SAS) 70 Type II audit. A SAS 70 Type II audit provides a Type I audit, which is a description of a service providers’ internal controls and their ability to reach described control objectives. In addition, SAS 70 Type II audits provide the opinion (attestation) of the independent auditor regarding the effectiveness of the company’s internal controls. In this respect, companies that outsource accounting-related services to an external service provider require this form of attestation in order to certify whether or not the internal controls at a particular company are sufficient.

In addition to this requirement, the SAS 70 Type II certification must be made in sync on a regular basis with the client company’s quarterly and annual report. The reasoning behind this is that a company cannot certify the strength of its internal controls on any financial report unless the certification of controls effective at the service provider’s end meets the standards demanded by auditors for either the sponsor or host company. External auditors of the host company cannot be the same auditors for the sponsor company due to a regulatory restriction that auditors are not allowed to provide both attestation and consulting services for the same client. Simply put, because of regulation by the Public Company Accounting Oversight Board (PCAOB), the external auditor for the sponsor company would not be allowed to provide SAS Type II certification of the host company.

**Offshoring Contracts**

One fear of outsourcing accounting-related functions to offshore vendors is that they in turn will outsource portions of their business process to other

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57 Typically within 90 days.

58 “Sponsor” company alludes to a company outsourcing a specific task or process and “host” company alludes to company insourcing the outsourced work.
vendors. Although this is common in the outsourcing/offshoring industry, it is often unacceptable to companies whose main intent was to lower costs without substantially increasing risk. One means to mitigate this problem in the future will be the development of a more active outsourcing/offshoring relationship. Often this relationship is cited as a partnership in which the processes of the vendor are transparent to the client and vice versa. In terms of outsourcing accounting-related functions, companies will begin to have more complex contracting methods and demands from one another. One trend is the “right-to-audit clause.” The “right-to-audit clause” is simply a natural extension to the requirement of SOX to consider outsource service providers as part of the firm during internal control testing. Companies will demand more transparency due to coupling of the host and sponsor companies. According to Smith (2007), the “right-to-audit clause” will be more than a single paragraph clause and will allow companies to have greater access to and know-how of a vendor’s operations. Therefore, firms will go beyond SAS 70 audits for risk assurance and will regularly conduct “surprise” audits of vendors. In turn with the new demands for security, companies will feel safer and more in control of their outsourced accounting functions.

On the other hand, BPO vendors that traditionally have kept away from these types of services, due to restrictions on sharing proprietary business processes, will have to rethink their strategy. Vendors who acknowledge these demands sooner will reap the benefits of more contracts. Overall, increased coupling between a host and sponsor company in the BPO industry will increase the amount of work performed by BPO vendors and allow for outsourcing of higher level accounting functions.

SAS 94

Although passed in 2001, the Statement of Auditing Standards (SAS) 94 has played a critical role in the outsourcing of accounting. Following the passage of SOX, Section 404 mandated that company executives provide their assessment of a company’s internal control infrastructure. In this light, SAS 94 provides critical guidance towards understanding and assessing the risk of how a company’s information technology is used to provide assurance to both internal and external auditors.

SAS 94 is formally titled “The Effect of Information Technology on the Auditor’s Consideration of Internal Control in a Financial Statement Audit.” SAS 94 is considered to be an update to SAS 55 (1988), with an emphasis on the role that information technology has in current business processes. In particular, SAS 94 comes at a time when the traditional methods of providing assurance through substantive tests of paper documents or file cabinets are
quickly becoming obsolete. In place of the paper “audit trail” are the paper-
less audits of information systems and the internet based networks utilized to
communicate with both vendors and customers. Auditors are still performing
substantive tests of controls and have transitioned to the reality of paperless
transactions. The decentralized nature of the initiation of transactions, man-
agement decision making, and monitoring of transactions has changed. The
impact of SAS 94 is uncertain at this point, but SAS 94 augments the ability
to provide assurance to both vendors and firms that their accounting functions
are protected.

