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Outsourcing decision processes: A case study of a Malaysian firm

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There is a growth trend towards the outsourcing of accounting activities. The drivers of outsourcing emanate from organisational initiatives, improvement focus, financial and cost objectives or growth objectives. Despite the increasing practical significance of this phenomenon, the academic literature is limited to a handful of studies concerned with the delegation of accounting functions. There are different drives and phases in the process of outsourcing but little is known on what drives accounting outsourcing and its process. Based on an in-depth case study, this paper seeks to understand the drivers and processes in accounting outsourcing. This study examines the mechanisms and practices adopted in accounting outsourcing in a Malaysian company. Interviews were conducted with vendor and client of the company studied. The findings reveal that there is no firm basis used by the company studied for evaluating its outsourcing decision.

Key words: Outsourcing, accounting, academic literature, vendor, client.

INTRODUCTION

Outsourcing is an increasingly important initiative being pursued by organizations to improve efficiency (Vining and Globerman, 1999). To be able to survive and be profitable in current globalization era, companies tend to use outsourcing in larger extent (Brannemo, 2006). In today's business environment, companies considered outsourcing to empower business focus, mitigate risks, build sustainable competitive advantage, extend technical capabilities and free resources for core business purposes (Bartell, 1998). Some companies outsource their core activities on the value chain extensively and other companies in contrast are extensively outsourcing their secondary activities of their value chains such as information technology, accounting systems and distribution (Johnson and Schneider, 1995; Lacity and Willcocks, 1998).

Juma'h and Wood (1999), defined outsourcing as the replacement of inputs or value added previously created in-house by provisions by an external provider within a

long-term contractual relationship within which only some of the expected mutual benefits and obligations are formally defined. It involves very high-level strategic decision answering the question 'what to make and what to buy' (Kakouris et al., 2006). According to Ellram et al. (2007), outsourcing has implications for day-to-day management and performance, as well as strategic implications. Therefore, company must outsource intelligently. Outsourcing decisions may affect company's cost structures, long-term competitive situation and can also alter the nature of risks that the company must manage (Brannemo, 2006). Hence, it is crucial for company to understand and have a clear conceptual framework of the outsourcing decision. Furthermore, company must also know the benefits and risks of outsourcing. Outsourcing has long been studied with a focus on manufacturing industries (Markides and Berg, 1998; Mol et al., 2004) and only more recently in the case of services (Kotabe et al., 1998) and the first services to be outsourced has been IT service. In Malaysia, limited studies can be found although outsourcing has gained tremendous interest especially in the financial sector. Kadir (2007) points out that Malaysia is a leading destination for the establishment of shared services and outsourcing hubs

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due to its low costs, modern infrastructure, business environment and high levels of global integration. Study by Abdul-Aziz and Ali (2004) explored outsourcing quality of quantity surveying activities at Malaysia's public works department and found that the officers view the consultants' performance as generally unsatisfactory. Based on the finding, they argue that it is important to monitor and control the outsourcing activities. Suhaimi et al. (2007), on the other hand, studied the practices of information systems outsourcing at a commercial bank. Their study highlighted challenges faced in outsourcing process including managing the partnership and handling staff transition and morale.

In another study conducted by Sohail et al. (2006) on the use of third party logistics services by manufacturing firms in Singapore and Malaysia found similarities and differences between firms in both countries. The similarities are in areas such as proportion of organizations using outsourcing service, involvement of functional managers, types of activities outsourced and budget allocation for outsourcing. Differences include process of making decision, benefits received and types of businesses utilizing the services. Their study also reported the following: (1) Malaysian organizations decision on outsourcing was made at the operational level, (2) Malaysian organizations utilize third party logistics services mainly for international businesses and (3) Malaysian respondents indicated time saving, improved customer services and payment or credit terms as the major benefits. Malaysia already had more than 130 shared services and outsourcing companies in Multimedia super Corridor (MSC) ranging from major local players to multinationals. Kearney (2009) Offshore Location Attractiveness Index has ranked Malaysia as the world's third most attractive shared sources and outsourcing (SSO) location. Malaysia offers low cost of labor and taxes, and good infrastructure for offshore centre to companies who are looking to set up shared services centre or to outsourcing their services in Asia. Despite these, little is known about accounting activities especially the outsourcing decision making process in Malaysia.

