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Outsourcing the Financial Chain: an Empirical Analysis of Sourcing and Partnering Potentials

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ABSTRACT

While many firms have used advancements in information and communication technology to optimize their supply chain and primary processes, there is still a substantial efficiency potential associated with financial processes. In this paper, a conceptual framework for a systematic financial chain management is developed. Based on this, an empirical survey with the Fortune 1,000 enterprises of Germany shows that while outsourcing of the financial chain is still quite rare it can be successfully used to focus on core competencies.

A main finding is that CFOs tend to systematically overestimate the quality of their financial processes and especially the firm's competencies compared to external experts. This is an important cultural barrier to a value redesign that could offer substantial efficiency improvements.

Keywords

outsourcing, financial chain, sourcing partner, competence, e-finance

INTRODUCTION

Many firms have used advancements in information and communication technology to automate their primary processes, to integrate internal systems and to tighten the network of partners transcending the firm's borders and thereby rearranging the entire value chain. But global competition requires a continuous quest for efficiency improvements. Based on an empirical survey with the CFOs of Germany's Fortune 1,000 enterprises, in this paper it is shown that outsourcing as part of a systematic financial chain management can offer a substantial source of value. In contrast to the large body of literature concerned with ex post success factors of outsourcing projects (e.g. Lacity and Hirschheim, 1993; Lancelotti, Schein, Spang and Stadler, 2003; Loh and Venkatraman 1992) we argue that using external process competence as a value source for a firm's financial chain requires, among others, a cultural readiness to accept that a prospective sourcing provider has higher competencies than the firm. We particularly analyze if there is an impact of outsourcing experience on competence evaluation by managers in charge. Our empirical analysis shows that besides technical integration challenges, there are cultural problems in that managers tend to systematically overestimate the quality of their in-house processes and especially their process competencies compared to external providers, thereby establishing barriers to a potentially advantageous value chain redesign.

In the next section, a conceptual model for a systematic financial chain management is developed. It is shown that the financial chain consumes a quarter of the entire IT budget but that CFOs are quite dissatisfied with their financial processes. Outsourcing (parts of) the financial chain could be one solution. Therefore, based on the generic financial chain developed in section 2, we analyze the status quo of financial chain outsourcing and especially the role of competence perception (section

3). Finally, an analysis of different potential sourcing partners reveals in which industries managers see the most promising sourcing allies for their processes.

TOWARDS AN INDUSTRIALIZATION OF FINANCIAL PROCESSES

Given that competition will increasingly occur between networks of enterprises rather than between singular firms (Lambert and Cooper 2000), optimizing the secondary processes can be a source of substantial competitive advantage. “Classical“ Supply Chain Management (SCM) describes the successful philosophy of an integrated planning, execution and fulfilment of physical goods and services production (Ballou, Gilbert and Mukherjee 2000), enabling real time production and avoiding cost and error intense media discontinuities (Sugimori, Kusunoki, Cho and Uchikawa, 1997; Waters-Fuller 1995). While traditional SCM is mainly focused at orchestrating physical and information logistics associated with the primary flow of goods, there is a substantial optimization potential associated with the often neglected financial processes (Phohl, Elbert and Hofmann 2003). Accordingly, the financial flows encapsulated in the financial chain, which is often tightly interconnected with the physical supply chain, have rarely been addressed in the literature as an autonomous source of competitive advantage.

General goal of a systematic financial chain management are cash flow improvements by integrating internal and external software systems. Thereby, the cash cycle can be accelerated, reducing the working capital and the days sales outstanding (DSO), i.e. the number of days between invoicing and payment. How can firms systematically broaden their range of process optimization to also include these important yet secondary processes?

