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The value impact of strategic intent on firms engaged in information systems outsourcing

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ABSTRACT

While information systems outsourcing has been on the rise in recent years, empirical evidence about whether IS outsourcing is value creating for shareholders is limited. Little is known about what factors influence the relation between information systems outsourcing and firm value. This study examines the effect of information systems outsourcing announcements on firm value by analyzing whether equity market reactions are associated with the management's strategic intent for outsourcing and firm characteristics of the outsourcing firm. After examining 103 IS outsourcing announcements made during the period from 1996 to 2003, results suggest that value is created for firms outsourcing with short-term operational intent rather than for longer term strategic reasons. In addition, the increase in firm value from an IS outsourcing announcement is positively associated with the firm's operating asset efficiency and the firm being in a service industry.

1. Introduction

Outsourcing of the information systems (IS) function has become increasingly common since the mid-1980s and has continued to grow in recent years.[3] Firms deciding to outsource part or all of their IS operations often cite one or more strategic intents for the IS outsourcing decision. However, recent work chronicling the benefits (e.g., Cross et al., 1997; Lacity and Willcocks, 1998; Loh and Venkatraman, 1992;

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[3] IS outsourcing made up approximately 30% of IT spending in 2000 and is expected to surpass $250 billion in 2008 (Mason, 2000; Caldwell et al. 2004).

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Smith et al., 1998) and risks involved in IS outsourcing (Aubert et al., 2004; Earl, 1996; Oh et al., 2006) suggest that there remains widespread uncertainty about the value-adding benefits of IS outsourcing.

Although conceptually the purported benefits such as cost reductions and improvements in system quality, access to expertise, organizational flexibility, and ability to focus on core competencies are appealing, they must be weighed against risks created by outsourcing arrangements such as vendor over-opportunism, loss of control, increased governance costs, and technological inflexibility (Beasley et al., 2004; Aubert et al., 1998). Therefore, the decision to outsource IS with the ultimate goal of impacting firm value through increased profits is a strategic decision, which weighs various costs and benefits, made by the managers of a firm. However, limited empirical evidence exists about whether management's strategic intent regarding IS outsourcing actually achieves the intended goal of increasing firm value.

Because many of the benefits of IS outsourcing are both intangible and long-term oriented, but many of the risks such as loss of control due to asset specificity (Lonsdale, 2001) and technological lock-in (Aubert et al., 2004) are near-term, there is a timing mismatch between risks and potential benefits. This study attempts to look at this mismatch by examining management's strategic intent for IS outsourcing in face of the known and unknown risks.

The event study methodology has been used frequently in recent years to explore the relationship between IT investments and firm performance (e.g., Dewan and Ren, 2007; Ranganathan and Brown, 2006; Dehning et al., 2003; Hunter, 2003; Chatterjee et al., 2002). The event study methodology is particularly appropriate in the IS outsourcing context because of its ability to capture market participants' perceptions of the future tangible and intangible benefits of IS outsourcing in current stock prices changes around the announcement of the IS outsourcing arrangement. This study uses the event study methodology to examine whether management's strategic intent for IS outsourcing and certain firm-specific characteristics are associated with increases in the market value of the outsourcing firm upon announcement.

In this study we also examine a previously under-researched area: the relationship between firm characteristics and the value impact of IS outsourcing announcements. Previous research has found that mean positive abnormal returns resulting from IS outsourcing announcements are higher for smaller firms (Hayes et al., 2000) and firms in the services sector (Oh et al., 2006; Hayes et al., 2000). However, beyond firm size and industry, little is known about the impact of other characteristics of IS outsourcing firms and whether certain firm characteristics lead to a differential market response to IS outsourcing announcements.

Building on prior work and establishing a new metric, strategic intent, the specific research questions we pose include: Does management's disclosed strategic intent for IS outsourcing impact the market's perceived benefits of the outsourcing agreement? Do firm characteristics impact the market's perceived benefits of the outsourcing agreement? Is there an interactive effect between management's intent and firm characteristics that impacts the market's perceived benefits of the outsourcing agreement?

This study extends previous research in this field in three ways: establishing a new metric for measuring management's strategic intent for IS outsourcing, examining management's overall strategic intent for IS outsourcing and the impact that has on the market reaction to IS outsourcing decisions, and testing whether firm specific characteristics affect the perceived value from IS outsourcing and whether these characteristics interact with the strategic intent in deriving benefits from IS outsourcing.

Although IS outsourcing announcements often include public disclosures of management's strategic intent, limited evidence exists as to whether the market reacts differently to these various public statements. Oh et al. (2006) find some initial evidence that a firm's stated intent of cost reduction through IS outsourcing is positively associated with market reactions to outsourcing announcements, suggesting that shareholders value public assertions of IS outsourcing motivated by cost savings opportunities. Beyond cost savings assertions, an empirical examination of the impact of other strategic intents is lacking. Thus, we extend previous research by examining management's overall strategic intent for IS outsourcing and the impact that has on the market reaction to IS outsourcing decisions.

Based on a sample of 103 IS outsourcing announcements during 1996–2003, the findings show that two-day cumulative abnormal returns (CARs) decrease as management's strategic intent for IS outsourcing changes from short-term operational benefits to mid-term tactical benefits to long-term strategic reasons. This suggests that shareholders value short-term operational benefits such as cost-savings associated with IS outsourcing, perhaps because the performance of such contracts can be more easily measured and monitored relative to other intents (Oh et al., 2006), or they do not believe that other managerial intents for outsourcing that are less likely to be realized in the short-term are credible.