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A Finance and Accounting Outsourcing Contract

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ABSTRACT

Finance and Accounting Outsourcing (FAO) is regulated by contractual provisions. An outsourcing contract is a record of the rights and obligations of both partners and legal measures that are supposed to be used in a given outsourcing undertaking. A precise agreement need to be transparent, concise and complete, which is a source of mutual relations in conflict situations.

Keywords: Outsourcing, contract, Finance and Accounting Outsourcing (FAO)

1. INTRODUCTION

Outsourcing is a concept well-established in the practice of the governance of organizations. Over the last 50 years, it has evolved from the method used to implement simple business tasks to the concept treated as a mechanism involving strategic shaping of the structure of business operations. One of the most innovative typologies is finance and accounting outsourcing, which embraces aspects of civil law as well as financial and tax law. The outsourcing contract is an important cooperation document, creating the basis for shaping the outsourcing relationship. This is particularly important because FAO can be global - it means that it is used by supranational organizations that choose service centres located around the whole world. The purpose of this article is to show outsourcing and its components as well as the role of finance and accounting outsourcing contracts.

2. DEFINITION OF OUTSOURCING

The term “outsourcing” comes from English, and it is an abbreviation for the words “outsider resource using,” i.e. the use of external resources [8]. The word "external" defines values created outside the internal organisation of the undertaking. Broadly understood resources form the basis of competitive advantage. However, companies frequently have a limited access to resources and without obtaining them from the external environment, it would be impossible for them to survive in a competitive market [4].

Outsourcing goes back the early 1970s in the United States. The concept was used as a quick and immediate meeting of a particular need or solving a specific problem, and its main premise was to limit costs [2]. As the technology developed, managers realised that enterprises would not be able to be experts in more than one, two basic areas. That led enterprises to renounce peripheral activities and to focus on elementary tasks being the core competence of the company.

Outsourcing involves commissioning tasks that have been carried out so far in the enterprise to other entities by separating them from the organizational structure (Nowicka, 2016, 6). It is a solution generally undertaken as a result of restructuring activities. Outsourcing may be used not only for individual services, or even other ancillary functions, but especially in the area of economic processes carried out previously independently by the client.

Knowledge, which is information whose validity has been established through tests of proof [2], has emerged as a strategically significant resource of the firm. Accordingly, knowledge management becomes a key factor to gain and sustain a competitive advantage [3]. Knowledge management is the process of capturing, storing, sharing, and using knowledge. In this, a major management issue is how to change individual into organizational knowledge, since organizational knowledge is inherently created and resides with individuals [37]. Another issue is how to integrate and manage organizational knowledge so that it results in successful performance. Since organizational knowledge is usually distributed within an organization and organizational products or services generally require multiple knowledge, organizations need to integrate this knowledge to produce new products or services, or to improve business performances [8].

Organizational knowledge is not only created within an organization but can also be acquired externally. Therefore, recently, increasing attention has been paid to how organizations learn from their partners and develop new competencies through strategic alliances [2]. Many scholars have discussed the introduction of alliances to acquire new capabilities from partners through organizational learning [1]. Here, we define knowledge sharing as activities of transferring or disseminating knowledge from one person, group or organization to another. This definition broadly includes both tacit and explicit knowledge. However, according to the definition of Nonaka and Takeuchi, tacit knowledge is personal, contextspecific, and therefore hard to formalize and communicate and explicit knowledge can be described as knowledge that is transmittable in formal, systematic language. Polanyi [9] also said that the only way to learn tacit knowledge was through apprenticeship and experience. Thus, we made more concrete and new definitions of tacit and explicit knowledge by using Polanyi's concept.

To do so, we introduce the concept of knowledge representativeness: the degree to which knowledge can be expressed in verbal, symbolic or written form. That is, we consider

the representativeness of knowledge to be a continuum. According to this rationale, tacit knowledge is defined as knowledge that cannot be expressed in verbal, symbolic and written form while explicit knowledge is knowledge that exists in symbolic or written form. Then, implicit knowledge is knowledge that can be expressed in verbal, symbolic or written form, but not yet expressed [5].