An important trade-off is between developing competencies and designing processes in-house and sourcing processes to external partners. Analogous to the renowned success stories in supply chain management, efficiency improvements only partially result from internal systems integration. This is rather a first step to an overall value chain redesign. The results can be seen in the automotive industry as very open cooperation concepts like continuous replenishment or vendor managed inventories (Fricke, Weitzel, König and Lampe 2002). The research metaphor of industrializing financial processes describes the approach to learn from these successes and transfer and adapt them to the financial chain, i.e. the flow of cash that is associated with all production processes. As in traditional supply chain management, both an efficient application of information and communication technology as well as the managerial readiness to engage in modern cooperation networks are crucial. Technical requirements include systems integration and standardization while organizational challenges result from heterogeneous incentives and different attitudes of partners in cooperation networks. In both areas, again analogous to earlier developments in the primary processes of the automotive, textile or consumer electronics industry, there is a trend leading away from internal and closed towards open strategies. The basic challenges remain the same though. They can be described as the systematic rearrangement of the entire value chain in order to exploit mostly specialization advantages and economies of scale. This can be achieved by selectively sourcing services and products from internal or external providers where service improvement, reliability, scalability and cost reduction result from superior process skills and focus on core competencies.

A GENERIC FINANCIAL CHAIN

To systematically identify efficiency potentials in financial processes, we have developed a generic financial chain (Figure 1). Based on this, an empirical survey discloses important areas to improve upon and helps to understand challenges and obstacles for outsourcing (parts of) the financial chain. In 2003, a questionnaire was sent to the 1,000 largest companies in Germany (according to their revenue; excluding banks and insurers). Prior to mailing the questionnaire, each company was contacted by telephone to identify the chief financial officer to whom the questionnaire was then directly addressed. 103 completed questionnaires were returned (10.3%).

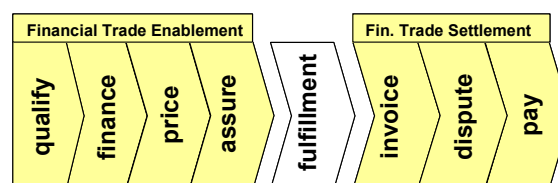


Figure 1: A generic financial chain [Pfaff et al. 2004]

The financial chain (Figure 1) begins with the business partner qualification by checking identity, credit worthiness and solvency (Arkhipov and Yong 2001). Then, the financing modus (e.g. supplier credit, leasing) for the deal is determined, followed by pricing (price negotiation and determination), sales offer and risk assurance (currency risk, transportation risks, credit default risk). After this financial trade enablement phase and the actual fulfillment, the processes of the financial settlement phase include invoice generation, invoice delivery and possibly dispute management (Lander 2001). The financial chain cycle terminates with the customer paying the bill. For a more detailed description of the financial chain see (Pfaff, Skiera and Weitzel 2004). All these processes utilize both internal and external data. For example, as part of the qualification process data from recent customer relations (CRM system) can be used for credit assessment as well as data from external providers (e.g. Dunn&Bradstreet).

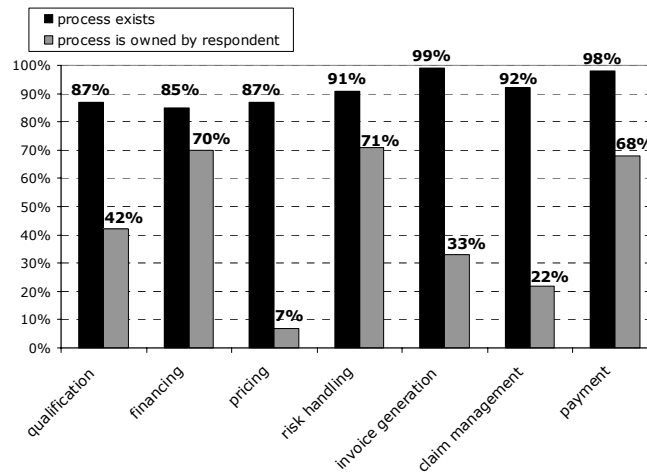


Figure 2: Generic financial chain in Fortune 1,000 enterprises (n=100)

