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FINANCIAL MANAGEMENT

Outsourcing of Finance and Accounting Functions





**United States
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**Accounting and Information
Management Division**

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The Honorable Strom Thurmond
Chairman, Committee on Armed Services
United States Senate

The Honorable Fred Thompson
Chairman
The Honorable John Glenn
Ranking Minority Member
Committee on Governmental Affairs
United States Senate

According to Office of Management and Budget (OMB) estimates, the federal government spent over \$7 billion in fiscal year 1997 performing, maintaining, and improving finance and accounting operations. Auditors, however, have consistently reported that these operations continue to be plagued by deficiencies that undermine the government's effectiveness and drain resources that could be used elsewhere. Outsourcing—contracting for performance of a function previously performed in-house—is one approach considered by private sector organizations, as well as state and local governments, to help reduce costs and improve the quality of financial management operations.

This report responds to one aspect of your request for information on the use of outsourcing to achieve cost savings, management efficiencies, and operating flexibility in finance and accounting operations. Specifically, the objective of this report is to present information on (1) the extent to which selected private sector and nonfederal public organizations used outsourcing as a strategy to improve financial operations and reduce costs, (2) existing outsourcing vendor capacity to perform finance and accounting operations, and (3) factors associated with successful outsourcing. As agreed with your offices, we will report separately on the remaining three areas included in your request.

This report is based on our analysis of information obtained from 15 large private sector and nonfederal public organizations that either outsourced or considered outsourcing a finance and accounting function. In addition, we analyzed information obtained from finance and accounting outsourcing consultants and vendors and related outsourcing literature.

Results in Brief

Our analysis of the experiences of 15 private sector organizations coupled with discussions with industry experts and outsourcing vendor officials and an extensive review of available literature revealed that nonfederal organizations use a variety of strategies to improve their financial operations and reduce costs. While all the private sector organizations we reviewed considered outsourcing as a financial improvement option, to date, they have relied principally on other strategies, such as consolidating systems and operating locations or reengineering business processes, to achieve their financial improvement objectives.

To the extent that these private organizations have outsourced any portion of their finance and accounting operations, such outsourcing was generally limited to routine, mechanical tasks, such as check writing or payroll processing. Only 3 of the 15 organizations we contacted had outsourced an entire process within a finance and accounting function. The existing limited capacity of outsourcing vendors to perform larger, more complex finance and accounting operations may have constrained wider use of outsourcing by these organizations. Experts in the outsourcing field have estimated that it may be 3 to 5 years before this type of capacity is widely available.

The experiences of the organizations in our review as well as our analysis of pertinent literature may provide some lessons learned for future federal agency outsourcing decisions. Specifically, the following factors were considered as part of the outsourcing decision process and were often associated with successful outsourcing:

- establishing an outsourcing policy that specifies what process and criteria to follow in making the outsourcing decision that will achieve the organization's overall goals,
- performing a strategic analysis to determine the organization's core competencies,
- benchmarking the organization's processes against those of world-class organizations to determine comparable costs and identify any deficiencies in its operations,
- performing market research to determine whether a competitive market exists for the outsourcing services the organization needs, and
- considering carefully the ramifications of potential job loss or other possible adverse personnel impacts that could occur as a result of outsourcing.

In addition, after an organization decided to outsource, two key factors were identified with successful outsourcing arrangements. First, successful outsourcing organizations ensured that they maintained sufficient expertise and control to effectively oversee the outsourcing vendor to prevent fraud, waste, or mismanagement. Without effective oversight controls, organizations cannot effectively ensure that vendors carry out their fiduciary responsibilities. Second, successful outsourcing was more likely when an organization established a results-oriented contract with an outsourcing vendor that included appropriate performance measures.

Background

A few organizations have outsourced parts of their operations for many years. Recently, however, interest in more widespread use of outsourcing has increased dramatically. This trend is documented in a recent research report which states that outsourcing has become “a growing business phenomenon and possibly even a cultural phenomenon.”¹

Early outsourcing focused on relatively low-skilled support functions such as janitorial, food service, guard, or data entry services. However, a recent international outsourcing study found that outsourcing in some areas, such as information technology—including information systems development—is growing rapidly.² Some organizations have also begun to outsource functions dependent on information technology, such as customer service, research and development, logistics management, and finance and accounting.

Outsourcing Definitions Vary

While outsourcing is growing, the concept is not clearly or uniformly defined. Definitions of outsourcing can be viewed as ranging from the prolonged use of consultants to perform a simple task to transferring the responsibility for performing an entire internal function to a third party. In our recently issued glossary of terms associated with government privatization initiatives,³ we state that “under outsourcing a government entity remains fully responsible for the provision of affected services . . . while another entity operates the function or performs the service.” We

¹Alex. Brown & Sons Incorporated, Outsourcing: Growth Opportunity of the '90s (Baltimore, MD; Alex. Brown & Sons Incorporated, 1996).

²PA Consulting Group, Strategic Sourcing: International Survey 1996, (London, UK; PA Consulting Group, 1996).