2. 1. Organizational capability

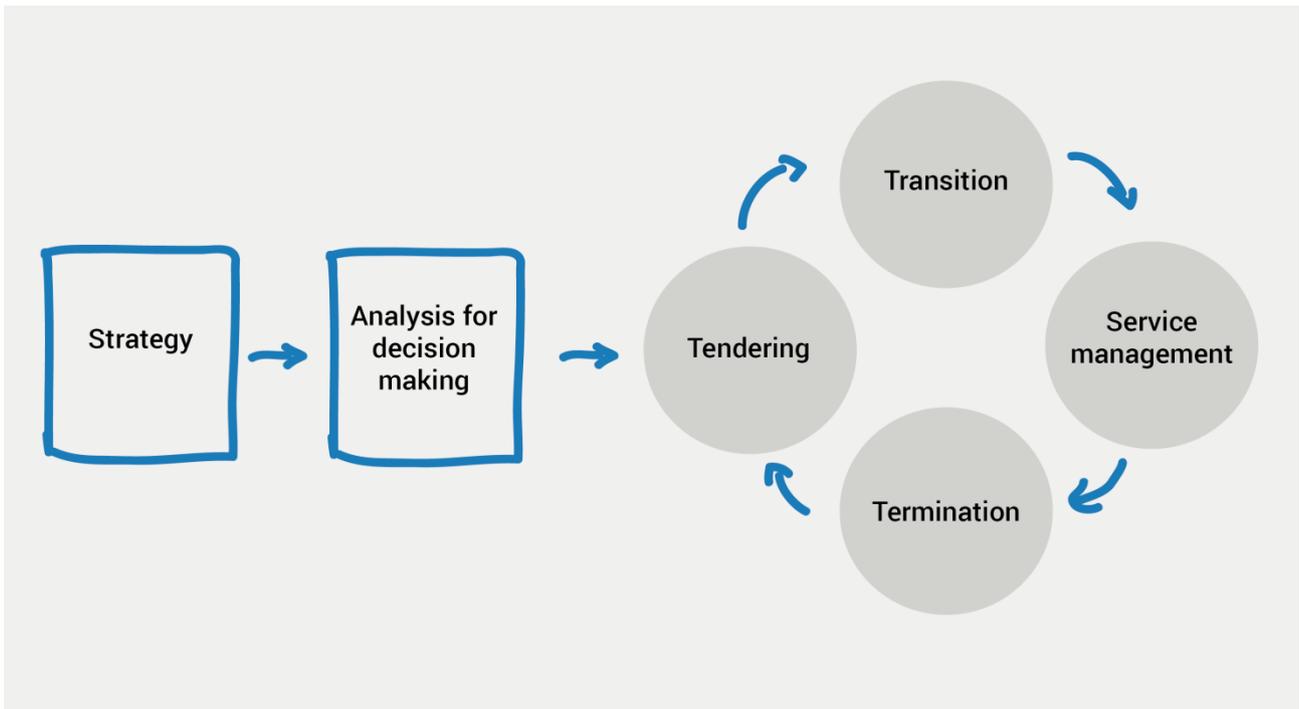


Figure 1. Business process outsourcing

Source: Lacity, M. C., Khan, S. A., & Willcocks, L. P. (2009). A review of the IT outsourcing literature: Insights for practice. *The Journal of Strategic Information Systems*, no. 18(3), p. 130-146.

The fundamental question in the field of strategic management has been how organizations gain and sustain competitive advantages. In the traditional approach, the attractiveness of an organization and its ability to establish competitive advantage over rivals are major factors of organizational capability.

However, with increasing uncertainty and the dynamics of business environments, the internal analysis of the firm rather than the external factors of the industry and its environment become a frequent question in strategic management [10]. This interest reflects dissatisfaction with the static, equilibrium framework of traditional approaches and leads to the resource-based theory of the firm. This view of the firm has led to the suggestion that organizational resources and capabilities are key success factors for competitive advantage and its sustainability [5].

Accordingly, the organizational capability depends on valuable resources that are inimitable, unsubstitutable, and durable; it depends on an organization's ability to acquire and

use them for competitive advantage. Later, this allows development of a dynamic capability approach. While the term “dynamic” refers to the capacity to renew organizational resources and capabilities to achieve congruence with the changing business environment, the term “capability” emphasizes the role of strategic management in appropriately adapting, integrating, and reconfiguring internal and external organizational resources and competencies to match the requirements of the changing environment [4].