The main purpose of this paper is to understand outsourcing decision process by Malaysian firm. The research questions are (1) how does Malaysian firm performs outsourcing decision process and (2) why does the firm decides to outsource some of their accounting activities. The findings will enhance the understanding of the drivers of accounting outsourcing decision practices in Malaysia.

This paper is structured as follows. The next section discusses the relevant studies in outsourcing. The following section presents theoretical framework for assessing outsourcing decision, costs and benefits from the company's perspective; Methodology section describes case study method used in this study; Finding section analyzes the decision making process. Finally, the conclusion

section suggests theoretical and practical implications of this study.

Literature review

Outsourcing

Outsourcing is a process of transferring the responsibility for a specific business function from an employee group to a non-employee group. Today, accounting outsourcing service is recognised as an effective management tool. Companies often incorporate outsourcing as a strategy in business planning. Companies can provide better client service, produce a better product, do a better job efficiently by outsourcing their non-core business function. When the companies outsource their accounting services functions, they put those responsibilities in the hands of professionals.

Accounting outsourcing means transferring part of accounting functions to a third party provider or a fully owned subsidiary in order to cut cost, gain access to scarce skills or obtain competitiveness (Nicholson and Aman, 2008). Some common examples of accounting outsourcing include general accounting, treasury and cash management, payroll processing, accounts payable outsourcing, invoice processing, and other industry specific processes.

Outsourcing decision

Economic principles is an ideal and commonly used basis in outsourcing decision making. Efficiency theory indicate that companies will allocate their resources within the value chain to those activities that give them a comparative advantage. Meanwhile, other activities that do not offer such advantages will be outsourced to external suppliers or partners. This is because some companies are highly integrated; others specialize and outsource their remaining transactions in market. Basically when companies outsource their activities to produce their products and services, they usually move towards a business strategy which helps them in maintaining their competitive advantage in serving customers. Hence, outsourcing is expected to imply cost saving relative to internal production or internal service function.

Beside cost savings, there are other drivers that influence outsourcing engagement. Ghodeswar and Vaidyanathan (2008) classify drivers of outsourcing into four categories: organizational drivers, improvement drivers, financial and cost drivers, and revenue drivers (Table 1). The decision to outsource can also be explained by transaction cost theory. Transaction cost theory explains how companies consider the relative cost of transaction using their own employees on the other hand and external parties on the other (Coase, 1937).

Table 1. Drivers for outsourcing.

Organizational drivers	<ol style="list-style-type: none">(1) To achieve a greater focus on core business.(2) To increase flexibility to deal with ever changing business conditions.(3) To gain access to products, services and emerging technologies.(4) To assign operational issues to an outside expert.(5) To have greater thrust on market positioning and new product development.(6) To redirect resources from non-core activities to greater focus in serving the customer.
Improvement drivers	<ol style="list-style-type: none">(1) To improve operating performance, quality, timeliness, and productivity.(2) To obtain expertise, skills, and innovative ideas.(3) To obtain technologies which otherwise will not be available.(4) To improve management and control of operational process including risk management.(5) To improve credibility and image by associating with superior providers.(6) To eliminate the fixed cost of internal staff by moving the function to a supplier.
Financial and cost drivers	<ol style="list-style-type: none">(1) To reduce investment in assets.(2) To reduce the invested capital funds in non-core business functions.(3) To expanding its operations into a new geographical region.(4) To reduce or control operating costs.(5) To access an outside provider's lower cost structure.(6) To achieve cost reduction with enhanced performance.(7) To handle varying demand more efficiently because of economies of scale.
Revenue drivers	<ol style="list-style-type: none">(1) To achieve aggressive growth objectives by gaining increased market access.(2) To leverage on the service provider's best process, capacity and systems.(3) To expand capacity to design, test and build new products and service.(4) To stretch its limit in handling the increased volume of business.(5) To manage demand efficiently through outsider's automation, process maturity and the latest technology.(6) To focus on enablers of business growth and strategies to fulfil them

Source: Ghodeswar and Vaidyanathan (2008).

