Briefing

OFFSHORE ACCOUNTING OUTSOURCING: THE CASE OF INDIA

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Executive summary

During the 1990s the reductions in cost and increased capacity of telecommunications and computing facilitated the global outsourcing of various business activities “offshore” to places where the labour supply is both cheap and plentiful. India, the Philippines and increasingly China are key locations for this work. Over the last decade, many firms have outsourced offshore parts or all of their in-house accounting and finance (AF) function. However, this presents significant risk due to poor performance and vendor opportunism. A previous report focused on financial services (FSA 2005) identifies the complexities of achieving suitable management oversight and control from a distance. The same report points to the need for appropriate governance frameworks, risk management systems and controls to identify and mitigate risk. What are these controls and risk management systems and how effective are they in mitigating risks from offshore accounting outsourcing? The study this Briefing is based on aims to improve our understanding of risk mitigation by providing case studies of firms engaging in offshore accounting outsourcing. The case study client and vendor firms vary in size and type of work outsourced. We analyse the risks, mitigating controls and trust which facilitate offshore outsourcing.1

The main issues are:

• A component of effective risk management is a balance of types and different levels of control and/or trust prescriptively related to the nature of the tasks outsourced (eg, see Aron and Singh 2005). However, control can be seen as evolving, influenced by local contextual issues and attitudes. Control and/or trust are shaped by particular historical circumstances.

• Small firms can engage in offshore outsourcing and there is a role for consultants, lawyers and other intermediaries to assist in providing standardised contracts and guidance at a reasonable price. Small firms considering offshore outsourcing should decide a predefined strategic planning goal beyond cost savings prior to offshore outsourcing.

• Guidance and recommendations on appropriate disclosure of offshore outsourcing should be provided. Our interviews revealed that some firms of chartered accountants do not inform their clients that their accounts preparation is outsourced to India.

• Vendors should be cognisant of the imperative for risk mitigation and present clients with a range of controls according to type of work and risk – control preference.

• Clients expecting more than the processing of generic ‘rules-based’ easily codifiable processes must expect to put a lot of effort into helping vendors ‘get it right’ supported by open gain-sharing contracts. Vendors in turn must feel motivated to welcome, encourage and facilitate client access to form close working partnerships.

1 Consideration of audit cost implications of offshore outsourcing is beyond the scope of the study.
1. Introduction

Offshore outsourcing of accounting is becoming an increasingly attractive option for many companies as a means of gaining access to scarce skills, cutting costs and obtaining competitiveness. Although vendor firms in other countries are involved, India is recognised as a leading location for remote customer interaction, data analysis and accounting.\(^2\) An Institute of Chartered Accountants in England and Wales (ICAEW) report\(^3\) has established the importance of offshore outsourcing of parts or all of the accounting function to India and other locations. However, there is currently sparse in-depth research on the practices and mechanisms involved in managing offshore outsourcing relationships. Our report *Offshore Accounting Outsourcing: The Case of India* (Nicholson & Aman, 2008) aims to fill this gap in the literature and complements previous ICAEW reports and our own prior work (Wood et al. 2001, Nicholson et al. 2006). Offshore outsourcing of accounting has long surpassed mere data entry and transaction processing. Table 1 below, taken from one of the major offshore outsourcing vendors, demonstrates the range of outsourced services available.

### Table 1: Accounting activities outsourced offshore

| Order to cash: order management, billing, accounts receivables, cash receipts and application, credit and collections, bank reconciliations |
| Purchase to payment: purchase order management, vendor management, accounts payable, cash disbursement, bank reconciliations, contract administration, cost accounting, fixed assets |
| Hire to retire: payroll, benefits administration, employee data administration, pension accounting, FAS 123(R) *Stock Option Accounting*, travel and expense compliance |
| Financial reporting: general accounting, consolidation and management reporting, intercompany allocations, activity-based costing, reconciliations, project accounting, tax compliance |
| Compliance and control: cash management, treasury, budgeting, forecasting, regulatory reporting, risk management\(^4\) |

A previous report focusing on financial services (FSA 2005) identifies the complexities of achieving suitable management oversight and control from a distance. The same report points to the need for appropriate governance frameworks, risk management systems and controls to identify and mitigate risk. This begs the following questions:

- What are the risks of offshore accounting outsourcing?
- What constitutes ‘suitable management oversight and control from a distance’?
- What are ‘appropriate governance frameworks, risk management systems and controls’?