Mowery, Oxlen and Silverman say that a key factor in the “dynamic capabilities” view of form strategy is the acquisition of new capabilities through organizational learning. The research interest in organizational capabilities has been recently revitalized by knowledge-based theories [6].

These argue that organizational knowledge, such as operational routines, skills, or know-how, are the most valuable resources and its strategic management capability is a key factor under a more dynamic and rapidly changing environment; i.e. from the knowledge-based perspective, organizational capability is considered as a key source of competitive advantage. For example, Badarcco introduced the concept of ‘knowledge link’ as one of the major organizational management capabilities for learning or acquiring needed knowledge from other organizations [3].

2. 2. Outsourcing partnership

While application packages, contract programming, and specific processing services comprised the major portion of IS outsourcing in the 1970 and 1980s, organizations in the 1990s outsourced their IS functions through enterprise-wide system integration, application development, and systems operation [3].

In the 1990s, many organizations experienced difficulties in forming and managing a successful outsourcing relationship with service providers as the nature of outsourcing evolved from a contract relationship between the service receiver and provider to a partnership relationship. To overcome this problem, several firms established intimate relationships with their service providers. On the research side, many studies also emphasized the importance of partnership in IS outsourcing. In this study, partnership is defined as an interorganizational relationship to achieve shared goals of the participants. Partnership is not a new concept [5]. Marketing and interorganization systems research has long explored relationships between customer and vendor, buyer and seller, manufacturer and distributor, or auditor and client, etc. and a number of different views emerged. Previous research classified the relationship between organizations into two types: transactional style relationship and partnership style relationship [4].

The first develops through a formal contract in which the rules are well specified and the failure to deliver on commitments by either party is resolved through either litigation or penalty clauses in the contract. In contrast, the second involves risk and benefit sharing, the need to view the relationship as a series of exchanges without a definite endpoint, and the need to establish a range of mechanisms to monitor and execute its operations. In the marketing area, the partnership style relationship is based on social exchange theory rather than an economic perspective, such as transaction-cost theory or agent-cost theory [1].

The social exchange theory is used to explain why organizations enter into a closer relationship. This theory sees the relationship as a dynamic process through specific sequential interactions in which two participants carry out activities with one another and exchange valuable resources. This assumes that processes evolve over time as the actors

mutually and sequentially demonstrate their trustworthiness while the exchange activities among organizations are enforceable from the economic perspective [5].

According to Blau [7], social exchange theory is based on the concept of “trust” to explain the exchange relationships among participants. It has been conceptualized as the firm's belief that the other company will perform actions that will result in positive outcomes, and will not take unexpected actions that would result in negative outcomes [8]. Trust plays a critical role in the development of a longterm relationship and in facilitating an exchange relationship. Therefore, trust is a basic concept in separating the relationship type into a transactional style or a partnership-style relationship and it evolves through mutually satisfying interactions and increasing confidence in the relationship [5].

2. 3. Research model

The objective of this study was to examine organizations that outsource IS functions, their success, and understand how some variables affect this success. The basic model studied the relationship between knowledge sharing and outsourcing success. The effects of organizational capability and partnership quality on this relationship were explored. The research model is shown in Fig. As described by Konsynski and McFarlan [7], partnerships can create a competitive advantage through the strategic sharing of organizations key information and knowledge.

Closer relationships result from more frequent and more relevant information and knowledge exchanges among high performance partners [9]. By sharing knowledge between the service receiver and provider, they are able to sustain a more effective outsourcing relationship over time. Since tacit knowledge is hard to formalize and communicate, this study focuses on explicit and implicit knowledge sharing between the service receiver and provider.

The extent of implicit and explicit knowledge sharing is represented by the left box in the figure. The dependent variable, outsourcing success, can be viewed as the level of fitness between the customer's requirements and the outsourcing outcome [4]. The first set of hypotheses explores the base relationship between the degree of knowledge sharing and outsourcing success.

There have been many studies on knowledge sharing among organizations [4]. Knowledge sharing refers to the extent to which critical or proprietary information is communicated to one's partners. It is widely accepted that one of the key sources of successful knowledge sharing is an organizational capability to learn or acquire the needed knowledge from other organizations: the higher the degree of organizational capability, the greater the outsourcing outcome [4].

