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# Challenges of control in functional organization structures: Example of outsourcing sector

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## Abstract

Effective control of an organization is strictly connected with its organization structure. When a company decides to outsource a part of its operations, a new structure is applied. Also, the system of control should be reviewed and adjusted to the new model of business in order to be effective. Usually, the outsourcing companies apply functional organization structure which is the most common way of grouping business activities. The goal of the paper was to point challenges and aspects which should be taken into consideration in order to adapt control systems to new organization structures in case of Business Process Outsourcing and Shared Service Centers. The research was based on literature studies as well as empirical analysis of selected companies from business service centers sector. The key findings of the study suggest that the mechanisms of control differ in Business Process Outsourcing and Shared Service organizations although both base on building trust and relationship. The main challenges of adapting the control system to new conditions comprise people and process related factors such as: knowledge management, control split and owners, new processes flows, virtual teams. Building control system is a process which foundation is a new organization structure.

**Keywords:** control, effectiveness, outsourcing, organization structure.
**JEL Classification:** M160, F16.

## Introduction

Outsourcing sector is dynamically developing in Poland. The growth of investments in outsourcing sector has become significant with the entrance of Poland to the European Union. Nowadays, average increase of employment in this sector in Poland reaches 20% year over year. Poland is a leader in modern business services sector in Eastern and Central Europe [www 1]. As the international business services are still relatively new and the phenomenon in Poland remains not fully explored, the literature and research related to this type of operational restructuring are not extensive. The author is trying to assess challenges of internal control in international outsourcing companies during restructuring phase. Usually, the companies apply functional organization structure [Kroon 2004, p. 223] with managers located abroad or employees working remotely. There are many factors related to control, starting by the change of organization structure that should be taken under consideration in the decision processes.

The literature treats widely the aspects of challenges related to implementation of outsourcing strategies. Many authors underline the need of control and its importance in implementation of outsourcing. Possible risks are described on general level as potential cons of outsourcing. The studies on how to adapt the control systems to new reality and what experiences related to control managers may have in transforming businesses are missing and have been identified as a research problem by the author. The goal of the paper is to show the challenges the company may face in the area of control while taking a decision of outsourcing selected part of the business. This kind of operational restructuring entails significant changes in the organizational structure of the company. The author refers to functional organization structure which is most commonly applied. The aspect of globalization has been taken into consideration as well.

The article consists of three chapters and conclusions section. The first chapter presents review of literature in the field of outsourcing and control. This chapter presents control as a key management function with focus on control in outsourcing and describes the transformations in organizational structures of the company while applying outsourcing strategy. The next chapter describes the research methodology and phases of studies conducted. The third chapter relates to research findings and summarizes the challenges a company may face while taking decision to outsource selected activities with distinction of outsourcing to external partner and creation of shared service center within a capital group.

## 1. Literature review

### 1.1. Control as a key management function

The research concept is based on literature studies as well as empirical analysis of selected companies from business service centers sector. The term *control* has broad meaning and is one of the most important ones in the management sciences. In its results, a company can see its past and rough the future out [Kuc 2009, p. 18]. Cambridge dictionary presents verb to control as "to order, limit or rule something, or someone's actions or behavior" [www 2]. The word control, coming from British and French tradition, was primarily used to assess legislation pieces. Currently, internal control is a key element of any organization [Wojciechowska 2015]. There are multiple definitions, but interpretation of Koontz and O'Donnell is valid despite the time, the object and the subject of control. According to the authors the process of control consists of three steps:

- set up norms,
- compare results to norms,
- correct deviations.

To ensure efficiency of control, it is crucial to correct deviations timely and apply appropriate tools to avoid these deviations in the future [Fayol 1926, p. 6]. Nowadays, many authors (i.e. Webber, Goetz, Kurnal) underline the need of anticipation in the process of control to ensure corrections can still be made. Also, the closeness of planning and control is widely present in the literature. The control should be present from the very beginning of strategy implementation [Kuc 2006, p. 27].

