
An Investigation of Off-Shoring of Tax Preparation Services by U.S. Accounting Firms

Jayanti Bandyopadhyay, Salem State College
Linda A. Hall, State University of New York at Fredonia

EXECUTIVE SUMMARY

This paper examines the extent of off-shoring of tax preparation services by U.S. accounting firms, the motivations for off-shoring tax services and arguments against its use, the impact of the decision to off-shore on firms, and the levels of disclosure provided to clients with respect to off-shoring, and the measures taken to assure security of information and competency of providers. Information on off-shoring was obtained from thirty-five top accounting firms in seven major U.S. cities to support the authors' findings and conclusions on the current and future practice.

Keywords: Off-shoring, Tax Preparation, Outsourcing, Accounting Services

OVERVIEW

For purposes of this study, off-shoring is defined as the procurement of services by CPA (certified public accounting) firms outside the United States through electronic media. The term outsourcing in this study refers to procurement of services outside the firm, but inside the U.S. A review of current literature indicates that off-shoring of accounting services has been increasing and will continue to increase in the future. A survey was conducted yielding a sample of thirty-five (achieving a twenty percent response rate from a population of 175) of the top accounting firms in seven major U.S. cities. The authors encountered resistance from several firms in obtaining information because of the sensitive nature of this topic. The most significant finding from the sample data was that an increasing trend in off-shoring was not evident. Thirty-seven percent of the responding firms off-shored only limited amounts of tax return preparation to India, a country that possesses an abundance of English-speaking, trained accountants. In making the off-shoring decision, both cost-savings and non-cost related factors played a role. Almost half of the firms reported a negative impact on the firm from the decision to offshore, and most claimed to experience negligible cost-savings. More than half planned to decrease or discontinue off-shoring in the future. The increased disclosure requirements of the American Institute of Certified Public Accountants (AICPA) and various State Boards of Accountancy along with the fear of losing clients may have influenced firms' decisions not to pursue off-shoring more vigorously. In the next phase of research, intermediaries or third-party service providers identified in this study may be contacted to gain more insight into the actual and relative volume of tax work done off-shore, and the future direction of off-shoring activity in accounting firms.

INTRODUCTION

Current literature regarding the patterns as well as costs and benefits of U.S. manufacturing firms in subcontracting or outsourcing production and assembly tasks to newly industrialized countries (NICs) and emerging markets such as India and China is rich and abundant as these processes have gained much attention during the past fifty years. Improvements in productivity, cost efficiency, quality, and performance have been among the primary reasons that have encouraged companies to subcontract non-core activities to locations around the globe offering a comparative advantage (Dankbaar, 2007; Slaughter & Soon, 1996). However, externalizing or subcontracting in the services sector to off-shore locations, specifically in the business services sector, has also been growing rapidly in the past two decades. Albeit the lack of reliable

national data, various published studies indicate that over a million service-sector jobs in the United States have been sent to off-shore locations to date.

Farrell et al. (2006) report (based on an examination of eight industries) that an estimated eleven percent (11%) of service jobs could be completed remotely in off-shore locations as the specific tasks require "neither substantial local knowledge nor physical or complex interaction between an employee and customers or colleagues" (Farrell et al., 2006, p. 24). Continuous advancements in technology and digitized communications only assure the increase of off-shoring of "impersonal services" or services that can be delivered electronically over long distances with little or no degradation in quality (Blinder, 2006). Published work in academic and trade-related journals, although limited, have focused primarily on identifying the criteria for successful outsourcing (on or off-shore), factors for choosing the right location and vendor, and the taxonomy of operating and strategic processes suitable for externalization (Farrell, 2006; Aron & Singh, 2005; Shamis et al., 2005). However, comprehensive studies at the industry and firm level of the nature and extent of outsourcing and off-shoring of services are rare, with one example being in the hotel sector (Espino-Rodriguez & Robaina, 2005). The results of the hotel sector study indicated that current outsourcing decisions were being decided on cost factors alone. However, any future increases in externalization would have to be determined based on strategic factors, not just cost reduction. The researchers suggested that more research-based studies be completed in other sectors to verify their findings. Therefore, the need for additional inquiries regarding firm strategy and behavior with respect to outsourcing and off-shoring across sectors is warranted.

In the accounting services profession, outsourcing to smaller accounting firms within the same country has been a common phenomenon among national and larger regional firms for decades. However, during the past five years, sending certain routine functions off-shore, such as tax return preparation and compliance work has been reportedly (although with anecdotal evidence) growing (Danziger, 2000; Goldman, 2002; Lombardo, 2003; McCausland, 2004; Mirchandani & Liggett, 2002). This growth has been attributed to the availability of electronic data transfer capability coupled with an abundance of cheaper skilled accounting and English-speaking labor pockets concentrated in countries like India and the Philippines. Friedman (2005) writes about the abundance of college graduates educated in accounting (and in English) in India. According to Friedman: "with the help of high-speed communications, stringent training, and standardized forms, these young Indians can fairly rapidly be converted into basic Western accountants at a fraction of the cost" (Friedman, 2005, p. 14). Indian companies specializing in accounting such as MphasiS, have established working relationships with small and medium-sized CPA firms in the U.S. The process begins with the electronic deposit of scanned documents such as the last year's tax returns and the current year's supporting tax documents on to a computer server in the United States. At the other end, in India, trained accountants access these raw data and complete the tax return directly on the server, without the capability of downloading, printing, or copying any of the confidential client financial information in order to assure protection of privacy (Friedman, 2005).

According to accounting trade journal literature, U.S. CPAs are beginning to off-shore tax compliance work (that does not require personal interaction with clients) not only for cost reductions but also to allow domestic staff to focus on higher-order services requiring personal interaction, such as tax planning and consulting, and to increase the speed of tax return processing by taking advantage of time zone differences (Robertson et al., 2005; Reeves, 2004). It is reported that the number of tax returns electronically prepared off-shore by Indian accountants is expected to increase from 25,000 in 2002 to 200,000 by 2004. One of the leading third-party tax providers has experienced more than 25 percent increase in off-shored services during the 2007 tax season (Wyle, 2007; Breslin, 2007; Gautreau II, 2005; Brody et al., 2004). A study by the Aberdeen Group (2003) predicts a one hundred and fifty percent (150%) growth rate in business process outsourcing (BPO) specifically in tax processing going off-shore within the next five years. According to Blinder (2006), further technological advancements will determine how much accounting work stays onshore and how-much will be delivered electronically from countries offering skilled labor at much lower wages. It is also estimated that not only will there be a significant increase in the off-shoring of tax return preparation, but other accounting services will also follow. The labor shortage within U.S. accounting firms, rising labor costs, and refocusing on higher revenue-generating activities such as advisory services, Sarbanes-Oxley compliance work, and financial consultation are some of the reasons for this increase (ValueNotes, 2006).

Apart from the aforementioned anecdotal evidence and forecasts on the increase in off-shoring, no current research exists showing the extent of, and significant impact, if any, of off-shoring of tax return preparation services from the perspective of U.S. CPA firms. Brody et al. (2006) collected a convenience sample of tax clients to explore their opinions and feelings about their tax returns being prepared off-shore. The authors reported that majority of the respondents who used a paid-preparer were not even aware that their tax returns may be outsourced to off-shore locations, and were not aware that paid

preparers were not required to disclose the use of off-shoring. Most respondents appeared to be concerned that their tax returns may be sent overseas. In addition, over eighty percent (80%) of the respondents felt that their privacy was being violated, and there was a loss of trust of their paid-preparers if they were not informed about off-shoring. While their findings (because of the sampling methodology) may or may not apply to the larger population, Brody et al. (2006) pointed out another important issue plaguing the accounting profession, i.e., the issue of disclosure or transparency to clients. The unethical behaviors of large public accounting firms contributing to corporate bankruptcies such as Enron and Worldcom have caused loss of public trust in the profession. The authors extended a request to the trade regulatory body (the AICPA) to take stronger steps in requiring accounting firms the disclosure of the utilization of off-shore service providers for tax return preparation.

Set against this backdrop, the study described in this paper attempts to fill a gap in academic literature in the sector-specific, firm-level research on the use of off-shoring. This inquiry examines the extent of off-shoring of tax compliance and tax return preparation work, the benefits and costs of the process from a firm perspective, and the implications of disclosure requirements to clients.

RESEARCH CONTEXT AND LITERATURE REVIEW

The design of this research paper is based on several main themes. First, it offers the modernization of the theory of comparative advantage in the accounting services sector as countries like India and the Philippines build their advantage with human capital. These emerging markets contain a sufficient pool of English speaking accountants with extensive knowledge and training in U.S. taxation. It is appropriate, however, to point out that advancement in electronic communication and technology has made it possible for these countries to gain this new advantage in that previously non-tradable services have now become tradable (Blinder, 2006). With respect to factors involved in choosing a location for off-shoring, Farrell et al. (2006) refers to analyzing cost factors (in relation to wages and infrastructure); availability of skills; environment and risks (e.g., political stability of the host country) and quality of infrastructure. In judging the quality of the appropriate labor pool, it is also important to determine the degree of sustainability of the location's labor pool. According to Farrell et al. (2006), the growth in the number of university graduates in emerging markets outpaces that of developed countries. In addition the significant excess supply of competent professionals in these emerging markets will keep wages low for some time. In the U.S., off-shoring tax preparation reduces the need for hiring temporary help during the busy tax season resulting in a significant cost advantage (Robertson et al., 2005; Blackman et al., 2004).

The second pervading theme here is the firm-level examination of core and non-core competencies and a strategic determination of the types of tasks that can be off-shored. In the context of accounting firms, this becomes the task of management to analyze and make a conscious decision to keep those tasks receiving high ranks in value-creation and value-capture in house (for example, tax planning and management consulting) and consider off-shoring those tasks that score low in the above hierarchy (preparation of routine individual tax returns or payroll data entry) (Aron & Singh, 2005; Allery, 2004). In this process, managers make sure that the service providers of the off-shored tasks cannot provide the higher-level tasks as well as they can in-house, so that core competencies are not lost to outsiders. A significant contributing factor to an increase in firms considering off-shoring is the changing demography in the accounting profession. It is predicted that seventy-five percent (75%) of the members of the AICPA will be eligible to retire in the next decade (Gamble, 2007). This leaves a gap in the supply of accounting talent needed in the U.S. (even after accounting for the anticipated increase of young accountants entering the profession). U.S. accounting firms are facing a limited supply of young or entry-level accountants, accountants whose talents cannot be wasted on lower-level more mundane tasks involved in tax preparation and audit compliance. In order to keep the top and brightest performers within the company for the long haul, firms need to continuously challenge and reward these young talents for performing increasingly higher-order tasks (Robertson et al., 2005).