However, organizational capability in knowledge sharing is dependent on the ability of an organization to acquire or create, integrate, and leverage knowledge. The service receiver's absorptive ability to recognize and assimilate the service provider's knowledge may lead to a successful outsourcing outcome, regardless of the degree of knowledge sharing between the service receiver and provider [3]. Therefore, I expected organizational capability to influence the base relationship between the degree of knowledge sharing and outsourcing success. While the degree of implicit and explicit knowledge sharing may or may not have a significant relationship with outsourcing success, the relationship would be stronger under a higher level of organizational capability.

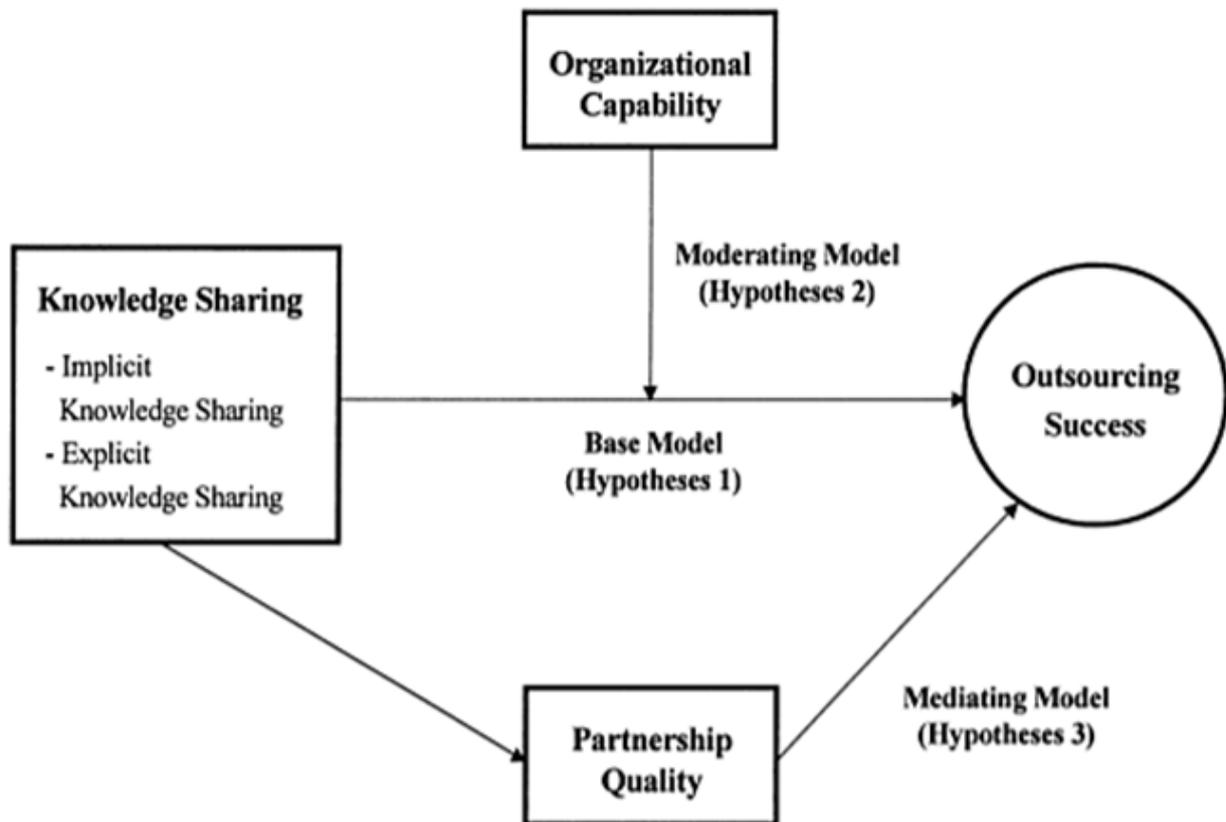


Figure 2. Research model

Source: Maelah, R., Aman, A., Hamzah, N., Amiruddin, R., Sofiah, & Auzair, M. (2010). Accounting outsourcing turnback: process and issues. *Strategic Outsourcing: An International Journal*, no. 3(3), p. 226-245.

The survey was carried out in four phases in 1998. First, measurement scales were developed based on relevant literature and interviews with 20 European and nonEuropean managers responsible for outsourcing contracts. Thereafter, the questionnaire was tested with three French managers [5]. Based on their responses, the pre-test was revised and re-tested with three Anglo-Saxon managers (i.e. one American, one British and one Australian). Finally, we mailed the questionnaires to senior executives in charge of managing outsourced activities for the 816 companies in our initial sample [10]. According to the single respondent approach, these executives are those who are most apt to provide the necessary information. Two follow-up letters were sent after the initial mailing [4].