According to Klein (2005), transactions differ in the degree to which relationship-specific assets are involved (asset specificity), the amount of uncertainty about the future (environmental uncertainty), the amount of uncertainty about other parties' actions (behavior uncertainty) and the frequency with which a given transaction occurs (Everaert et al., 2007). Previous studies provide evidence that asset specificity is a significant driver in the outsourcing decision (Masten et al., 1989; John and Weitz, 1988; Monteverde and Teece, 1982). Meanwhile study carried out by Anderson and Gatignon (2005) explained that both asset specificity and behavioral uncertainty seemed significant in explaining the entry mode of outsourcing activity. Asset specificity has been found to be an important driver for outsourcing of IT (Watjatrakul, 2005; Barthelemy and Geyer, 2005). Speklé et al. (2007) and Widener and Selto (1999) found that both asset specificity and frequency is important driver for outsourcing of the internal audit function. These studies

concentrated on the outsourcing of production tasks (so-called backward integration).

According to Vandaele et al. (2007), to govern the outsourcing decision of business service, more emphasis should be placed on behavioral uncertainty, asset specificity (especially human asset) and trust. Klein (2005) suggests that alternative theories of the companies, based on capabilities, power and trust could be potentially become important in explaining why companies outsourcing some of their activities. Furthermore, companies should also look from the strategic perspective, which focuses on further aspects to the outsourcing decisions besides costs.

Outsourcing decision process

In order to make an effective decision, an organization must also identify its needs and understand why outsourcing

may or may not be appropriate to the organization. Some organizations outsource their core activities on the value chain so extensively and others are extensively outsourcing their secondary activities of value chains. Yet, many organizations only understand a general idea of outsourcing is to save resources and allow them to focus on core competencies (Smith et al., 1998). Outsourcing decisions depend on more than that and questions such as when should an organization outsource its activity, whom should an organization select and how much control should be given to the supplier/vendors are pivotal and must be considered and answered.

'Make-or-buy' question asked by manufacturers themselves and the 'do it ourselves or buy it on' question asked by service providers must be answered by those responsible for sourcing (Kakouris et al., 2006). Furthermore, as highlighted by Hickey (2005), in the current global economy, factors that should be considered when making outsourcing decisions are long-term productivity and cost projections, physical and data security, long-term business and employment stability, political agenda and cultural differences and business continuity capability. Those factors are important because outsourcing enables companies to leverage the global market place, to choose the work they want to do and where they want to do the work in order to ensure the greatest profit. Once a company decides to outsource its activity/activities, the process of selecting a partner or supplier must be put in place. Analytical, thoroughness and careful insight are required in order to choose the 'right' supplier or partner (Hatonen and Eriksson, 2009). Handfield and Nichols (1999) argued that managers can only achieve the corporate objectives after the collaboration of satisfactory vendors or supplier. According to Krell (2007), managing the relationship with outsourcing vendors technically begins during the provider selection process, when a request for proposal initiates communications with the eventual provider.

The outsourcing decision is the most critical step within the whole outsourcing process (Lonsdale and Cox, 1998; Jennings, 1997). There are many important criteria when making supplier decision. The most frequently cited criteria are quality, delivery performance history, price and location. Furthermore, a thorough cost-benefit analysis should be conducted where organizations must identify all internal and external costs and benefits in order to make an effective and reasonable decision. Organization must conduct full analysis in order to have better picture and clear impact of the choice.