Although the sub processes of the financial chain as described above can be found in almost all enterprises, a look at the process ownership reveals a low extent of process orientation. While the processes exist in 85-99% of the Fortune 1,000 firms, they are surprisingly often not in the responsibility of the CFO. This is a strong indication of a lack of integration of the financial chain. Generally, integration of process activities and extensive IT-support of the entire process are supposed to have a positive impact on organizational performance (Grembergen and Belle 1999; Pollalis 2003). Related Research on business process redesign (BPR) argues that designating an owner for an entire business process is crucial for a successful optimization (Armistead, Pritchard and Machin 1999; Davenport and Short 1990). Our study reveals that firms where many organizational units (instead of one in charge of the financial chain) share financial process operations are significantly less content with their processes (Pearson's correlation coefficient of 0.381 with $p \leq 0.01$).

Analogous to successful supply chain management approaches, an industrialization of financial processes by closely integrating the financial chain seems to be a promising optimization approach. Confirming this hypothesis, the majority of the CFOs (77.1%) considers an integration of the processes to yield a higher optimization potential than an optimization of isolated sub processes. A case study conducted alongside the empirical survey gives an impressive example of the potential of a systematic financial chain management. A large, multinational producer of consumer goods reported that up to 70% of all B2B invoices were (rightfully) complained and returned by the recipients due to price errors. As a result, 30-50% of the entire sales force was solely occupied with dispute management due to wrongly stated prices resulting from a lack of integration of the pricing and invoicing systems (Pfaff, Skiera and Weitzel 2004). Generally speaking, pricing errors are the main reason (83,3% according to Spann and Pfaff 2001) for invoice disputes. And this is a severe problem, as a look at the invoicing volume reveals: the German Fortune 1,000 generate an average of 67.687 invoices in the B2B and 230,294 invoices in the B2C domain every month. Across all industries, 8.24% of all invoices are incorrect with average costs of €128 per dispute.

Costs of the financial chain

The costs associated with financial processes can be substantial. Mostly, they are measured as fraction of overall IT costs. The mean IT budget in the responding enterprises is € 35 million (ranging from € 130,000 to € 1.5 billion). Half of the managers could not precisely explicate the costs for the financial chain. Among those answering, the financial chain consumes 22% of the annual IT budget.

Efficiency of the financial chain: everyone's top

Only 6.1% of all responding CFOs are „fully content“ with their financial chain. About one third is somewhat content. The remaining two thirds are either dissatisfied or indifferent about their financial processes. Also, one out of two CFOs has already identified areas to improve upon. Still, quite surprisingly two out of three consider the efficiency of their financial chain management to be good or very good compared to industry competitors. Despite the common dissatisfaction with the financial chain, only 3.2% consider their own financial chain management to be inefficient compared to industry partners. This overly optimistic self-evaluation can also be found when self assessing the quality of the IT support for the primary processes (supply chain) or of internal data quality.

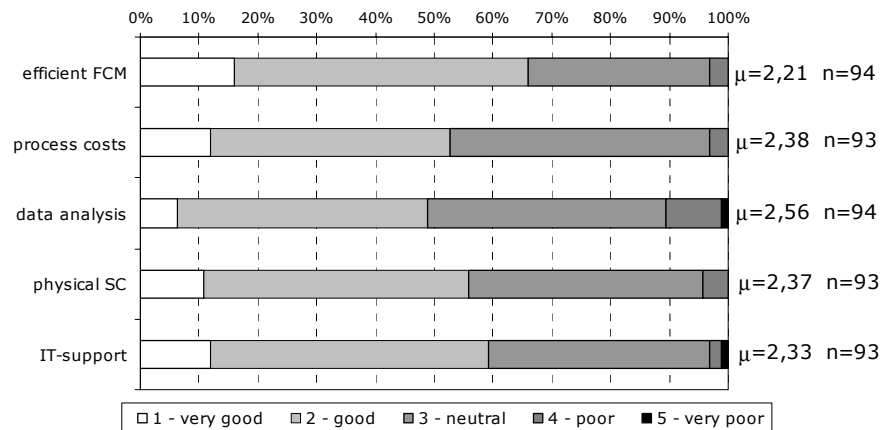


Figure 3: Self-evaluation of firms (compared with competitors of the same industry)