A total of 91 completed questionnaires were received, representing a response rate of approximately 11 per cent. Owing to the senior level from which we needed responses and the length of the survey (16 pages of text), we had a relatively low response rate [7].

However, this response rate is only slightly lower than the 15 per cent response rate found in a number of recent large-scale surveys carried out in two continents and a dozen countries [4]. Moreover, the extent of the information we were able to obtain may help counter-balance the relatively low response rate.

2. 4. Components of outsourcing

Experience shows that every financial and accounting outsourcing contract should contain elements of an obligatory and optional nature. Obligatory provisions in a well-functioning outsourcing agreement are considered to be mandatory [5]:

- scope of services performed,
- commitment of the organization ordering services,
- remuneration for the supplier,
- guarantees and exclusions,
- provisions regarding the confidentiality of information and data protection,
- protection of intellectual property,
- hardware and software provisions,
- termination of the contract.

The most common drawback of contracts is the use of routine, too general statements. This creates the threat of not only a subjective interpretation of the records, but also the omission of matters seemingly minor, but extremely important for the manner of contract performance. Regulations referring to the subject of the financial and accounting department can not be comparable to the separation of simple auxiliary tasks. Obligatory elements of the contract form the core of a functioning relationship between partners regardless of the subject of the services provided [6].

The optional provisions are, however, the provisions defining [8]:

- controls, audits,
- confidentiality of data,
- obligations to employees,
- sharing profits,
- uninterrupted service provision.

Conclusion of such elements of the contract on the status of optional elements contributes to better cooperation of the parties' partners. The emergence of optional elements can be taken as an expression of concern for the firm deployment of outsourcing in the strategy of the parent organization.

It is worth adding that ensuring the proper functioning of financial and accounting outsourcing requires understanding the complexity of financial and accounting processes and reflecting this in the outsourcing agreement by detailed provisions regarding the subject of the contract [6]. Transparency is necessary and completeness of the defined scope of the functions and tasks of the financial and accounting division as well as the design of their course [4]. The range of functions and tasks of the financial and accounting division taken over by the contractor allows him to create an image of expectations as contractors for the services ordered. The more precise and thoughtful it is, the smaller the images of the expectations of both partners are.

The outsourcing contract must ensure that the derivation of the functions and tasks of the financial and accounting division duly corresponds [6]:

- with the strategic goals of the organization,
- with expected results,

- with the requirements of an organization providing outsourcing services.

This results in the need to participate in negotiating the contents of the contract of persons who will then be responsible for the implementation of the contract itself. This means that at the stage of agreeing the contract, the opinions and suggestions of the finance director, located lower in the hierarchy of the client, should be taken into account and then taken into account [2].

The provisions of the concluded agreement must be referenced in the vision of the future course of the processes. The vision itself, as well as its substantive assessment is essential, all the more that there is no procedural documentation in the organization ordering financial and accounting outsourcing, or it is outdated and not very detailed [3]. The solution to this problem is the use of the knowledge of own employees and participants of the processes to be output.

Both parties to the contract should understand in the same way the provisions regarding the scope and course of derived functions and tasks of the financial and accounting department. Only this is a prerequisite for the service provider to be able to meet the expectations of the client. The functions and tasks of the financial and accounting department are seemingly the same, especially from the perspective of top management. However, each organization gives them character, course and requirements characteristic for their needs. This is due to the specificity of the organization, its size, business area, technical conditions of the systems used, customs, as well as the attitude of people working in the financial and accounting department [4]. There is no single perspective on the implementation of the functions and tasks of the financial and accounting division. This fact already causes the parties to face interpretation problems. Therefore, particular attention should be paid to the clarity of formulations and avoiding ambiguity in formulating the financial and accounting outsourced to perform tasks [10].