Successful companies in outsourcing work often have clear understanding of their core-activities, have done adequate research and planning and most importantly have developed clear objectives, goals and expectations of outsourcing activities (Barthelemy, 2003). Guideline introduced by Financial Services Authority (2003) suggested six steps to be followed by an organization in order to minimize risk exposure (i) Strategic decision to

outsource – assess strategic risk and rationale for outsourcing, (ii) Due diligence process – ensure supplier is competent, honest, financially sound, and has relevant knowledge and expertise, (iii) Contract and service level agreement – formal contract and service level agreement between the two parties, (iv) Change management – as company's risk can increase, plan and effectively use project or change management, (v) Contract management – Appointment individuals to manage the contract and do periodic review, (vi) Exit strategy and contingency planning – prepared for new arrangement with minimal disruption to business.

Theoretical framework

There are few frameworks available to analyse decision process in outsourcing. For example, Choudhury et al. (1995) explain outsourcing process model that consists of six steps: (i) the company describes whether to outsource or not (ii) the company decides on the degree to outsource (iv) the company prepares a list of possible vendors and (iv) the company start lists vendors based on key decisions (v) company issues request for proposal to receive bids from the short-listed vendors (vi) company selects a vendor and develops policies and control to manage outsource issues. Next, Lee and Kim (1997) suggested that outsourcing process model involves six stages: (i) outsourcing strategy selection (ii) service provider evaluation (iii) service provider selection (iv) contract negotiation (v) outsourcing implementation (vi) control management and (vii) performance feedback. These models are quite general and have not provided detailed guidelines for outsourcing decision process.

Later, Fill and Viser's (2000) outsourcing framework presents specific guidelines for outsourcing decision process. The framework consists of three main components; contextual factors, strategy and structure and transaction costs. The first part of the framework develops contextual factors that consider both quantifiable and non-quantifiable criteria of external and internal factors. Quantifiable criteria are costs, increased cover of fixed costs, investments and revenues (Brannemo, 2006). Non-quantifiable criteria are of strategic interest, confidentiality, linkage with operations, stability of employment, management and dependence on suppliers (Fill and Viser, 2000). The second part of the framework concerns with strategy and structure. Companies should consider the structural aspects associated with the decision and help to focus on how integrated the company should be (Brennamo, 2006). The third part concerns with examining the transaction costs; production costs and transaction costs (Fill and Visser, 2000).

At the same time, Mclvor (2000) suggested four stages of outsourcing framework: (i) identifying the core and non-core activities of the company. The core activity is perceived by the customers as adding value and being a

Table 2. Detail of interviews.

Officers	Client - Depro (h)	Vendor - BPA (h)
Accountant	1 × 4	
Head, Corporate Service Division	1 × 2	
Head of Finance and Administration	1 × 2	
Senior Project Manager		2 × 3
Total hours (h) of Interview	8	6

major determinant of competitive advantage (ii) analyzing the competencies of the company in core activities in relation to potential external sources. This involves an evaluation of the relevant value chain activities' and the total cost analysis of the core activities. A relative performance of the company is identified and this helps to understand the disparity between the sourcing company and the potential supplier (iii) attempting to measure all the actual and potential costs involved in sourcing activities. In this stage, two types of costs are identified: cost estimation of carrying out the activity internally, and cost estimations associated with potential suppliers and (iv) analysing the relationship with the vendor if the company wishes consider to outsource its core activities.

This paper will use McIvor's framework to further explore outsourcing decision practice by a small sized company in Malaysia. McIvor's framework provides comprehensive as well as practical ways in analyzing outsourcing decisions. Advantage of this framework it does distinguish the core and non core activities analysis in outsourcing decision process. Even though, the framework did not taken into consideration the needs and constraints faced by small and medium sized companies, it is found useful for understanding the decision process especially when identifying the core and non-core activities of the company. At the same, drivers of outsourcing are identified using classification by Ghodeswar and Vaidyanathan (2008).

RESEARCH METHODOLOGY

In order to understand the the outsourcing decision process, case study method is used. Case study approach is found useful for this study as this study is mainly exploratory. According to Benbasat et al. (1987), by using case study research, one can study the topic in a natural setting and generate theories from practices and at the same time answer 'how' and 'why' questions, that is, to understand the nature and complexity of the process taking place. According to Yin (2002), case study method is most appropriate when the research does not require central over behavioral event and when the focus of the research is on the existing events.

