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Outsourcing the procurement function: Do actions and results align with theory?

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ABSTRACT

Are common theories of outsourcing useful in predicting the extent of and performance gains from the outsourcing of procurement activities? Or does procurement's broad scope and boundary-spanning role confound successful analysis? This study applies a theoretical framework combining concepts from transaction-cost economics (TCE) and the resource-based view (RBV) to study the procurement outsourcing decisions of two hundred and eighty US-based electronics manufacturing firms. Findings suggest that TCE and RBV act in complementary ways on the procurement outsourcing decision. TCE, through fear of supplier opportunism, appears to be the primary driver of the extent to which procurement activities are outsourced. The RBV, through which the OEM's resource position in procurement vis-à-vis its outsourcing partner is determined, appears to be the primary determinant of the performance results of the outsourcing decision. Procurement activities are outsourced to a greater extent when fear of supplier opportunism is low, but such outsourcing is only "justified" (expected to yield performance benefits) when the OEM has a weak resource position vis-à-vis the outsourcing partner. An "enriched" TCE–RBV framework is presented and discussed as part of study results.

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1. Introduction

Once considered a stop-gap arrangement to cover temporary capacity constraints (Gregory, 1995; Carbone, 2000; Harrington, 2000; Kador, 2001), functional outsourcing is now a key strategic component of supply chain strategies (e.g., Carbone, 1996b; Frohlich and Dixon, 2001; Mason et al., 2002; Brewer et al., 2013). Manufacturing is possibly the most commonly outsourced function, and recent decades have witnessed an explosion in the growth of contract manufacturers offering a variety of services from straight manufacturing, to distribution, procurement, new product development (NPD), inventory management, order fulfillment and more (Carbone, 1996a; 1996b; Harrington, 2000).

While a considerable amount of research has been done on the outsourcing of manufacturing, there is a relative dearth of research on the outsourcing of other supply chain functions such as procurement.³ This is somewhat surprising given procurement's potential impact – it is estimated that purchased goods and services can account for 50–90% of a firm's cost of goods sold (Emiliani, 2010). On the other hand, outsourcing procurement is likely approached with great caution, since by definition the procurement function is the crucial boundary-spanning linkage connecting the firm to its supply base (Knudsen, 2003; Kerkfeld and Hartman, 2012). Procurement outsourcing may also be somewhat difficult to effectively study, since "procurement" is a broad term encompassing a wide range of strategic and tactical activities. The limited sources available offer conflicting conclusions, with procurement outsourcing touted as a way to improve financial performance and

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E-mail addresses: bbrewer4@uwyo.edu, barry.brewer7@gmail.com (B. Brewer), cynthia.wallin@byu.edu (C. Wallin), ashenbb@muohio.edu (B. Ashenbaum).¹ Tel.: +1 801 422 4933.² Tel.: +1 513 529 8013.³ For this study, we assume terms such as *procurement*, *purchasing* and *strategic sourcing* to be largely synonymous, and to all represent the firm functions responsible for developing sourcing strategies, maintaining supplier relationships and ensuring the flow of goods and services into the organization. The use of "procurement" for this paper is chosen for paper flow and readability.

reduce cost (e.g., Olson, 2010), and alternately disparaged due to a loss of control over supplier costs (Parry et al., 2006).

It is our opinion that theory, which offers a lens to predict actions and performance, has not been fully utilized to examine this phenomenon. As such, our goal in this paper is to provide insights into procurement outsourcing utilizing theoretical lenses which have been applied to outsourcing in other contexts. The specific research questions motivating this study are:

1. Can existing outsourcing theories provide insights into procurement outsourcing, given procurement's boundary-spanning and multi-varied nature?
2. How do various outsourcing theories complement or conflict with one another when applied to procurement outsourcing?

We will attempt to answer these questions by presenting the results of an empirical study of the US electronic manufacturing industry, having chosen firms who are engaged with contract manufacturers and who have made decisions regarding the extent of procurement outsourcing to follow. The next section of this paper reviews the existing procurement outsourcing literature and then focuses upon the two theories which will inform our study: transaction-cost economics (TCE) and the resource-based view (RBV). These theories have historically been among the most utilized to study outsourcing in general, and they offer both complimentary and conflicting assessments of the outsourcing decision. As discussed in more detail below, this study's key contribution is the finding that these theories appear to provide complementary ways to assess outsourcing. TCE appears to provide stronger insights into why outsourcing decisions are made, but RBV appears to provide clearer explanations for the varying performance results of these decisions. As such, an enriched TCE–RBV framework is presented in the discussion and contribution sections.

2. Literature review and hypothesis development

2.1. Procurement outsourcing

The extant literature that specifically examines the outsourcing of the procurement function is somewhat sparse, and also largely atheoretical. Existing work focuses primarily on competence, performance, and the enabling role of information technology (IT).