Analogous to the self-assessment concerning the financial chain management, process costs of the financial chain are expected to rank good or very good in an industry benchmark. Especially here, it is surprising to see that only 3.2% of all firms expect to be worse than competitors. Despite the fact that only about one third is explicitly content with the processes of the financial chain, process costs are deemed dissatisfying by only a very small fraction of the CFOs.

OUTSOURCING OF FINANCIAL PROCESSES

The financial chain is usually a secondary process to support a firm's core business (Porter 1985). Therefore, it is rarely designed and optimized to provide a competitive advantage on its own. Secondary processes only account for 23% of all business process reengineering projects, core processes account for 44%, the remaining are business network and management processes (Kallio, Saarinen, Salo, Tinnilä and Vepsäläinen 1999). But outsourcing (parts of) the financial chain to a specialized provider might offer the chance to employ excellent services even for secondary processes. This approach is called business process outsourcing (BPO). In contrast to information technology and infrastructure (IT/I) outsourcing, BPO describes the sourcing of entire processes rather than the infrastructure and resources delivering the services. See e.g. (Lacity, Willcocks and Feeny, 1996) for selective vs. full sourcing.

51.5% of the CFOs consider outsourcing of parts of the financial chain possible. 32.3% answer that selective sourcing is not an option. Those firms that have already identified areas of improvement in their financial chain are more likely to consider selective sourcing an interesting option (Pearson's correlation coefficient 0.292 with $p \leq 0.01$). Less than half of all firms (49.4%) have already evaluated possible outsourcing benefits in the financial chain.

The impact of outsourcing experience on competence evaluation

Besides economies of scale, an important argument in favor of outsourcing throughout the literature is using the higher competencies of the sourcing partner (provider) (Dibbern and Heinzl 2001) or a lack of particular competence in-house, respectively. Since outsourcing can be an important means of improving a firm's value chain with regard to specialization and scale advantages and therefore to utilizing the partners' expertise, the question of the extent of appreciation of that competence becomes crucial for a firm's readiness to redesign its value chain. In the automotive industry, there is the famous saying „don't raise the cattle for your leather seats“, describing the experience that focusing on core competencies and thereby a substantial reduction of the vertical range of integration can be a key source of value. In contrast to these prominent

examples, our empirical study reveals that the CFOs consider the core competence concerning financial chain management to be in-house and are therefore often reluctant to consider outsourcing projects.

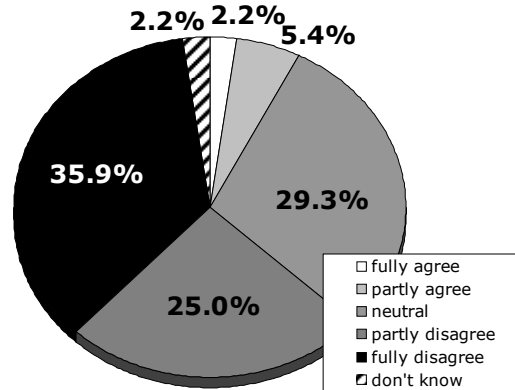


Figure 4: Is the sourcing provider's process competence regarding an optimization of (parts of) the financial chain superior to my own (n=92)?

We wanted to know if former experiences with outsourcing might have an influence on the perception of the competence distribution between outsourcer and provider. For this purpose, we first determined the status quo of BPO in the firms (Figure 5).