In summary, although SAS 70/94, past vagueness found in off-shoring
contracts, and restrictions mandated by SOX make outsourcing prohibitive
in many instances, there are mitigating factors. These mitigating factors may
be the cause of why companies are able to transcend many perceived barriers
and continue to outsource accounting-related functions. The next section will
discuss these factors in addition to how today’s global supply chains facilitate
more efficient markets.

V. Service Agreements, Transaction Cost Economics, and
Outsourcing of Accounting

*Legal Uncertainty and SLA’s*

Despite the growth in the ITES sector, offshoring or offshore outsourcing
of accounting-related functions poses numerous risks that are both unique and
shared by the ITES industry. In particular, legal precedence such as the EU
Data Protection Directive of 1995 or SOX impose both transfer restrictions
and increased liability that may prohibit outsourcing. In the absence of legal
protections governing privacy, intellectual property, data protection, and trans-
fer regulations, companies must negotiate their own agreements. These often
come in the form of service level agreements (SLAs).

SLAs are considered to be the most common way to mitigate fears or
increases in perceived risk that come with outsourcing of accounting related
functions post-SOX. Some accounting vendors such as Global Infosys, a UK
accounting firm and Indian service provider partnership, provide clients with
a simple one page printout of timescales and process descriptions. Other ven-
dors such as OPI (an independent outsourcing vendor in New York and India),
however, feature a “more comprehensive arm’s-length type contracts.”

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59 AuditNet, “Service Level Agreements and Internal Audit.” *Audit Net: The Global Resource for
60 Brian Nicholson, Jones, Julian, and Susanne Espenlaub “Transaction costs and control of
outsourced accounting: Case evidence from India.” *Management Accounting Research*, 17 (2006), 238-
258.
Post-SOX, these agreements range from providing clients with lease and sale back options, reverse transition causes for not meeting outsourcing agreements, or even gain sharing. 61 Without these stipulations, risk factors due to uncertainty of legal protection would not allow for cost savings to be realized from outsourcing. In addition, some companies set limits to customization of accounting services provided to its clients. Service vendors may set limits on customization because it often decreases the economies of scale gained by offering lower level, transactional focused processes. Therefore, cost drivers are significant not only for the company looking to outsource but also for the sourcing provider as well.

Cost Drivers and Accounting Outsourcing

While outsourcing accounting-related work is the most obvious selection in perfect markets, the increased legal risk and uncertainty may make it more expensive than keeping in house. In order to analyze this issue, the outsourcing literature uses various techniques that include both quantitative and qualitative determinates of whether to outsource.

An analytical technique which uses a quantitative measurement for whether to outsource work is done by Gupta, Seshasai, Mukherji, and Ganguly (2008). These researchers utilize a two country model followed by a decision model in order to gauge the impact of complexity and time duration on cost savings and risk perception. Gupta et al (2008) found that over time, outsourcing more complex and strategic tasks becomes a viable and desirable option for the company. In the case of outsourcing accounting, these tasks may be higher level work such as managerial accounting, M&A support, or treasury functions. The results of the two country model allude to the fact that companies can realize higher profitability by outsourcing or offshoring more complex (higher risk) projects and should forge strategic long term partnerships between vendor and client. This quantitative measure is very sophisticated and contemporary in approach. Conversely, Transaction Cost Economics (TCE), a qualitative approach, offers similar guidance for decision makers.