The term outsourcing was used in 1979 for the first time, but only in recent years became popular and present in each economy branch [Radło 2013, p. 19]. Currently, terms Business Process Outsourcing (BPO) and Shared Service Centers (SSC) are used to indicate two types of modern business services centers. BPO companies provide services for external clients while SSC are internal business units created for concentrating selected services inside the company [Budzyńska 2012, p. 42]. The decision of operational restructuring is not easy for any business. However, many internal and external factors like competition, continuous improvement need or globalization are making more and more companies take up such a challenge. Outsourcing is a chance to lower costs, to enhance effectiveness, to standardize, to remain competitive, to focus on main company functions [Grycuk 2014, p. 1]. Often, the decision to adapt to current trends is a decision of "to be or not to be". The choice of an outsourcing strategy drags the need of control. The control of such an organization is one of the key issues interesting primarily for investors and managers. It is also one of the factors determining the success of the investment. It should be included in the transformation plan and designed at the strategic level.

The control in the literature is present for years. Already Fayol [1926, p. 8] highlighted that effective control should be based on fast reaction to deviations. Nowadays, the concept of control is much wider. With regard to outsourcing, the literature treats the subject of control on general level. Many authors underline the need of control and its importance in implementation of outsourcing. Possible risks are described on general level as potential cons of outsourcing [Power, Desouza & Bonifazi 2010; Vitasek, Ledyard & Manrodt 2011; Szejniuk 2012; Trocki 2001]. Only selected control tools like SLA (Service Level Agreement), Green Star, Six Sigma have been described [Kończewski 2011; Sobińska 2006; Gay & Essinger 2002]. Therefore, there is a need to ask the questions: How the change of company structures in case of outsourcing influence control systems? Could control be as effective as before restructuring? What challenges should we consider and accept in area of control when selecting Business Process Outsourcing or setting up a Shared Service Center?

The standard of control is determined by company's goals and objectives. All control systems must be goal-oriented [Flamholtz 1996, pp. 3, 10, 16]. Top management determines goals and issues directives to operating managers who set the objectives and execute them [Ghosh 2005, pp. 45-46]. The internal control system ensures that management decisions are based on a reliable data. Control is dynamic and must adjust to changes in goals over time. The internal control plays a crucial role in the process of management:

- it safeguards assets,
- it ensures the reliability and integrity of financial information,
- it ensures compliance,
- it promotes efficient and effective operations,
- it ensures the accomplishment of goals and objectives.

It should cover the following functions [Kałużny 2008, p. 56]:

- informative, giving systematically feedback to business owners in order to correct decisions,
- corrective, revising errors,
- inspiring, motivating to improve the processes,
- preventive, anticipating negative phenomenon in the future,
- advisory, showing right ways of proceeding,
- educational, constituting a base for employees' assessment.

Outsourcing is a strategy which should bring benefits on various levels. Executives require the processes to be performed timely, in a more effective way, to keep high quality standards and confidentiality of data. Not all companies need a control system which refers to a set of processes and techniques which have been designed explicitly as a system to influence behavior of people [Flamholtz 1996, p. 10]. In large international organizations the control system is mostly in place. It has the following features:

- internal control involves people and their working relationships with other people in the business, it depends on people for its establishment and execution, the system should include all personnel from directors to junior employees,

- the system never guarantees 100% of accuracy, the system does not allow for an unlimited number of control or unlimited personnel to implement them, it should be built in balance between cost and benefit,
- the internal control system is a complementary system that support reporting of the financial and non-financial operations of the company,
- internal control is an evolving process, it must develop as the business develops.

A correctly structured internal control system should be constructed with the following elements:

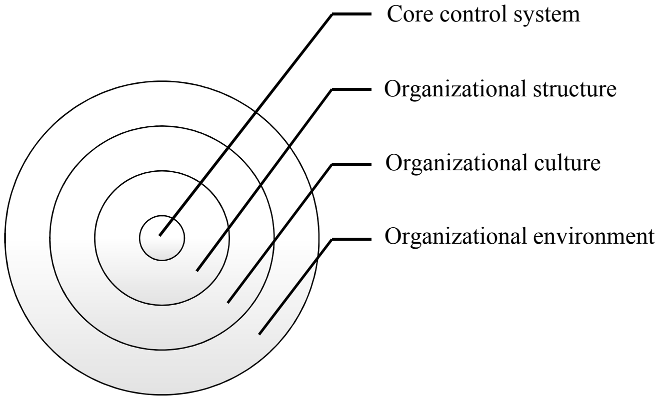
- the control environment, overall attitudes to accountability and responsibility of the organization,
- inherent risk, every business carries a degree of risk that its assets or operations could be targets for fraud or manipulation,
- information and communication, methods used by the reporting system,
- control activities, procedures to ensure that policies are in place at all management levels,
- monitoring as an ongoing process, the system should be regularly reviewed to be effective [Trenerry 1999, pp. 9-10].