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\(^3\) *From outsourcing to offshoring*, special report SRS5, London: Faculty of Finance and Management, ICAEW, October 2004. This report contains a review of locations for outsourcing.

\(^4\) The list of activities of a vendor – Outsource Partners International www.opiglobal.com. OPI were interviewed as part of this research, reported in Nicholson et al. (2006).
The three case studies described below were conducted to improve our understanding of these questions by providing an analysis of how individual vendors and clients are mitigating risk to facilitate offshore outsourcing. This includes the visible control mechanisms, less visible social interactions and relationships that underpin trust in outsourcing offshore. This research has two specific objectives:

• To identify the risks of offshore accounting outsourcing.

• To identify the types, role and impact of control and trust in managing risk.

The three case studies involve multiple in-depth interviews in selected organisations which involve both the ‘client’ (in the UK) and the ‘vendor’ (in India). The three client and vendor case studies all have some accounting processed in India-based centres. We have chosen to focus on vendors with centres in India for two reasons:

• India is currently widely regarded as the most attractive location for offshore outsourcing; and

• according to the Indian trade association Nasscom, India is currently the leading country in terms of volume of offshore accounting work undertaken for foreign clients.

Initial data was collected in 2002 and during a period of intensive fieldwork in 2005-6. This included interviews with UK clients and vendors in India. We also collected other documentary evidence such as contracts and press articles. Data was also gathered from discussions with accounting outsourcing experts (consultants, lawyers etc.) in UK and India. The case studies illustrate how risks are mitigated in offshore outsourcing cases of different size, complexity and types of accounting activity outsourced. The first case study, Alphacorp and BetaCom, is the largest case study in terms of firm size and outsourced volume. Alphacorp is one of the world’s largest chemical companies. BetaCom is one of the world’s largest offshore AF outsourcing vendors and maintains multiple global processing centres. BetaCom process Alphacorp’s accounts from several European centres via a Portugal-based hub and a proportion of the work is then undertaken in the BetaCom centre in India.

The second case study is that of Gowing and IndiBackoffice. Gowing outsource 90% of their accounting function to IndiBackoffice and the majority is processed in India. This is a case study of relatively smaller firms but where a greater proportion of accounting work is outsourced offshore. ‘Middle tier’ vendor firms such as IndiBackoffice are representative of vendors who are able to maintain regional presence (eg, USA, Europe, and Asia) but do not have the multiple global processing centres of BetaCom.

The third case study involves a small client and vendor both of which employ less than 50 people and have revenues under £1 million per annum. Ardon, the client, is a chartered accountant firm in North West England. The vendor is Technoaccounts operating from Chennai, India. We describe the theoretical concepts to identify how the risks evident in the cases are mitigated by certain controls and/or trust.

5 All three cases are anonymised at the request of vendor and client.

6 Consideration of audit cost implications of offshore outsourcing is beyond the scope of the study.
2. Risk and offshore outsourcing of accounting

The framework for analysis presents two major forms of risk affecting AF outsourcing: performance risk and relational risk. Instances of these two categories of risk may be mitigated by implementing controls of a formal or informal nature or by the existence of goodwill or competence trust.

Figure 1: Theoretical framework

Relational risk is the risk of a partner not co-operating in good faith; the probability and consequences of not having satisfactory co-operation in an outsourcing relationship. Opportunistic behaviour such as cheating, shirking, distorting information etc, may be manifested by either vendor or client or both firms (Das and Teng, 2001). European firms are restricted by the Data Protection Directive with regard to what data can be transferred or stored in countries without equivalent rules and enforcement procedures. India has no such regulations. The issue of differences in legal institutions complicates the monitoring of outsourcing contracts where there are no comparable data protection laws. Even if a legal case may be prepared, the Indian legal system, although based on the British colonial judiciary, is relatively overburdened and subject to backlog and delay. Thus, shirking, reneging or poaching by vendors of proprietary processes, intellectual property or confidential data, is subject to limited or untimely legal redress. Other authors have drawn attention to widespread corruption in India suggesting a heightened risk of opportunistic behaviour from vendors (Varma, 2004, BBC News, 2005a, b, Transparency International, 2006).