The third theme or strand of literature in this study addresses the negative aspects of off-shoring. One of the negative effects of off-shoring is the perception that the firm is being un-American by sending jobs to foreign countries. Sending work off-shore can lead to staff morale problems. Firms and clients are concerned with the quality of work completed off-shore, and with the risk of loss confidential client information. From a personnel management perspective, off-shoring limits the tax preparation experience of entry-level accountants as that form of on-the-job training is done by outsiders. If the entry-level accountants or fresh graduates in the U.S. are not exposed to the hands-on practice of preparing tax returns, they will lack

procedural knowledge that may hinder advancement in their career path (Robertson et al., 2005; Brody et al., 2004). Pinto (2005) points to the importance of information gathering from face-to-face meetings with tax clients which would be impossible in the off-shoring scenario. She refers to her own experience as a tax return preparer where many tax saving areas were detected from simple social conversation with clients. Macduffe (2008) also mentions the absence of 'nonlinguistic cues' or 'small talk' in electronic mediated conversations which restrict spontaneous social interactions. Pinto (2005) brings out the significance of understanding of American culture and business practices and their application to U.S. tax laws which is impossible for someone from another country in a remote location thousands of miles away to realize.

Another significant theme underlying this study is protection of confidential information, a topic that has received attention in the current literature on off-shoring (Ramanujan & Jane, 2006). As employees of third-party providers in foreign countries have access to and are privy to valuable and sensitive client information, concerns about misuse of this information are placing pressure on U.S. companies to protect customers' privacy. In the light of the fact that no enforceable international law exists on data security, both off-shore providers and U.S. companies are increasingly more responsible for identifying potential risks and designing measures to protect against this risk (Basu & Jones, 2003; Bierce, 2003). In the U.S., Ireland, and the EU, specific laws such as the Gramm-Leach-Bliley Act contain rules governing the disclosure of personal financial information. Tax preparers are considered providers of financial products and services and are therefore, are bound by these laws. For clarification, the usual steps involved in off-shoring tax preparation services are as follows: 1) the U.S. company collects clients' tax information, scans and transfers it into electronic files and delivers it to a facilitator's website, 2) the facilitator encrypts the files and makes these available to the third-party provider in the host country, 3) the third-party provider prepares the return and electronically posts it along with supporting documentation on the facilitator's website, and 4) the U.S. company then retrieves the information from the website, reviews it and makes adjustment, if necessary, and forwards to the client for final filing. During this process, preparers in host countries are not able to download, copy or print client information (Robertson et al., 2005).

As in any electronic transfer of confidential information, security risks must be mitigated, and firms must take measures to ensure that the third-party providers have adequate security controls in place. For those accounting firms off-shoring, issues of security and disclosure must be addressed. Rising concerns within the accounting profession as to the disclosure of the use of third-party service providers led to the AICPA's Professional Ethics Executive Committee's (PEEC) Ethics Ruling 112 under Rule 102 – Integrity and Objectivity. This ruling requires that prior to sharing confidential client information with a service provider, firms inform their clients, preferably in writing, that they may be utilizing the services of an outside provider for certain professional services. The PEEC also issued Ruling 12 under Rule 202 – Compliance with Standards. This ruling clarifies the application of Rules 201 and 202 with respect to firms utilizing third-party service providers for professional services. Ruling 12 states that firms are responsible for all work provided by the service provider. Finally, the PEEC issued Ruling 1 under Rule 301 – Confidential Client Information. This ruling applies to the firms' relationship with the third-party service provider. Specifically, the ruling requires firms to enter into contractual agreements with providers to maintain the confidentiality of client information, and requires that firms take steps to be reasonably assured that service providers exercise appropriate security measures to prevent unauthorized access to confidential client information. The resulting Rulings were adopted in October, 2004, to be effective July 1, 2005. In June 2005, the PEEC issued sample client disclosure language that could be used to meet the requirements of Ethics Ruling 112, that is, provided the firm chooses to disclose the use of outsourcing or off-shoring in writing (AICPA, 2005). It is noteworthy that Ruling 112 does not require that firms provide written disclosure to clients. Firms may want to protect themselves from litigation by putting such disclosure in writing. Firms should also be aware that their State Board of Accountancy may require different levels of disclosure with respect to the use of off-shoring.

The AICPA's suggested language for the written disclosure of the use of outside providers reads: "The firm may from time to time, and depending on the circumstances, use third-party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third-party service provider. Furthermore, the firm will remain responsible for the work provided by any such third-party service providers" (AICPA, 2005). One potential problem with this language is that it does not specifically inform the client that their account is being off-shored, only that it may be. Firms that utilize

off-shoring must be fully aware of which clients' services will be off-shored, and thus would be able to disclose it. Other potential problems with the suggested language are that it does not include the specific nature of the professional services to be outsourced, or the location of the third-party service provider. Clients may not want certain types of confidential information shared, and particularly shared outside the State or country. No mention of the reasons for the use of outside services (e.g., to provide quality service at an affordable price) is mentioned. Brody et al. (2006) found that the overwhelming majority of tax clients cared or cared to know whether their return was prepared off-shore, and nearly half were not sure if in fact, their preparer off-shored. The greater majority was also not aware of the specific disclosure requirements, but would question the trustworthiness of their tax preparer if they were not informed about off-shoring.

PURPOSE OF STUDY

Based on the above discussion, the purpose of this research is threefold. First, the authors wish to explore and examine the extent of the practice of procuring tax preparation services off-shore by certified public accounting firms based in the United States. This study is an attempt to establish that the phenomena reported in the literature exist in statistically significant terms in the U.S. accounting profession. Second, for those firms reporting off-shoring as a business practice, the study proposes to identify the international host regions that are the recipients of this off-shoring activity and the effect on firm profits as a result. The researchers also wish to identify the cost and non-cost factors influencing the off-shoring decision and the processes firms follow ensure the quality of service providers in the international arena. Finally, the authors intend to examine the way that firms utilizing off-shoring address the disclosure requirements promulgated by the various State boards of accountancy and the AICPA. The impact of off-shoring on firm/client relationships is another area of interest in the study.