Transaction Cost Economics

One of the more common techniques for analyzing the cost of outsourcing a product or service is utilizing TCE. In this case, TCE is used to gauge which processes should be outsourced and which processes should be kept within the firm. TCE provides a qualitative measure or guide to analyze the benefits and hurdles that companies must overcome in order to outsource work. Although

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no measurement variables exist for considering SOX, there has been general research on how TCE provides a gauge for outsourcing accounting-related functions. Nicholson et al. (2006) tackle the issue of FAO with TCE by analyzing the three phases of outsourcing: contact, contract, and control. These are identical to the outsourcing stages of evaluation, negation, and control utilized as a framework by Barrar, Wood, and Jones (2002). Within these three phases, the researchers analyze the viability of outsourcing accounting-related services using three types of outsource service providers:

1. Subsidiaries
2. Former subsidiary servicing former parent
3. Third party vendors.

Utilizing TCE which covers the contact and contract phase of FAO, there are three contributing factors to estimating transaction costs. The first of these is uncertainty. Uncertainty is the degree to which the intended performance of a task or the environment in which a task is being performed cannot be predicted. The second of these is asset specificity. Also referred to as idiosyncrasy, asset specificity measures the degree of customization that is required by both the client and the vendor. A case which demonstrates this point is in comparing accounting functions. Accounting functions such as accounts receivable and accounts payable are considered to be non-specific transactions because they do not require additional assets or specialized knowledge by the vendor. On the other hand, tax planning, financial reporting, and management accounting demand specialized accounting knowledge and experience. Lastly, task frequency is critical in calculating the viability of outsourcing within TCE.

According to Nicholson et al. (2006), uncertainty and task specificity are critical. In terms of low specificity and low uncertainty, the market provision is seen as the most efficient option (market provision or outsource). Alternatively, when task specificity becomes more frequent and complex, then costs and risk increase. Therefore, the accounting function should not be outsourced (firm provision or in-house). Overall, the market provision to outsource is dependent on these three factors in conjunction. FIGURE 4 presents a framework in the contact and contract phase for outsourcing accounting functions as previously described:

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62 Revisit section titled DEA Theory and Small and Medium Firms.
**Study Results**

The results from this research are that TCE presents a rational framework for understanding the outsourcing of accounting and finance. In addition, if the TCE framework is understood and applied as a metric to gauge outsourcing decisions, then transaction costs can be minimized for both the outsourcing vendor and sponsor company. What is interesting from this research is that two of the three third party vendors surveyed are able to transcend the predictions of a firm provision for frequent, idiosyncratic, and high uncertainty transactions. This is counter to the TCE prediction that the market provision is undesirable under these circumstances. According to the example used by Nicholson et al (2006), the two Indian vendors OPI and Inaltus have developed methods and practices to mitigate the potential opportunism or uncertainty that comes with outsourcing accounting related functions to India. This is interesting because prior research has alluded to the fact that companies may face problems with poor telecommunications, separate time zones, cultural differences, and language barriers.  

Transcend TCE

Part of the reason why outsourcing accounting-related functions to India occurs despite the perceived risks are because Indian firms have high levels of certification that are recognized around the globe. These can alert the sponsor client of qualifications, standards, and possible weaknesses at an accounting service provider. These certifications come in a variety of forms but can range from ISO 9001, SAS Type II audits, and Capability Maturity Model (CMM) to name a few. In fact, 75% of the world’s CMM level 5 software centers are in India, and many of the firms which have transitioned from being software service providers now provide a range of BPO related services. In addition to certification, vendors such as WNS and OPI provide codes of conduct regarding secrecy of client data by incorporating technological limitations and industry standards for data protection. For instance, these centers do not allow employees to bring personnel items such as cell-phones and personal computers, and they prohibit access to the internet for the purposes of web-browsing and/or checking personal email. In addition, employees are searched upon entry to the buildings, are separated by frosted glass, must sign non-disclosure agreements, and are not allowed to talk to interviewers. This level of security is unheard of in U.S. accounting firms or service providers, and this allows Indian firms to transcend the firm provision predicted by TCE to a market provision. Moreover, working with the increased propensity for firms to select the market provision for higher level accounting functions and services is the development of more sophisticated supply chains.