Performance risk is concerned with the range of factors that may affect the performance of the outsourcing relationship, or in other words the vendor’s ability to perform to the outsourcing agreement. Performance is dependent on the resources and capabilities of the vendor and client firms including available capital, technology, skills of vendor and client staff. Risks are caused by breakdown in operations at the vendor location, resulting not from deliberate opportunistic action, but as a consequence of complexity of operations, geographical separation, cultural differences or limitations of communications equipment.

Indian vendors are often in areas prone to natural disasters and geopolitical risks. For instance, floods are common in Mumbai and in 2005 several Indian operations were put out of operation including UK directory enquiries. There was a resurgence of hostilities between newly nuclear armed India and Pakistan in 2001 causing an exodus of expatriates which stalled many contractual negotiations. In 2008, severed cables disrupted
internet services in large parts of Middle East and India following damage to two undersea cables in the Mediterranean. Transferring accounting to India exposes the client to the potential consequences of such natural disasters or conflict.

Communication between the client and the offshore vendor may be problematic due to relatively poor telecommunications, cultural differences, accents and language ability. Time-zone differences, which are often overcome by shift work patterns, accentuate these communication difficulties (Sarkar and Sahay, 2004; Walsham, 2002). The offshore personnel may lack domain knowledge in the client’s business application, and the transfer of such knowledge is hampered by distance (Cramton, 2001; Nicholson and Sahay, 2004). Differences in infrastructural standards raise issues of reliability of telecommunications connections. Furthermore, there is considerable evidence to suggest that international variation in accounting standards and practices persists (Choi and Levich, 1991; Weetman and Gray, 1991). Gray (1988) notes consequences on financial reporting practices. Although the level and quality of educational pools in India is high, US or UK GAAP is not widely taught at Indian universities. This potential labour supply risk is overcome by two major factors: training programmes which equip Indian staff with this knowledge and secondly the repatriation of Indians qualified in Western Europe and USA.

However, high staff attrition is a characteristic of the Indian offshore outsourcing industry with normal staff turnover rates for transaction processes reported at around 30% per annum. Moving activities to India also exposes clients to an accentuated risk of potential vendor bankruptcy and merger and acquisition as the Indian IT-enabled services industry is in a relatively early phase of development, characterised by a significant potential for shakeout and consolidation (Mishra, 2005; The Economist, 2004).

Control and trust

Das and Teng (2001) in their review of current research in this area argue that control and trust are the only routes to risk reduction. A client’s perception of risk determines the need for trust and control and the level of acceptable risk determines the control and/or trust needed. Risk may be reduced by trust which engenders positive expectations of a partner, suggesting undesirable outcomes are less likely. Control is more interventionist and proactive, being concerned with directly influencing the behaviour of the partner. Control may be understood as a process of regulation and monitoring for the achievement of organisational goals. Control mechanisms include governance structures, contractual specifications and other managerial arrangements concerned with controlling the partner and the alliance.

Output control consists of control over the outcomes of a process. Measures comprise metrics, benchmarks and indicators used to judge desired outcomes against actual performance. Behaviour control consists of rules, procedures, incentives and punishments to monitor, motivate and reward the vendor. ‘Chunkification’ involves control of risk by sub-division of outsourced activities to guard against risk of opportunism or poor performance. Thus a client may choose to maintain parts of a process in house and/or outsource to more than one vendor (Aron et al. 2005).

Social and informal controls are concerned with propagating organisational norms, values, and culture to encourage desirable behaviour. For example, client and vendor staff have regular meetings and perhaps staff secondments to align objectives. Social control, in contrast with other forms of control, involves no attempt to specify the behaviour or outcome at the start.
Trust may be understood as ‘positive expectations regarding the other party in a risky situation’. We follow Das and Teng (2001) in focussing on two major types of trust: goodwill and competence trust. Positive expectations regarding goodwill and competence of a vendor can reduce perceived risk in a relationship. **Goodwill trust** is concerned with a partner’s good faith, good intentions and integrity. Goodwill trust, if present, may act to reduce the likelihood of opportunism. If built up over time it suggests good intentions to make the relationship work and may therefore impact on relational risk. Das and Teng point out that goodwill trust has little or no impact on performance risk as sources of performance risk lie in appropriate resources or industry competition which are not affected by presence of goodwill. The second category of trust is **competence trust**. Competence is based on the various resources and capabilities of the firm. Resources may include capital, human resources, physical properties, market power and technology. These resources and capabilities provide the basis for the competence or expertise that is needed in outsourcing relationships. A vendor’s competence, established by reference site visits prior to outsourcing or experience gained over time once outsourcing has taken place, is tantamount to low performance risk. Competence trust based on experience or reputation may provide a firm with sufficient confidence to outsource even the highest performance risk activities offshore. However, competence trust does not act to reduce relational risk. Competence trust is concerned only with the **ability to do appropriate things** and not the **intention to do so**; a competent firm may choose to act opportunistically.

