

## **Accounting Functions Outsourcing and SMEs: Empirical Evidence from Iran**

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### **Abstract**

*The purpose of this paper is to examine the factors that influence the outsourcing of accounting functions in Iranian manufacturing small and medium enterprises (SMEs). Using transaction cost economics (TCE) and resource-based theories, results from a questionnaire survey of 658 SMEs show that outsourcing of accounting functions is positively associated with trust of the SME owner/manager in an external accountant. In addition, the technical competence is positively and significantly related to outsourcing, but firm size was not supported in our sample.*

**Keywords:** *Outsourcing, External accountants, SMEs, Resource-based theory (RBT), Transaction cost economics theory (TCE)*

## **1. INTRODUCTION**

Small and medium enterprises (SMEs) play a significant role in emerging economies (IFAC, 2006). For example, SMEs encompass ninety percent of all enterprises in Iran (Bayati and Taghavi, 2007). In effect, they have an important role in the development of the Iranian economy (Bayati and Taghavi, 2007). Indeed, most SMEs tend to fail because of lack of planning, knowledge, absence of overall managerial skills, competencies and capabilities (Dyer and Ross, 2008). By relying on outsourcing, SMEs can obtain the capabilities and competences they require from external service providers (Gilley et al., 2004). Consequently, the presence of outsourcing practices has provided an option for SME survival (Jayabalan et al., 2009). In fact, activities in which the companies lack the necessary resources or capabilities internally can be outsourced (McIvor, 2009). In general, transaction cost economics (TCE) theory would point out that outsourcing by smaller firms should produce lower costs (e.g. employment, payroll and training) than when those functions are performed in-house because smaller firms lack the competences that result from scale and experience effects (Gilley et al., 2004). Additionally, the resource-based theory (RBT) indicates that the limited capabilities and competences of smaller firms make it necessary for them to obtain resources from external sources (Hadjimanolis, 2000).

Accounting functions are shown to have significant roles in SME environment nowadays, but most SMEs face problem in dealing with their accounting tasks (Jayabalan et al., 2009). For example, SMEs lack expertise and accounting knowledge because the accounting functions not only require knowledge of generally-accepted accounting rules, but also need that one knows how to utilize the rules in a company environment (Marriott and Marriott 2000; Everaert et al., 2006; Jayabalan et al, 2009 ). In actual fact, most SMEs lack resources to permit accounting functions to be conducted in house (Doing and Gooderham, 2005). Hence, SMEs are more vulnerable than larger firms (Gooderham et al, 2004). Indeed, in large part this vulnerability is explained by RBT in the sense that SMEs lack the necessary competencies for survival (Gooderham et al, 2004). Therefore, outsourcing of accounting services can add value through the higher quality available from external sources, in particular external accountants (Gilley et al., 2004). By outsourcing functions or tasks, SMEs would be able to focus on the value-creating functions that drive competitive benefit (Gilley and Rasheed, 2000; Jiang and Qureshi, 2006). In fact, accounting function outsourcing is an option for SMEs so as to sustain a competitive benefit in the business environment as

outsourcing could reduce the burden suffered by SMEs (Jayabalan et al., 2009). Consequently, external accountants can assist SMEs operating in a competitive environment, to incorporate operational considerations within long-term strategic plans (Ismail and King, 2005). For example, external accountants carry out a number of roles in the SME community: they not only offer accounting services, but also prepare advisory services for a variety of broader business management issues (Marlow and Carter, 2005).

The studies in SME context with respect to outsourcing of accounting functions are growing (Everaert et al., 2008; Everaert et al., 2007; Doran, 2006; Carey et al., 2006; Gooderham et al. 2004), but limited research is conducted in developing countries (Jayabalan et al., 2009). Therefore, empirical evidence from studies on developed countries may not be as relevant to developing countries such as Iran (Mashayekhi and Mashayekh, 2008). Developing economies such as Iran are very different from those of developed economies particularly the extent and type of the government interventions on accounting issues (Ismail and Zin, 2009; Ismail and King, 2006). Therefore, this study has attempted to shed light on the factors that influence outsourcing by applying resource-based theory (RBT) and transaction cost economics (TCE) theory using a sample of Iranian manufacturing SMEs. Consequently, the main question can be stated as: what are the factors that determine whether an Iranian SME will outsource its accounting functions? The rest of the discussion is arranged as follows: Section 2 provides the background of study and develops hypotheses utilizing the resource based theory (RBT) and transaction cost economics theory (TCE) to guide the framework to investigate the outsourcing of accounting functions. Section 3 explains the research method. Section 4 presents the findings and discussions the implications thereon. Section 5 concludes with suggestions for future research.

