

The Offshoring Of Accounting And Finance: Where It's Been And Where It's Going

J. Richard Anderson, (E-mail: jranderson@stonehill.edu), Stonehill College
Richard N. Vita, Legal Research Network, New York

ABSTRACT

This article surveys the past and future of FAO – finance and accounting outsourcing. It tries to identify why the offshoring of finance and accounting work has lagged three or four years behind most other business functions, in spite of its seemingly significant cost advantages. It then outlines some of the major emerging trends in the field, including its extension to mid-size firms, the proliferation of venture-capital financed offshore start-ups, the creation of dedicated environments to address security concerns, its expansion beyond India, the non cost-related advantages of offshoring, and the attempt to put an American face on the entire process.

INTRODUCTION

Although the recent level of publicity makes it seem like a new issue, the outsourcing of basic finance and accounting activities has long been an established feature of the American business environment. From its simple beginning in the 1970's with the movement of payroll and repetitive transaction processing to firms like ADP and First Data Corporation and the placing of overdue receivables with collection agencies, it has lately grown at a 10% per year pace to an estimated \$65 billion annual market, according to a survey done by the Holdus Group, an IT research and advisory agency. For example, ADP now pays one out of six American workers, while First Data employs 30,000 people to process transactions for over 400 million charge cards issued by almost 1500 credit card companies. Recent surveys have shown that about 30% of firms responding are currently engaged in Finance and Accounting Outsourcing (FAO) activities, with nearly half of the respondents expected to be involved within the next four years. The discussion in most corporate board rooms today is not over whether to outsource; instead, it's about how to "globally source" the finance and accounting function.

WHERE IT'S BEEN

Why the recent push toward FAO? Many companies feel that while finance and accounting functions are critically important, they are not central to their business and offloading them to a third-party will allow managers to better focus on their core competencies by shifting non-core activities off-site. The hoped-for result is an eventual reallocation of limited internal resources (particularly managerial time and investment dollars) into areas more directly related to profit-making. Indeed, one recent survey found that respondents cite "focus on core competencies," "tap new expertise," and "improve efficiencies" more often than monetary factors in justifying their decision to outsource.

However, clearly one of the biggest drivers of the FAO movement has been the significant cost savings that large firms have realized in the past decade through the "offshoring" of Information Technology, Customer Service, and Human Resources functions. Companies who have aggressively farmed out specific IT and HR tasks to India, Malaysia, Pakistan, Singapore, Ireland, South Africa, and Australia have claimed cost savings of 50-75%, even after considering the additional overhead involved in managing a global process. Outsourcing (turning work over to an independent contractor) may not be a new way of handing finance and accounting functions, but offshoring (moving work out of the country) definitely is, driven by the desire to gain the same kind of cost savings already being generated in other parts of the business.

American businesses have achieved these dramatic savings using two quite different approaches: starting their own captive offshore divisions or entering into long-term supply contracts with independent third-party contractors. GE Capital International Services, for example, employs more than 15,000 Indians in various finance, accounting, and marketing positions, while Morgan Stanley has hired a large group of equity analysts to follow U.S. companies from Bombay. Indian knowledge workers can expect a salary of about 10-20% of what American employees can command for similar work; a chartered accountant can be hired with full fringe benefits for about \$8 per hour. The large number of firms that have chosen to take the contractor route has spawned literally thousands of offshore start-ups to meet the demand, as well as attracting big world-wide players such as Accenture, IBM, and EDS. Accenture now employs over 10,000 professionals in its Indian operations. While occasional problems have been encountered and firms such as Dell have chosen to “repatriate” certain sensitive functions (for example, corporate customer service) the general experience has been so positive that “should we go offshore” has been replaced by “what should go offshore?” as the burning question to be answered.

A key factor in the decision to go global is the presence of a highly-skilled, highly-motivated, English-speaking and technologically literate workforce in India and a few other Asian countries. When they lacked opportunities at home, these people often would gravitate to America or Europe seeking careers; with offshoring, many are now able to find (relatively) well-paid jobs in their own country. By 2008, India expects outsourcing-related employment to exceed 1 million. While many of the early outsourced jobs were limited in scope and repetitive in nature, this is changing rapidly as the last few years have seen tremendous improvement in the quality of the Indian workforce. A number of factors have caused this: more emphasis on management education in the universities, observation of Western management techniques in the workplace, exposure to cross-functional team environments, and specialized training programs set up by the larger outsourcing companies. As they gain more experience, Indians are learning not just to accomplish tasks, but to understand and manage the entire work process.