In summary, risk, trust and control are interrelated in a dialectical manner. For example, if high levels of goodwill and competence trust exist between client and offshore provider, then this may limit the need for high levels of control. What activities are outsourced and the split of those activities between vendors may act to control opportunism. For appropriate activities, the mix of output, behaviour and social control present a gamut of options or a control–trust mix related to the risk that a client is able to tolerate.
3. Understanding risk and risk mitigation: case studies

Relational risk

Clients in the three case studies perceived India as presenting no more risk of shirking, cheating or poaching than may be experienced in any other country including the UK. The Alphacorp-BetaCom case study involves offshore outsourcing between very large, global firms with a long-term arrangement and mature processes. Alphacorp is one of the pioneers of offshore accounting outsourcing and although dealing in very large volumes, outsources only transactions. The Gowing–IndiBackoffice relationship involves much smaller firms but began at a financial crisis point for Gowing. Gowing subsequently outsourced 90% of their accounting function to IndiBackoffice. Ardon and Technoaccounts is a case of small firms engaging in offshore outsourcing. Specific examples of relational risks across the cases are presented in Table 2:

Table 2: Examples of relational risk

<table>
<thead>
<tr>
<th>Type of risk</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poaching</td>
<td>BetaCom serves a number of clients in the India centre, presenting the potential for opportunistic poaching. BetaCom could potentially use Alphacorp’s proprietary processes or staff for another client. Moving staff between clients is an IndiBackoffice practice to provide variety for staff in order to overcome high attrition levels in India. However, sharing is seen by clients as a benefit as it promotes efficiency and best practice. Clients are content to share when outsourcing back office processes (transactions) using common enterprise systems where there is little risk of loss of intellectual property. Experienced staff in India are often poached by other companies in the local cluster presenting the risk of lost knowledge of client processes.</td>
</tr>
<tr>
<td>Fraud</td>
<td>In 2005 a newspaper reporter from a tabloid newspaper was able to buy bank account, credit card, passport and driving licence details of UK bank customers from a Delhi-based call centre operative. Although a criminal breach of the Data Protection Act had occurred, UK police had no jurisdiction to prosecute.</td>
</tr>
<tr>
<td>Renegotiation</td>
<td>Alphacorp no longer has in-house resources to perform accounting work, and would face difficulties in bringing the processes back in house. As the sole supplier of 90% of accounting services to Gowing, IndiBackoffice could opportunistically raise prices (vendor hold-up). However, exit assurance clauses are an integral part of client contracts and there are many examples of clients changing suppliers limiting the need for Alphacorp to reverse transition. Reverse transition clauses are applied in some contracts.</td>
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</table>

7 A reverse transition plan is intended to repatriate client processes back to the client or to another vendor. It should include reverse knowledge transfer, project personnel debriefing and infrastructure decommissioning. The inclusion of such clauses is typically done at contract negotiation phase along with conditions indicating which party should bear the cost.
Performance risk

Alphacorp experience performance risk problems related to language, culture and communication. A much greater proportion of the accounting function is outsourced at Gowing including some relatively unstructured tasks that are difficult to objectively codify and measure. This potentially exposes them to higher levels of performance risk. The experiences of Ardon demonstrate how small firms with limited resources face difficulties in managing attrition levels and expanding in size. The Ardon vendor in India presents high potential for performance risks because of its small size and limited resources. Table 3 presents examples of performance risks across the cases.

Table 3: Examples of performance risks

<table>
<thead>
<tr>
<th>Issue</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Communication issues</td>
<td>Lack of ability to communicate clearly in English through emails and on the telephone caused frequent misunderstanding between the BetaCom (Portugal) and India staff. Communication between IndiBackoffice (India), Gowing and IndiBackoffice (UK) occurs mainly through emails which are often delayed due to telecommunications infrastructure problems.</td>
</tr>
<tr>
<td>Cultural issues</td>
<td>At Alphacorp–BetaCom, public holidays occur at different times across the centres in UK, Portugal and India. Relative to UK-only outsourcing, there are a greater number of occasions during the year when problems may be experienced in maintaining a critical mass of staff. The team in BetaCom (India) were described by Portugal-based staff as not engaging in effective ‘questioning behaviour’ and instead often taking instructions on ‘face value’ leading to errors. The India team were perceived by Portugal staff as lacking a ‘sense of urgency’ because they were not dealing directly with Alphacorp staff.</td>
</tr>
<tr>
<td>Knowledge</td>
<td>At the inception of BetaCom outsourcing from Portugal to India, staff that were leaving were unwilling to share information about the process during the transition period. Although many processes were documented, training and handover was problematic where there were informal practices which were undocumented. Variation in accounting standards and practices such as tax laws and statutory accounts are different in each country served by BetaCom. While vendor staff built up knowledge of these variations performance was reduced. These are examples of how performance of vendors is unlikely to be perfect from day 1 and should be reflected in key performance indicators (KPI).</td>
</tr>
</tbody>
</table>

8 KPIs are measures of business performance, used to check performance against targets, or as benchmarks to signal areas of performance in need of improvement.
Governance

Both BetaCom–Alphacorp and Gowing–Indibackoffice had structured governance procedures involving comprehensive service level agreements (SLA)\(^9\) for the vendor, operational level agreement (OLA) for the client and tiers of governance meetings. The contract at Gowing–Indibackoffice is open book and utilises target pricing with service credit. Service credit is a discount that a client receives if the vendor fails to meet certain service requirements. Availability of alternative vendors in the contract provides a deterrent to vendor opportunism such as vendor hold up. Alphacorp have contracts with two major suppliers performing respective parts of the accounting function divided according to Alphacorp geographical locations. The scale of the Alphacorp contract is also important, as it is a significant source of revenue for the vendors. The reputation of BetaCom in India ensures its attraction as an employer and less attrition is evident than in other similar companies in India. The Ardon-Technoaccounts contract is much simpler than the two large firm case studies and consists of a few pages of documentation that embody the responsibilities of each party. Table 4 presents specific examples of the governance structures across the two large firm case studies.

Table 4: Governance structures at Alphacorp–BetaCom and Gowing–Indibackoffice

<table>
<thead>
<tr>
<th>Contract</th>
<th>Alphacorp’s contract with BetaCom is based on open book gain sharing. The contract has a baseline cost, the cost that Alphacorp would have to pay to BetaCom and the gain above the cost as a result of efficiencies is shared in the proportion agreed in the contract. Similarly, Gowing’s contract with Indibackoffice is based on an ‘open contract’ and both parties set the target price in advance and share variances and incentives.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meetings</td>
<td>Governance meetings at BetaCom–Alphacorp and Gowing–Indibackoffice consist of operational level, managerial level, and highest managerial level held jointly between client and vendor at set periods. An example of participatory decision-making used at Gowing–Indibackoffice deters both client and vendors from acting opportunistically and reduces performance risk as it encourages both sides to lay out reasonable and achievable targets.</td>
</tr>
</tbody>
</table>

Behavioural and output control

The SLA, staffing policy and training are effective behavioural control mechanisms in both Alphacorp–BetaCom and Gowing–Indibackoffice. Security controls over the process mitigate fraud in all three cases to varying degrees. BS7799\(^{10}\) is an important security standard implemented by BetaCom and Indibackoffice. At Alphacorp, Sarbanes-Oxley implementation has augmented behaviour and output controls over the accounting process and thus over BetaCom. Ardon has developed some forms of output control but it is more reliant on vendor provided control to ensure accurate standard output. Table 5 lists examples of behaviour and output control used in Alphacorp–BetaCom.

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\(^9\) The set of promises and indicators (KPI) to assess vendor performance in relation to expectation.

\(^{10}\) BS7791 (ISO 27001) Information Security Management System Specification.
Table 5: Behaviour and output controls

Service level agreement (SLA) – the set of promises and indicators (KPI) to assess vendor performance in relation to expectation. Operational level agreement (OLA) is the set of client promises to enable the SLA.

