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Adding Value In Finance And Accounting Outsourcing

Law360, New York (September 05, 2013, 11:44 AM ET) -- Finance and accounting functions were among the first business processes to be outsourced, and F&A remains one of the most robust outsourcing areas for business today. The most commonly outsourced F&A functions have included the order-to-cash, procure-to-pay and order-to-report cycles, payroll and travel and expense ("T&E") processing, and similarly transactional functions. However there is momentum to outsource more strategic activities, such as budgeting, internal auditing and strategic sourcing. Across this spectrum, customers can use contractual mechanisms to help secure commitments to deliver the anticipated value from the outsourcing project. This article will share some key insights and lessons that we have learned from handling dozens of F&A deals, including some of the largest ever attempted.

The Value of Contract Terms

Contract terms can deliver value to F&A customers in three ways. First, contract terms can secure commitments to perform the F&A functions for a reasonably firm price in accordance with a customer's business requirements and contracts, as well as with applicable laws. Commitments deliver value by providing an assurance of the needed services and by delivering anticipated savings.

Second, contract terms can provide options to increase, reduce or change volumes and requirements; these options deliver value if there is a change during the term. Finally, contract terms can provide a financial incentive for a provider to perform in a way that increases the value of the customer enterprise, even in areas where there is no express contractual commitment.

These financial incentives deliver value in the same way that paying a commission to a sales representative delivers value: by motivating the provider to use its influence in areas that it cannot control. For example, a provider might commit to an incentive arrangement around invoice processing speed or reductions in days' sales outstanding.

The Spectrum of F&A Outsourcing

Providers offer a spectrum of solutions for outsourcing F&A functions. One end of the spectrum focuses on the performance of nondiscretionary tasks, often for less money than it costs the customer to perform those tasks. These cost savings are largely achieved via labor arbitrage, centralization in shared delivery centers and tool consolidation. Obvious customers for these types of services are large organizations that have invested heavily in accounting systems that are not candidates for retirement or replacement.

On the other end of the spectrum, some providers offer turnkey F&A solutions that often leverage software-as-a-service ("SaaS") platforms with cloud capabilities. These solutions can be very attractive to small- and medium-sized organizations because this plug and play approach may offer more robust capabilities than the current in-house solution. These solutions are also increasingly attractive to large organizations for functions such a payroll processing.

Each end of this spectrum presents different legal and contractual challenges, options and trade-offs. This article focuses on the larger outsourcing transactions where the provider is taking over an existing function using customer systems. We would note, though, that at the other end of the spectrum customers need to watch for the issues generally seen in cloud and SaaS agreements.

Securing the Services Commitment

So, how can the outsourcing agreement be leveraged to secure commitments for F&A outsourcing? Sourced services are typically defined by accounting processes and financial systems, although the scope may differ by geography or business unit (for example, different systems or different business practices). You can add further clarity and commitment by describing the steps in the accounting process, including the systems utilized and handoffs between customer and provider.

Carefully defining the handoff points not only helps to avoid fumbled handoffs but also helps to maintain control and measure performance. For example, if a customer outsources a portion of the accounts payable process, service levels can be defined for the outsourced portion to reinforce performance management and align the provider's incentives with the customer's needs.

The handoff points also play an important role to ensure that control objectives are met. A customer may decide not to outsource all accounts payable functions and, instead, retain control of certain critical pieces. For example, a customer may retain the processing and payment of invoices to certain critical suppliers to ensure that missed payments do not result in raw material interruptions. While a service level could be used in lieu of retaining this function internally, the cost of raw material interruptions may be greater than any service level credit.

Compliance failures are a primary risk in F&A outsourcing arrangements. This often involves a trade-off between maintaining the internal controls relied upon by the customer for F&A functions generally and leveraging the internal controls that the provider has designed and implemented in its shared service delivery centers. Requiring the provider to comply with customer-defined internal controls may prevent the provider from leveraging the reliability, efficiency and cost savings designed into its multi-customer service delivery model without offering greater compliance assurances or other value.

Therefore, it is recommended that the customer start with high-level F&A control objectives and ask the provider to propose internal controls that will meet those objectives. If the proposed controls are acceptable, they should be memorialized in the service management and governance manual or desk procedures. Under this approach, the provider will still need to comply with those controls, but those controls can be updated more quickly to address new threats.

The outsourcing agreement must contain a robust set of audit rights that include not only internal audit rights, but also audits by government regulators and other third parties.

Audits

Audit rights are an important element of any outsourcing deal, but they take on more significance when the scope includes F&A functions. The outsourcing agreement must contain a robust set of audit rights that include not only internal audit rights, but also audits by government regulators and other third parties. For F&A arrangements, there are typically two types of audits: (1) audits to confirm whether the provider is meeting its contractual commitments and (2) audits related to the F&A functions themselves.

