Journal of Operations Management 27 (2009) 344–361

Contents lists available at ScienceDirect

Journal of Operations Management

journal homepage: www.elsevier.com/locate/jom

Unlocking the business outsourcing process model

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ARTICLE INFO

Article history:
Received 29 November 2007
Received in revised form 18 November 2008
Accepted 19 November 2008
Available online 27 November 2008

Keywords:
Outsourcing
Supply management
Empirical research method

ABSTRACT

Outsourcing has emerged as a prevalent business practice that is having a transformational impact on how many organizations manage their global supply chains. Despite this prominence, anecdotal reports from multiple reputable organizations suggest that many businesses fail to realize the benefits anticipated from their outsourcing initiatives. Motivated by these observations, this study investigates those management practices during the outsourcing process that are key drivers of outsourcing performance. Specifically, detailed data from 198 sourcing executives and managers responsible for outsourcing initiatives are used to investigate the influence that *strategic evaluation*, *contractual completeness*, and *relationship management* practices have on achieving projected outsourcing results. The results offer strong empirical evidence that outsourcing performance is significantly influenced by extensive strategic evaluation and proactive relationship management practices. Moreover, the impact strategic evaluation has on outsourcing performance is not direct, but rather is partially mediated by the relationship between the parties. Finally, the results show that contractual completeness does not distinguish between successful and unsuccessful outsourcing efforts, and can be considered qualifying activity.

1. Introduction

There is hardly a more salient question faced by industrial leaders than “which aspects of our value chain should we perform internal to our organization and which aspects should we source externally?” Some have addressed this question as the classic make-or-buy decision or the decision as to the extent of vertical integration. More recently, this demarcation of firm boundaries has been studied from the perspective of outsourcing. When considering outsourcing, firms are evaluating whether or not to reverse a prior decision to “make”. In other words, outsourcing involves the re-shaping of existing firm boundaries. Outsourcing can further be conceptualized as a process which begins with the development of a sound business case for outsourcing followed by the implementation of the external sourcing model, and ultimately the management of the relationship with the provider.

Outsourcing has clearly emerged as a prevalent and transformational business practice. Given this popularity, the experiences being reported by many organizations are somewhat surprising. According to a Deloitte Consulting study (Landis et al., 2005), 64% of respondents indicated that they had brought outsourced services back in-house and 44% did not realize cost savings. Moreover, Dunn and Bradstreet found that 20–25% of all outsourcing relationships *fail* within 2 years and half fail within 5 years (Doig et al., 2001). A more recent and expansive Deloitte survey of 300 business executives also found the need for improved outsourcing practices. Only 34% were satisfied with the provider’s innovation and 61% indicated that they had to “escalate” problems to senior management within the first year (Robinson et al., 2008). Further, 75% of service providers interviewed felt that their clients were ill prepared for the

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doi:10.1016/j.jom.2008.11.002

outsourcing initiative often lacking a well-developed strategy and clear understanding of how it would work. These anecdotal findings which suggest that there is a troubling gap between expectations and reality serve as the motivation for this research.

This study contributes to the operations and supply chain literature in several fundamental ways. First, the construct of strategic evaluation in defined and developed. Traditionally, empirical studies concerning firm boundary decisions focus on the ability of the various "theories of the firm" (e.g. transaction cost and resource based) to predict or explain existing firm boundaries found in practice (Harrigan, 1986; Masten, 1984; Masten et al., 1989; Monteverde and Teece, 1982; Novak and Eppinger, 2001). However, with few exceptions (Gopal et al., 2003; Lee et al., 2004; Leiblein et al., 2002; Poppo and Zenger, 1998), this literature stops short of testing the performance implications of these decisions. Moreover, the sourcing decision itself is the focus of this literature, and not the actual management of the outsourcing effort. Performing an extensive strategic evaluation of an outsourcing opportunity not only facilitates the sourcing decision, but also develops a clear understanding of the risk and coordination implications of outsourcing. This knowledge can be utilized to inform the development of an effective contract and strengthen the development of a mutually beneficial relationship with the provider. To our knowledge, these effects have not been empirically explored in the literature.