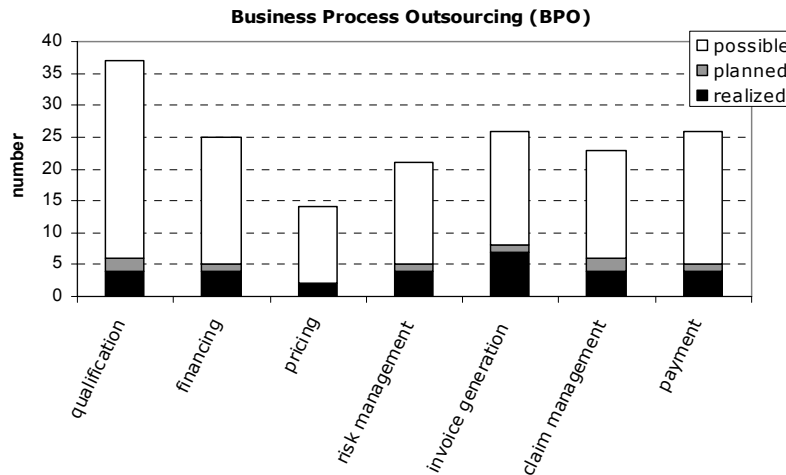


Figure 5: The status quo of financial chain outsourcing in Germany's Fortune 1,000

We found BPO rates (realized/(possible+planned+realized)) between 11% (qualify) and 27% (invoice), depending on the sub process. Operational cost savings associated with the outsourcing of processes of the financial chain are 10.3%. Interestingly, most firms that already had experience with financial chain outsourcing reported these projects to have been successful. According to large parts of the sourcing literature, success was not measured as cost savings realized but rather as the extent of planned cost savings achieved. In no case the achieved cost saving were higher than the planned ones. "Successful" projects were considered those where planned equaled achieved savings. Projects that deviated by 5.6% (on average) were considered "partly successful" while failures performed on average 27.5% below expectations.

In contrast, keeping the processes in-house but using a shared service organization (SSO) to realize economies of scale can be found in 41% (dispute) to 71% (finance) of all responding enterprises, enabling operational cost savings of 13.7%.

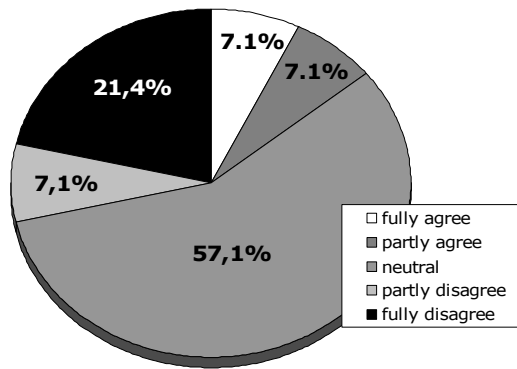


Figure 6: Efficiency of outsourcing of parts of the financial chain (n=14)

Now we can look at the question if the perception of who has the higher competencies changes with outsourcing experience. In fact we find substantial deviations especially concerning the appreciation of the process competence of the sourcing provider. Accordingly, the results from Figure 4 significantly change to a more positive view of the partners' competencies. Only 28.5% of the CFOs *with* outsourcing experience (instead of 60.9% *without*) consider their own process competence superior to that of the provider.

Finding partners for financial chain outsourcing

When outsourcing the financial chain, there is a lot of alternatives regarding the scope (partial sourcing vs. entire sourcing vs. founding a service company) and providers (banks, IT service providers etc.). An interesting question is if certain industries particularly qualify as competent sourcing partner. For financial chain outsourcing, interesting partners are especially banks, other financial service providers, IT service providers, consulting firms and even other firms from the same industry.