³Glossary: Terms Related to Privatization Activities and Processes ([GAO/GGD-97-121](#), July 1997).

also state that this approach “includes contracting out, granting of franchises to private firms, and the use of volunteers to deliver public services.” Consistent with this definition, we have defined outsourcing for this report as applied to nonfederal organizations as contracting out the continuous performance of a process, activity, or task that was previously performed within the organization.

One form of outsourcing used in the federal arena is cross-servicing, an arrangement where one agency provides support services to another agency on a reimbursable basis. Cross-servicing can range from providing computer and software timesharing services to full-service administrative processing. An analogous arrangement in the private sector is the use of shared service centers, which are locations or organizations within a large organization that provide common services to operating locations or business units. In accordance with the definition of outsourcing used in this report, these intra-organization arrangements are discussed as alternative strategies that nonfederal organizations have used to improve their financial operations.

In addition, when considering outsourcing, an organization may focus on an entire function or portions of a function. To illustrate, an organization’s finance and accounting function⁴ is comprised of processes, activities, and tasks. The payroll process includes various activities, such as calculating employees’ gross compensation for the pay period, determining and deducting amounts from gross compensation to calculate net pay, and printing and distributing payroll checks. Each activity, in turn, includes one or more tasks. The activity of calculating employee compensation, for example, includes such tasks as collecting time cards, tabulating time worked or leave taken per employee, and multiplying hours worked or leave taken per employee by the appropriate pay rate. An organization would have the option to outsource an entire process, one or more of the activities, or merely one or more of the tasks.

Federal Agencies Are Increasingly Considering Outsourcing

OMB Circular A-76, first issued in 1966, encourages agencies to obtain reliable, internal cost and performance information before acquiring goods and services from the private sector through outsourcing. The circular established the policy and procedures federal agencies must follow in

⁴Considerable ambiguity exists as to what constitutes an organization’s finance and accounting function. Appendix I, which is based on our synthesis of available sources, lists and describes the processes we considered to be part of the finance and accounting function for the purposes of this report.

determining whether existing federal government commercial activities should be outsourced. OMB officials told us that they consider outsourcing to be a viable tool for improving financial management in the federal government and stated that they would like to see federal agencies outsource as much of their accounting and finance functions as possible to other government agencies or the private sector.⁵

At present, a number of federal agencies have their payroll processed by the Department of Agriculture's National Finance Center through a cross-servicing arrangement. Several other agencies, including the Department of Justice and the Agency for International Development, have outsourced portions of their financial operations.⁶

Recently, there has been considerable interest in outsourcing DOD's support activities. In August 1995, the Deputy Secretary of Defense directed the military services to make outsourcing of support activities a priority. A May 1995 report by the Commission on Roles and Missions of the Armed Forces identified financial management as a prime candidate for outsourcing in DOD. Further, an August 1996 Defense Science Board (DSB)⁷ Task Force report on outsourcing found that functions such as accounting, payroll, travel reimbursement, invoicing, debt management, and other support functions are routinely performed in the private sector by a range of outside vendors and recommended that those functions be outsourced. A November 1996 DSB report estimated that such finance and accounting outsourcing could result in substantial savings for DOD. However, subsequently, while agreeing that the potential for savings exists, we questioned the size of DSB's savings estimates.⁸ In addition, a number of studies to determine the feasibility of outsourcing certain DOD finance and accounting activities, such as travel processing, payroll, and contract disbursements, have been requested by the Congress and are now under way.

⁵In a 1989 decision, the Comptroller General stated, with regard to federal agencies, that the services of contractors could not be procured to exercise discretion, make value judgments, or set policy on behalf of the government. (B-237356, December 29, 1989.)

⁶The Government Management Reform Act (GMRA) of 1994 established a franchise fund pilot program. Under this pilot program, designated agencies will provide common administrative support services such as personnel, payroll, or accounting services through self-supporting organizations in a businesslike manner.

⁷The Defense Science Board is a Federal Advisory Committee established to provide independent advice to the Secretary of Defense.

⁸Defense Outsourcing: Challenges Facing DOD as It Attempts to Save Billions in Infrastructure Costs (GAO/T-NSIAD-97-110, March 12, 1997).

Objectives, Scope, and Methodology

The objectives of our review are to develop information on (1) the extent to which selected private sector and nonfederal public organizations used outsourcing as a strategy to improve financial operations and reduce costs, (2) existing outsourcing vendor capacity to perform finance and accounting operations, and (3) factors associated with successful outsourcing.

To accomplish our reporting objectives, we obtained information on finance and accounting outsourcing from an outside consultant with unique information on the business process outsourcing market. We also conducted an extensive literature and Internet search on the subject of outsourcing, and we interviewed individuals from a number of organizations representing varying perspectives on outsourcing finance and accounting operations.