The magnitude of the cost savings achieved by offshoring is a matter for debate. While business executives initially projected savings of up to 70%, a recent McKinsey Global Institute survey of 216 U.S. executives found average savings closer to 20%. A recent study has shown that almost 50% of companies considering outsourcing decide against it because they judge the cost savings not to be large enough to justify the risk involved in giving up control over important operations. However, survey respondents may have unintentionally biased their estimated savings downward by including one-time costs such as employee severance payments and equipment lease buy-outs in their calculations. As contrary evidence, major companies like GE Capital and American Express with long-established operations in India report consistent cost savings of 50-60%. Additionally, as Neil McAllister of *InfoWorld* asserts, outsourcing should not be pictured simply as “a low-cost drop-in replacement for in-house resources. Instead, organizations considering the offshore route must weigh the cost savings against the actual value received from the outsourced organization.”²

Accounting and finance have lagged behind other corporate functions in the rush to move offshore for a number of reasons: concern about loss of control over data, the importance of timely, accurate accounting information for decision-making, and the fear of adding a new layer of internal control risk in light of the Sarbanes-Oxley Act. Also, without any pressure from above in the organization, accounting/finance managers had no strong motivation to explore large-scale outsourcing of entire business processes. However, the experience of early entrants into the field has clearly changed the game. General Motors, BP Amoco, Citigroup, and British Airways were among the first to move major parts of their back office operations offshore. American Express has been doing revenue and expense accounting, general ledger management, account reconciliations, budgeting and forecasting in India since 1993. Major credit card companies estimate that 25% of their collection activity is now being done offshore, with the potential to move as much as 75% of the work overseas. While IT projects went offshore in the late 1990’s to chase expertise and found cost savings, finance and accounting functions started going offshore strictly as a “cost play,” but are likely to also find impressive skills and significant quality improvements.

When outsourcing began, managers were hesitant to lose control over sensitive internal processes. But as they saw the success of initial limited FAO efforts such as allowing account reconciliations to be done abroad, and more importantly, did not see any horror stories about offshoring disasters in the front pages of the financial press, they gradually become more comfortable with the concept. This comfort factor, combined with new pressures from

CEO's and CFO's anxious to reduce overhead costs, has resulted in FAO moving to the head of many agendas. As finance/accounting executives begin to actively consider the issue, Bart Perkins of Leverage Partners, Inc. suggests two things: first, firms can successfully take advantage of the benefits of outsourcing if they focus on moving the operation of a function to a third party, but not the responsibility for its overall effectiveness, and secondly, companies should never outsource a broken operation as a way of fixing it.³

WHERE IT'S GOING

The offshoring of finance and accounting activities is maturing in a way very similar to the path taken by information technology and human resource functions. Led by a few bold pioneers, FAO began with the transfer of a limited number of simple, repetitive operations such as transaction processing, account reconciliations, and report generation- activities that could be compartmentalized and tightly controlled. As the results came in - work flow accomplished on time and on budget with low error rates - initial fears subsided and other companies began to test the FAO waters. Meanwhile, favorable experience with the offshore labor pool and the strong sales pitches of major consulting firms were broadening corporate views of the work that could be profitably outsourced.

What trends are we likely to see in the next few years?

- All large and mid-size firms will have to seriously consider offshoring. The same "global sourcing strategy" that has been universally applied to materials or production processes will be applied to back office activities. When the FAO movement began, it was headed by financial services and real estate firms who wanted to lower their "cost of services provided" to increase their gross margins or possibly reduce their prices. Now the process is beginning to extend to companies who are looking to lower their general and administrative overhead costs. According to Marc Schwarz of Deloitte & Touche, today CFO's must be very aware of the costs of finance and accounting functions and cannot afford to put themselves at a disadvantage by having cost levels that are not comparable with world-class companies.⁴ The pressure to put an offshoring strategy in place will come from the CEO or possibly directly from the Board of Directors. Just as America realized in the 1990's that it could no longer afford to make televisions or athletic shoes in this country, the next decade may convince many firms that it isn't economical to keep their general ledger domestically. The cost advantage of offshoring is an 800-pound elephant that cannot be ignored.
- While offshoring has thus far primarily been a game for the Fortune 1000 types, smaller players are beginning to get involved. Venture capital companies have begun to write offshoring provisions into the term sheets for new investments, thus obligating investees to become involved whether they like it or not. Some analysts expect FAO activity to explode at smaller firms of 100-1000 employees, as business processing outsourcing (BPO) firms like Mellon HR Solutions are beginning to target middle-market firms for the first time. However, this broadening of the market will have its difficulties, since the management of an \$800 million annual sales operation is not likely to be as globally-oriented in its thinking as larger firms are. Additionally, in mid-size firms it will be difficult to strip off and export administrative functions while keeping managerial duties at home, since in firms of this size they are often done by the same people.
- While venture capitalists are pumping about \$1.5 billion per year of start-up capital into offshore BPO startups, there will still be a major consolidation among offshore outsourcers. To some extent, this is already happening: In the past year, Hewitt Associates acquired Exult for \$691 million and IBM acquired Daksh eServices for about \$160 million, while Tata, WiPro, and Infosys have all gone public recently to help facilitate future acquisitions. After the dust settles, the winners will be financially and technologically capable of offering a broader array of services at a higher level of performance, able to attract and retain large numbers of talented staff, and be willing to assume more risk.
- The captive subsidiary form of offshoring should become less popular as outsourcing becomes more established and more companies want to offload supervisory responsibilities. For larger clients who want to get the benefits of offshoring but still feel that they are retaining some control over the process, third-party contractors are beginning to provide dedicated environments – space, equipment, technology, and people devoted exclusively to their needs. Outsourcers will encourage potential clients to "picture it as your back