Changing from Supply Chain to Supply Web

The success of firms performing accounting related functions post-Sarbanes Oxley may be attributable to the changing nature of companies supply chains. According to Jones, Bowonder, Wood (2003), traditional supply chains or “value chains” are being reassembled into “value webs” which transcend both industry boundaries and geographical boundaries. Although SOX calls for more stringent monitoring of a company’s internal controls and that of its suppliers, the fragmentation of the “service value chains” may actually ensure greater control and reliability of financial information. In terms of TCE, not all exchanges reflect transaction efficiency. This is due to the underwriting

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64 CMM level 5 is the highest possible score.
of outsourced transactions/processes by large industry specialists along with allowing the organization to be more nimble and exploit economic benefits outside of traditional industry.\(^{68}\)

SOX reflects the traditional hierarchies and business process expectations of the past, even though its intent is to protect investors and ensure that companies operate fairly and ethically in the future. Although SOX may increase risks for firms which outsource in the short run, these companies themselves will be at a greater risk of liability and data protection issues if they do not outsource in the long term. From an organizational standpoint, this is due to non-core competencies such as accounting departments which have little incentive to improve and will often result in “defective monopolies.”\(^{69}\) These “defective monopolies” do not make sense from a strategic perspective when more reliable, cost efficient and long-term solutions are available.

Although the TCE framework provides a flawed gauge of outsourcing based on the assumption of “homo economicus” and with disregard for bounded rationality, its application to FAO is a decent measure. Overall, a new wave of outsourcing is occurring which is changing the rigid structure orientation of TCE. As suggested by Nagpal (2006), the TCE framework should be seen as one piece of analyzing the global sourcing of IS related work and should be combined with a discussion of “co-evolutionary drivers of outsourcing”. SOX could be one of these drivers in FAO along with the blending of industries and vendor supply chains. Ultimately, transaction costs are becoming one piece in the drive for outsourcing accounting related work following SOX.

VI. The Impact of Sox on the Future of Outsourcing

**Global Accounting Standards**

The future of the outsourcing/offshoring of accounting-related functions or services is dependent on the emergence of global accounting standards. Global accounting standards or International Accounting Standards (IAS), as proposed by the International Accounting Standards Committee (IASC), would lower the barriers of entry to the global economy, lower the cost of capital for many firms facing outsourcing decisions, and improve the quality of financial statement comparability. Countries such as the United States, Canada, England, Germany, and India will be the net beneficiaries of the ongoing convergence of U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS).

Minimally, the transition to IFRS could further spur India’s growing

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knowledge process outsourcing industry.\textsuperscript{70} While on the upside, the emergence of global accounting standards coupled with the growth of the Indian ITES sector could be a major precursor to the development of world class accounting firms in India. According to a KPMG report in Economic Times, an Indian publication, “Elimination of these differences on adoption of IFRS may have a significant impact for corporate India.”\textsuperscript{71}

One significant step towards the emergence of global accounting standards is permitting foreign companies interested in being traded on a U.S. stock exchange to submit financial statements following IFRS to the Securities and Exchange Commission (SEC). The net effect of this standard is that foreign firms would only need one set of financial statements following IFRS. They would not need to produce a second financial statement that reconciles IFRS to U.S. GAAP.

On November 15, 2007 the Securities and Exchange Commission (SEC) voted in favor of this measure with the exception that foreign companies must comply fully with the International Accounting Standards Board’s (IASB)\textsuperscript{72} version of IFRS. In terms of the outsourcing of accounting, smaller regional firms in Europe, India or other markets may now find it desirable to seek financial funding from capital markets in the United States. Similarly, chartered accountants in countries outside of the U.S. do not necessarily need to be trained in U.S. GAAP in order to file financial reports with the SEC.\textsuperscript{73}