Our interviews included 12 judgmentally selected private sector corporations, 1 large international quasi-government organization, 1 state government organization, and 1 city government organization. These organizations represent a broad cross-section of U.S. industries ranging from commodities to the transportation and manufacturing industries. We selected the organizations based on either (1) literature citations indicating that they had outsourced one or more accounting functions or (2) size, industry, and level of accessibility. All but one of these organizations had annual revenues in excess of \$1 billion and about two-thirds had annual revenues exceeding \$15 billion. Our interviews of cognizant key officials in these organizations focused on first determining if they used finance and accounting outsourcing to improve their financial management organization. If they used this type of outsourcing, we asked them to describe the factors they considered important to a successful outsourcing arrangement. We also asked executives at each organization about outsourcing trends they were aware of in their respective industries.

We contracted with G-2 Research, Inc., to provide us with detailed information related to the finance and accounting outsourcing market. G-2 Research is the market research firm that identified business process outsourcing (BPO), which includes finance and accounting outsourcing, as an emerging market approximately 5 years ago. At the time of our fieldwork, G-2 specialized in tracking and compiling data on the BPO market. G-2 informed us that it uses annual interviews of nearly 3,000 corporate executives as well as its regular contacts with major outsourcing vendors, to track the outsourcing market and identify trends and major market participants.

Through an extensive literature and Internet search, we identified outsourcing vendors, customers, trade organizations, consultants, and knowledgeable academicians and obtained information on the finance and accounting outsourcing industry capabilities and trends. We subsequently talked with 13 major outsourcing vendors and 12 consultants who are active in the outsourcing industry.

Many of our discussions with private sector organizations addressed information of a sensitive business or proprietary nature. To protect this type of information, our report does not identify either the outsourcing service providers or end-users that we talked to.

Finally, we synthesized and analyzed the numerous documents acquired from our search or provided by the various organizations we interviewed to determine procedures and factors that are generally accepted as vital to successful outsourcing.

We provided a draft of this report to our consultants at G-2 Research, Inc. and the President of the Private Sector Council. We incorporated the technical clarifications they provided as appropriate in the report. We also provided relevant sections of the report to those organizations included in our review that are referred to in specific examples throughout the report and incorporated their comments as appropriate. Our work was conducted in accordance with generally accepted government auditing standards from July 1996 through September 1997.

Outsourcing Is One of Several Approaches Considered for Improving Financial Management

Organizations have a number of options for improving their financial management operations. In addition to outsourcing they can, among other things, reengineer their business processes, consolidate the performance of functions in shared service centers, or implement new enterprisewide accounting and information systems. Over the past several years, organizations have to varying degrees and in varying combinations used all of these financial management improvement approaches.

The use of outsourcing to help improve finance and accounting activities is growing and there are clear indicators that more large private sector organizations are actively considering it as an option to improve efficiency and drive down administrative costs. A 1996 American Management Association (AMA) member survey found that finance and accounting outsourcing, while used less frequently than other types of outsourcing, has grown rapidly since 1994. Eighteen percent of the 619 responding

firms were outsourcing all or part of one or more finance and accounting functions other than payroll. Payroll was outsourced in whole or in part by 38 percent of the responding firms. In addition, the survey found that larger firms—those with 10,000 or more employees—were more likely to outsource one or more financial processes.⁹

This buttresses the results of a 1995 survey, conducted for an outsourcing firm, of 400 senior managers of medium and large firms on business change strategies.¹⁰ That survey found that 25 percent of the respondents considered payroll and accounting processes best suited for outsourcing. A research organization has predicted that business process outsourcing (including finance and accounting outsourcing) will grow by over 20 percent a year until the year 2000.¹¹

Representatives of all of the 15 organizations we spoke to said they had considered outsourcing as a management strategy for improving their financial management operations, and 12 organizations had outsourced portions of their finance and accounting functions. However, only 3 of the 12 organizations outsourced one or more entire processes such as accounts payable, pension payments, general ledger accounting, fixed asset accounting, or excise and property tax administration.

Thirteen of the 15 organizations indicated that they had also used other options to improve their financial operations, such as reengineering all or parts of their accounting and finance functions, establishing a shared service center, or upgrading their financial systems. For example, officials from one company stated that their approach to improving financial management consisted of: (1) consolidating the accounting function into as few locations as possible and having each location move to a single system to accomplish the function, (2) simplifying existing processes, (3) developing systems that capture data at the point the transaction originated, regardless of the location within the organization, and (4) outsourcing all or parts of processes that could be done more efficiently or effectively by a third party. Through these steps, the company was able to reduce the number of accounting staff by approximately two-thirds in a 15-year period. However, according to

⁹American Management Association, *Outsourcing: The AMA Survey, 1997*, (New York, NY; American Management Association, 1997). For the purposes of this survey, payroll outsourcing was considered a human resource process rather than a finance and accounting process.

¹⁰The Wirthlin Group, *Executives on Re-Sourcing: Quantitative Survey* (McLean, VA; The Wirthlin Group, 1995).

¹¹G-2 Research, Inc., *Business Process Outsourcing: Market Overview*, (Mountain View, CA; G-2 Research Inc. 1997).

organization officials, most of the efficiencies achieved were due to actions other than outsourcing, and they estimated that outsourcing accounted for less than 10 percent of the total savings. Officials from another organization told us that they were able to reduce the number of personnel involved in processing accounting transactions by an estimated 90 percent over a 12-year period through the use of shared service centers, consolidating systems, and reengineering their accounting processes.

