

# Going out gets more expensive

Tighter accounting regulations will make it costlier to use outsourced service providers, says Luvisa Rains

**Since the WorldCom and Enron accounting scandals hit the headlines earlier this year, a great deal of attention has been paid to how large companies produce their accounts. These and other recent industry events have led analysts, auditors and regulators to examine how outsourcing providers book the revenue from large deals and their accounting practices.**

Ultimately, the customers of these companies will feel their effects. Only time will tell what impact WorldCom's collapse, for example, will have on the IT and telecommunications sectors. But outsourced services are likely to become more expensive.

"Outsourcing" can generally be described as the transfer of responsibility for providing an internal business function or service to an external service provider. This often includes the transfer of the infrastructure, assets, staff and contracts necessary to provide the service.

It has traditionally been considered an effective tool for financial engineering. Various outsourcing models can be used to create balance sheet "improvements" for customers. This has obvious appeal. For example, the financial incentives alone for customers can include reduction of capital expenditure, transferring the risk to the service provider and changing fixed costs to variable costs.

At the moment, organisations can outsource in a number of ways. They may use a "traditional cost-plus service fee" model, in which the outsourced service provider charges the customer the cost of providing, say, cleaning services, plus an agreed profit margin. This is often expressed as a pre-determined unit cost for certain services.

A "benchmarked fee" involves setting charges according to current market prices, as determined by an independent assessor.

In a "shared risk and reward" deal, the service provider is paid if it meets agreed performance targets. The principle of this model is to give outsourced service providers incentives, and to reduce or contain the upfront costs and risks to the customer.

Joint ventures and special purpose vehicles are the ultimate risk-reward model, as the outsource service provider and customer are willing (usually on a long-term basis) to operate as partners or co-investors.

This involves setting up a jointly owned company that provides the services back to the customer, while the latter gets a share of the profits. In joint ventures, the customer also gets the opportunity to share in the profits made from other customers.

The final model, "sale and buy or lease back", involves selling the customer's IT infrastructure (or other) department to the outsourced provider as a going concern. The customer continues to buy its services (on one or more of the bases set out above) from the sold-off department.

It seems inevitable that regulators will focus on the implementation of more stringent accounting standards. In turn, these changes will increase the cost of outsourcing to customers.

## General regulations

The US has rules that regulate when a company can book revenue in its accounts (called revenue recognition). These rules are set out under the generally accepted accounting principles (GAAP). As a consequence of the WorldCom and Enron scandals, investors, analysts, auditors and regulators are now focusing on these accounting principles. The rules on revenue recognition are tightening.

Also, the European Union has just implemented regulations to adopt GAAP. Its objective is to have industry-wide global standards for revenue recognition by 2005.

The impact of these stricter accounting standards on the outsourcing sector is that some of the financial models referred to above will not be commercially workable any more.

For example, in the risk-reward model, when will a service provider be able to book revenue if it is subject to targets that cannot be determined yet? The revenue will not be recognised until all of those conditions have been met. This sort of deal will be expensive to outsourcing service providers.

They will look to employ new business and financial models in their large outsourcing contracts, or to adaptation of existing models, or both.

These changes are already hitting service providers' revenue. For example, EDS, one of the world's largest outsourced service providers, recently saw its share price plummet after not meeting its third-quarter revenue forecast (partly because it couldn't book revenue it had anticipated).

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Service providers will look at new ways of financing deals, including joint venture and special purpose vehicles (where the joint venture partner may provide capital), and obtaining funding through securitisation.

In this context, securitisation would involve the service provider granting rights and benefits under long-term contracts to a bank or a financial institution in return for finance (from which capital expenditure is then funded).

Customers will need to rethink the basis for outsourcing certain services and functions. Historically, one of the principal reasons why companies have outsourced has been to cut costs and to change their cost structure (by reducing capital expenditure, for instance).

But these may no longer remain primary drivers to outsource because they will cost too much. Using contracts to provide large key customers with cheap financing (through the use of financial engineering) may become less common.

The risks involved in entering into long-term deals that adopt those models may become too high for outsourcing service providers. In the future, the business drivers for outsourcing from a customer's perspective seem likely to be as much about making efficiencies and concentrating on core business functions as they are about cutting costs.

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