These latter audits can be thought of as the same audits that the customer would need to perform on the F&A functions if those functions were performed in-house. The scope of such audits is more focused on whether or not the outsourced F&A functions are performed in accordance with GAAP and the customer's accounting policies than whether the provider is doing what it agreed to do.

Regardless of the type of audit, however, providers may seek to limit the amount of audit support that is included in the base charges. In that case, the customer should try to build in a certain amount of audit support at a fixed price with the option of purchasing additional audit support if necessary. However, there should be an exception for audits resulting from the provider's breach of its obligations.

Because of the importance of maintaining strong controls over the performance of F&A functions, it is also important that the agreement contain a commitment by the provider to have its operations audited under SSAE 16 or ISAE 3402 (the successors to SAS 70) and to deliver an unqualified controls audit report. To provide a stronger incentive for the provider to deliver an unqualified controls audit report, the agreement should contain financial credits, enhanced liability and/or termination rights for the failure to provide an unqualified controls audit report.

While most providers of F&A services will perform a controls audit once per year, this audit is typically limited to controls in the provider's shared delivery center. Because the provider's controls audit report is generally not customer-specific, each customer must separately contract with either the provider or the customer's auditor to audit the customer-specific controls.

Pricing

Customers generally seek a secure commitment to savings and, as a result, prefer either fixed prices or prices based on such outputs as invoices processed or employees paid. Fixed prices are common on transition activities because the provider generally has a deep understanding of the effort involved to move from the customer's current environment to the provider's solution. Likewise, transformation and governance activities are generally within a provider's control and area of historical knowledge and are commonly performed for a fixed price.

Making those fixed prices for transition and transformation activities be subject to deliverable credits for missed milestones can provide a valuable incentive for achieving those milestones. Similarly, a fixed price approach is often used for the cost of tools and technology used to support and deliver the services because the provider generally understands the costs associated with these items better than the customer does.

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F&A deal pricing is often more complicated for the actual performance of F&A functions. Transaction-based pricing is fairly common in IT deals, but there is more variability in F&A solutions, and F&A tasks are frequently measured in ways that do not lend themselves to transaction-based pricing. For example, a customer may track the number of invoices that it processes but not how many of those invoices require manual intervention or the extent of intervention needed. Thus, the parties may be uncomfortable with a "price per invoice" unless they know the number of invoices requiring manual intervention.

As a result, the parties often default to full-time equivalent ("FTE") pricing models as it is easier to measure and price the labor effort associated with a basket of F&A activities than the individual tasks. This assures the provider its profitability, but often means that the customer bears the risk that the provider will over-hire, be inefficient or fail to deliver true full-time effort from its people.

FTE-based pricing models are often viewed as lacking any meaningful commitments to savings and cost improvements.

However, this does not need to be true. One contractual approach to achieving savings commitments under an FTE-based model involves the creation of an "FTE glide path" that starts at the current number of FTEs and then declines based on the provider's committed productivity improvements. The outsourcing agreement can contain a mechanism to adjust the glide path based on volume and provide that the fees charged to the customer will be based on the lesser of the actual number of FTEs used to deliver the services or the FTE glide path. To incentivize the provider to achieve additional productivity gains beyond those assumed in the FTE glide path, a gain-sharing structure can share some of the savings if the number of actual FTEs is less than the FTE glide path.

Ideally, the FTE-based customer has an option to replace FTE-based pricing with a transaction-based approach. As discussed above, the parties often lack adequate data to incorporate transaction-based pricing at the time of contracting. To gain the value of transaction-based pricing without the data to support it at signing, the agreement should contain options that allow the conversion from an FTE-based model to a transactional one. To do so, the parties must first agree on the "resource units" being measured, such as "invoices processed."

For F&A deals, the term "transaction volume unit" ("TVU") is often used in lieu of the more IT-centric "resource unit." Once the TVU is defined, the provider should measure and report on monthly actual TVU consumption. Additionally, the provider should measure and report on the number of FTEs required to process the given TVU volume. After enough TVU data has been collected to determine a per-TVU price, the agreement should contain an option that allows the customer to convert to this alternative method.

Another important issue is the allocation of currency fluctuation risk and wage inflation risk. If the provider is performing the outsourced functions from another country, the provider is typically being paid in one currency (such as dollars or euros) and incurring some or all of its performance costs in a different currency (such as Rupees). Currency fluctuations thus may change the relationship between the charges to the customer and the provider's cost, and some providers ask the customer to bear that risk. Additionally, wage inflation in some offshore locations, such as India, has historically been far greater than wage inflation in the United States, Europe and other countries.

Most customers are uncomfortable with the risk of unchecked currency fluctuation or wage inflation based on an offshore standard, especially since they have no control or ability to mitigate the risk. These risks can be shared with a variety of mechanisms, including price adjustments tied to an appropriate COLA index in the customer's home country or currency exchange rates and perhaps allocation percentages, thresholds, caps and collars.