## **2. BACKGROUND OF STUDY**

### **2.1 Outsourcing**

Outsourcing is usually explained as the contracting with an external party to provide services or activities that could be provided by an internal source (Carey et al., 2006). On one hand, the process of outsourcing includes the 'external accountant,' comprising both the professional accountant and the accounting firm (Everaert et al, 2008). On the other hand, the process of internalizing involves the 'in-house accountant' who is the employee performing the accounting functions in the SME (Everaert et al, 2008).

### **2.2 Professional accountants in Iranian SMEs**

After privatization in 1991, financial reporting has gained significance in Iranian businesses due to international pressures from the World Bank and the International Monetary Fund regarding privatization (Mashayekhi and Mashayekh, 2008; Mirshekary and Saudagaran, 2005). Therefore, the need for financial information and auditing the accounts of companies has been enhanced after privatization of economic entities (Mirshekary and Saudagaran, 2005; Salehi and Azary, 2008). To satisfy this need, the Iranian Association of Certified Public Accountants (IACPA) was established in 2001 as an independent professional body (Mirshekary and Saudagaran, 2005). Professional accountants play a significant role in the Iranian economy. This is more significant for SMEs because they constitute over ninety percent of enterprises of Iran (Mirshekary and Saudagaran, 2005).

### **2.3 Accounting functions in SMEs**

In Norway, Gooderham et al. (2004) investigate factors associated with small firms relying on their external accountant as a business advisor and they suggested that most small firms rely on their external accountant as business advisor. Furthermore, in UK, Sian and Roberts (2009) find most of small firms outsourced accounting services including financial statements, tax or VAT information and accounting system. In Malaysia, Jayabalan et al. (2009) find the types of accounting functions outsourced are based on the standard

functions which include bookkeeping, accounts receivable, accounts payable, financial reporting, management reporting and tax filing. Moreover, in Belgium, Everaert et al. (2007) reveals that more than half of the SMEs use a combination of outsourcing and insourcing of accounting functions, while 35 percent of the SMEs use only in-house accountants' services and 12 percent use total outsourcing of accounting services. In Australia, Carey et al. (2006) find 45.5 percent SMEs outsource some or all of their internal audit functions. In the UK, Berry et al. (2006) find 85 percent of small enterprises used their external accountant as a source of advice. In the UK and Canada, Blackburn et al. (2006) report that SMEs use accountants more than any other single source as their main provider of advice in relation to dealing with their regulatory obligations. In Australia, Carey et al. (2005) find 67 percent of SMEs use external accountants as a source of professional services and also indicate that there is room for external accountants to enhance the amount of advisory services to SMEs. Whilst these studies are conducted in more developed countries, literature on role of professional accountants in emerging economies or lesser developed economies such as Iran is not evident except for a limited research in Malaysia (Jayabalan et al., 2009).

#### **2.4 Theoretical framework and hypotheses**

Two important theories that influence outsourcing are transaction cost economics (TCE) theory and the resource-based theory (RBT) of the firm, in particular in the SME environment (McIvor, 2009). These two theories are concentrating on two different issues. The TCE indicates the functions that are not company-specific should be outsourced, while the RBT suggests that functions not significant to core competencies must be outsourced (Gilley et al., 2004). In general, concentrating on and developing certain capabilities is central to the RBT that indicate what functions (tasks) should be conducted in-house and what ought to be outsourced (McIvor, 2009).

##### *2.4.1 Trust of the SME owner/manager in an external accountant*

The notion of trust is usually related to one party having confidence in another and this often implies some degree of alignment between relevant value systems (Blois, 1999). Everaert et al. (2008) define trust in the external accountant as the expectation of the owner/manager that the accountant (1) can be relied upon to fulfill legal obligations, (2) will behave in a predictable manner, and (3) will act and negotiate fairly when the possibility for opportunism is present. The transaction cost economics theory (TCE) framework has been extended by adding personal characteristics, such as top management's trust in its service provider (Brouthers and Brouthers, 2003; Gilley et al., 2004; Everaert et al., 2006; Everaert et al., 2008). Kim et al. (2007) suggest that trust is key significant driver affecting the intention of adopting business process outsourcing. Bennett and Robson (1999) in the UK find that the decisions made about assistance are not only related to the type of issue but also the level of perceived trust between the supplier of assistance and the SME client. Therefore, Bennett and Robson (1999) suggest that external accountants are in a position of high trust with their clients. It is notable that they indicate that accountants are as "high trust" providers because accountants work within a government-backed self-regulatory framework and achieve a high level of institutional trust. For instance, the trust placed in accountants would appear to arise from their accredited, professional position within the community and from frequent interaction (Marlow and Carter, 2005). Everaert et al. (2008) find that the owner/manager's level of trust in the external accountant was significantly associated with outsourcing of accounting services. Bachmann (2001) obviously indicates that the SME's decision to outsource accounting services is not only based on the characteristics of the transaction, but also is influenced by the interpersonal trust of the owner/manager in the service provider.

Hypothesis 1: The greater the trust in the external accountant, the higher propensity that outsourcing is used.

#### *2.4.2 Technical competence in accounting services*

One of the objectives of the RBT is to help owner/managers to realize why competences can be perceived as a firms' most valuable asset and understand how those assets can be used to improve firm performance (Caldeira and Ward, 2003). SMEs outsource the functions that are not core competences, and concentrating on activities included in the core competences can enhance firm performance (Gilley et al., 2004; Espino Rodríguez and Padrón-Robaina, 2004). Attributes of technical competence of an accountant include appropriate qualifications and experience, essential specialized skills, industry specialization and technological expertise (Carey et al., 2006). The largest parts of SME owner/managers have no professional, management and other formal qualifications (Stanworth and Gray, 1992). Indeed, external accountants' services to their SMEs can include a range of competencies providing an important source of competitive benefit (Gooderham et al., 2004). One possible way for a smaller firm to obtain competencies is to utilize qualified persons (Gooderham et al, 2004). Therefore, by relying on outsourcing, smaller firms can obtain the competence they need from external service providers (Gilley et al., 2004). Moreover, the reliance by SMEs on external accountants is indicated to be a result of the perceptions of SMEs that external accountants are competent and able to provide a value-for money service in providing accounting services (Leung et al, 2008).

Many of SME owner/managers lack financial skills and knowledge of how financial control systems might be utilized to aid decision-making (Deakins et al., 2001). For instance, the functions involved providing advisory services on internal planning, decision-making and control, that is, in areas where a SME owner/manager often lacks competence (Gooderham et al, 2004). Hence, SMEs rated very highly the technical competence of external accountants concerning regulation matters (Blackburn et al, 2006). For example, the competence of external accountants providing professional services are also rated highly, but not to the same level as for accounting services (Carey et al. 2005). For example, Gooderham et al (2004) find that technical competence of the external accountant were positively associated with the utilization an external accountant as a business advisor. It is predicted that perceptions of external accountants' technical competence will influence the decision to outsource accounting tasks (Carey et al., 2006). Consequently, the earlier arguments are summarized in the following hypothesis:

Hypothesis 2: The stronger the perception that external accountants are more technically competent concerning the delivery of accounting activities than in-house accountants, the greater the propensity for outsourcing of accounting functions.

#### *2.4.3 Firm size*

One important characteristic of smaller firms is that they rarely have the resource to allow accounting functions to be carried out in house (Doing and Gooderham, 2005). Therefore, RBT explains that the use of external support and professional services interacts with the size and age of the firm (Bennett and Robson, 2003). For instance, smaller and younger businesses are likely to have more limited internal resources than larger companies (Johnson et al., 2007). Consequently, small firms seek external assistance from accountants (Doing and Gooderham, 2005). In addition, TCE theory influences firm size via economies of scale whereby smaller firms are shown to have lower frequency of activities than larger enterprises (Carey et al., 2006). For example, smaller firms have greater difficulty to create economies of scale, and cannot have any justification for adopting in-house facilities and enhance outsourcing alternatives (Carey et al., 2006). Empirical studies suggest that the use of professional and support services is positively associated with size of the firm (Johnson et al., 2007). For example, using univariate method, Johnson et al (1998) indicate that the utilization of business services and advice by SMEs is positively related to firm size. Additionally, Robson and Bennett (2000) find that firm size is a key variable influencing using

external support services. Indeed, this is corroborated by Boter and Lundstrom (2005), using multivariate techniques.

Similarly, Dyer and Ross (2008) report that age and size of the firm have an effect on seeking for information and support services. Conversely, Gooderham et al. (2004) find that the sourcing of professional services from external accountants to be unrelated to firm size in the SME environment. Mohan-Neill (1995) shares this view, indicated that younger and smaller firms utilize less market information when they make decisions. That is why the new and smaller firms have a limited financial and human resource, which makes collecting information a difficult task (Mohan-Neill, 1995). However, outsourcing provides SMEs with the opportunity to utilize accountants' services at a cheaper price (Carey et al., 2006). For example, smaller firms choosing to outsource can shun the high set-up costs of an in-house accounting department (Carey et al., 2006). Although large firms might also benefit from the intrinsic efficiencies of an external accountant, the comparative benefit of the external accountant is likely to lessen as the firm size increases because larger companies have greater capacity to get cost efficiencies via economies of scale from an in-house facilities (Carey et al., 2006). Therefore, based on the prior discussion, this study tests the following hypothesis.

Hypothesis 3: The smaller the firm, the greater the propensity for outsourcing of accounting functions.

### **3. METHODOLOGY**

#### **3.1 Data collection**

In this study, the population comprising of SMEs in the range of less than 250 employees in the context of Iran derived from UNIDO (2003), and we excluded micro-firms with fewer than 10 employees because micro enterprises hardly have any option between outsourcing and insourcing of accounting functions (Everaert et al, 2008). Therefore, the population of this study takes in all manufacturing SMEs of Iran because manufacturing SMEs are highly important in view of generating both manufacturing value added and exports in the context of Iran (UNIDO, 2003). A sample of 1150 manufacturing SMEs was generated randomly, using a stratified random sampling approach. We first selected the SME list and then sent the questionnaires to every SME owner/managers that were listed in a directory of manufacturers. Therefore, we received 770 questionnaires and finished up with 658 usable answers, representing an effectual response rate of 57 percent.

#### **3.2. Measurement of the variables**

##### *3.2.1 Trust of the SME owner/manager in an external accountant*

Trust in accountant is developed by Everaert et al. (2008), and this variable has four dimensions including (1)The owner/manager has confidence that the external accountant will treat fairly, this means to correctly charge for the performed duties, (2)The owner/manager has confidence that the external accountant will inform correctly, (3)The owner/manager has confidence that the external accountant will accurately perform the duties, and ( 4) The relationship between the owner-manager and the external accountant is based on trust. Accordingly, the respondents were asked how much they trust their external accountant. Ranking on a 7-point Likert scale (1- totally disagree, 7-totally agree). This item scale exhibited a sufficiently high Cronbach's alpha ( $\alpha = 0.88$ ).

##### *3.2.2 Technical competence*

Technical competence derived by Carey et al. (2006) includes six items (Specialized industry wide knowledge, expertise in internal control, experience and qualifications, depth of understanding of client organization, expertise in computerized information systems (CIS)

accounting and auditing, expertise in risk management). Therefore, for measuring this variable, respondents were asked to indicate degree to which the firm perceives its external accountant has technical competence to source accounting functions in each item, using 7-point Likert scale where 1= lowest score and 7 = highest score. The measurement of the variable displayed an adequately high Cronbach's alpha ( $\alpha = 0.90$ ).

### 3.2.3 Firm size

For measuring firm Size in this study, we used the number of employees similar to Audet and St-Jean (2007). The participants are asked how many people work in the business. Respondents were provided with six categories.

### 3.2.4 Outsourcing

In this study, accounting functions (tasks) include bookkeeping, interim reporting, period-end accounting, preparation of financial statements, product/services costing, budgeting/forecasting, customer profitability analysis, financial planning, management accounting, non-statutory audit, tax consultancy, business advice, management consultancy, financing advice and IT consultancy that a firm needs and are applicable in Iranian SME are similar to that derived from Everaert et al. (2007), Doran (2006). Hence, for measuring outsourcing of accounting functions, we used the measurement developed by Espino-Rodríguez and Padrón-Robaina, (2004), respondents were asked to indicate the level of outsourcing of the accounting tasks on a 7-point Likert type scale, with 1- not outsourced and 7-totally outsourced. The measure of outsourcing was found to have acceptable reliability in the sample (Cronbach's  $\alpha = 0.91$ ).