RESEARCH DESIGN AND SCOPE

Seven major U.S. metropolitan areas were identified as targets for this study based on population size, export orientation, international involvement, and review of accounting trade literature on off-shoring. The study sample were drawn from the regional accounting firms listed in 'Book of Lists' in Atlanta (AT), Boston (BS), Chicago (CH), Los Angeles (LA), New York City (NY), San Francisco (SF), and Washington DC (DC). Questionnaires were color coded to identify each firm's location by city. The top 25 firms in each city were included in the sample to receive questionnaires.

Information was obtained from the relevant State Boards of Accountancy from web sites or via e-mail or telephone to determine the individual disclosure requirements placed on firms utilizing off-shoring. Except for the California Board of Accountancy, the various state boards do not have additional or stricter guidelines than the aforementioned AICPA guidelines on disclosure requirements and assurance of competency of third party service providers. The California Board requires written disclosure and written permission from the client (California Board of Accountancy Regulations, 2007).

Survey questions were designed to elicit information pertinent to the research questions and covered the following areas:

- General business characteristics including age and size of firm
- The extent of outsourcing and/or off-shoring of tax preparation and/or any other accounting services
- Nature and extent of off-shoring including revenue impact of off-shoring
- Reason(s) and factor(s) influencing off-shoring decisions including choice of country location
- Future direction based on current off-shoring experience
- Reason(s) for avoiding off-shoring
- Client disclosure practices with respect to outsourcing and/or off-shoring
- Assurance measures of the security of confidential client information and competency of third- party providers

A pilot survey was conducted using a sample of Boston firms. The questionnaire pre-test was completed in February 2007 through face to face interviews. Tax partners of three firms in Boston were interviewed to fine-tune the survey instrument. Questionnaires were administered to these firms and therefore, produced valid responses. The revised survey was sent after firms' busy tax season in May 2007. Follow up telephone calls were made to encourage response. After second requests (by mail and via phone), a response rate of twenty percent (20%) (35 responses) was achieved. Responses were collected until

November 2007 (Table 1). It is appropriate to report here that considerable resistance was met in obtaining information once the topic (off-shoring) was revealed. In at least five instances, during the initial phone call, a response was promised, however, questionnaires were not returned. In two instances, firm partners (California-based) abruptly ended the conversation as soon as they found out that the inquiry involved off-shoring of tax preparation services. Although no definitive answer can be obtained, this lack of cooperation revealed two potential problem areas with obtaining the survey data. First, firms may have misunderstood our intentions, believing us to be selling tax-preparation services, and therefore, were unwilling to respond, either because they already had a suitable off-shoring service provider, or they were not interested in off-shoring and feared future sales efforts. Alternately, firms may have been unwilling to share their strategy with respect to off-shoring to avoid any negative fallout. In sum, the nature of the topic may have inherent non-response bias.

TABLE 1: RESPONSE RATE, OUTSOURCING AND OFF-SHORING BY REGION

<u>City</u>	<u>AT</u>	<u>BS</u>	<u>CH</u>	<u>LA</u>	<u>NY</u>	<u>SF</u>	<u>DC</u>	<u>Total</u>
Sample	25	25	25	25	25	25	25	175
Responses	5	10	4	5	4	4	3	35
Rate	20%	40%	16%	20%	16%	16%	12%	20%
Outsource in U.S.	2	1	1	1	2	0	1	8
Percent	40%	10%	25%	20%	50%	-	33%	23%
Off-shore	2	5	1	2	2	0	1	13
Percent	40%	50%	25%	40%	50%	-	33%	37%

ANALYSIS AND INTERPRETATION OF FINDINGS

The Extent and Nature of Off-shoring

Twenty-three percent (23%) of all firms reported outsourcing services within the U.S. Thirty-seven percent (37%) indicated that they are off-shoring tax preparation services (Table 1). Seven of eight respondents that utilized outsourcing also off-shored, indicating a propensity in those firms to utilize third-party service providers. From the review of literature described earlier, much more evidence of off-shoring was anticipated. Regional variation with such a small sample group cannot be analyzed.

Forty-seven percent (47%) of respondent firms classified themselves as local firm, with one location (Table 2). Of local firms forty percent (40%) utilized off-shoring. Local firms accounted for half of the firms reporting off-shoring activity. A large percent of the firms (41%) responding were regional, with one or more office. Thirty-one percent (31%) of regional firms off-shored, representing thirty-three percent (33%) of all firms that utilized off-shoring. Although only two national and two international firms responded, accounting for sixteen (16%) of firms off-shoring, the magnitude of their off-shoring activity is most likely very significant. It is interesting to note, though, that only two of the four national and international firms off-shored. It would be interesting to learn why some national and international firms off-shore, while others do not.

Fifty-six percent (56%) of firms reported being autonomous offices, of which thirty-three percent (33%) off-shored. This indicates that when decision-making with respect to off-shoring is under the control of the responding firm, one-third of those firms engaged in off-shoring. Half of all firms off-shoring fell into this category. Firms that are headquarters reported a greater degree of off-shoring (50%), which also points to autonomy of decision making with respect to off-shoring. However, the difference between an autonomous office and a headquarters may be blurry as some partners may view a single-location firm with no branches or subsidiaries a headquarters. In any case, even though firms have the ability to make the decision to off-shore, many are choosing not to. A majority of the sample firms (64%) reported revenues of over \$10



million. One-third of these larger firms are off-shore, which accounts for sixty-nine percent (69%) of all firms off-shoring. While this indicates that larger firms are utilizing off-shoring more than smaller firms, the smaller firms are still very much engaged in the practice. The overall characteristics of the sample firms show that local and regional firms with autonomous status and revenues over \$10 million make up the bulk of off-shoring firms. However, one must not neglect the impact of large international and national firms as the dollar value and volume of work they handle is much larger than their counterparts. On the other hand, the fact that four firms with less than \$10 million annual revenues actually were off-shoring may indicate that even smaller firms are beginning to experiment using third-party providers overseas linked by technology.

TABLE 2: FIRM CHARACTERISTICS AND OFF-SHORING

<u>Characteristic</u>	<u>% of Firms</u>	<u>% Off-shoring</u>	<u>% of Total Off-shoring</u>
Local	47%	40%	50%
Regional	41%	31%	33%
National	6%	50%	8%
International	6%	50%	8%
Autonomous Office	56%	33%	50%
Branch Office	13%	25%	8%
Office Headquarters	31%	50%	42%
Revenue <= \$10 million	36%	33%	31%
Revenue > \$10 million	64%	43%	69%

When examining the characteristics of just those firms off-shoring, the results become richer. Of those off-shoring, tax work was the only type of service procured in this manner. The specific type of tax work off-shored was exclusively the preparation of individual income tax returns. When the relative amount of tax work off-shored is examined in the firm context, this information is not as significant. Twenty-five percent (25%) of firms that off-shore earn less than thirty percent (30%) of their total revenues from tax work (Table 3). Fifty-seven percent (57%) earn thirty to fifty percent of their revenues from taxes, while only eighteen percent (18%) earn over half of their revenues from the tax area. However, a majority of the firms (58%) who off-shored sent ten percent (10%) or less of their total tax preparation service volume overseas. Only twenty-five percent (25%) of firms off-shored more than twenty percent (20%) of their tax work. In this context, the volume and significance of off-shore tax preparation seems smaller. In addition, all firms off-shoring reported using service providers in India. The results of the study with respect to the scope and relative volume of work off-shored and the location of service providers is surprising based on the literature. The authors expected to find evidence of more widespread use of off-shoring both in type of service procured and location of service provider. Sixty percent (60%) of off-shoring firms had used the Indian service providers for only one year or less, thirty percent (30%) for up to two years, and only ten percent (10%) for more than two years. This finding supports published literature that off-shoring is a relatively new phenomenon within the accounting services sector. The next section will examine the factors involved in contemplating and finally making the off-shoring decision at the firm level, and the impact of the decision on firm profits and the use of off-shoring in the future.

TABLE 3: OFF-SHORING FIRMS' CHARACTERISTICS

	<u>% of off-shoring Firms</u>
Percent of firm revenues from Tax Services:	
Less than 29%	25%
30 – 50%	57%
More than 50%	18%
Percent of total tax services off-shored:	
Less than 10%	58%
10 – 20 %	17%
More than 20%	25%
How long has firm been utilizing off-shoring?	
Less than 1 year	60%
1 – 2 years	30%
More than 2 years	10%

Decision Factors

In response to the inquiry as to what factors influenced firms' decision to offshore, several responses were prominent (Table 4). Firms were allowed to answer positively to more than one factor, but also asked to note the most important factor for their firm. Thirty-eight percent (38%) reported that cost effectiveness was a decision factor for their firm. However, only one firm claimed cost effectiveness to be the most important factor in their decision making. The limited supply of young CPAs (fresh graduates) in the U.S. and improving the quality of life during the busy tax season were the two most prominent decision factors at fifty-four percent (54%). Faster service to clients (by employing third-party service providers and taking advantage of the time difference between India and the U.S.) and better utilization of staff for higher order services such as tax planning were important factors for forty-six percent (46%) of firms. Only sixteen percent (16%) reported the opportunity to increase revenues as a factor that influenced their decision to off-shore. One firm (8%) was only taking the off-shoring step as an experiment. Only nine firms indicated the most important factor influencing their decision. Better utilization of staff was chosen as the most important reason by 4 of 9 firms. The limited supply of CPAs and improving quality of life were the most important factors for two firms each. As mentioned earlier, cost effectiveness was chosen by one firm as the most important decision factor. From these results, it may be postulated that firms most likely selected third-party providers in India because of the available labor pool offering appropriate knowledge for the most routine tax preparation functions. The firms anticipated that this decision would make it possible for them to redistribute the firm's U.S. labor resources to tax planning, strategic consulting and other higher order services. In addition, the desire to improve the quality of life for staff (and partners) also played an important role in the decision to off-shore. In sum, while cost saving was one important factor influencing the decision to off-shore, in all cases firms considered several other factors before making the decision to utilize third-party service providers and off-shore tax preparation work. In all instances, Indian providers were chosen, and it appears that they were chosen based on their competitive advantage in offering educated and skilled English-speaking accountants at a lower cost.