Effective system of control is crucial for investors and service providers. In case of contractual outsourcing (BPO) the contract describes internal control system, monitoring tools, frequency of reporting, including penalties for not keeping agreed service level. In case of capital based outsourcing (SSC), at the moment of splitting activities the control system should be adjusted. It requires analysis of processes which will be performed by a new organization unit. Nowadays, the processes are not outsourced as they are. The activities are often standardized and new informative systems are implemented before being taken over. Persons responsible for reporting, analyzing and presenting control results should be nominated. One of the most common traps in outsourcing strategy is a wish of controlling everything. It comes from a fear of losing control at the moment of operational restructuring [Vitasek, Ledyard, Manrodt 2011, p. 57].

## 1.2. Outsourcing − changes in organization structure

The term *structure* comes from botanical sciences. There are multiple definitions of structure. It can be defined as an arrangement of parts, elements that are put together in a particular way [Kraśniak 2012, p. 11]. Organization structure provides foundation of an effective control system. As the company grows, new approaches are developed, systems are redesigned and a more effective organization is worked out. The model of an organization control system is presented schematically in Figure 1.

**Figure 1.** Organizational control system model




Source: Based on: [Flamholtz 1996].

The concept of core control system presents an integrated structure of five basic organizational processes: planning, operations, measurement, feedback and evaluation-reward.

Structure functions as a control mechanism by specifying the behaviors expected from people in the performance of their roles, as well as by specifying the authority and reporting relationship of the entire set of roles which comprise organizational structure.

The structure of any organization depends on its activities. Basically, there are three types of structures used in big organizations:

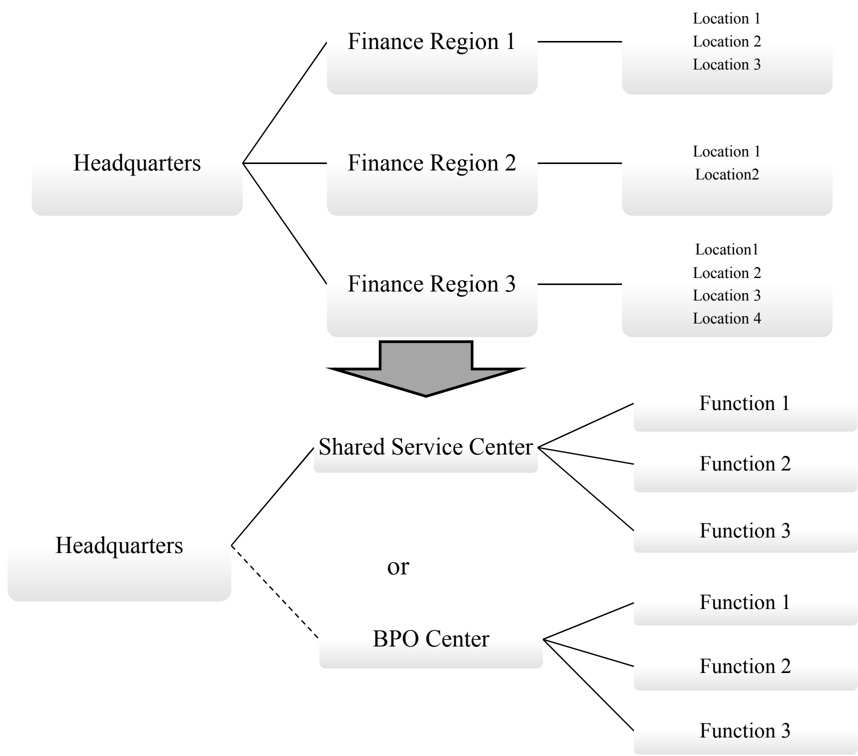
- **Functional.** Functional organizational structure involves structuring an organization around basic business functions such as production and operations, marketing and finance. An advantage of functional organizational structure is a high level of specialization: each unit operates as a mini-company. An expert in his functional area can perform tasks with a high level of speed and efficiency, is more productive. Such experts may have difficulties to work together with workers from other units. They may not be that used to the teamwork. Also, when organizations get larger the top management needs to delegate more decision-making responsibilities to functional areas. It increases autonomy, but it requires more formalization, makes communication, management and control maintenance more challenging.
- **Divisional.** A company with a divisional organization structure has various company divisions operating autonomously as business under a broad cooperate framework. A division is run by its own management group which makes easier to assign responsibility for results and decisions can be made

fast. Potential duplicity of functions or conflict between divisional heads are listed as main disadvantages.