2. 5. Effect of the outsourcing agreement on international relations

Financial and accounting outsourcing radically changes interpersonal relationships in the parent organization. The necessity to change the current state of these relations means that there is a sense of threat and sometimes excessive expectations among the client's employees. In such situations, there may be conflicts between people. They can seriously jeopardize the implementation of these contracts. This undesirable state of employee attitudes comes first of all from ignorance, that is from ignorance of the content of the contract or its misunderstanding [5]

Counteracting frustration, chaos and excessive expectations among the client's employees as factors activating the risk of not meeting the expectations of financial and accounting outsourcing is possible thanks to such definition of the scope of functions and tasks that clearly indicate their purpose [6]. Therefore, they should be clear and understandable for executive team managers so that they can participate in the work of teams restructuring employment and dispel doubts of subordinate employees.

Situations of the lack of adequate transparency of records related to the scope of tasks in financial and accounting outsourcing are very common. You can not expect from organizations that have decided to implement financial and accounting outsourcing so that they have enough experience in this topic. For this reason, an open discussion of partners is so important that it will reveal the gaps and cause their closure in the course of processes while

negotiating the provisions of the contract [7]. The scope of functions and tasks of the financial and accounting division is so extensive that it is easy to forget about some of the less significant, often administrative functions. This is because of the fact that it is considered too obvious and therefore not worth it. This is due to the fact that parent organizations, analyzing financial and accounting outsourcing, see only the current course of implementation of specific functions and tasks [8].

Transaction costs can be broken down into *ex ante* (i.e. search and contracting) and *ex post* (i.e. monitoring and enforcement) costs [5]. The link between outsourcing contracts' contents and transaction costs is quite straightforward. According to Balakrishnan and Wernerfelt [4]: 'As the number of contingencies in the contract goes up, it becomes more expensive to write, monitor and enforce.' When a contract contains elaborate clauses, *ex post* transaction costs are high because of the expenses involved in:

- ensuring that the vendor fulfils contractual requirements (i.e. monitoring costs);
- enforcing contractual clauses (i.e. enforcement costs) [5].

Thus, the more complex the contract, the more expensive it becomes to manage the relationship with the outsourcing vendor. Interestingly, this link has seldom been tested and there has not been a great deal of change since Williamson [3] observed: 'A common characteristic of (TCE-based empirical) studies is that direct measures of transaction costs are rarely attempted.'

2. 6. Title and conditions for payments receiving services

It is important to precisely specify in the contract the titles and terms of payment for the remuneration for the service provided. A lot of attention is paid to financial matters in the negotiations, however, price negotiations mainly focus on how high the remuneration for the performance of the subject of the contract should be [8]. Routine contractual penalties are also routinely taken into account, which entails incurring additional costs.

The reason for these costs lies in the imperfection of the contract - imprecisely formulated subject of the contract. It turns out that the contracts should contain statements allowing quick indication of responsibility for the state generating additional costs of outsourcing [8].

Most TCE-based empirical studies found that vertical integration is necessary when relevant contingencies are either numerous or unpredictable. Williamson suggests that organizational forms such as outsourcing are very sensitive to environmental uncertainty, which is defined as the inability to predict changes in relevant factors surrounding the exchange. As adaptations cannot be made unilaterally (as with the market) or by fiat (as with hierarchy), changes in outsourcing relationships require mutual consent [3].

When environmental uncertainty is high, outsourcing contracts should be very detailed to make monitoring less difficult and to facilitate adjustments [6]. Elaborate contractual clauses should be built in the contract to permit adjustments as events unfold and to avoid constant renegotiations aimed at reaching mutual consent [7]. More recently, options theory has suggested that higher levels of uncertainty require flexible provisions and lead to complex contracts [9]. Hence, we propose that environmental uncertainty also has a positive impact on contract complexity.

3. CONCLUSIONS

Outsourcing of financial and accounting services is a common phenomenon. Most of the businesses transfer portions of such work to outside suppliers. The vast majority of business entities using outsourcing are satisfied with the level of services offered to them.

A crucial element is the outsourcing agreement, which may never be detailed enough to be able to regulate every single issue in outsourcing. It is postulated that basing only on the contract does not create the basis for properly functioning finance and accounting outsourcing. This is because, in every situation, a smooth transfer of knowledge, relocation of processes and provision of financial and accounting outsourcing services at the expected level should be ensured differently. However, the agreement is a base to which both parties refer in conflict situations, looking for solutions to existing problems or confronting unknown issues. The precisely formulated agreement creates a general framework for the cooperation between partners, but it might not be able to fully ensure the desirable behaviour of individuals who operate to fulfil the content of the provisions contained in the contract.

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