## 4. RESULTS

### 4.1 Descriptive statistics

Our sample included 658 SME owner/managers, 79 percent male and 21 percent female. Most of the respondents were quite well educated, and 89 percent of them had a university graduate degree. For example, 87 percent of them had a university undergraduate degree and 13 percent postgraduate degree. The overall level of managerial experience was high with nearly three-fourth of respondents having over five years of experience, and 68 percent companies employed between 10-50 people, and 32 percent of the firms employed more than 50 people (less than 250).

Table1: Descriptive statistics and correlations

Variables	Mean	S.D.	1	2	3	4
1. Outsourcing	59.10	24.145	1			
2. Trust	22.106	5.695	.465**	1		
3. Technical Competence	30.612	8.616	.485**	.564**	1	
4. Firm Size (number of employees)	2.79	1.424	.019	.050	.106**	1

\*\*Correlation is significant at the 0.01 level (2-tailed).

Moreover, Table 1 demonstrates the descriptive statistics including the mean and standard deviation (S.D.) and correlations among the main variables. Thus, the results of a correlation analysis of the independent variables and dependent variable are presented in Table1. The correlation between independent variables and dependent variable was such that multicollinearity is not a concern.

### 4.2 Hypotheses testing

Table 2 shows regression coefficients and standard error (S.E) for each of the independent variables. Adjusted R<sup>2</sup> reveals that 29% of the variance of outsourcing. According to the multiple linear regression analysis in Table 2, trust of the SME owner/manager in an external

accountant (hypothesis1) and technical competence (hypothesis 2) were significantly associated with outsourcing (Coefficient =1.182,  $p<0.001$ ; Coefficient =.926,  $p<0.001$  respectively). Hypotheses 1 and 2 were supported. Besides, in preparing for our regression analyses, we noted that size of the firm (hypothesis 3) might be positively associated with outsourcing, but the results did not support our prediction. This means that firm size was not related to outsourcing (Coefficient = -.496,  $p=.380$ ). Thus, hypothesis 3 was not supported.

Table 2: Result of regression analyses

Independent variables	Outsourcing Coefficient(S.E)
Trust of the SME owner/manager in accountant	1.182***(.170)
Technical competence	.926***(.113)
Firm size	-.496(.565)
Constant	6.022(3.692)
R2	.288
Adjusted R2	.285
F-value	87.816
DF-Model	3
DF-Error	650

Note: n=658. Unstandardized coefficients reported. Numbers in parentheses are Standard Errors (S.E). Significance at \*\*\* $p<0.001$ .

## 5. DISCUSSION AND CONCLUSIONS

In this paper, we have examined the factors that influence a firm's propensity to outsource accounting functions. Drawing on the resource-based theory (RBT) and transaction cost economics theory (TCE) of the firm, generated and tested on data regarding the use of outsourcing by SMEs in the context of Iran.

- 5.1 As hypothesized earlier to this in section 4.2, outsourcing of accounting functions is positively associated with trust of the SME owner/manager in an external accountant. Similar to finding by Everaert et al. (2008), reveals that the owner/manager's level of trust in the external accountant was significantly associated with outsourcing of accounting services.
- 5.2 The result indicated that technical competence of accountant is positively related to outsourcing. These findings corroborate the previous research conducted by Gooderham et al. (2004), suggest external accountant's competence in delivery of accounting services has a significant effect in using of advisory activities, and by Carey et al., (2006), indicate the technical competence of an external accountant positively associated with outsourcing of internal auditing services.
- 5.3 Our results suggest that the size of the firm by itself is not associated with the outsourcing. This result is in line with Carey et al. (2006), who reveal that firm size is not associated with the level of internal audit outsourcing, but it runs counter to a few of preceding findings which suggested a broadly positive association between size of the firm and outsourcing.
- 5.4 Most of the previous works with respect to outsourcing have focused on the areas such as human resource and IT, but we have performed a comprehensive study by focusing on the outsourcing of accounting functions using a broader view of SME with large sample in an emerging economy. Thus, outcomes of this study would be useful to assist SME owner/ managers and professional accountants in Iran and other developing countries to develop comprehensive actions plans to garner the existing capabilities of professional accountants in serving the SME community.

## 6. LIMITATIONS AND SUGGESTIONS FOR FUTURE RESEARCH

First, the generalization of this research is limited because all of the enterprises in the sample were manufacturing, generalizing the findings of this research to service sector may not be suitable. Second, we examined only Iranian SMEs, so our findings may not be generalized to SMEs in other countries. Nevertheless, this study focused on quantitative method using questionnaire survey, thus future research should employ more in-depth, qualitative methods.

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