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Implications of service processes outsourcing on firm value

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ABSTRACT

Outsourcing is one of the important strategies acknowledged by firms recently. With an increase in globalization and the proliferation of information technology, more and more firms outsource not only their production but also their service processes including back office business processes and information technology functions to external suppliers. Recognizing the criticality of outsourcing service processes in marketing management, the authors build on the outsourcing literature and integrate it with the finance literature on market efficiency to develop a conceptual framework. The authors collect outsourcing announcements from the *Wall Street Journal* and business news available at Lexis-Nexis between 1995 and 2005 to conduct an event analysis. Results indicate that outsourcing in general creates positive firm value, i.e., cumulative abnormal returns; however, such effects vary depending upon different levels and dimensions of an outsourcing decision. The authors conclude with managerial implications and future research at the end.

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1. Introduction

Because of its tremendous financial and strategic implications, outsourcing has become one of the important business strategies in the last two decades. Previous research defines outsourcing as a firm's strategic decisions to rely on external suppliers as alternative to make business activities in-house (Harris, Giunipero, & Hult, 1998; Loh & Venkatraman, 1992). With the proliferation of information technology and ever soaring competition, we have observed that after the first wave of outsourcing with a primary emphasis on manufacturing activities in the 80s and 90s, more firms have begun to outsource service processes including information technology (e.g., data management) and business processes (e.g., human resources management), resulting in the second wave of outsourcing (Kingson, 2002; Mears, 2003; Schmerken & Golden, 1996), which is the focus of this research.

Despite recent rush in outsourcing service processes, its advantages and disadvantages brought to firms are increasingly debatable across industries (Kotabe, