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Does IT outsourcing deliver economic value to firms?

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ABSTRACT

The question of whether or not IT outsourcing initiatives deliver economic value to firms is an important yet under examined one. This study extends extant outsourcing literature by evaluating how firm value is created through IT outsourcing. Using Porter's Value Chain Model as the theoretical framework, the study systematically traces and measures the value added through IT outsourcing for firms in the manufacturing and retail industries. The results indicate that the effect of IT outsourcing is better detected at the intermediate process level rather than at the firm-level. Firms are able to realize economic benefits of cost savings, but less so in efficiency. Improved cost is observed in inbound logistics and supporting activities. With the exception of inbound logistics, no efficiency improvements are observed in operating activities and outbound logistics, suggesting that the positive impact of IT outsourcing is limited.

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1. Introduction

Instead of being tightly controlled in-house, information technology (IT), the lifeblood of contemporary business organizations is being outsourced at an unprecedented speed and scale. The Gartner Group found that the total contract value of publicly announced IT outsourcing (ITO) deals exceeded $150 billion from 2003 through 2006. In 2008 alone the top 20 worldwide ITO contracts were worth nearly US $20 billion (Gartner, 2008). Although the extensive investment in ITO signals that firms of all sizes view this practice as a viable value-adding strategy, few studies have rigorously evaluated the economic return of ITO and systematic evidence regarding its tangible business value remains limited (Wang et al., 2008). With IT permeating firms' entire value chain and enabling, if not driving, the most recent transformations (Gunasekaran et al., 2008; Porter and Millar, 1985), it is imperative that firms base their sizable ITO investments on evidence rather than on assumed benefits or unwarranted beliefs. Research that appropriately assesses the business value of ITO becomes even more important when industry reports have suggested that one-fourth to one-half of ITO initiatives fail to deliver their bottom-line promises and the mimicking of peer firms has been widely cited as an important impetus of outsourcing IT (Lacity and Hirschheim, 1994; Venkatraman et al., 1994). ITO represents large and difficult-to-reverse investments and has been associated with various inherent risks and costs (Watjatrakul, 2005). This puts pressure on researchers and professionals to ensure that firms make informed and effective strategic ITO decisions and avoid the pitfalls of commitment to isomorphic behavior.

Hence, the objective of this study is to examine the extent to which firm value is created through ITO initiatives. To understand the business value of ITO, managers and researchers must have in place an appropriate framework designed

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to systematically capture the impacts of each outsourcing endeavor on different business aspects. Consequently, this study draws on Porter's Value Chain framework and develops a process-oriented conceptual model that (1) considers the possible impacts of different ITO initiatives on the discrete business processes in a firm's value chain and (2) predicts how such impacts will be reflected in specific process-level accounting performance measures. The adopted process-oriented approach is important because outsourced IT is intended to support activities and processes, and therefore its impact should be assessed at the process level where its direct effects are expected to be manifested.

This research extends the current literature on the returns of ITO in two important ways. First, it provides useful empirical insights on the economic returns of ITO. By using objective, audited, and externally reported accounting performance measures, the findings of this study serve as an important corroborator of prior results that are predominantly descriptive in nature and based on self-reported perceptual measures. Second, prior research has suggested that the business value of ITO is best documented at the process level (Wang et al., 2008). But without an appropriate framework, the selection of appropriate business processes and performance measures for examination can become a hit-or-miss endeavor, leaving less obvious yet critical impacts of ITO unexamined. Porter's Value Chain framework is well recognized and has been used in the literature to identify important business processes of value creation (Dehning et al., 2007). By applying this framework, this research provides a systematic approach to map the performance consequences of each ITO initiative onto a corresponding value process. This mapping enables us to not only thoroughly examine different aspects of ITO impacts but also identify the appropriate accounting measures that capture such impacts. It also allows for detailed analyses and subsequent monitoring of value creation through ITO and better guides firms' IT sourcing decisions as a result. While various ITO related issues have been examined by prior studies, including some that have appeared in this journal, such as the determinants of ITO (Watjatrakul, 2005) and the conditions under which ITO can be successful (Cullen et al., 2005), empirical work that focuses on firm performance after an outsourcing initiative is relatively scarce. This study adds to extant streams of research by evaluating and documenting the economic ramifications of ITO.

The rest of the paper is structured as follows. First, the work on IT business value and ITO is reviewed. Thereafter, the theoretical framework used to govern the discussion and to identify the measures considered is presented. The research methodology and the results of an empirical analysis are then reported. Finally, the strategic implications for practitioners and the directions for future researcher are outlined, followed by the conclusions and limitations of the study.

2. Related work

2.1. Business value of IT outsourcing

Given the level of expenditure and the high potential benefits and risks associated with ITO, it is vital that outsourcing decisions be supported by systematic and conclusive empirical evidence regarding their returns. However, to date only a few studies have sought to provide such evidence and it is still currently unclear whether ITO delivers tangible business value for the contract-granting firms (Han and Mithas, 2009; Jiang and Qureshi, 2006). For instance, using expected cost reduction as an indicator of ITO success, Lacity and Willcocks (1998) interviewed 145 US and UK IT managers (61 sourcing decisions) and found that only 56% achieved their cost reduction expectation, 23% did not, and 16% were unable to determine. Using stock market price as a measure for ITO outcome, Hayes et al. (2000) indicated that outsourcing is a value-added business exchange only for smaller and/or service firms. Oh et al. (2006) suggested that investors reacted more favorably to ITO announcements only when they perceived a low transactional risk.

With the limited body of research, several important gaps can be identified. First, most current studies employ an approach which seeks to establish a link between ITO and broad high-level firm performance indicators such as the overall cost objective achieved (Lacity and Willcocks, 1998), stock price changes around ITO announcements (Oh et al., 2006), or satisfaction with the overall economic benefits of ITO (Lee et al., 2004). Conclusions solely based on broad performance indicators can be elusive because these indicators can be influenced by factors other than ITO (Dehning et al., 2007). This approach is conceptually insufficient because researchers have found that the effects of ITO are better detected at the intermediate process level as outsourced information technologies are intended to target specific business processes (Wang et al., 2008). Thus a process-based approach is more appropriate. Second, performance measures adopted in prior studies are predominantly self-reported perceptual metrics such as managers' self-reported perception of whether the outcome of their IT sourcing decisions met their expectations or objectives and their satisfaction with the achieved strategic, economic, and technological benefits (Jiang and Qureshi, 2006; Lacity and Willcocks, 1998). Recently, there has been a call for using externally reported and more objective accounting metrics in the examination of the effect of ITO on firms' performance (Wang et al., 2008). A systematic analysis of the effects of IT outsourcing on objective accounting performance measures complements studies using self-reported perceptual measures, thereby serving as an important validation and confirmation on the return of ITO.

However, the choice of appropriate accounting-based performance measures requires extra caution and effort because accounting metrics do not directly capture the effects of IT (Dehning et al., 2009). In the literature, researchers have suggested the use of Porter's Value Chain framework in the analysis of IT business value and the identification of corresponding accounting measures that reflect such value (Dehning et al., 2009, 2007). The following section briefly reviews the literature of IT payoff using value chain analysis.

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