TABLE 4: FACTORS INFLUENCING THE DECISION TO OFF-SHORE

Factor	% of off-shoring Firms	Most important factor
Cost effectiveness	38%	1 firm
Faster service to client	46%	-
Opportunity to increase revenues	15%	-
Opportunity to better utilize U.S. staff	46%	4 firms
Limited supply of young CPAs in U.S.	54%	2 firms
Improve quality of life during tax season	54%	2 firms
Other (tried as a test)	8%	-

Firms were questioned on the impact of off-shoring on their firm's profits: more specifically if they experienced cost savings as a result of off-shoring. Only fifteen percent (15%) of firms reported experiencing cost savings as a result of off-shoring, while sixty-two percent (62%) reported no cost savings (Table 5). The remaining firms did not respond. Those reporting cost savings indicated a range of savings from one to fifteen percent. Over half (54%) of off-shoring firms reported that their experience with off-shoring was positive; that off-shoring had a positive impact on their operations, while forty-six percent (46%) reported the opposite. When asked if firms were planning to increase their use of off-shoring, five firms (38%) responded affirmatively. However, the same firms that reported a negative impact also stated that they would decrease their use of off-shoring with the possibility of discontinuing it completely. The primary reason for contributing to dissatisfaction was that the quality of work was not as expected. Other reasons for decreasing or discontinuing off-shoring included having to spend additional time reviewing or re-doing work, and not experiencing cost savings. One can surmise, based on the data collected in this study, that an increasing trend in off-shoring is neither established nor supported. These findings directly conflict with several predictions reported by various authors as described earlier (Blinder, 2006; Friedman, 2005; Aberdeen Group, 2003).

TABLE 5: IMPACT OF DECISION TO OFF-SHORE

Result	% of off-shoring Firms
Cost savings experienced	15%
No cost savings experienced	62%
Off-shoring decision was positive	54%
Off-shoring decision was negative	46%
Will increase off-shoring	38%
Will decrease/discontinue off-shoring	46%

It is noteworthy here to mention that this study also collected information from firms that did not off-shore at all. Of the twenty-two firms that did not off-shore, sixty-eight percent (68%) cited the fear of loss of security for confidential client information as a factor influencing their decision not to off-shore. Forty-five percent (45%) expressed that the fear of losing clients was a reason for their decision. Several firms believed that the cost would outweigh the benefit of off-shoring (32%). During a face to face interview, one partner declared this to be the most important reason for not off-shoring, as well as his having access to a sufficient labor pool within the country. Other factors that influenced firms' decisions not to off-shore included patriotism (23%) and fear of loss of U.S. jobs (14%).

The current focus in the professional financial service industries on full disclosure, protection of confidential client information, and assurance of the quality of work done by third parties warranted the authors to ask survey participants about



their practices in these areas. The next section will address the analysis of information collected on disclosure, assurance of information security and quality of work.

Disclosure to Clients and Assurance of Quality

When asked about providing disclosure to clients, ten of the thirteen firms (77%) stated that they disclose in writing that a third-party provider may be used to service their account (Table 6). However, none of the firms disclosed the location or the identity of the third-party provider. One firm utilized an engagement letter to notify clients in writing. Two firms (15%) verbally informed clients that third-party providers will be used without disclosing any other details. Surprisingly, one firm (8%) did not disclose any information at all which indicates non-compliance with the AICPA guidelines. As noted earlier, the AICPA requires that prior to sharing confidential client information with the service provider, firms inform their clients, preferably in writing, that they may be utilizing the services of an outside provider for certain professional services.

TABLE 6: DISCLOSURE OF OFF-SHORING TO CLIENTS

<u>Disclosure</u>	<u>% of off-shoring Firms</u>
Written disclosure that a third-party service provider may or will be used	77%
Verbal statement that a third-party service provider may or will be used	15%
No disclosure	8%
<u>Guidelines</u>	
Use AICPA guidelines for disclosure	85%
Use State Board of Accountancy guidelines for disclosure	69%
Use Internal Revenue Service guidelines for disclosure	46%
Use internally developed guidelines for disclosure	38%

It is of no surprise that eighty-five percent (85%) and sixty-nine percent (69%) of the firms reported following guidelines promulgated by the AICPA and the appropriate State Board of Accountancy, respectively (Table 6). Forty-six percent (46%) used Internal Revenue Service guidelines. Thirty-eight percent (38%) of firms even had internally developed guidelines. Since the types of disclosure are not mutually exclusive, firms indicated any and all guidelines they follow. The respondents did not believe that disclosure of third-party providers had any effect on their clients' behavior. It may be inferred that the firms did not want to disclose the identity or the location of providers to clients for fear of this information having a negative impact on clients' perceptions of security.

With regards to protection of client information, eleven firms (85%) maintained written agreements with third-party providers for protecting the confidentiality of client information, but only two firms (15%) disclosed the existence of these written agreements to clients (Table 7). Only three firms (23%) actually obtained written consent from clients to share their information with third-party providers. Although none of the firms believed that disclosure would make any difference to clients, the majority did not specifically disclose off-shoring activity or the identity of the third-party providers to clients. One of the goals of this study was to investigate the impact of Ethics Ruling 112 on the use of off-shoring and the level of disclosure that firms provide on off-shoring professional tax services. The increasing concern for security of confidential client information within the profession (Robertson et al., 2005; Brody et al., 2004; Pinto, 2005), and the possibility of increased disclosure requirements may have played an important role in forty-six percent (46%) of firms planning to decrease or discontinue off-shoring activity as described earlier.