On the other hand, U.S. companies have questioned whether they would have the same option to file with IFRS. Accountants in the U.S. held roundtable discussions on this issue in December of 2007. Although U.S. firms currently must follow U.S. GAAP, the results of these talks are that U.S. capital markets should move towards IFRS.\textsuperscript{74}

\begin{footnotesize}


\textsuperscript{72} IASB is the standard setting body of the IASC. This body is congruent to the US standard setting body FASB


\end{footnotesize}
Barriers to Filing IFRS

Unfortunately, filing financial statements with the SEC following IFRS is not a panacea towards minimizing financial statement drafting and accounting overhead at foreign firms. For example, it is a misconception that because the European Union follows IFRS that it is in full compliance with the version of IFRS suggested by IASB. Rather, they follow a regional version of IFRS or European IFRS. In all, according to a speech by Chairman Christopher Cox of the SEC, over 100 countries from around the world prescribe to a version of IFRS.\(^75\) Of these countries following IFRS, the SEC has identified approximately 30 different versions of IFRS established by various governmental jurisdictions.\(^76\) In terms of outsourcing portions of financial statement preparation, many regional differences still exist. A push over the next few years for greater convergence to IFRS as proposed by the IASB is necessary.

In order to list on U.S. stock exchanges, the companies must first reconcile regional IFRS to IFRS from the IASB. Although the option to not reconcile with U.S. GAAP is available, it still requires reconciliation\(^77\) to IFRS proscribed by IASB. Thus, countries following versions of IFRS are in some ways on par with the U.S. in that both standards are not fully compliant with IFRS.

Although the European Union and other regions have unanimously accepted IFRS, they are not fully compliant themselves. Nevertheless, both the Financial Accounting Standards Board (FASB), which follows U.S. GAAP, and IASB share the same goal of fully converging national accounting practices with the version of IFRS proscribed by IASB by 2011.\(^78\) Globally, many companies competing on the world economy have decided on 2011 as the convergence year. In particular, The Institute of Chartered Accountants of India (ICAI) has specifically set a full compliance deadline of April 1, 2011.\(^79\) Furthermore, all countries are working towards a global accounting standard convergence that is still a long way away.

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\(^77\) Even though European IFRS must reconcile to IFRS by IASB, this is much closer than reconciling US GAAP to IFRS by IASB


Metric for Gauging Convergence

In terms of outsourced accounting work, it is uncertain as to the level of convergence between GAAP and IFRS necessary to begin outsourcing all accounting related work. Post SOX, national legislative self-interests, especially in valuations, continue to exist between countries that are preventative towards full convergence. Because of this, certain metrics that look beyond regional legal barriers have been proposed for evaluating convergence.

Erchinger and Melcher (2007) propose a metric to gauge the progress of the convergence between US GAAP and IFRS. In their metric, a “0” alludes to diversity in the accounting practices and a “1” alludes to an identity or no difference. Between these two extremes is convergence and divergence. This dynamic process of comparing areas of convergence and divergence in accounting methodology provides a means to gauge the progress made in converging IFRS and U.S. GAAP. Ultimately, the closer this gauge comes to “1”, the more likely firms will begin to outsource or offshore accounting related work to lower labor cost markets or take advantage of accounting talent from around the world. Within this gauge, companies that switch sooner to IFRS and fully comply with regulation by the SEC will become specialists and global sourcing providers for accounting-related work.

Current Restrictions

Most countries have their own version of GAAP or systems of valuations based on historical precedent and economic stability. This diversity in accounting regulation and practices is more common than one may initially perceive. In addition, the emergence of global accounting standards does not mean complete convergence or little diversity. For instance, historical methods of valuating assets have to be taken into consideration when converting to IFRS.

In the case of Mexico, Mexican GAAP takes the fair market value of assets. In contrast, U.S. GAAP uses historical cost when accounting for most assets, although there are recent changes even in this standard. Although Mexico’s system may seem problematic for an accountant in the U.S., the U.S. accountant may be unaware that the reasoning behind Mexico’s system is historically high inflation rates. Thus, adoption of IFRS would not discriminate between national differences like this one, and region specific experts would still be required if the complexity of business transactions become too

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idiosyncratic.