- **Matrix** [Ghosh 2005, p. 45]. A matrix organizational structure involves employees reporting to multiple managers in team projects situations. It is a combination of functional and divisional organizational structure. It brings together employees and managers from different departments to work toward accomplishing a goal. Main advantages of matrix organizational structure are efficient exchange of information and increased motivation of employees. However, some employees may be confused as to who their direct manager is. Also, double supervision is more expensive and sharing employees may cause conflicts between managers.

The strategy of outsourcing entrails changes in organization structure. Example of such a change resulted from outsourcing of finance activities is shown in the Figure 2.

**Figure 2.** Change in organization structure resulted from outsourcing strategy

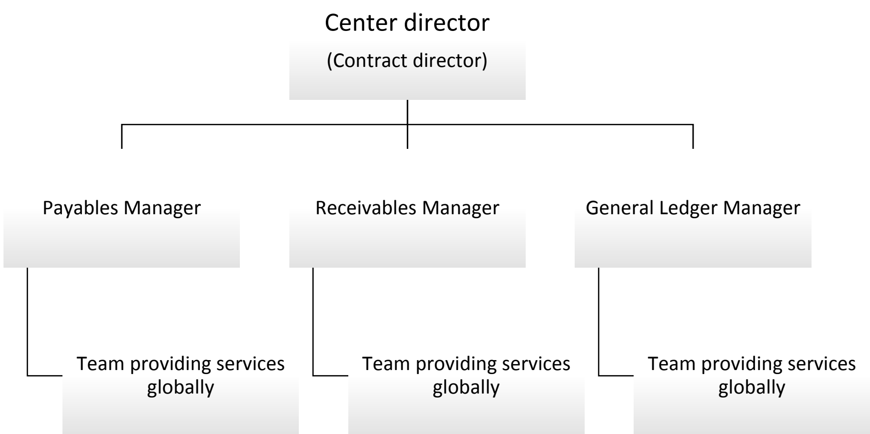



Source: Based on: An outsourcing company structure based in Poland.

Before implementation of outsourcing strategy, the large company is usually divided into locations with headquarters. Large corporations establish very often divisional organization structures. Figure 2 shows 9 locations in 3 regions. Each location has its own accounting department, very often without a strict segregation of duties. It means the same person can book suppliers invoices, issue customer invoices and settle payments. The outsourcing moves the company from local to global.

A shared service center or an external partner in outsourcing limits the number of locations for an outsourced activity. For instance, finance operations are delivered globally from Poland, or from Poland and India. Also, the segregation of duty is mostly in place. There are separate teams dealing with supplier invoices or payments for various locations. It mitigates the risk related to fraudulent acts within a company. The structure of outsourced activities becomes more transparent. The usual organization structure for contractual and capital outsourcing presents Figure 3.

**Figure 3.** Example of organization structure in finance outsourcing




Source: Based on: an outsourcing company structure based in Poland.

At first glance it seems that it is easier to control operations which are located in one or two places. Also, the segregation of duties and introduction of specialization should minimize the risk of fraud and improve quality long term. However, the move of a part of operations to a new location is connected with new management, often new employees, modified processes, new goals and procedures, sometimes new ERP systems. It is not only the change of locations, resources but also a transfer of knowledge. Babińska [2013, p. 10] underlines the role of knowledge in internationalization of firms focusing on the ways new knowledge can be acquired and knowledge sources. Without any doubt a huge portion of new knowledge, experiences and skills is associated with the process of outsourcing. However, the transfer of knowledge to new employees in a new location causes a risk of knowledge loss. It may have significant impact on control activities and its effectiveness. New control system should deliver information on effectiveness of new staff and transformed processes. It should help assessing the level of goals achievement.