This study also contributes a contractual completeness construct. The closest concept found in the extant literature is contractual complexity. The complexity of a contract has been operationalized by the level of customization (Poppo and Zenger, 2002) and the length of the contract (Joskow, 1988; Poppo and Zenger, 2002). The length and customization of a contract is not the same as the current conceptualization of contractual completeness. Other studies have looked at the effect of contract enforcement as a means of mitigating principal-agent conflict (Tosi et al., 1997). A study by Aron et al. (2008) considers at how recent technological advances allow firms to more effectively monitor the activity of off-shore business process outsourcing providers resulting in more effective enforcement of contractual process quality objectives. Contract enforcement is certainly an important aspect of activity management. However, enforcement only comes into play after the development of a contract with well-specified service objectives. Thus, the focus in the current study is on the extent to which the outsourcing organization developed an effective contract and not on contract enforcement.

Concurrently evaluating the effects of contractual completeness and relationship management on outsourcing performance is the third contribution of this study. There is an impressive body of supply chain literature which evaluates how inter-organizational relationship practices influence the performance of *pre-established* exchanges. Many have studied the positive effect of cooperative buyer–supplier relationships on exchange performance from the buying firm's perspective (Carr and Pearson, 1999; Chen et al., 2004; Shin et al., 2000). Others have considered these effects from the perspective of the supplier (Benton and Maloni, 2005; Prahinski and Benton, 2004). The current study extends this literature to realm of outsourcing which entails the establishment of new exchanges for business activities traditionally performed within the firm, often with no physical product involved. Moreover, the influence of relationship management on outsourcing performance is considered along with the influence of contractual completeness. To date, the influence of these two constructs on outsourcing performance has not been concurrently evaluated.

Fig. 1 summarizes the conceptual model to be evaluated in this study as described above. In the next section, an

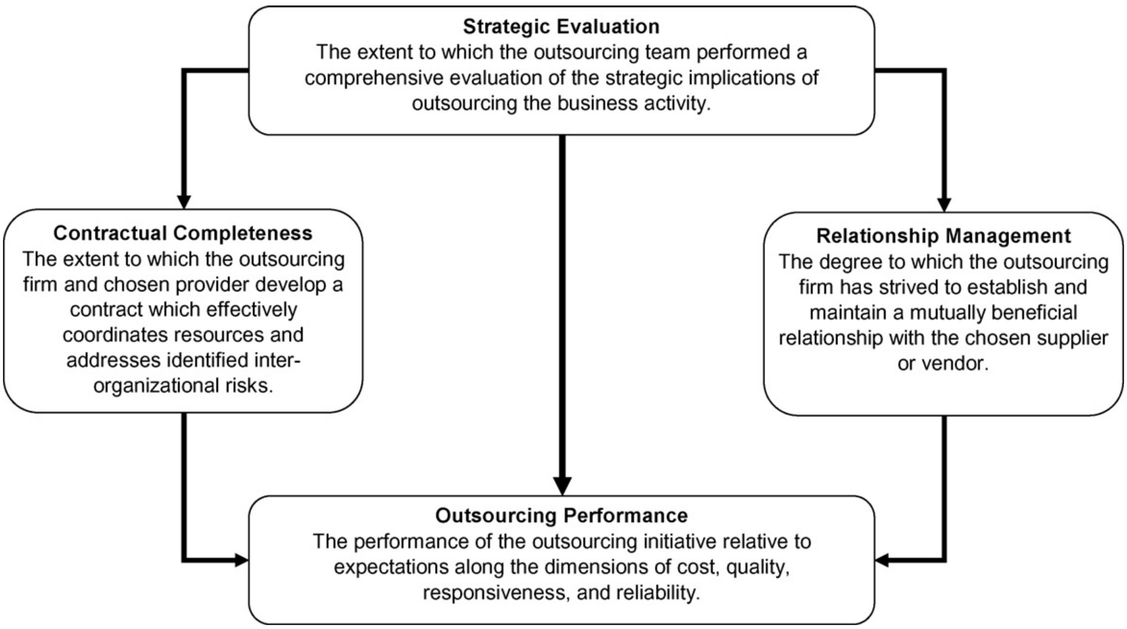

Fig. 1. Conceptual model.