Even companies that outsourced entire processes had reengineered these processes or obtained new accounting systems prior to or at the same time as outsourcing. For example, one company reengineered its accounting processes concurrently with outsourcing a number of accounting processes. According to a company official, the reengineered processes along with the outsourcing arrangements contributed greatly to large productivity improvements.

Most Outsourcing to Date Has Involved Stand-Alone, Labor-Intensive Tasks

Most organizations that have used outsourcing for portions of their finance and accounting operations—particularly larger companies—have contracted for services that typically involve discrete, repetitive, labor-intensive tasks. According to the AMA 1996 outsourcing survey, over 70 percent of the organizations that used outsourcing for clerical, bookkeeping, or data processing portions of their finance or accounting functions only outsourced parts of these processes.

A good example of this task-oriented type of outsourcing is in the accounts payable process, where a company might handle all the activities and tasks associated with managing accounts payable in-house, but contract with an outsourcing vendor to carry out the check printing and mailing tasks. Another example is payroll processing, where a company might handle the human resource and payroll tasks of entering data and computing employee gross pay amounts in-house, but contract with a vendor for net pay computation and paycheck printing and distribution tasks. Such arrangements might also require the vendor to do other tasks, such as accumulating employee pay information and preparing and distributing W-2 statements at the end of the year.

Mixed Success of Outsourcing Arrangements

Recent research has shown that, in general, although outsourcing organizations did not fully achieve the benefits they envisioned, most achieved at least partial benefits. For example, the 1996 AMA member survey found that less than 25 percent of the responding member firms

that outsourced finance and accounting activities and established cost reduction, time reduction, or quality improvement goals believed they had fully achieved their goals. However, most respondents indicated that they had partially met their goals for these areas.

Some of the 12 outsourcing organizations we contacted, while not willing to share specific results with us, indicated that they had realized their anticipated benefits, while others indicated that they had not. The outsourcing vendor of one of the organizations, with its client's consent, told us that it reduced the number of staff processing accounts payable by almost one-third, cut the amount of time to process accounts payable transactions by over two-thirds, and was able to implement a computer matching process for about 30 percent of the firm's purchase transactions. In contrast, one company that outsourced pension payments believed that its costs actually increased. In addition, to the extent that cost reduction is an outsourcing goal, reductions in the number of an organization's finance and accounting personnel does not in itself translate into reducing the organization's overall costs because such reductions may be offset by increased outsourcing vendor contract costs.

Current Vendor Capacity May Not Meet the Outsourcing Needs of Large Organizations

The generally limited use of outsourcing for repetitive, labor-intensive tasks may be attributed, in part, to the lack of a mature vendor marketplace with sufficient capacity to provide the larger scale, more complex finance and accounting services often required by large organizations. However, there are indications that the outsourcing market may be on the verge of dramatic growth. Some experts in the field have estimated that in 3 to 5 years, organizations with large, complex finance and accounting operations will be able to outsource their entire accounting or finance function. To date, existing capacity concerns appear to have been a significant factor in organizations with large, complex finance and accounting operations moving relatively slowly toward outsourcing.

Three organizations that outsourced portions of their accounting function, for example, found only one vendor that was capable of providing the breadth of service they required. According to one consulting firm, while large organizations have been able to find vendors to outsource portions of their finance and accounting functions, they have not been able to find vendors that could take over the entire function. The firm's study of payroll practices at over 50 firms confirmed that payroll outsourcing may not be a viable option for larger operations because outsourcing vendors

presently cannot offer them payroll services at cost-effective rates. One organization found that it could not outsource its payroll process because it was too complex for payroll vendors.

One state government decided to consider outsourcing its payroll processing to a third party and requested pricing and service information from major payroll outsourcing vendors. None of the vendors could perform the proposed outsourcing at what the state deemed to be a competitive price. The proposed fees were above what it cost the state to do payroll internally, and the vendors refused to consider a long-term contract with the state.

We have previously reported that the lack of a competitive marketplace affects the cost savings that can be achieved through outsourcing.¹² Consequently, if available outsourcing vendors cannot provide desired services at a competitive rate, an organization procuring outsourcing services may not achieve its outsourcing objectives.

Factors Associated With Successful Outsourcing Decisions

Our work with outsourcing users, vendors, and consultants identified the following five key factors often associated with successful decisions to outsource finance and accounting operations.

Outsourcing Should Be Done in Context of Overall Outsourcing Policy

A corporate outsourcing policy can ensure that all factors associated with an outsourcing decision are identified and addressed. Concerns over whether and the extent to which outsourcing may affect an organization's goals and operations must be carefully considered. Such a policy should be explicit on the extent to which outsourcing will be used to reduce costs, improve efficiency, or increase organizational flexibility. The overall view gleaned from the 15 organizations and outsourcing experts interviewed is that the outsourcing decision and implementation should involve the same type of rigorous analysis, careful planning, and management involvement as any other major business decision.