## 2. Research methodology

The research was based on literature studies as well as empirical analysis of selected companies from business service centers sector. Publications in the fields of outsourcing and control have been analyzed. Following the literature review, the gap in the studies held on the field of control in outsourcing sector has been identified. Importance of the subject (control as a key success factor in outsourcing strategies) and its practical value for developing industry branch in Poland, lead to further empirical studies. The research was based on interviewing 20 employees from business services sector in Poland during 2015. Four companies took part in the study − two are BPO companies with locations in Poland and India and two are Shared Service Centers based in Poland. All four organizations have their mother companies outside Poland. The maturity of selected firms was assessed as defined ("Works within processes are standardized, stable and repeated") or managed (defined as "Applying process effectiveness measurements makes it possible to identify threats and undertake effective actions correcting structural adjustments"). The interview contained five open questions:

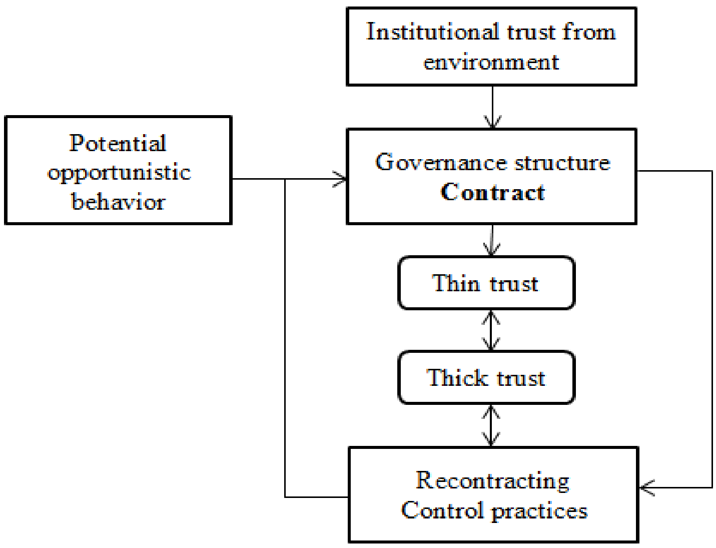
- What were the main challenges during the process of transition of activities to Poland in terms of control?
- How the organization structures of the company changed with outsourcing?
- Why do you consider the new control system as more/less effective?
- How did the process of building new control system look like?
- What advises in the field of control would you give to investors who plan to outsource activities to Poland?

The responses helped to draw a general overview of the investigated issues and showed the regularities in answers. Surely, it is a good starting point for further studies in this field.

## 3. Research findings

Company's executives from one side and operational management from the other should regularly assess whether current control system is effective and reflects the business as it is. With regard to Business Process Outsourcing, the base for control is a contract. Figure 4 presents how the control is enhanced with the time. The fundamental problem that the parties face at the start of an inter-firm relationship may be potential opportunistic behavior by the partner. It concerns both BPO and SSC organizations. To mitigate this risk a governance structure is negotiated that copes with appropriation concerns. A contract is signed and the control structures incorporated in this contract produce thin trust. The control structures are practiced. Also contracting itself may be viewed as a control practice because periodically new contract negotiations are needed when problems occur or when the contract expires. The control practices may build the trust and the trust will influence the control practices back. The re-contracting process also results in changes in the contract which again influence the control practices. In shared service centers there is more trust and based more on partnership than on the relation client-service provider. The interviewed persons agreed the trust usually grows with the time. According to studies a higher degree of trust is observed in case of SSC than BPO organizations.

**Figure 4.** Interaction between control and trust




Source: Based on: [Minnaar 2014, p. 126].

According to literature, the following aspects determine efficiency of control system [Kuc 2009, p. 340]:

- **Precise and clear job descriptions for all employees.** It is important for both: employees and management to know which duties are assigned to individuals to fairly assess their performance and to control them.
- **Training enabling employees performing best their duties.** The training is a crucial and challenging phase in outsourcing. It is not easy to fill out any detected gaps afterwards since original team is not available any more.
- **Segregation of duty between departments.** Segregation of duty is a standard approach in outsourcing. ERP systems help limiting accesses to particular transactions to a selected group of individuals. An accountant cannot set up new customer accounts in the system, book invoices and settle payments. Also the organizational structure imposes the split of responsibilities.
- **Procedures, regulations and instructions describing all activities present in a company including especially sensitive processes.** Operating procedures, created as an outcome of trainings are the base for employees and could include control points.
- **Hierarchical daily supervision.**
- **Effective self-control in place.**

In Shared Service Centers the above responsibilities remain in the hands of SSC Director, but depend a lot on the global company procedures. In Business Process Outsourcing these activities are usually in service provider hands to avoid the split of responsibilities between two entities. Job descriptions and levels might be globally defined, however, they need to be adapted to new positions within shared device center. Some positions might exist in the past (i.e. Accountant, Senior Accountant), but some of them will be new. For example, with the change of the divisional organizational structure to functional a position of functional Lead/Manager will be new (i.e. Payables Manager). Similarly, the global trainings path could be developed and working well in big corporations, however, in the shared service center there might be a need for additional trainings. For example, it happens that before implementation of SSC or BPO a call center system did not exist. If it is implemented in the time of SSC/BPO set up, training on call center system might be required. With regard to segregation of duty, the procedures and ERP roles should be reviewed from two perspectives: to ensure that the fraud risk is mitigated as well as to ensure the employees have accesses need to perform their own duties. With the setup of SSC/BPO and new structures there might be a need to create new roles in an ERP system.