Broadly speaking, a competence perspective is one that argues for firms to focus on core competencies and outsource remaining activities (e.g., Venkatesan, 1992; Quinn and Hilmer, 1994; Christiansen and Maltz, 2002; Chen et al., 2009). In this spirit, some argue that procurement is increasingly seen as an important strategic function, and that therefore outsourcing this function may lead firms to miss important innovations that could make manufacturing more efficient, products more competitive, and improve performance (Mol, 2003; Holcomb and Hitt, 2007; Agndal and Nordin, 2009; Ellinger et al., 2011). Furthermore, supplier relationships are frequently described as strategic (Kraljic, 1983; Dyer et al., 1998), and so a firm's success at leveraging these relationships may be tied to the buying firm's procurement competence (Cox, 1996). Conversely, others make the case that procurement is a gray area when it comes to competency as it encompasses many tactical activities, such as the acquisition of indirect and non-critical materials (Parry et al., 2006). Therefore, when resources are constrained, procurement can be outsourced to allow focus on higher-valued activities (Huber et al., 2009; Olson, 2010).

Often the motivation for procurement outsourcing, like outsourcing in general, is to improve performance. In a healthcare-industry study, Nollet and Beaudieu (2005) found that organizations joining a third-party procurement consortium increased negotiation power and were able to drive prices down.

Procurement outsourcing has been shown to potentially reduce operational costs by 15–20% (Favre et al., 2003; Huber et al., 2009; Olson, 2010) and administrative costs by up to 75% (Hesketh, 2008). Additional benefits include increased behavioral and process discipline (John, 2003) and increased contract compliance, potentially saving a company as much as 4% of cost of goods sold (Favre et al., 2003). In contrast, procurement outsourcing has also been linked to degradation in performance. Parry et al. (2006) noted a loss of control over supplier performance, costs, and legal issues in these situations. Outsourcing procurement can reduce supply-base visibility, leading to unauthorized part or supplier substitutions, overbilling, mistreatment of suppliers, loss of buying-firm leverage and a general risk of supplier opportunism (Leavy, 2001; Amaral et al., 2006).

The rise of IT-enabled B2B processes has made procurement outsourcing more feasible, and so has helped the push for doing so from competence and performance standpoints. IT has reduced procurement costs in a number of ways, such as lowering search costs for finding potential suppliers and improving efficiency by automating many tactical procurement tasks (McIvor and Humphreys, 2004; Humphries et al., 2006). Successful IT implementation at the buyer-supplier interface allows for the outsourcing of tactical tasks, freeing up time for the buying firm to focus instead on value-added activities (McIvor et al., 2000).

In summary, the literature base regarding procurement outsourcing is still forming and has for the most part been exploratory in nature, either conceptual (Humphries et al., 2006; Olson, 2010), or based on interviews or case studies (McIvor et al., 2000; McIvor and Humphreys, 2004; Nollet and Beaudieu, 2005; Amaral et al., 2006; Parry et al., 2006; Agndal and Nordin, 2009). We therefore answer the call of researchers to conduct additional research in this area (Maltz and Ellram, 1999; Trent, 2004; Ogden et al., 2005), utilizing theories which have long been applied to outsourcing more generally – transaction cost economics (TCE) and the resource-based view (RBV).

These are arguably the two most influential theories applied to the general study of outsourcing, as they primarily concern themselves with which activities should be undertaken within the boundaries of the firm, and which should be contracted for in the market. Whereas other behavioral theories can be applied to outsourcing decisions, these are often broader in scope, examining the need for task delegation (agency theory) or external resource control (resources dependency), to provide two examples. In our opinion, the TCE and RBV frameworks provide the most concise lenses for examining the outsourcing decision, as this is ultimately at the core of their models. In the section below we consider them both to sharpen this study's hypothesis development.

2.2. Transaction cost economics and the resource-based view in the outsourcing decision

TCE is primarily concerned with firm boundaries, defined as whether a particular transaction or activity is conducted within the hierarchy of firm governance, or is outsourced to the market (Coase, 1937; Williamson, 1975; 1985; Brewer et al., 2013). A given transaction or activity is posited to possess both behavioral and transactional attributes. The behavioral attributes of opportunism and bounded rationality are presumed to be inherent to the transacting parties and are, therefore, omnipresent in any and all transactions (Williamson, 1985). Opportunism represents the risk that one of the parties in the transaction would take advantage of the other when the opportunity presents itself, and bounded rationality refers to the fact that there would always be elements of the circumstances surrounding the transaction that are unknown. Transaction-specific attributes include asset specificity, uncertainty, and frequency. Asset specificity is defined as the

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