Many experts believe that a corporate policy that describes and requires a structured outsourcing process is necessary for successful outsourcing. For example, on the basis of extensive research, one organization

¹²Public-Private Mix: Effectiveness and Performance of GSA's In-House and Contracted Services (GAO/GGD-95-204, September 29, 1995) and Defense Depot Maintenance: Commission on Roles and Mission's Privatization Assumptions Are Questionable (GAO/NSIAD-96-161, July 15, 1996).

developed an outsourcing policy to guide and provide a structured process for deciding whether to outsource. In part, the policy requires (1) clear objectives for outsourcing, (2) a recognition of all available service delivery options (e.g., internal staff versus third party), (3) a rigorous cost/benefit analysis, (4) buy-in by all affected parties, and (5) communication with employees throughout the outsourcing decision-making process.

Under another organization's outsourcing policy, the designated outsourcing team was to identify those functions that were candidates for outsourcing and apply specified criteria for deciding what functions to outsource. Outsourcing proposals were to include a detailed risk analysis that addressed the proposed outsourcing's potential impact on such key areas as cost, savings, service quality, system conversion, retraining of personnel, and the potential for disruption of services. Management believed that the outsourcing arrangements developed under this policy were successful in that the company met its outsourcing goals.

In contrast, two organizations we talked to had negative outsourcing experiences, which they attributed, in part, to not having an outsourcing policy in place that clearly prescribed a methodology for analyzing costs and for considering all relevant risks associated with such an outsourcing decision. Not until one of these organizations had obtained bids from vendors and was near awarding a contract were concerns raised about the validity of cost estimates and the increased legal and computer security risks. The organization's president decided to cancel the planned outsourcing until the organization had an outsourcing policy and cost estimation methodology in place. Another organization made the decision to outsource in a rapid fashion without going through a structured process that would be specified in a corporate outsourcing policy. The resulting outsourcing arrangement was not well received by the organization's employees and resulted in confusion over the purpose and extent of the arrangement.

Assessment of Core Competencies Critical When Determining What to Outsource

Decisions on outsourcing are becoming part of the organizational strategic planning process with the goal of increasing competitiveness in the world market. In considering whether to outsource, organizations have assessed functions strategically in terms of their relationship to core competencies. Core competencies, as defined by G-2 Research, Inc., a firm specializing in business process outsourcing market research, are the essential, defining functions of an organization—those things that if given to an external

party, would create a competitor or result in the dissolution of the company. A hospital's core competencies, for example, would be those directly associated with caring for patients. Core competencies have also been defined as those few functions within a company where the company can dominate, that are important to the customers, and that are embedded in the organization's systems. Involvement of an organization's senior management in the process was often identified as essential to ensuring that an organization's competencies are assessed strategically on an organizationwide basis rather than by function.

Other functions are considered non-core and can be considered either critical or noncritical. Non-core critical functions are important to an organization but are not directly linked to what the organization perceives as its primary mission. If not performed at world-class levels, however, these functions can place an organization at a competitive disadvantage or even endanger its existence. For most organizations, such functions would include finance, accounting, and human resources administration. Noncritical functions are those that supply no competitive advantage and that even if performed poorly, may not seriously harm an organization. Examples generally include cafeteria services, groundskeeping, and laundry.

Outsourcing arrangements for many organizations usually start with noncritical functions. As the organization becomes more accustomed to relying on others to perform simple, noncritical functions, the organization tends to consider outsourcing a more diverse and critical set of activities. Reasons that an organization might want to outsource one or more of its critical but non-core functions (such as finance and accounting) include the potential for (1) significant cost savings, (2) access to needed skills and expertise, (3) access to the latest technology or world-class capabilities, (4) accelerated implementation of planned improvements, and (5) freeing management resources for other purposes.

For example, after identifying its core competencies, one organization decided that outsourcing should be used as an option to improve business performance through reducing costs in non-core areas, leveraging the expertise of best-in-class service providers, and providing a better career path for employees in non-core areas. As part of its determinations, senior management decided that any function that was not a core competency could be subject to outsourcing. Factors considered included whether or not a function (1) involves decision-making, (2) adds significant value to the company's bottom line, or (3) interfaces directly with its customers.

Company officials informed us that they believed there was no long-term risk to the company's competitive position in outsourcing these types of processes.

Another organization we spoke to also identified its core and non-core activities within the accounting and financial management function. In this case, management decided not to outsource any finance and accounting activity that

- was important to maintaining control of the business,
- was important to maintaining the company's competitive position,
- involved company confidential information,
- involved a critical expertise that the company could not afford to lose, or
- was used to develop staff for managerial advancement.

Based on these criteria, the organization concluded that managerial analysis and decision support work were core activities, but that other activities, such as the clerical aspects of the accounts payable and payroll processes, were non-core and therefore candidates for outsourcing. Officials of this organization also pointed out the need to maintain control of the outsourced activities or tasks and said it was important to keep some level of knowledge and expertise in-house.

