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Financial Outsourcing Risk Analysis from the Perspective of Service Sector

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Abstract **Review Article**

Financial outsourcing is becoming increasingly common in China's domestic market. Suffering from inadequate policy and system, relatively low management level and insufficient professional staffing, however, the market sees that management of relevant firms do not have a clear understanding risks of financial outsourcing, which easily exposes relevant firms to large potential losses. Based on the rapidly developing service industry, this paper reviews the relevant theoretical contents, focusing on risks pertaining to firm financial outsourcing. It analyzes the outsourcing risks involved, and finally proposes reasonable and feasible coping strategies for these specific risks.

Keywords: Financial outsourcing; risk management; risk identification; risk prevention.

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1. INTRODUCTION

In order to gain a foothold in the increasingly complex competition, companies are focusing more on developing their core business, thus choosing to transfer part of their non-core business to external professional organizations, thus booms financial outsourcing.

Broadly speaking, financial outsourcing can be defined as: firms outsource part or all of their financial activities to professional organizations by means of an entrusted contract, with the aim of reducing management costs, improving competitiveness and achieving increased corporate value. The underlying theory supporting outsourcing are rooted in (1) core competence theory, which defines outsourcing as the effective means to enhance the core competence; (2) transaction cost theory, which argue that one of the goals of outsourcing is to reduce overhead costs, reduce corporate expenses, and increase productivity and operational efficiency. For the outsourcing service provider, focusing on a specialized business will result in lower costs through economies of scale. This is certainly a "win-win" option for both sides of the outsourcing contract.

With in-depth development of financial outsourcing business, contents of outsourcing is also gradually expanded, and the common financial outsourcing mainly includes employee compensation, taxation, financial reporting, and accounts receivables. However, when companies switch to outsourced financial business, they also pose many risks that cannot be completely eliminated per se, but rather take steps to control them effectively. This paper then attempts to put forward effective alternatives to control financial risk in specific industry.

2. LITERATURE REVIEW

Lankford and Parsa (1999) suggest firms should consider outsourcing when certain support functions can be completed faster, cheaper, or better by an outside organization. This suggestion is obviously is in line with the theory of comparative advantage. Tas and Sunder (2004) states that offshore outsourcing yields significant opportunities for improving flexibility and making fixed costs variable for financial service industry in a difficult market environment. Klimovets (2015) also puts financial outsourcing up to be one of the commonly accepted instruments of corporate strategy implementation as it is the stimulate force in developing and enhancing competitive advantage. As for the risk inherent in the outsourcing, Belcourt (2006) points out that many of the benefits of outsourcing are not being fully realized, while transferring expertise and insider knowledge to the providers will be risky. Abdullah and Verner (2012) builds a conceptual risk framework for identifying outsourcing risks in IT system development from the client's perspective, and they conclude that the risks include complexity and the team. However, there is still a lack of research on

financial outsourcing risks. On the other side.

Ren and Liu (2010), Sheng et al. (2012), Zhou and Jiang (2012), Wan (2013), Yin (2017) and Qin (2019), respectively, proposed some measures for risk identification, management and control, but in general, the study of financial outsourcing risks still needs a more systematic and targeted in-depth research.

3. Financial outsourcing risk recognition

Risk management means identifying and analyzing risks and finding various feasible solutions to minimize the risks at the lowest cost and reduce the possible losses suffered by the firm. To prevent firm from risks of financial outsourcing, the possible risks should be identified in the first place.

3.1 Financial outsourcing risk identification methods

(1) Flowchart analysis method

Based on the sequence of each financial outsourcing decision and implementation within the firm, each link is drawn into a flowchart according to its chronological order, in order to analyze the problems and propose the risk points, and finally complete the identification of financial outsourcing risks. The following flow chart illustrated the process is shown in Fig.1.

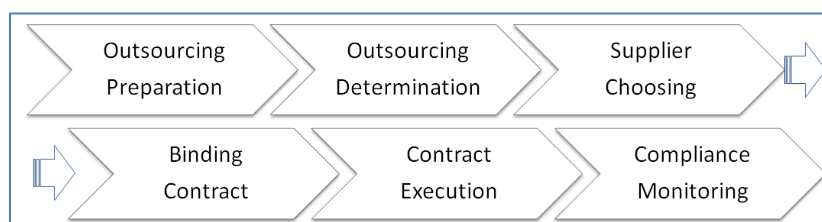

Fig-1: Financial outsourcing flow chart

(2) On-site comparison method

On-site comparison method is the relevant personnel of the enterprise to observe and examine the project on site to get more realistic results. Using this method to identify outsourcing risks requires advance preparation, such as investigation time and personnel arrangements, identification of key investigation targets, prediction of potential risk points, etc. Conducting on-site investigation can get more realistic answers and can effectively monitor the services provided by the service provider to the enterprise to ensure the smooth operation of outsourcing business.

3.2. Financial Outsourcing Risk Checklist

The most important thing to improve the level of awareness of financial outsourcing risks among firm managers is to be able to identify potential risks based on an accurate understanding of the possible causes of a particular risk. The possible risk factors of financial outsourcing are:

(1) Financial outsourcing decision mistakes

If a company makes decisions that are not in line with its current development status and future strategic goals, it will deviate from its firm goals, which then leading to financial outsourcing risks。

(2) Service provider selection risk

The quality of outsourcing services is not only affected by the professional ability of service providers, but also limited by their management level, performance ability and ethical philosophy, so multiple issues need to be considered in service provider selection. Identifying this risk can be carried out from the causes of risk generation, either by taking the on-site comparison method, arranging professionals to conduct the activity to find out whether there are risky matters and potential risk factors; or from the financial outsourcing process, if the firm decision fails to fully consider the standards expected to be set, making the selected service provider unable to meet the needs of the firm, then there will also be risks during the process.

(3) Information data security risk

In the case of high level of information technology, the implementation of financial outsourcing may cause the financial information of the firm to be easily perceptible by the competitors, which may bring threats to the business management of the firm and cause great losses. Information data security risk mainly occurs in the process of implementing the agreement, providing the required financial information to the service provider and the financial data prepared at a later stage is prone to be easily leaked. This risk factor is mainly identified through the flowchart analysis method. There is the possibility of risk occurring in all the procedures involving important information of the firm.

(4) Financial outsourcing quality risk

The quality of the work of the service provider affects the quality of financial outsourcing. Generally, it is difficult to identify the quality risk of financial outsourcing, mainly because firms often ignore the inspection of the quality of their work after choosing the service provider and blindly believe in the quality of the work results of professional providers, thus making the higher probability of the occurrence of this kind of the quality risk. The identification of this risk type requires on-site observation of the work of the provider and its state of communication with the firm, to determine the degree of significance and understanding

of its own services, so as to identify whether there are factors that cause this risk to occur.

(5) Over-reliance on service providers

Dependence on the service provider is an issue that is considered only after the implementation of financial outsourcing. This risk factor can be identified when the partnership is established, and it is necessary to determine the arrangement of the business model of the firm after the responsibilities transfer, and if there is an obvious motivation to reduce or eliminate a certain financial function, it can be determined that the reasons for the occurrence of this risk already exist.

(6) Inadequate performance monitoring risk

Some firms lack management and control of outsourced finance, which is reflected in insufficient monitoring, incomplete monitoring or ineffective implementation of monitoring, thus generating financial outsourcing risks. Supervision of financial outsourcing is the last resort of the financial outsourcing process, and the risk of inadequate monitoring is easier to identify.

4. Financial outsourcing risk analysis

Risk analysis is to further analyze the possibility of risk occurrence and the degree of impact on the expected target after specific risks are identified. Through the results of risk analysis, the risk points that should be focused on during the implementation of financial outsourcing projects can be identified, and the work of prevention beforehand, control during the event and handling afterwards can be properly performed.

4.1. Financial outsourcing sub-divisional risk

The analysis of sub-divisional risks can usually be performed using risk assessment map. Risk assessment map require a combination of professional expertise and past information to derive information about the probability of risk occurrence and the degree of deviation from expected objectives, and to identify the key risk points for financial outsourcing. By drawing the assessment map, multiple inherent risks can be visualized, the priority risk points can be identified and a reference for developing targeted strategies can be documented. According to the characteristics of the service industry, the probability distribution of occurrence and the degree of impact of financial outsourcing risks can be derived as shown in Fi.2.

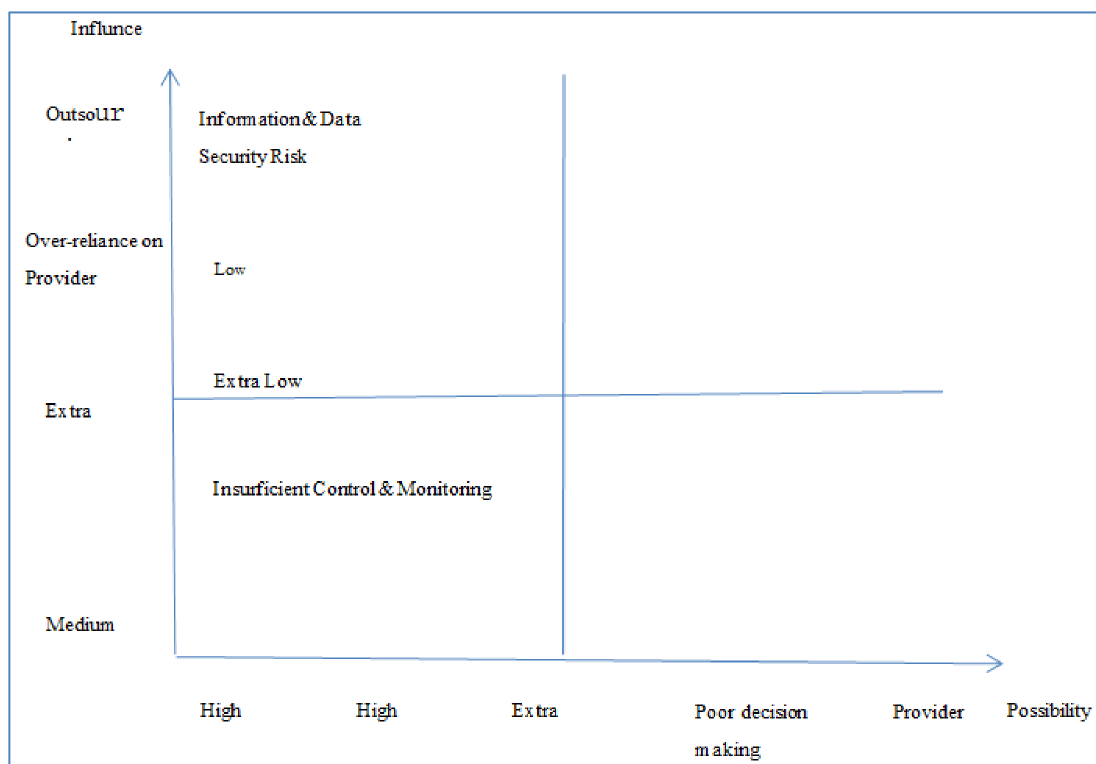

Fig-2: Financial outsourcing risk assessment

4.2. Causes of the risk

For the firms anchored in the line of service, the main business of some firms is divided into off-season and peak season. When the business is busy, they choose to outsource the corresponding financial work to professional organizations, while keeping the corresponding financial personnel, which can ensure the integrity of financial work, reduce the cost brought by the increase of business, and also avoid the over-reliance risk due to the reduction of their own financial capacity. Because of the immaturity of the domestic financial outsourcing market, firms should also make adequate preparations before making decisions to avoid poor decisions due to lack of experience and

consideration, on the other hand, firm managers should dedicate to increasing risk prevention measures, i.e., to improve the qualification standards of service providers before the implementation of decisions to reduce the risks caused by the lack of business ability or moral hazard of the provider. All the above factors will aggregately produce lower risk of financial outsourcing quality, service provider selection and poor outsource decision, which are located in relatively low risk areas in the assessment map as shown in Figure 2. However, for the service industry firms who place emphasis on its domestic business and unintentionally ignore the supervision and lack of professional guidance on outsourcing activity, the occurrence possibility of insufficient monitoring is higher, which enlarge its risk and location on the assessment map. Similarly in the case of less control, ineffective or inadequate monitoring over the financial data in the firm, the information is highly likely to be obtained by the competitors or revealed by the service provider, thus the risk of information security occurs to be higher, which affects the firm reputation and operational activities, as shown on the map.