office within our building.” Furthermore, enhanced security can be accomplished by instituting systems in which the data continues to reside in the U.S., with offshore workers accessing it via the Internet. Instead of fixed-price contracts, more FAO deals will be written using target-based pricing and an open-book approach. The parties involved will negotiate a target price for the services which offers a fair margin to the service provider; if actual costs are less than the target, the savings will be shared.⁵

- Outsourcers will significantly increase their US presence, adding staff in this country to call on potential new clients, co-ordinate workflow with existing customers, and possibly to ease political pressure by putting an American face on the offshoring process. Many outsourcers will wind up with a U.S. headquarters and an American-sounding name, even though most of the heavy lifting will be done overseas at much lower wage rates. As examples of this trend, recently WiPro and Infosys have each hired about 500 American IT professionals, and Performix Technologies has relocated its headquarters from Ireland to Massachusetts to be near its largest customers. To relieve executive worries about compliance with the Sarbanes-Oxley Act, outsourcers will perform some of the more sensitive accounting / finance work in America; as an additional comfort factor, most service providers will go to the extra expense of having an international CPA firm perform a “Type II” internal control evaluation of their offshore operations.
- For mid-size firms, there will be a push toward much more standardization of FAO work as companies begin to see big cost savings in letting an outsourcer use similar programs / procedures on multiple clients. Outsourcers will want to “put you on their platform” as opposed to “taking your platform offshore,” with the goal of supplying even more consistent, timely, and accurate data than companies are used to from their in-house systems. While firms now fear a loss of control or less reliable information from outsourcing, what they are likely to wind up with is improved state-of-the-art processes. As Jane Linder writes in the *MIT Sloan Management Review*, “Outsourcing can be more than a tool for cutting costs and improving organizational focus. Increasingly, it is a means of acquiring new capabilities and bringing about fundamental strategic and structural change.”⁶
- While India currently has captured about 80% of the offshore outsourcing market, other countries are quickly developing the talent and infrastructure to become major players in the game. China, Costa Rica, The Phillipines, and Eastern Europe are likely to emerge as serious competitors, especially as America and Western Europe begin to outsource more F&A functions, most of which require less contact with outsiders than customer service call centers and thus have less advanced English language needs. This is important because the burgeoning FAO market, combined with the continuing drive to outsource IT and HR activities has begun to put some pressure on the seemingly inexhaustible Indian labor market. Wage inflation among Indian professional workers is running 15-17% per year, and a number of major consulting firms are predicting serious labor shortages in some specialties by 2008.
- Outsourcing firms are quickly going beyond transaction processing, reconciling accounts, and report preparation to a full BPO model. While cost reduction will continue to be part of their sales pitch, Bob Pryor, president of outsourcing for Cap Gemini Ernst & Young, says that in the future, FAO will not be about taking your “mess for less;” instead, it will be about driving continuous improvements from finance and accounting functions- a value-added model.⁷ While saving money may drive the initial decision to outsource, transforming processes and boosting productivity will soon emerge as the long-term goal. Managers are just beginning to picture the outsourcing process as a catalyst to break down entrenched habits and rethink long-established processes. Clarence Schmitz, chairman of Outsource Partners International, says: “We haven’t experienced a company that outsources F&A purely for the cost. They want to amend, correct, or improve something else. They are looking at FAO as a business process management tool.”⁸

While a few CFO’s still wish it would go away, clearly the movement of finance and accounting functions offshore is here to stay. The cost and quality advantages that it promises are simply too enticing for large or medium-sized businesses to ignore. While most observers don’t expect the entire FAO function to be fully outsourced in the foreseeable future, for many companies the days of keeping the books totally in-house are gone forever.

FOOTNOTES

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