Identifying Deficiencies Through Benchmarking Is a Key Factor for Outsourcing Decisions

Benchmarking generally involves identifying organizations that have developed world-class processes and then, using applicable performance measures (such as cost per transaction, average processing time, or error rate), comparing an organization's performance to that of the world-class organization. Benchmarking lets an organization know how well it is doing and puts it in a better position to assess which improvement initiative, if any, best fits its situation. A key result of an effective benchmarking process will be a full understanding of the extent and nature of any existing deficiencies in an organization's finance and accounting operations. As discussed later in this report, this understanding of deficiencies in an organization's finance and accounting function is critical to successfully establishing and monitoring an outsourcing contract.

A recent international outsourcing study found that the most important single factor contributing to successful outsourcing was that the activity was well defined.¹³ Many of the companies we talked to have used

¹³PA Consulting Group, Strategic Sourcing: International Survey 1996, (London, UK; PA Consulting Group, 1996).

benchmarking to help them determine if any finance or accounting processes or activities they perform were in need of improvement and the extent of improvement needed. Once processes have been benchmarked, an organization is able to determine areas that need improvement and decide on a means of improvement. While some organizations have chosen outsourcing as a first-line means of process improvement, many others have relied more heavily on reengineering processes, installing enterprisewide systems, or establishing shared service centers as their primary approach to improving financial management.

If through benchmarking an organization finds a particular internal process to be world-class, it might decide that little could be gained by outsourcing. In situations like this, some organizations may offer their services externally and turn the function into a profit center. If all or part of an organization's finance and accounting function were determined to be world class, and if the organization determines that the function is not one of its core competencies, it may decide to outsource the function to free management resources.

Consistent, objective, and measurable baseline data on operations compared with baseline data from a world-class organization is essential to a reliable benchmarking assessment. One outsourcing industry consultant said, for example, that an organization must develop reliable, quantitative data on costs as well as other objective measures of the area being considered for outsourcing. Failure to obtain reliable data can increase the risk that data will be manipulated to achieve a desired result. For example, the organizational component being considered for outsourcing may have an incentive to exclude relevant costs so that the costs of its operations appear to be lower than they actually are. Outsourcing vendors performing this analysis, on the other hand, may be inclined to include as many costs as possible.

Market Research Needed to Determine Capacity and Quality of Outsourcing Vendors

As discussed previously, vendor capacity for large, complex accounting and finance functions is a consideration in the outsourcing decision process. Although vendor capacity is expected to grow rapidly over the next several years, the existence of a competitive marketplace for outsourcing services is a factor that will affect the efficiencies and cost savings that can be achieved.

A number of vendors, outsourcing users, and outsourcing experts we talked to recommended that large organizations with complex processes

pilot test a segment of a process before attempting to outsource an entire process. The segment chosen for the pilot should be one that is most amenable to outsourcing. Then, after a successful pilot, the organization could gradually expand the scope of the outsourcing arrangement. A pilot test approach to finance and accounting outsourcing would give the organization time to streamline its outsourcing process while allowing the vendor marketplace to build up the capacity to perform services for large organizations.

Organizations must also research the quality of vendor services. An official of one organization that had outsourced an accounting process stated that its vendor had a turnover rate much higher than the organization's internal staff that previously performed the process. He said that the high vendor turnover presented a problem as his employees were constantly dealing with new vendor employees who did not know the organization's business. One large company decided to bring its outsourced payroll process back in-house and do its own payroll processing because of the poor service it received from its vendor.

Organizations must also consider if process improvement is an institutional goal and whether or not the services offered by vendors represent an improvement over the effectiveness and efficiency of existing processes. One organization credited its outsourcing vendor with bringing "cutting edge" technology to some of the organization's accounting and finance processes. Another organization for which process improvements were important decided not to outsource its accounts payable after determining that none of the potential accounts payable vendors would be able to improve upon its current business operations.

Personnel Issues Must Be Addressed

Organizations cited outsourcing's potential impact on personnel as a particularly sensitive issue in considering whether and what finance and accounting operations to outsource. Outsourcing is likely to result in a reduction in the number of an organization's employees. Addressing sensitive issues associated with potential job loss and other possible adverse personnel impacts will be critical to dealing with potential resistance to outsourcing and to building momentum for change.

According to one organization, the issue of job loss resulting from outsourcing is the most difficult hurdle to overcome in reaching a decision to outsource all or part of an organization's finance and accounting operations. In some instances, we were told, organizations determined

that internal opposition to outsourcing was so widespread and vocal that planned outsourcing was halted until employee concerns were addressed. For example, we were told that addressing the concerns expressed by labor unions was considered to be of paramount importance to one organization in reaching a decision to outsource all or part of a function. In addition, a member of the organization's management stated that it is difficult to convince an organization's senior managers to reduce their "power" (based on the number of people reporting to them) by firing or laying off personnel in conjunction with outsourcing all or part of a function.