As shown in Table 7, thirty-one percent (31%) of firms off-shoring conducted in-person reviews of their third-party service providers and trained staff face-to-face. The geographic distance (in all cases to India) made this activity difficult and expensive. Only four firms trained face-to-face, probably by sending staff to India and thus contributing to an increase in the overall cost structure of off-shoring. Fifteen percent (15%) of firms conducted this review and training on-line. An intermediary was utilized by forty-six percent (46%) of firms, in which case these firms had to rely upon the reputation of the service providers. What is very interesting is that seventy-seven percent (77%) of all off-shoring firms reviewed every single



return prepared off-shore to assure accuracy and quality. Reviewing every single tax return most likely significantly reduced the cost advantage gained from accessing cheaper skilled labor of Indian accountants. In fact, two thirds of those planning to decrease or discontinue off-shoring reviewed every return.

TABLE 7: ASSURING THE SECURITY OF INFORMATION AND THE COMPETENCY OF PROVIDERS

<u>Protection of Client Information</u>	<u>% of firms</u>
Maintain written agreement with all third-party service providers	85%
Disclose existence of written agreements with providers to clients	15%
Require written consent from clients to share confidential information	23%
<u>Assuring Competency of Providers</u>	
In-person review of provider's infrastructure and face-to-face training of staff	31%
Review and training through electronic means	15%
Use of an intermediary	46%
Review every tax return prepared by the provider to assure accuracy	77%

CONCLUSION AND RECOMMENDATIONS FOR FUTURE RESEARCH

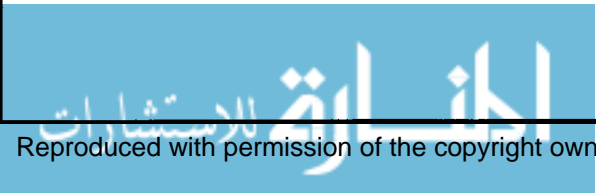
This study was designed to examine the extent of off-shoring of tax preparation services by U.S. accounting firms, the motivations for off-shoring tax services and arguments against its use, the impact of the decision to off-shore on firms, the levels of disclosure provided to clients with respect to off-shoring, and the measures taken to assure security of information and competency of providers. The conclusions drawn from the analysis are based on data gathered from thirty-five top accounting firms in the U.S. and a comprehensive review of the current literature in the field.

Conclusions reached in the area of the nature and extent of off-shoring activity among U.S. accounting firms is interesting, in that only thirty-seven percent of top firms utilize off-shoring. What is surprising to find is that all the work procured off-shore was individual income tax preparation, and the relative amount of clients' returns sent out was small. Most firms earned less than half of their revenues from tax work, and most that off-shored sent less than twenty percent of their returns overseas. All respondents used Indian service providers. Ninety percent (90%) of off-shoring firms have been doing so for two years or less. These results indicate that off-shoring activities are narrower in scope and of lower relative volume than the literature predicts.

With respect to the motivations for off-shoring, the most important factors reported by firms were the limited supply of young accountants to perform lower-level work, improving the quality of life during tax season, better utilization of U.S. staff (which supports the limited supply factor), and faster service to clients. Cost effectiveness was not the most important factor, though it was named by almost forty percent of firms as important. For a majority of firms that did not off-shore, the fear of loss of security for confidential client information was a motivating factor against off-shoring. They also cited a fear of losing clients as a reason for not off-shoring.

When examining the impact of off-shoring on firms, again the results are surprising. Only fifteen percent (15%) of firms reported cost savings or an increase in profitability since utilizing off-shoring. A little over half of all firms considered their firm's decision to off-shore a positive one. Of those, less than forty percent plan to increase their use of off-shoring. Slightly less than half of all firms considered their firm's decision to off-shore as a negative one. Of those, about half plan to decrease or discontinue its use. These data are in direct conflict with the increasing trends predicted in the literature.

A majority of the firms followed disclosure requirements and informed their clients in writing that their work may or will be sent off-shore. It was interesting that while some provided verbal disclosure, one firm did not disclose the fact at all. Firms



felt that their clients would not be affected by this lack of disclosure, which is refuted in the literature. A majority of firms maintained written agreements on the security of confidential client information with their third-party service providers, and disclosed this to their clients as well. Although reasonable measures were carried out to ensure the competency of third-party providers, a great majority of firms reviewed every return prepared off-shore for accuracy and quality. This practice seems to negate some of the value of off-shoring. It appears that some firms are utilizing off-shoring as a patch rather than a long-term business strategy.

Of course there are inherent strengths and weaknesses in this study. Data was obtained from some of the top U.S. accounting firms that are actually engaging in off-shoring. In-person interviews with partners in three firms strengthened the questionnaire and added insight into the analysis. The small sample size weakens the validity of our conclusions as statistical significance cannot be ascertained. Potential non-response bias is also a weakness, because although off-shoring is legal, there is a negative stigma attached to sending work out of the country for whatever reason. Firms that utilized off-shoring may not want to reveal firm information, even in a confidential study. As mentioned earlier, the researchers experienced some resistance in receiving responses to the questions on off-shoring due to the sensitivity of the topic. More research is needed to examine whether non-responding firms are involved in off-shoring or not. A possible research angle is to gather information from intermediary firms or third-party providers. The second phase of this study will focus on intermediaries in order to gain more insight into the future of off-shoring from the perspective of the third-party service providers and to better gauge the absolute and relative volume of tax work sent off-shore.

In conclusion, this study shows that off-shoring of tax preparation services is being utilized in U.S. accounting firms. However, the volume and scope of this practice is limited. The use of off-shoring does not appear to be growing at alarming rates by any means; in fact, it may be declining in some firms. One could suggest that although the use of off-shoring may continue and grow among larger firms with large individual tax practices, this phenomenon is most likely concentrating instead of spreading within the accounting services sector.