4.3. Impact of outsourcing risks

The degree of risk impact is specific to a particular firm goal, and the occurrence of risk will prevent the business from achieving the expected set goals and have different degrees of impact on the production and operation of the firm. Poor financial outsourcing decisions will cause more resource waste and deviation from the achieving firm goals. Inappropriate choice of service providers will risk the inability to fulfill its obligations in a timely manner, which will ultimately affect the progress of the firm business. Information data leakage will make employees lack trust in the firm, and even generate conflicts between the firm and employees and between employees, and may also cause external stakeholders to break off cooperation with the firm, ultimately reducing the firm value. Low quality of financial outsourcing can directly affect business decisions or deteriorate the relationship between the firm and its partners with far-reaching effects. This will result in mistakes that are difficult to correct right from the very start of the business. Poor quality data may also terminate the relationship or lose the trust that has been established among cooperation, which will have a greater impact on the normal operation of the firm. Over-reliance on outsourcing service providers of those firms may affect the progress of their work, leading to inefficient work and unsustainable cooperation. If a firm lacks monitoring of outsourcing, it cannot obtain accurate information in a timely manner, and at the same time cannot effectively restrain the behavior of service providers. Obviously, the above-mentioned risks have a profound impact on firm.

4.4. The overall risk of financial outsourcing

The overall risk of financial outsourcing can be analyzed and determined by using the expert survey method or determining the overall risk level. Making full use of the expertise of experts facilitates the implementation of financial outsourcing risk management. In addition, management can determine the overall risk level of financial outsourcing by judging the opinions and criteria provided by experts on the basis of individual grading of each risk, and provide a basis for its later management to determine whether this outsourcing should be executed and the level of attention that should be put on the risk if the outsourcing is performed.

5. Response and countermeasure to financial outsourcing risk

Business managers can choose to use one or more combination of strategies or solutions according to their own conditions to keep the risk within the business tolerance.

5.1. Risk Avoidance Strategies

The main risk-averse strategy for such companies is to give up entering this market. In addition, for firms that adopt financial outsourcing, the degree of risk impact varies depending on the firm’s ability. If a risk beyond the firm’s tolerance occurs, the firm must choose to abandon the implementation of the decision, if necessary, based on its current business situation and financial ability.

5.2. Risk Reduction Strategy

Making efforts to reduce outsourcing risk to be tolerable can be done by carefully selecting outsourcing service providers, reserving and training finance staff, formulating detailed outsourcing contracts, enhancing communication between the two partners during the outsourcing process, and strengthening the supervision on service providers.

5.3. Risk sharing strategy

Risk sharing is regarded as an effective mechanism for most firms who are eager to reduce risks. The more common way to share the risk of financial outsourcing is to make a strict outsourcing contract, which can not only stipulate the obligations of both parties, but also transfer the responsibility of taking risks to the other side by setting up protection clauses. In addition, the purchase of insurance to share the risk is a common way to share the risk in China, where the company pays a certain amount of money as premium to transfer or share the risk with the insurance company.

5.4. Risk tolerance strategy

If the impact of the risk is low, the enterprise may choose to bear the risk itself. From a cost-benefit perspective, if the cost of taking action is higher than the loss of undertake the risk, the firm will prefer to

assume the risk that is within the firm's tolerance and to make decisions that are more beneficial to the firm's interests.

6. CONCLUSION

Although China's financial outsourcing market has just started, the progress of the times has brought great opportunities for financial outsourcing, both in terms of policy, economic environment and culture, and service providers are developing rapidly with the support of the general environment. Proper use of financial outsourcing can not only reduce costs and focus on core business development, but also seize growth opportunities for the outsourcing firms.

But whether to implement financial outsourcing also needs to be combined with their own development position, to make well awareness of the symbiosis of opportunity and risk, reduce the negative impact companying the risk. To this end, the first task of the firms is to correctly understand the risks of financial outsourcing, appropriately take advantage of financial outsourcing, improve the ability to deal with risks, and jointly promote the healthy development of financial outsourcing.

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