When to tell employees outsourcing is being considered, how to involve employees in the outsourcing process, and whether to require the vendor to offer employment opportunities to the displaced employees were repeatedly identified as essential elements to any outsourcing decision. One organization, citing its corporate philosophy supporting its employees as its most valuable asset, told us that it has strived to avoid employee layoffs even when selected jobs were phased out through process improvement or outsourcing. Instead, it has relied primarily on attrition and job transfers to reduce numbers of employees and has offered, at certain times, retirement incentive packages to employees whose jobs have been phased out. The organization's top management advised employees when it was seriously considering outsourcing and sought appropriate employee input in the outsourcing decision.

One organization's officials told us that they have delayed outsourcing specific activities because the affected employees may not have the necessary skills to transfer to other areas in the accounting department. Organization officials stated that, rather than displacing existing staff, they will continue to pursue internal operating efficiencies and will wait for the employees to leave through reassignment or normal attrition before outsourcing those positions.

Officials from another organization that adopted this approach also stated that they believed this strategy contributed to successful outsourcing. The organization believed that because it kept employees informed, it was able to prevent rumors and speculative gossip from becoming a barrier to outsourcing its general ledger accounting processes. The organization also arranged for the outsourcing vendor to offer employment to virtually all of the displaced employees. The vast majority of the employees transferred to the vendor and, for the most part, continued to perform the same duties they had before outsourcing. The outsourcing organization expressed its

belief that the employees were treated fairly and equitably and now have more career opportunities because the vendor has multiple career paths.

In contrast, we were told that some of another organization's employees may have first learned about the potential outsourcing from its outsourcing vendor. This created a great deal of resentment and ill-feelings and was a major barrier to the outsourcing arrangement, particularly because none of the outsourced employees were to be retained by the outsourcing vendor.

Another risk posed by outsourcing is the loss of important corporate knowledge. One organization that outsourced accounting activities required the vendor to hire key employees—those who had decision-making responsibilities related to the outsourced area. However, the outsourcing vendor found, while training its new staff, that it needed the unique accounting process knowledge held by lower-level staff. The outsourcing vendor then hired the former lower-level employees to train its new employees and discovered that many of these lower-level jobs required a much longer time to learn than planned.

Effective Controls and Performance-Based Contracts Essential to Successful Outsourcing

We identified two key factors that, once organizations decided to outsource, were associated with an increased likelihood of the outsourcing arrangements' ultimate success. These key factors are (1) maintaining sufficient expertise and controls to effectively oversee outsourced operations and (2) establishing a well-defined, results-based contract with the outsourcing vendor. An organization needs to address these critical factors not only to help ensure that it is meeting its cost reduction and/or process improvement goals, but also to avoid an increased risk of unexpected cost increases, poor quality services, or even fraud. In addition, effective oversight controls are critical to ensuring that outsourcing vendors effectively discharge their fiduciary responsibilities for the funds and other resources entrusted to them.

Effective Oversight of Outsourcing Vendor Is Essential

Ensuring that an organization maintains sufficient expertise and has an effective set of controls in place to oversee the vendor's operations were identified as essential to successful outsourcing. In recent testimony, we stressed the need for effective contract monitoring and oversight to evaluate contractor compliance and performance in outsourcing

arrangements, but found that such monitoring was not always done effectively.¹⁴

The PA Consulting Group's report on its 1996 survey also raised concerns about the adequacy of contract oversight. The study found that contract monitoring was very important in ensuring that organizations reach their outsourcing goals and that service quality and customer satisfaction were the areas most commonly monitored by organizations. However, the study also found that the level of skill and sophistication necessary for effectively monitoring outsourcing arrangements may exceed the capability of many organizations.

One organization's experience illustrates the importance of maintaining sufficient in-house expertise to maintain effective oversight controls over an outsourcing vendor's performance. The human resources department had outsourced the pension payment process believing that they could "wipe their hands clean of it." However, the organization has subsequently had to consider bringing the process back in house, in part because it has become increasingly concerned about whether it can retain sufficient expertise in-house to effectively oversee the outsourcing vendor to ensure that the organization's retirees are properly paid.

Among common contract monitoring techniques organizations have used to maintain control over the outsourcing vendor's operations were retaining the right to audit the vendor's operations and periodic reports of cost and service performance and meetings to discuss performance. For example, one organization stipulated in all of its agreements with vendors that its internal audit department must be able to audit the vendor's records, procedures, policies, and controls related to the outsourced function. Another organization that outsourced a number of accounting processes received monthly performance reports that tracked vendor performance against contractual expectations. In addition, the organization had ongoing meetings with the vendor to discuss performance concerns and any potential process improvement changes and conducted periodic evaluations to determine if outsourcing goals were met and to establish future expectations.

Performance Measures Must Be Established and Used to Monitor Outsourcing

A well-defined results-based contract—based on clearly defined, results-oriented performance measures rather than on the processes to be followed—is recognized as one of the primary ways of helping to ensure

¹⁴Privatization and Competition: Comments on S. 314, the Freedom From Government Competition Act ([GAO/T-GGD-97-134](#), June 18, 1997).

that an organization will achieve the desired level of benefits. While a results-based contract will not guarantee good contractor performance, it will help in measuring the performance and the extent to which expected benefits have been achieved.