Reporting – a two-way process, via monthly and daily meetings, to alleviate issues related to performance.

Staffing and training – the client is involved in the recruitment of vendor staff and may ask the vendor to remove a staff member. Vendor staff sign non-disclosure agreements.

Policies and rules – staff face dismissal if they contact the end client.

Physical and systems security – physical security includes the use of security cameras, mobile phone detection and a clean desk policy. System security includes creation, validation, and maintenance of staff member identity, firewall and anti-virus protection in accordance with BS7799.

Audit – an external audit and Sarbanes-Oxley audit is performed by Alphacorp’s external auditors at both the Portuguese and Indian sites.

Internal control manual – this provides guidance on how tasks should be completed. There are two semi-annual assessments against the internal control performed in vendor locations to report evidence of each control.

Social control

Social control is concerned with values and objectives of vendor and client to achieve satisfactory cooperation. In the case of Alphacorp–BetaCom, silent running is an important form of social control. Silent running was described as an idealised state where there are no complaints or problems, only the desirable state of operating ‘silently’. Thus, silent running is the desirable outcome and effectiveness test of output and behaviour controls. By constantly responding to client needs, complaints and feedback (‘noise’) and making necessary adjustments, the vendor becomes attuned to the client and the process over time enables convergence of goals, procedures and work culture (social control).

Social control was implemented via an intermediary employed as contract manager at Gowing but whose responsibilities spanned the boundaries between Gowing and IndiBackoffice. Another key example were the staff secondments from client to vendor at Alphacorp–BetaCom. Table 6 explains more about how social control is used across the case studies.

Table 6: Social control

Silent running – in the case of Alphacorp–BetaCom, silent running is an important control measure and a mechanism to identify ad hoc issues that need to be resolved. In essence, if there are no complaints (noise), the systems have achieved silent running. Alphacorp–BetaCom also have reciprocal secondments, for example, an Alphacorp senior manager had operational responsibility for the BetaCom (Portugal) centre for several years.
**Table 6: Social control**

**Intermediary** – at Gowing–IndiBackoffice, the contract manager plays a major role in mitigating relational and performance risk. She proactively communicates and develops relationships and networks with vendor staff and uses these to drive change and improve the process. Her interpretation of the contract is that as contract manager she may be involved wherever appropriate in the process in the vendor location for mutual gain. Social control measures include unprompted regular telephone calls to the UK and India, and quarterly visits to IndiBackoffice (India) to check on process and progress. She communicates directly and informally with the team in India, working together with them on improving the transaction process and solving problems faced by the teams in all locations. Her actions were initially perceived as ‘performing out of the scope of her role as a contract manager’ and attempts were made to restrict Gowing access to IndiBackoffice. However, this perception was later revised as the Gowing contract manager developed the reputation of being a knowledgeable and experienced manager, useful to IndiBackoffice for developing mutual understanding, and solving problems and issues at both sides resulting in process improvement. In addition, her knowledge of IndiBackoffice’s process and her political position in Gowing facilitate problem resolution with the Gowing directors.

**Chunkification**

Horizontal chunkification determines what portion or fraction of an activity will be allocated to client and vendor(s). Alphacorp determines the scope and type of work outsourced to Portugal and India, and no tasks requiring judgement are outsourced. BetaCom transfers Alphacorp’s accounting to a ‘hub’ location in Portugal. A subset of that is transferred to India. IndiBackoffice have a UK centre which acts as a hub between the client and India. Hubs act as a ‘halfway house’ to mitigate the communication, language and cultural risks through proximity to clients, local skills, institutions and infrastructure in the hub location. Vertical chunkification describes which activities will be allocated to the client and vendor or multiple vendors. For example, Alphacorp outsource to BetaCom and another major vendor to mitigate relational and performance risk. Ardon has smaller needs in terms of volume, scope and the type of work outsourced to India, and only ‘straightforward’ tasks are outsourced. Table 7 presents examples of chunkification.