A company for this case study was selected based on purposeful sampling which is useful for understanding issues related to the research questions (Patton, 1990). One of the main criteria for selecting a company is that the company must be a local company that involved in accounting outsourcing activities with local outsourcing vendor. Eisenhardt (1991) suggested that selection of cases is an important aspect of theory building in case studies. The companies were not selected in random, but reflected the selection

of specific cases to extend the theory.

Two companies involved in this study include a local Malaysia firm (client) and its local outsourcing firm (vendor). Data was collected using a triangulation approach that included interviews, documentation review and observations. The study spanned a period of two years following the various phases of accounting outsourcing projects over time. Historical reconstruction of events was undertaken to observe changes over time from the inception of the company (2001 to 2007) and during the field study period from 2007 to 2009. There have been a total of 14 h interviews with Accountant, Head of Corporate Service Division, Head of Finance and Administration of the client firm and a Senior Project Manager of a vendor firm (Table 2). Interviews lasted between one to two hours. The interviews were transcribed and subsequently summarized. Interview questions were tailored to each particular person and focused on their background, experience and their perception of outsourcing events they had experienced. Other questions were focused on how outsourcing decisions were made.

The data once collected was analyzed by identifying themes related to outsourcing decision process. Nevertheless, the finding and analysis section do not provide a complete description of the outsourcing decision process, but merely present a broad outline of the outsourcing process. The case-study data was theorised by looking for evidence of mechanism and practices that can be rationalised as outsourcing decision process and associated with McIvor outsourcing framework. Background descriptions of the case is discussed in the following section.

Case study background

Depro Technology (Depro) is one of semi government agency operating under one of the ministries in Malaysia. It offers expert services to other department, private entity and public citizen. Depro uses fund that was received from the government to support its operation and development and is required to submit quarterly cash flow statement to the ministry to explain how the fund is spent. There are only four staffs in the Finance Department of Depro consisting of the Head of Finance Department, an Accountant and two Account executives. The department is responsible for preparing budget for services offered, financial planning for specific project, internal audit and tax. Since its establishment, Depro has been using accounting outsourcing services provided by Brilliant Power-Up Associates (BPA). At that time, Depro wanted to focus on its core business.

BPA has handled the accounting function of Depro since its inception on 13 January 1997. Depro sends all its accounting work to BPA including data entry, daily account transaction, preparing annual report and payroll. BPA is an outsourcing company offering business process and accounting services. BPA was chosen because of the relationship between the BPA senior manager with the top management at Depro. The accounting outsourcing contract was from June 2006 to 31 December, 2007 and was extended another one year until 31 December, 2008. BPA allocates a team of three to four people to handle accounting work for Depro.

FINDINGS AND DISCUSSION

The evidence reveals that Depro has no firm basis for evaluating the outsourcing decision. The choice of the accounting activity to outsource is made because Depro is new and has no sufficient staff to conduct the accounting activities. As noted by its accountant "...we are new and do not have people to carry out the accounting jobs". Therefore, it could be said that Depro make outsourcing decision primarily on the basis of reducing its headcount and costs. The driver for its outsourcing is improvement driver, which the company would like to eliminate the fixed cost of internal staff by moving the accounting function to a vendor. The choice to outsource is made by ascertaining what will save most on overhead costs, rather than on what makes the most long-term business sense.

The decision to outsource a function should start with a sound business plan. This plan should adequately identify all costs associated with the current method of conducting business and all costs that are anticipated once is deployed. When determining current cost Depro should understand of all aspects of costs and how costs are accounted. Since Depro has direct relation with the government agency, it also should consider the potential political consequences. The outsourcing decision frameworks proposed by McIvor assume that in general all non-core activities will be outsource. However, it must be pointed out that certain factors such as industrial relations, may impact on the freedom a company has to outsource activities. In the case of Depro, it uses fund that was received from the government to support its operation. Therefore, this will involves issues of confidentiality and public money.