While both systems are appropriate for their governments, their financial statements under IFRS would not provide investors with congruent information. Therefore, presentation and implied meaning from regional differences may continue regardless of the adoption of global accounting standards. In terms of outsourcing of accounting functions overseas, these regional problems are exacerbated when one country’s accounting information is viewed as congruent to another country’s information. With a variety of cultural, temporal, linguistic and historical differences, the perceived risk of outsourcing may be too high.

To understand how development issues and differences in practice can occur, one only has to look at the development of GAAP in the U.S. An example is FASB statement No 95 (FAS 95), commonly referred to as the statement of cash flows. FAS 95 took almost 20 years to fully develop and implement the methodology now used in financial accounting. This development began with GAAP mandating the reporting of sources and use of funds (1971) to the final implementation of the statement of cash flows (1987). During this interim, many firms assessing the operating cash flows at a firm utilized an imperfect measure of cash flows known as the “statement of changes in financial position.” In many ways, the thought of using the latter financial statement methodology, reporting of sources and use of funds, seems irreconcilable to accounting valuation practitioners today who rely on the statement of cash flows for Discounted Cash Flow (DCF) analysis. Bearing this in mind, changes in accounting practices, although non-intuitive in some respects, take time to develop in order to consider the opinions and methodology of a practice that is constantly changing.

Following SOX and the significant drive toward convergence between US GAAP and IFRS, many accounting methodologies will undergo changes which may end up differing significantly from their initial form. The example of differences between national GAAP’s and development within a country’s own national GAAP demonstrate that a shift to IAS by the convergence date of 2011 may be complicated and difficult. The outsourcing of accounting following SOX will be contingent on the speed and efficiency in which companies adopt the global accounting methodology and whether global accounting standards are successful. The uncertainty as to the number of years necessary to transition is one contingency which may hinder outsourcing of accounting.

**Long Term Perspective**

Although the emergence of a global capital market presents a more permanent transition and challenge to accounting practices, it will drastically reduce
the barriers of entry across all markets and improve the quality of accounting standards throughout the world. When considering outsourcing or offshoring accounting-related functions, companies must evaluate not only whether they follow IFRS but the historical and cultural practices that will continue to persist beyond the switchover date in 2011.

Allowing foreign firms to file financial statements in IFRS versus a second reconciliation financial statement in U.S. GAAP is a significant step towards allowing accounting-related work and analysis to be performed in multiple locations around the world. Deloitte India, as previously discussed, already trains Indian accountants in U.S. GAAP as a means to decrease work turn-around time. A single standard of financial reporting would enable firms to reduce training costs and tap accounting talent from around the world without asymmetric differences. A homogenous accounting methodology and system of rules regardless of location would allow accounting firms to leverage chartered accountants or those knowledgeable in internal controls on a 24-hour basis.

24-Hour Knowledge Factory

Post SOX, the future of outsourcing of accounting presents numerous opportunities for firms to reduce compliance related costs, improve quality of accounting work, and reduce turn-around time. In the natural progression from outsourcing tactical accounting work to more strategic alternatives, public accounting firms or firms in industry may push towards a new global work paradigm.

One such model is the 24-Hour Knowledge Factory envisioned by Professor Amar Gupta. In the 24-Hour Knowledge Factory, work that is semi-structured in nature is partitioned across multiple time zones in three succinct 8-hour shifts.\(^{82}\) Work that is done in one time zone is worked on for eight hours. At the end of the first time zone’s work day, the work is succinctly passed on to another accounting team or department. This work is then further developed for an additional eight hours until it is eventually passed on to the original accounting department. By utilizing the 24-Hour Knowledge Factory, accounting firms and industry can take advantage of global talent, expertise, and entry to new markets. Although the 24-Hour Knowledge Factory focuses on a normal eight hour work day, its application can be applied in a less stringent hybrid method. For example, a particular hybrid method would be an audit team working at an audit engagement with support from a 24-Hour

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Knowledge Factory audit team.