**Table 7: Chunkification, near shore and offshore outsourcing**

<table>
<thead>
<tr>
<th>Horizontal chunkification</th>
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<tbody>
<tr>
<td>Alphacorp’s decision to outsource only rules-based transactions and to maintain critical business tasks such as cash management in-house is an example of chunkification. By maintaining some internal competence, Alphacorp reduces its strategic dependence on any one vendor. The BetaCom Portugal centre is an example of ‘near shore’ outsourcing as Oporto is physically closer to the UK than India. Travel time is reduced in the case of for example problem management requiring presence of a UK manager. Furthermore, Portugal is a data ‘safe harbour’, within the EU, being subject to EU data protection legislation.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Vertical chunkification</th>
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<tbody>
<tr>
<td>Alphacorp has a second vendor that also performs transactional processing work for other Alphacorp subsidiaries in different geographical areas. By using vertical chunkification, Alphacorp is able to compare performance and maintain an awareness of relative competitor capability. This reduces performance risk by building a competitive environment for the vendors.</td>
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</tbody>
</table>
Trust and small firm risk

The case studies provide examples of how goodwill trust can reduce the likelihood of opportunism and of competence trust to reduce performance risk. As a small firm Ardon has limited resources to impose extensive controls. Goodwill trust mitigated relational risk expressed in the friendships between the directors and staff at Ardon and Technoaccounts maintained by regular communications. Competence trust in Technoaccounts gained at the early stages from recommendations given by existing clients led to a rapid implementation of offshore outsourcing at Ardon. However, there was a regression of trust as Technoaccounts reneged on certain promises. In our final meeting with Ardon, they were implementing controls and seeking out a second supplier and only sending ‘straightforward jobs’ to Technoaccounts. Ardon were bold in their approach to offshore outsourcing and suffered consequences of personnel recruitment disadvantages and financial limitations which did not allow frequent travel to India as demonstrated in the other cases. Small firms have high search costs and as a result Ardon did not engage in a thorough due diligence process. They incurred relatively high set-up costs relative to the transaction size. Ardon reported that cost savings of offshore outsourcing were no better than could be achieved with outsourcing within the UK. This can be explained by the relatively low volume of transactions compared with Gowing and Alphacorp.

Large vendor organisations are unlikely to be interested in doing business with small firms like Ardon although we were told that some firms (eg, Mphasis) are able to undertake standardised activity such as tax returns for small firms. Table 8 explains more small firm offshore outsourcing practices.

Table 8: Small firm outsourcing practices at Ardon–Technoaccounts

- A small client firm faces high levels of risk relative to a large firm when undertaking offshore outsourcing of AF. Vendor opportunism could be financially devastating and small firms do not typically have the managerial experience, the financial resources, and the in house know-how to control risk of offshore AF outsourcing the way large firms do.

- In 2006, Ardon was a relative veteran of offshore outsourcing having outsourced to India since late 90s and were cognisant of some of the risks (eg, data loss, disaster).

- Contact costs and performance risks were mitigated by recommendations of existing users enabling competence trust. Potential for vendor opportunism was mitigated by goodwill trust as Ardon did not have the resources to engage in a full due diligence process or engage in India travel, risk analysis and tendering as seen in the large firm examples.

- Technoaccounts provided a standardised service and used IT effectively to reduce client side control costs to a minimum. Technoaccounts have enabled Ardon to overcome skills shortages, focus on core competences with their clients, and freeze price increases.

- Technoaccounts are subject to difficulties common to all small firms. The problem of high India staff attrition was seen to impact Ardon in terms of the number of queries and problems derived from lack of consistent Technoaccounts personnel. Technoaccounts reneged on promises as they struggled to cope with rapid growth and the tensions of staff attrition.

- The cost savings of India offshore outsourcing were not greater than could be achieved with outsourcing to a UK firm explained by the relatively low volume of transactions.
4. Conclusions

Despite the legal differences, most interviewees perceived that offshore outsourcing to India does not present a higher risk of opportunism than UK outsourcing. They felt this risk could be effectively controlled using an appropriate portfolio of behaviour and output controls as outlined in table 9. The main performance risks associated with offshore outsourcing include knowledge transfer, communication and culture. Ardon trusted the competence and goodwill of Technoaccounts. Ardon do not have the resources to engage in a full due diligence process or impose controls in the way the larger case studies demonstrate.

The findings concur with theory as behaviour and output control is implemented when the transaction is codifiable and measurable (eg, payroll). Social control is implemented when transactions involve a degree of judgement or discretion, are relatively non-codifiable, and have un-measurable output (eg, process improvement). However, social control was also important at Alphacorp which demonstrates that a focus on transaction attributes alone cannot enable control choice. The need to consider local context was also shown to be important. The role played by intermediaries in various ways including secondments (Alphacorp), the skills and personality of the contract manager (Gowing) and account managers (Technoaccounts) mitigated relational and performance risk.

Alphacorp mitigated risk using chunkification. Horizontal chunkification overcomes the potential for fraudulent activities by determining the scope and the type of work outsourced and sending only tasks where there would be insufficient information available for fraud to occur. Chunkification between hubs helps to mitigate the communication, language, and cultural risks. The use of vertical chunkification is evident in the division of work between vendors. The control mechanisms used across the cases to mitigate risk are summarised in table 9:

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<th>Control and trust mechanism</th>
<th>Illustration from the case studies</th>
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<td>SLA/OLA</td>
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<td>Regular visits of middle person as bridges to mutual understanding</td>
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</table>
Some key lessons

• Potential clients of outsourcing are advised to consult models (e.g., Aron and Singh 2005; Aron et al. 2005) to design a balanced portfolio of types and levels of control and/or trust. Such models correlate the nature of outsourced tasks to controls. However, there are limits on such prescriptive models that present causal relationships between factors focussing only on the attributes of transactions. Instead, the cases show how choice of control can be seen as evolving (e.g., trust can go into reverse if the vendor reneges), to be influenced by local contextual issues (e.g., high attrition in India) and attitudes (e.g., a perceived need for secondments), and that control and/or trust are shaped by particular historical circumstances (e.g., Alphacorp’s long-term vendor relationship) and the actions of individuals and groups (e.g., the Gowing contract manager’s skills as an intermediary). Effective control of offshore outsourcing is as much a social process as a technical one.

• Furthermore, outsourcing codifiable processes only does not limit control to outputs and behaviour. We observed social control to be also a major feature of the Alphacorp–BetaCom relationship due to the size of contract and volume of transactions.

• Small firms can engage in offshore outsourcing and there is a role for consultants, lawyers and other intermediaries to assist in providing standardised contracts and guidance at a reasonable price for small clients. The Ardon–Technoaccounts case study is much smaller in terms of scale and scope than either of the other case studies. At Ardon, cost savings were not a major factor underpinning the decision to outsource to India. Instead, the major benefit and challenge was seen to lie in standardised output and constant labour supply. We were told that the savings achieved as a result of outsourcing offshore were roughly commensurable to outsourcing to UK-based freelance homeworkers and thus dramatic cost savings were not achieved. This can be explained by considering the relatively small volumes outsourced compared with Alphacorp or Gowing. Small firms have the potential to use offshore outsourcing successfully. At Ardon offshore outsourcing led to several benefits such as a focus on consultancy services for clients. Small firms considering offshore outsourcing should consider a predefined strategic planning goal beyond cost savings prior to offshore outsourcing.

• Guidance and recommendations on appropriate disclosure of offshore outsourcing should be provided. Our interviews revealed that some firms of chartered accountants do not inform their clients that their accounts preparation is outsourced to India.

• Vendors should be cognisant of the imperative for risk mitigation and present clients with a range of controls according to type of work and risk – control preference. Clients such as Gowing which are outsourcing considerably more than simple codifiable generic transactions expect ‘value added’ from vendors beyond reduced cost and quality within SLA tolerance limits. Effective management of such relationships requires client access and active participation in areas of the vendor’s operation which might previously have been considered ‘out of bounds’ to clients. Clients have responsibilities to vendors too which can be formally and informally acknowledged: for instance, Alphacorp was governed by the OLA to enable the vendor’s SLA. For the control and innovation of higher value added activities, leadership style and communication skills become as crucial as technical ability. It is not, however, the solution for clients to think of the vendor as an extension of their accounts department as that may lead to tensions around boundaries and responsibilities. After all, vendors have responsibilities to many clients. However, the Gowing case shows that clients expecting more than the processing of generic rules-based codifiable processes must expect to put a lot of effort into helping vendors ‘get it right’ supported by open gain sharing contracts. Vendors in turn must feel motivated to welcome, encourage and facilitate client access to form close working partnerships.
References


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