One needs to keep in mind that current control systems reduce, but never eliminate:

- possibility of taking a wrong decision,
- human errors,
- conscious neglect of control system by employees,
- unexpected events.

According to Mazurek and Knedler [2010, p. 42] a good control system characterizes by:

- punctuality, any deviations should be found fast enough to limit losses,
- saving, costs cannot overcome benefits,
- accountability, controlled activities should be reported,
- appropriate location, control goals should justify its presence in a given process.

The strategy of outsourcing demands that the following aspects should be considered with regard to effective internal control system:

- the system of control was present in the locations for a long time before outsourcing,
- the system of control had to be redesigned and is new for operational managers and employees working in Shared Service Center as well as for mother company directors to some extent,
- if a new control system is implemented at the moment of outsourcing strategy implementation, there is no historical data to make dynamic analysis and correctly assess the work of teams,
- the control of multiple activities is in one person hands while in local divisions was spread among several managers,
- often, functional manager is not located in the same country as other team members,
- often, the responsibilities are not clearly defined between new organization and retained staff,
- often, the global team is divided into locations or the team is working on shifts to deliver services round the clock,
- mother company would like to control as much as possible without reviewing purposefulness of certain metrics.

## Conclusions

The companies search for more effective ways of conducting business. Globalization, growing competition and continuous improvement need are main reasons for changes in companies' structures. One of the strategies is outsourcing of selected activities. Creation of shared service center requires a change of organizational structure as a new company's unit is created. Also outsourcing of activities to external partner assumes new structure. Whatever type of outsourcing strategy is selected, the investor needs to review and reorganize the system of internal control or create one.

The goal of the article to present challenges which a company may face in the area control, focusing on the change of organizational structures has been accomplished. The study shows variety of issues managers should consider at different stages of being in outsourcing structures. The author indicated potential differences in the control mechanism between the two forms outsourced and shared. In outsourcing, the most common mistake of investors is the willingness to control everything. The author referred to natural process of building trust and relationship. The system of control should deliver information on effectiveness of processes, employees' performance and the level of goals achievement. One should keep in mind that the system of control must be effective itself. The question whether a control system could be as effective as before restructuring was answered. It is developed through the process of building trust and relationship with a new organization. It should change with the business and should be reviewed regularly. New organizational structure is a foundation of a good control system. The more complex the structure is, the more challenges in the control system implementation might be faced. Usually, outsourcing units and BPO organizations apply functional organizational structure. In international companies, the fact of the distance between employee and controller might be a challenge. An internal audit department is often global. Employees are experts in their area as they have been trained during the phase of transition of activities from local divisions. The control system should be adjusted and often rebuilt at that moment latest. In many cases, professional consulting companies advise the investor and design 'to be' organization. With a high attrition rate in outsourcing sector procedures, job descriptions, back-up structures, and control metrics are methods to make sure the knowledge do not leave the company with last employee who actively took part in the transition process. The control in large organizations is usually supported with an ERP system which allows for tailoring various reports. It is partially automated which minimizes the risk of human error or data manipulation. Apart from the control objects and subjects, it is crucial to assign control owners. Finally, the best control system does not work without a good leadership. A supervisor is responsible for his team results and he should understand, put in place every day and make efficient the control system. The control system is not static and supervisors are first to raise a need of modifications.

The study based on a few organizations experiences with outsourced or shared structures. Therefore, the results has limitations and do not base on statistical data although supported by literature examples. The paper does not exhaust the subject of challenges in control area BPO/SSC organization, but can be a good starting point for further research in this area. Thinking about the control as key management function, it gets double important when it may decide about the success or failure of a restructuring strategy. The future works should concentrate on categorizing the challenges of control in outsourcing and shared structures, assessing effectiveness of control processes and structuring the best practices model for practical usage.

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