Following SOX, the level of outsourcing of accounting related work has grown considerably. Although many firms are outsourcing work, eventually the cost saving from outsourcing work will diminish.\textsuperscript{83} In this scenario firms will shift from tactical costs saving decisions to allocating accounting work based on strategic long term planning. In this manner, the 24-Hour Knowledge Factory would allow firms to leverage talent from around the world.

\textbf{VII. Conclusion}

Over the next few years the outsourcing of accounting related services will accelerate in conjunction with the growth of the global BPO market. India will be the largest net beneficiary of this trend due to the competitiveness of India’s ITES sector. Currently, the growth of FAO will encourage more firms, both domestic and international, to consider outsourcing accounting related functions to the lowest-cost location where quality accounting skills and expertise are not sacrificed.

Just over the course of the past few years the sophistication and complexity of accounting tasks which were traditionally done in-house by accounting departments are now being performed by competent outsourcing vendors. This has taken the form of BPO vendors attracting transactional focused work along with BPO vendors partnering with European or American accounting firms to outsource accounting work. Although many accounting departments already outsource a significant portion or all of their accounting function, even the CFO or comptroller positions are capable of being outsourced. Although some sourcing firms feel uncomfortable with this arrangement, outsourcing firms such as Geller & Co. may be willing to absorb these positions.\textsuperscript{84} This is especially the case as firms become more and more specialized.

Following the passage of SOX, the huge increase in compliance work and the reduced profitability during the 2001 recession forced many companies to evaluate the long-term goals and purpose of their accounting departments. As a result, many companies have decided to outsource portions of their accounting department to service providers offshore. Small and medium sized firms are key examples of this trend because they disproportionately bear the cost of SOX compliance as compared to large firms. The cost driver of SOX compliance internal control work coupled with narrowing profitability makes outsourcing, despite an increase in perceived risk, a desirable option.


In conjunction with this rationale, several methods have been developed which have allowed for an academic study of whether firms should outsource accounting-related functions. The two methods—one (DEA) for small and medium firms, and another (TCE) for all firms—provide a framework for the future analysis of outsourcing decisions. Although both have controversial applications, they are a quantitative (DEA) and qualitative (TCE) method which have frequently been used.

Nonetheless, some limits persist on the outsourcing of accounting. These primarily are regulatory issues ranging from protection of intellectual property, information transfer restrictions, and accounting differences. The convergence of U.S. GAAP to IFRS to form a global accounting standard or IAS is one such hurdle. Although global markets are moving toward IFRS, it is unlikely that conversion issues will cease for at least a decade or so after the transition date of 2011. Until then, many companies will continue to have redundant accounting personnel in locations all over the world and may be reluctant to outsource work.

The trend to outsource accounting is leading to a strategic shift in what, where, and by whom accounting-related services are performed. Firms may begin to consider forming 24-Hour Knowledge Factories as quality accounting services abroad coupled with secure and reliable networks are increasingly becoming the norm. The accounting fields of auditing, tax, consulting, and financial planning may begin to see this occur in some variation or another. The public accounting industry may be the first to apply such a model because the big four firms, such as Deloitte and Ernst and Young already partition work both horizontal and vertical in nature between offices in the US and India.

Overall, firms will continue to outsource accounting-related functions as long as lower cost alternatives are available and quality is not sacrificed. The outsourcing and offshoring of accounting may have lagged behind the general BPO wave in IT, but FAO may soon become the most profitable portion of the BPO industry. As outsourcing vendors continue to offer services and assurances which transcend language, culture, and perceived risk, firms will continue to outsource accounting. Post SOX, it is only a matter of time until the majority of firms outsource or offshore accounting-related services to accounting service providers.
References


