

## Managing Relational Risks in Accounting Outsourcing: Experiences of Small Firm

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**Abstract:** This paper aims to explore the relational risks in client-vendor accounting outsourcing relationship of small firms and the innovating strategies in managing the relational risks. This study used interpretive case study approach with in-depth interviews, document reviews and observations in order to understand the relational risks and strategies in managing the risks. Findings show the importance of understanding client's ability and capability at the early stage of relationship. Vendor's perceptions could contribute to relational risks. Innovating strategies in managing risks are ad-hoc and would be relied on the type of relational risks aroused. Innovating strategies in managing relational risks especially in small outsourcing firms could contribute to further understanding in developing long-term relationship with vendor/clients and could enhance profit performance of the firms and accounting outsourcing industry.

**Key words:** Relational risk management • Accounting outsourcing • Small firm • Management strategy • Innovation

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### INTRODUCTION

Outsourcing is a technique that has been widely used to reduce cost and time of a firm. The outsourcing is also expected to give firms more concentration on their main activities. There are three types of outsourcing which are; (i) in house outsourcing that is conducted by subsidiaries of mainly involving large firms, (ii) indirect outsourcing company through onshore vendor and (iii) direct off shoring to a foreign outsourcing company [1]. There are a range of activities been outsourced by firms. The activities consist of call centre, data digitized, data processing, accounting, web development, animation and many more [2]. Previous studies [1-4] have showed the importance of accounting outsourcing (AOS). Firms have outsourced various activities of accounting. The activities could be as simple as general accounting and debt management (account receivable) to the higher level of accounting activities such as employee payment (payroll), financial ratio and analysis. However, the range of tasks complexity would not be the basis of accounting outsourcing needs to a firm [3].

The AOS activities involved few processes where their complexity could lead to significant risks [2]. Prior

studies [5-7] categorized risks in outsourcing into relational risk and performance risk. Relational risk is the risk that arise when client or vendor has conduct their relationship not in good faith; it would cause any one or both of the parties feel dissatisfied of the relationship process [6]. Performance risk occurs when the client is not satisfied because of vendor's lack of capital, technology or expertise that might affect their performance as requested [6]. Relational risk and performance risk is related to each other. However, it is important to differentiate both risks as identifying the risk category could assist a firm in determining its strategic risk management [5].

Risks in AOS must be appropriately managed to enhance the client-vendor relationship [4]. Failure of managing risk in AOS would result in higher vendor turnover. The vendor's contract termination cause a loss to both parties; cost, time and also reputation to the vendor. A successful risk management is crucial to enable a firm achieve its goal [8]. Previous studies suggested various elements to manage risk in outsourcing such as use control [9], trust and control [6, 7] or power and control [10]. Other researchers [12, 13] suggest the use of power, trust and control in managing outsourcing risks.

AOS presents high risks due to the range of complexity in performing the client-vendor relationship. The types of risks are different according to the distinction of several factors such as type of industry and firm size. Resources capability determines a firm's character, while the capability is depending upon a firm's size [14]. This shows that size is an important factor that distinguishes firms' decision in identifying their management strategies. A firm's size will determine its capabilities of human resources, material, technologies and fund. It is obvious that smaller firm would have lower capability compared to bigger firm. At the same time, smaller firm also require AOS services more compared to bigger firm due to the cost and expertise. Therefore, the notion of having good relationship between client-vendor is crucial since the complexity of the AOS transactions are more related to the smaller firm's capability in fulfilling its needs. The AOS process between client-vendor that experience high complexity task will lead to relational risk [2]. However, there is only few studies focus on small firms and their innovativeness in managing relational risks particularly in outsourcing work.

Furthermore, the processes of innovation in small firms are poorly understood. Innovation is about the belief of new services or ideas of concept adopt and implement in aiming to improve the previous ways of doing it [15]. Organizations develop strategies to achieve objectives. The aim of this paper is to understand the innovative strategies in managing relational risks by small firms involved in accounting outsourcing work using a case study of a small healthcare firm in Malaysia. Specifically, the researches questions are what is the relational risks faced by small firms and how does the firm manage their relational risks.

This study hopes to provide a clear picture of how small firms invent strategies when facing relational risks in outsourcing work. At the same time, this study extends the ideas of managing relational risks in strategic alliances using different types of control and trust [5-7] with more ideas of power and trust [10, 4].

The remainder of the paper is organized as follows. The next section provides conceptual foundation of this study in the area of relational risks and innovation strategies in managing relational risks in outsourcing. Consequently, the paper describes the research methodology adopted in this study and presents a case study. Discussion and analysis include the identification of issues related to relational risk types and suggestions to manage them. Finally, the concluding remarks of this study are presented.