Depro also did not produce a clear marginal decision in cost analysis of the outsourcing decision and did not evaluate the relevant value chain activities. BPA was selected based on the good relationship between BPA Senior Manager with the top management of Depro. As highlighted by Depro's accountant "...the CEO has a good relationship with BPA Senior Manager. So he insists to outsource the accounting activities to BPA".

Depro also did not conduct total cost analysis of core activities. This analysis is important in identifying all the activities and costs associated with the outsourcing decision (McIvor, 2000). This involves attempting to measure all the actual and potential costs involved in sourcing the activity; internally or externally.

Depro also failed to consider issues such as:

(1) Should the company strive to maintain and build its capability in a particular activity or turn to the best-in-class source. (2) If there is a disparity between the company and supplier, how much investment is required internally to match the capabilities of the supplier.

The evidence reveals that Depro is not achieving the desired benefits from outsourcing. Its outsourcing decision

is motivated primarily by the search for short-term cost reduction. According to Yoon and Naadimuthy (1994), the outsourcing decision can often be a major determinant of profitability making a significant health of the company. Furthermore, as highlighted by Ptak and Noel (1998), successful outsourcing depends on planning and process.

The results from the study showed that Depro has lack support when dealing with outsourcing questions. The outsourcing decision has earlier been made by its CEO. Furthermore, there is no proper documentation on its outsourcing decision. This made it difficult for Depro to go back and review if the outsourcing decision is still strategically right for the company. As highlighted by the company's accountant '...realizing the difficulties doing the accounting works in house and the risks of outsourcing the work, I need to recommend to the CEO whether or not to renew the contract with BPA...'.

The sourcing decision should be followed up after some time. In the case of Depro, there is no basic structure used on the evaluation of the outsourcing decision. After five years of operation, Depro's profit decreased for about 35%. Therefore, Depro's financial evaluation ought to be made after its sourcing decision. Furthermore, cost is an important aspect that ought to be analyzed before taking sourcing decision. But, Depro did not calculate and analyzed cost before taking an outsourcing decision.

Conclusion

In short, this article has answered the research questions of this study: (1) how does firm perform outsourcing decision process and (2) why does the firm decide to outsource some of their accounting activities. Findings from this case study reveals that outsourcing decision process made by Depro did not follow formal and structured framework. While this contradicts McIvor's framework, the findings is consistent with King et al. (2009) who found that firm's size influence the decision to adopt formal budgeting practice. It was argued that small businesses have low levels of formal planning and control (Chenhall and Langfield-Smith, 1998). For Depro, it chose to outsource its accounting activity because of limited resources such as cost and accounting staffs to perform accounting work at its start of operation. Depro did not perform cost and benefits analysis before deciding whether or not to outsource its accounting work. The decision to outsource mainly came from its close relationship with one of the local outsourcing vendor. Depro's top management was convinced on the general benefits of outsourcing that he could gain by outsourcing its accounting work to BPA. Reasons for outsourcing are because of cost savings, expertise and focus on core business.

This study makes several contributions. Theoretically, this study presents evidence that the formal framework of outsourcing decision process suggested by McIvor and others did not apply to small size firm such as Depro

because of limited resources. Thus, this study extends the outsourcing decision framework to a small size firm where most of decision made is adhoc and bounded to limited capability and resources.

Practically, this paper provides insights of the outsourcing decision process in a Malaysian company. There are a few points discussed in this paper that can be beneficial if a company faces a decision whether or not to outsource accounting function: the outsourcing decision should be treated as a fundamental business decision and cost analysis and risk analysis should be carried out in order to evaluate the external capabilities with internal capabilities.

However, in interpreting the results, the limitation of this study should be acknowledged. As with other case studies, the use of one company limits the capacity to generalize the findings to larger population of small service firms. The kind of activities companies choose to outsource and the reason they outsource may differ and may be influenced by their leader's political and cultural influences. Future studies should further elaborate the outsourcing decision and focus on leadership, political and cultural influences of outsourcing decision process in small and medium sized firms.

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