Service providers, consultants, and end-users agreed that outsourcing contracts should be results- rather than process-based. According to one service provider, process-based requests for proposals and contract documents often preclude providers from developing the most appropriate outsourcing solution. Officials of one organization that had outsourced major portions of its accounting and finance functions told us that they developed a results-oriented request for proposal that was very descriptive of both current functions and what was expected from the vendor in terms of improved performance. The contract detailed performance expectations for the outsourced processes, including the timing of reports and the presentation, availability, and quality of accounting and finance information and established a related set of performance measures intended to help determine the extent to which the goals of the outsourcing arrangement were achieved.

Outsourcing contracts that are process rather than results driven may also tend to reinforce any existing finance and accounting deficiencies and limit the vendor in implementing efficiencies and changing processes to improve operations and reduce costs. For example, more staff would be required to process accounts payable if the contract required the vendor to manually match the purchase order, receiving report, and invoice than if the contract specified the vendor was responsible for making timely and correct payments for 99.5 percent of the dollar value of the invoices processed. In the latter case, the vendor would be able to take advantage of such techniques as electronic data interchange and evaluated receipts, thus enabling payments to be based upon efficient and accurate computerized matches of key elements on the purchase order and receiving report.

We are sending copies of this letter to the Ranking Minority Member of the Senate Committee on Armed Services and the Chairmen and Ranking Minority Members of the Senate and House Committees on Appropriations, the House Committee on National Security, the House Committee on Government Reform and Oversight, and the Subcommittee on Government, Management, Information and Technology of the House Committee on Government Reform and Oversight. We are also sending

copies to the Director, Office of Management and Budget, and the Secretary of Defense. Copies will be made available to others on request.

If you or your offices have any questions concerning this report, please contact either Lisa G. Jacobson or David R. Warren at (202) 512-9095, or (202) 512-8412, respectively. Major contributors to this report are listed in appendix II.



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Definition and Scope of Finance and Accounting Function as Used in This Report

Transaction Processing

Accounts Payable

Processing and paying vendor invoices for business expenditures incurred. Activity begins when an invoice is coded and approved for payment. Excludes purchasing and receiving activities.

Invoice Processing

Match invoice, purchase order and receiving report; resolve discrepancies; approve and code invoices for payment; maintain appropriate files.

Payment Processing

Prepare checks, electronic payments, and wire transfers; initiate and process recurring payments; respond to vendor inquiries.

Benefits Plan Accounting

Activities to account, track, and report on benefit plans.

Billing

Revenue accounting and the documentation and issuance of bills for products sold and services rendered.

Cash Application

Recording and tracking payments received from customers.

Credit and Collection

The extension of credit to customers and collecting of slow pay and past due receivables from customers.

Fixed Asset Accounting

Recording and controlling the physical records and financial activities related to fixed assets of the corporation.

General Accounting

Overseeing, coordinating, and controlling the accounting records and closing activities of the corporation. Includes maintaining the general ledger, preparing the trial balance and other finance reports, and related activities.

Inventory Accounting

The accounting for and valuation of raw, intermediate, and finished materials, spare parts, supplies, or products received, transferred, retired, or sold.

Payroll

The payment of wages, salaries, and pensions in accordance with organizational policies. Activity begins at the point of entry into the payroll system. Does not include benefits administration.

Time and Attendance Processing

The input of employee time cards into the payroll system.

Travel and Entertainment Accounting

Overseeing and processing expense reports and cash advances.

Cash Advances

Approve and disburse cash advances; resolve cash advance problems.

Expense Reports

Verify that expense reports meet guidelines; approve expense reports; prepare payments; resolve travel expense problems; distribute travel and entertainment expenses.

(continued)

Appendix I
Definition and Scope of Finance and
Accounting Function as Used in This Report

Travel and Entertainment (T&E) Card Administration

Oversee issuance of T&E cards, monitor use of T&E cards.

Control and Risk Management

Financial Budgeting and Forecasting

Establishing long-term and short-term financial plans, budgets, and forecasts. The focus is on developing detailed financial budgets and controlling actual expenses by comparing them to an historical budget.

External/Consolidated Reporting

Reporting consolidated financial information as dictated by generally accepted accounting principles, Securities and Exchange Commission regulations, and statutory, subsidiary, and international reporting requirements.

Decision Support

Banking and Cash Management

The activities involved in the handling of cash flows and bank relations for noninvestment accounts.

Cost Accounting

Calculating product or service fixed, variable, and semi-variable costs. Developing allocation schemes and analyzing cost variances.

Financial Analysis and Management Reporting

Analyzing financial and operational information to assess, interpret, and predict business performance to support management decisions. Evaluating capital investment decisions. Gathering, evaluating, and presenting financial, operating, and contractual information about proposed business transactions for internal management.

Tax Planning

Examining tax issues for the corporation to optimize tax effectiveness of management decisions.

Treasury and Trust Management

The activities associated with securing funds to meet the corporation's cash flow needs and investing any excess funds.

Source: GAO analysis of Institute of Management Accountants' finance and accounting functions.

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