REFERENCES

- Aberdeen Group. (2003). *The global sourcing benchmark report*. Boston: Aberdeen Group, Inc.
- American Institute of Certified Public Accountants. (2005, May 19). *Professional ethics executive committee approves sample client disclosure language for new outsourcing rules*. Retrieved July 2, 2007, from http://www.aicpa.org/download/ethics/Sample_Disclosure_Notification.pdf.
- Allery, P. (2004). *Effective outsourcing: Practice and procedures*. West Sussex: Tottel.
- Aron, R., & Singh, J.V. (2005). Getting offshoring right. *Harvard Business Review*, 83(12): 135-143.
- Basu, S., & Jones, R. (2003). E-commerce and the law: A review of India's Information Technology Act 2000, *Contemporary South Asia*, 12(1): 7-24.
- Bierce, W.B. (2003, January). Tax preparation services, taxpayer confidential information and identity theft: potential liability for service provider's wrongful disclosure (Abstract). Retrieved April 29, 2008, from <http://jobfunctions.bnet.com/abstract.aspx?q=wrongful&docid=87323>.
- Blackman, A. B., Freedman, M., & Levy, J. (2004). Outsourcing by CPAs: Are we a business or a profession? *CPA Journal*, 74(5): 6-8.
- Blinder, A. S. (2006). Offshoring: The next industrial revolution? *Foreign Affairs*, 85(2): 113-128.
- Breslin, P. (2007, March 19). Beyond tax returns. *Accounting Today*, 21(5): SR7.
- Brody, R. G., Coulter, J. M., & Jewell, J. (2006). Losing the public's trust: Third-party service providers and disclosure. *CPA Journal*, 76(9): 66-70.
- Brody, R. G., Miller, M. L., & Rolleri, M J. (2004). Outsourcing income tax returns to India: Legal, ethical, and professional issues. *CPA Journal*, 74(12): 12-14.
- California Board of Accountancy Regulations. (2007). California code of regulations: Title 16: Professional and vocational regulations: Article 9: rules of professional conduct. Retrieved April 21, 2008 from: http://dca.ca.gov/cba/laws_and_guidelines/regs9.pdf.
- Dankbaar, B. (2007). Global sourcing and innovation: The consequences of losing both organizational and geographical proximity. *European Planning Studies*, 15, 271-288.
- Danziger, E. (2000). Overnight to India. *Journal of Accountancy*, 189(6): 57-59.

- Espino-Rodriguez, T. F., & Robaina, V. P. (2005). The management perception of the strategic outsourcing of services: An empirical examination in the hotel sector. *Service Industries Journal*, 25(5): 689-708.
- Farrell, D. (2006). Smarter offshoring. *Harvard Business Review*, 84(6): 84-92.
- Farrell, D., Laboissiere, M. A., & Rosenfeld, J. (2006). Sizing the emerging global labor market: Rational behavior from both companies and countries can help it work more efficiently. *Academy of Management Perspectives*, 20(4): 23-34.
- Friedman, T. L. (2005). *The world is flat*. New York: Farrar, Straus, and Giroux.
- Gamble, M. (2007, March 19). Maximizing opportunities with outsourcing. *Accounting Today*, 21(5): SR-6.
- Gautreau, J.C., II. (2005, August 8). Outsourcing will improve quality. *Accounting Today*, 19(14): 6-23.
- Goldman, S. L. (2002). Today's business: Think value, not dollars. *Journal of Accountancy*, 194(2): 55-57.
- Haylock, J. (2006). The other side of outsourcing. *Chartered Accountants Journal*, 85(8): 66-67.
- Lombardo, C. (2003). Outsourcing tax prep is in, in, in. *Accounting Technology*, 19(4): 26-29.
- McCausland, R. (2004). A passage to India. *Accounting Technology*, 20(4): 33-37.
- MacDuffie, J.P. (2008). HRM and distributed work: Managing people across distances. In Walsh, J.P., & Brief, A.P. (Eds.), *The academy of management annals* (Vol. 1) (pp. 549-615). New York: Erlbaum.
- Mirchandani, K., & Liggett, J. (2002). Using outsourcing to stay on top. *CPA Journal*, 72(6): 18.
- Pinto, J. M. (2005). Swimming against the tide: The hidden costs of offshoring. *CPA Journal*, 75(1): 9-11.
- Ramanujan, S., & Jane, S. (2006). A legal perspective on outsourcing and offshoring. *The Journal of American Academy of Business*, 8(2): 51-58.
- Reeves, J.F. (2004). CPAs and foreign outsourcing. *Accounting Today*, 18(Suppl.): SR-23.
- Robertson, J., Stone, D., Niederwanger, L., Grocki, M., Martin, E., & Smith, E. (2005). Off-shore outsourcing of tax-return preparation. *CPA Journal*, 75(6): 55-57.
- Shamis, G.S., Green, M.C., Sorensen, S.M., & Kyle, D.L. (2005). Outsourcing, offshoring, nearshoring: What to do? *Journal of Accountancy*, 199(6): 57-61.
- Slaughter S., & Soon A. (1996). Employment outsourcing in information systems. *Communications of the ACM*, 39(7): 47-54.
- ValueNotes (2006, November). Offshoring tax returns preparation to India. Retrieved April 21, 2008, from <http://www.researchandmarkets.com/reports/c46387>.
- Wyle, D. (2007, March 19). Benefits, challenges, and opportunities. *Accounting Today*, 21(5): SR-3.

This study was made possible through a research grant from State University of New York at Fredonia.

Jayanti Bandyopadhyay is Professor, Department of Management at Salem State College.
Linda A. Hall is Professor, SUNY Fredonia School of Business at State University of New York.