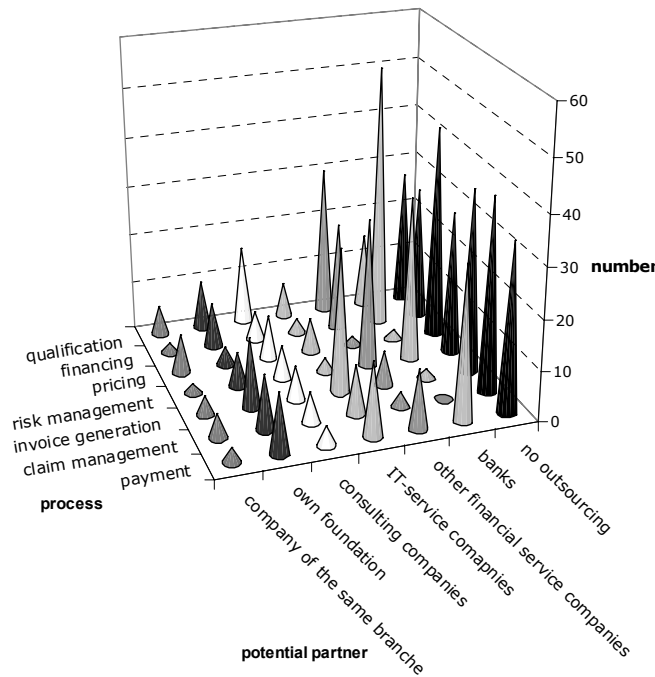


Figure 7: Possible partners for financial chain sourcing (n=103)

For most processes of the financial chain, CFOs prefer keeping the processes in-house. For the qualification process “other financial service providers” are seen as most competent, while for “finance” (54 respondents) and “assure” (33 respondents)

banks are deemed the best partner. Besides keeping it in-house, IT service providers are considered to be the most competent providers of the invoice and dispute process. Not surprisingly, for payment banks are attractive again.

CONCLUSIONS

Outsourcing is a means to utilize core competencies and the scale of operations of external experts to reduce the vertical range of integration and contribute to optimized processes. In contrast to many primary processes that are frequently the focus of optimization efforts, there are substantial efficiency potentials in the financial chain of many firms. A reason for this is that financial processes are rarely seen as a core competence by firms.

Our empirical study shows that outsourcing of the financial chain is still quite rare. Yet, those firms that could gather experience with it mostly report successes and could realize substantial operational cost savings. Depending on the respective sub process of the financial chain, banks and IT service providers could be valuable partners in financial chain sourcing projects. Despite the fact that the financial chain is not a core competence for most firms, the main result though is that CFOs tend to systematically overestimate the quality of their financial processes and especially their competencies compared to external experts. This is an internal cultural barrier to a value redesign that could offer substantial efficiency improvements. Further research will investigate whether the observed cultural difference in estimating the quality of own processes also holds for banks and financial service providers, which were not addressed in this empirical survey.

An important question is how external partners could provide their financial chain expertise as sourcing partners. In a first step, a firm can achieve improvements together with a sourcing partner in a traditional one to one relation e.g. by outsourcing of the invoicing sub process. For example, Deutsche Bank offers an electronic bill presentment and payment solution called db-eBills that covers large parts of the invoicing part of the financial chain which is the sub process with the highest expected optimization potential. Also, supporting our findings concerning adequate sourcing partners, Accenture recently took over global procurement and invoicing from Deutsche Bank. A further redesign of the value chain can be achieved by cooperative sourcing. If economies of scale are sought, i.e. variable costs decreasing with transaction volume, a firm can profit from another firm's transaction if it is cleared on the same platform. These "transaction partners" might well be competitors. An important example of such co-opetition successes is the World Wide Web Consortium (W3C), an industry consortium where firms like Microsoft and IBM jointly develop the standards for the web (e.g. XML). Accordingly, Deutsche Bank and Dresdner Bank are planning to commonly source their payment processes to Deutsche Postbank, indicating that industrial cooperation networks are not restricted to the automotive industry or academic equilibrium models. But to do so, one has to be inclined to accept that specialization also means that there are others better in doing parts of what I am doing.

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