## **Conceptual Foundation**

**Relational Risks in Accounting Outsourcing:** Previous studies suggested that outsourcing could give some benefit to the firms. Most firms outsourced their activities due to financial aspects [16]. There are five factors that lead to the outsourcing decision; cost reduction, focus on core activities, cash liquidity requirement, expertise and capability and environmental issues [17]. Other than reducing the cost, the chance to focus on main activities has lead into increasing the production quality [17]. Most of small firms' decision to outsourcing is related to these factors. In AOS perspective, most of the accounting tasks need higher accounting knowledge and skills to perform the analysis [3]. Some businesses natures are required to equip their management with high level of financial analysis and reporting [17]. However, these objectives could be achieved when the outsourcing is successful. The client-vendor relationship will be the key of the outsourcing achievement [12]. Relationships that have negative outcomes are at risk [6]. While risks in outsourcing that is not appropriately managed would end with vendor's contract termination [4].

Relational risk occurs when client dissatisfied with the process of outsourcing task conducted by vendor during performing their relationship. Most Firms in outsourcing alliance face various problems in outsourcing due to relational risk [18]. Previous studies [10, 3] have identified five types of relational risk in outsourcing which are:

- Staff pinching - When the client/vendor staffs have opportunities to show their best skills and knowledge during the outsourcing relationship, the potential employer (client/vendor) may offer a better remuneration or position.
- Shirking - When vendor deliberately avoid task agreed or stated in the contract.
- Opportunistic renegotiation - Lack of expertise and resources on the client's side will give the vendor opportunity to renegotiate the service charge or job scope when renewing the contract.
- Insufficient personnel - Vendors might provide outsourcing personnel less than promised. Lack of personnel might cause other problems such as communication or any difficulty during the outsourcing process being conducted.
- Poaching - Poaching occurs when the vendors has used the client's information to achieve something back from it, intentionally or not. The information might be used by the vendor themselves or given or sell to other party.

**Strategies in Managing Relational Risks:** Relational risk should be managed by trust and control [5]. Trust is categorized to goodwill trust and competence trust. Goodwill trust means a party believes that a party will react in a good faith, good intention and integrity. The party will deal fairly with care about its partner firm's welfare in alliances. Competence trust is according to a partner's capability that lead to its competence and expertise that is required in the alliances. Their study also suggested that relational risk is highly recommended to be managed by goodwill trust while performance risk by competence trust.

Control mechanisms may assist in managing the outsourcing risks [6, 19] such as the use of contract as a formal control mechanism in managing relational risks in outsourcing [6]. Risk could also be managed by power [10] as opportunistic behavior could present in both parties' actions. Client should use their power when vendor renegotiate contract renewal [10]. Other studies [5-7] suggest goodwill trust and contract control to manage relational risk. Nevertheless, the process of managing relational risks is a process that involved either client or vendor or both parties.

Firm have to be innovative in determining the right strategies in managing relational risks and take into consideration its internal and external environment [20]. An increasing amount of research on innovation and strategic management [21, 22, 20] shows the important of identifying its management strategy based on the firm's uniqueness of risks. Prior studies of innovation attempting to understand the factors needed for innovation to occur especially of why, how, when and where they are required and their processes [22]. Hence, it is important to clarify the understanding of relational risk and the innovativeness in managing the relational risks using power, trust and control especially in small firm.

## MATERIALS AND METHODS

This study adopted an interpretive case study approach [23]. The case study involved a small firm in a healthcare industry: a client-vendor relationship where the client is the healthcare firm and the outsourcing vendor is the small accounting outsourcing firm. Their relationship started in May 2005 until now.

Alpha Healthcare (Alpha) is an AOS client of Beta Consultation (Vendor). Alpha started its operation in 2002 and currently, has four healthcare centers. There are at least two to three administrative and account staffs in

Table 1: Details of Interviews

Firm	Interviewees	Interviews Frequency	Hours
Client: Alpha	Managing Director	1	11/2
	Senior Account Executive	2	21/2
	Senior Admin Executive	1	1
Vendor	Partner	1	1
	Account Manager	1	11/2
	Tax Manager	1	11/2
Total		7	9 hours

every centre. Each centre will report their administration and account transactions to the head office at the end of each month. The account manager in headquarter will prepare financial statements for Alpha and its four centers. Alpha outsourced part of its accounting activities to Beta due to lack of expertise. They have been introduced by a friend and never knew each other before. Alpha and vendor depend on their trust to the vendor based on the introducer's recommendation. The activities involved account receivable, taxation and financial analysis.

Data were collected through semi structured interview with three key managers from the client firm and three key managers from the vendor firm, which provide multiple perspectives to ensure validity of data collected. The interview session involved both parties; Alpha and vendor. They involved in the ongoing management of AOS process. Details of interviews are in Table 1.