Key Options for Retaining Leverage and Managing Change

Mechanisms for retaining control of outsourced functions and managing change are critical in F&A outsourcing because of the high degree of uncertainty during the initial stages of the relationship (e.g., FTE-based pricing, productivity commitments). Nonetheless, there are certain options that should be included in the agreement that the customer can exercise to retain leverage in the relationship.

Mechanisms for retaining control of outsourced functions and managing change are critical in F&A outsourcing because of the high degree of uncertainty during the initial stages of the relationship.

The option to award (or deny) new services to the provider can be a powerful incentive to make customer satisfaction is a top priority for the provider. Likewise, the option to in-source or move work to third parties for existing services gives the customer the opportunity to fix problems in the event the provider cannot perform the services as expected. For example, if the provider cannot process invoices in a particular language, the customer needs the ability to move that work to a third party that can perform those services. Moreover, the right to move work away from the provider can be important in addressing other contract issues and disputes.

Another powerful contractual tool is the option to withhold disputed charges, including a commitment by the provider to continue to provide the services regardless of the level of disputed charges. Short-paid invoices quickly garner the attention of provider senior management, which, in turn, focuses attention on the underlying problem causing the dispute.

Termination rights are valuable options and can be valuable incentives. Termination rights commonly may be exercised “for cause” upon a material breach by the provider and do not require the payment of termination charges. Additionally, the customer should have the option to terminate “for convenience” or upon a change of provider control with termination charges. Regardless of the type of termination, the agreement should include the option for the customer to continue receiving the steady-state services during the disengagement period for a predetermined price that avoids price gouging.

Other options to consider under termination include the ability to hire provider personnel for service continuity and knowledge transfer purposes and the ability to obtain rights to third-party software, equipment and materials to the extent necessary to transition the services in-house or to a new provider.

Key Contract Clauses for Provider and Third-Party Technology

The F&A outsourcing model continues to evolve. At one point, the primary driver was labor arbitrage based on lower FTE costs offshore. However, wage differentials are shrinking. The focus today is more on tools that reduce costs and increase speed and accuracy of the F&A functions. Each provider touts its own tools, and many use third-party products.

Such tools present a challenge from a contractual perspective because the customer would like a commitment from the provider that the tools will deliver the promised value. Options such as the ability to terminate transition if the tools are not working as promised can mitigate that risk. Also, customers are seeking corresponding reductions in transaction pricing or maximum FTEs to offset costs for new tools.

Often, the parties must build interfaces between provider tools and customer systems. The allocation of operational and financial responsibility for developing those interfaces should be clearly documented in the agreement. Likewise, the agreement should define stage gates (including specifications and acceptance criteria) for moving the integrated system into the production. If the provider is relying on third-party tools to perform some of the services, the obligation to obtain necessary required consents should be documented in the agreement, as well as an option for the customer to work directly with the third party.

Provisions commonly sought by customers in SaaS and license agreements can help them mitigate the risks and secure the value of these tools. Also, customers may consider licensing or subscribing to third-party tools directly from the third party to allow continuity in a termination and the ability to use the same tools across their enterprises.

Compliance with Applicable Laws

Compliance with laws is a challenging topic in F&A outsourcing because of the range of compliance obligations and the differing ways that different customers and suppliers allocate responsibility for F&A functions.

Laws that require compliance can be grouped into at least four categories: (1) laws directly impacted by the outsourced functions, such as data privacy and export control laws; (2) industry-specific laws, such as licensing requirements for third-party pension administrators; (3) laws specific to the F&A functions being performed, such as payroll tax laws, ACH rules and debt collection restrictions; and (4) generally accepted accounting principles and customer policies that, if not followed, may result in a misstatement of financial results in violation of laws.

Instead of taking a cookie-cutter approach to compliance with laws, the parties can consider which party will be better able to monitor changes to which laws and enforce compliance of which laws in the applicable jurisdictions. For example, most providers have created shared delivery centers to achieve a particular set of results, which may involve compliance with such common functions as applying proper taxes to payroll.

Part of the cost savings the customer will receive as a result of outsourcing certain F&A functions is based on leveraging those shared delivery centers. On the other hand, some compliance functions are better handled by modifying the customer’s accounting systems. With that approach, the customer can retain the right to define its requirements and ask the provider to define what it can do to meet those requirements.

Final Thoughts

Finance and accounting outsourcing involves unique opportunities and risks because of the central, highly regulated role of the F&A function within an organization. The right contract terms can help to maximize value and avoid costly pitfalls by securing commitments, providing options and aligning incentives. You can get the right terms by combining standard outsourcing provisions with unique terms designed for the unique challenges of F&A outsourcing.

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