The interview questions were open ended and were arranged based on the research questions and objectives. The open ended questions cover basic questions such as their education and work background, company background, outsourcing related work, issues around the relationship between client and vendor and how they overcome the issues. Results or findings were drawn from the recorded and transcribed interviews. We identified relational risk and the relational risks management strategies in AOS activities. The data was analyzed by identifying themes suggested by [3, 7, 10]. Triangulation is performed by cross-checking information from interviews with other sources of evidence such as company reports and documentations.

## RESULTS AND ANALYSIS

**Types of Relational Risk:** Finding from the research shows the main concern in managing relational risk in AOS of small firm is based on the types of relational risk aroused. It is evident that there are two main relational risks occurred during Alpha-vendor conduct their AOS relationship. They are:

**Risk of Providing Lack of Knowledge Staff:** Findings show that there is risk that the knowledge of Alpha staffs have is insufficient to perform the accounting work or dealing with AOS process. The Managing Director of Alpha outsources his accounting work due to insufficient accounting knowledge of his staffs. However, the reason was seen as risks to vendor. The director explains:

*"To me, although my staffs are lack of knowledge, they can be trained. I knew their limitation and I am aware of it. That's why I decide to outsource," - En. Rozman, Managing director, Alpha Healthcare.*

This is because their background qualification and experiences is not as high as expected. The vendors explain:

*"The financial statement prepared by Alpha's staffs is not accurate... the reconciliation has not been properly monitored... may be because of they don't have enough knowledge and experiences...." - En. Shahrin, Partner, Vendor*

*"It is quit frustrating when we found that an account executive could not properly prepare a full set of account." - Cik Emma, Tax management manager, Vendor.*

The lack of accounting knowledge could disturb accounting outsourcing work and process. Both client and vendor should be clear on their scope of work before proceeding with outsourcing contract. The outsourcing contract could determine the scope of outsourcing work to be performed [24]. Therefore, it is crucial that the vendor knows the ability and capability of the Alpha accounting staffs before agree to perform the outsourcing work.

**Risk of Additional Job Scope:** After signing up an outsourcing contract, Alpha and vendor are bounded in the contract that stated the importance of clarification such as price, job scope and payment terms. However, findings show that misinterpretation of job scope exists during the outsourcing work. For example, one of the clauses in the contract required that the vendor has to prepare a full set of financial analysis report for every three month.

This means that Alpha has to prepare financial statement and submit the statement to vendor, who will prepare financial analysis report. However, findings show that most of the time the financial statements are not

properly prepared and must be rectified. The issue is who will be responsible to do the rectification? Senior Account Executive of Alpha felt that it should be the responsible of vendor, while the vendor felt that it is not within their job scope.

*"We didn't have enough skill to recognized either our financial statements are reliable or not. Therefore, we rely on vendor to do the job." - Pn. Dalila, Senior Account Executive, Alpha Healthcare*

*"The analysis is actually based on the financial statements but they are preparing incomplete full set of account." - En. Shahrin, Partner, Vendor*

This situation will contribute to the risk of additional job scope. This is similar to shirking characteristics as identified by previous studies [3, 10] due to the vendor avoidance of performing promised outsourcing work.

**Strategies in Managing Relational Risks:** Findings show that some of the innovative strategies used to manage relational risk in the AOS activities include social site visit and on the job training.

**Social Site Visit:** Alpha has requested vendor to visit their premise from the early stage of relationship and during the outsourcing work. According to vendor, the site visit allowed them to get-to-know the staffs especially in the terms of their skill, knowledge and experience. Therefore, they could evaluate the staffs' capability in handling outsourcing work. According to the Managing Director of Alpha:

*"Before we appoint the vendor, we request them to come and visit us. Just to have a look around and give some opinion on our system... get-to-know our staffs, since they are going to deal with the accounting outsourcing job." - En. Rozman, Managing director, Alpha Healthcare*

The site visit is actually a request from Alpha to vendor before they start their outsourcing work or discuss the job scope and service fees. This indicates the use of power by Alpha as an innovative strategy in managing relational risks. Prior researcher [25] suggested that client has the ability to influence vendor's action towards bounding future contract. By meeting Alpha's request of site visit, trust towards vendor could also be enhanced through initial understanding that developed during the site visit. The Managing Director of Alpha explains:

*"I will request most of our vendors to come and visit us. The vendor who fulfill our request.. of course has enhanced our trust. We want to share our goal... our ambitions... our believes..." - En. Rozman, Managing director, Alpha Healthcare.*

Goodwill trust could enhance assurance that there will be less opportunistic behavior from vendors [7, 10]. At the same time, vendor also felt that site visit is important and will still conduct the site visit even if there is no request to do so. The vendor explains:

*"We are very glad to receive an invitation from Alpha to visit their premise. This is because if they did not ask for it, we will ask for a visit.. It is important for us to know their capability in terms of staffing, accounting system, admin system like filing and others... and to most of our clients, this is how we determine our payment term and charges... either to charge them deposit or not... it is all based on the first impression from our first visit..." - En. Shahrin, Partner, Vendor.*

In other words, the site visit is important to vendor, not only as control mechanism but also to determine their service charges and job scope. The site visit provides vendor with some exposure about any risks that could arise due to the staffs ability and capability. In short, findings highlight the use of client's power in requesting vendor to carry out a social site visit to his premise. The visit could enhanced client's trust to vendor and allow vendor to develop initial understanding on client's ability and capability before signing up contract.

**On the Job Training:** In addition to social site visits, findings also show that vendors provide on job training to client's staff. For example, the vendor will explain the evaluation report to the Alpha staffs and make sure that they understand the reason of preparing accounting report. As a result, the staffs become more knowledgeable in their accounting work. One of the account executive explains:

*"My friend and I have been trained (by vendor) on doing our tasks. Our training are hands on... we don't have to attend any class.. it is a one to one coaching... and after few sessions, I start to understand the reason for each transactions that I have to complete..." - Pn. Dalila, Account Executive, Alpha Healthcare.*

However, the training was not easy due to differences in individual's background. For example, most of the time, the vendor faced difficulty to explain the evaluation report to the Managing Director who is an engineer and did not have accounting background.

*"En. Rozman is an engineer, he has perceptibly lack of accounting knowledge. Therefore, I use business language to enable him understand the submitted report." - En. Shahrin, Partner, Vendor.*

Despite the difficulties, the knowledge of the client's accounting staffs were improving and the client was happy. The managing director expressed his satisfaction:

*"I am really satisfied with my staffs after the training (on job training) conducted. They (vendor) charged us, we understand. As long as there are returns from the investment (training), I'm willing to spend." En. Rozman, Managing director, Alpha Healthcare.*

As indicated in the quote above, although the training cost was not included in the outsourcing contract, the additional fees charged by vendor for the training were not considered as a burden to the client, especially when he found that the training improved his staffs' performances and his own understanding on accounting report. Hence, vendor's innovative strategy of providing on the job training to client's staff and the director, has overcome the risks of additional job scope. In directly, the strategy that the vendor used has enhanced client's trust. The training provided benefits to both vendor and client; the vendor gained additional profit, while the client improved his staffs' capability. As previous studies [5, 6, 7] suggested, goodwill trust arouse when the vendor share the goal and objective of its alliance.

## DISCUSSION AND CONCLUSION

The above findings show that power, control and trust has been used in managing relational risks of AOS in small firm. However, the use of power, control and trust is ad-hoc and depends on the innovativeness of the strategies used by small firms in managing the relational risks.

Theoretically, this study has enhanced the model for managing risks [7] that presents the risk of outsourcing process (relational risk). Specifically, this study unpacks

relational risks faced by small firm's outsourcing vendor such as unknowledgeable client's staffs and client's demand of additional job scope. Although this study supports the importance of detailed contracts in managing relational risks of accounting outsourcing, the findings extend previous studies [10, 4] that power and trust could be used to enforce the outsourcing contract. Nevertheless, the use of power and trust depends on the innovativeness of small firm in managing their foreseen relational risks.

Practically, this study illustrates clients used of power. Instead of acting opportunistically, client use his power of requiring a social site visit as a condition to be fulfilled before signing an outsourcing contract is an innovative strategy in managing relational risk in AOS. Vendor's selection is a common practice in ensuring their ability and capability of performing outsourcing task. The case shows innovative steps by which client voluntarily requires vendor to evaluate his ability and capability before starting outsourcing relationship in order to avoid future misunderstanding. For a small firm, the client's top management might have different perspective of staff's accounting skills and knowledge that the perspectives that the vendors have on the staffs. This is crucial since the client's staff will deal directly with vendor for the AOS process. Overall, the findings of this study could contribute to the body of literature of accounting outsourcing [1, 2, 3] and small firm's activity, strategy and decision making [26, 27].

This study, however, has several limitations in terms of scope and methodology. Firstly, the scope of this study is limited to the context of accounting outsourcing work and is very specific to the issues of managing relational risks. This is to ensure that the issues in the process of managing relational risks in accounting outsourcing are well understood. Although other issues, such as performance risk seem apparent, they are not the primary focus here, but could form the basis of future studies. Finally, this study uses the qualitative interpretative case study approach, which has been argued as being too specific and difficult to generalize from. Nevertheless, this study overcame these constraints by using the triangulation approach and crosschecking information.

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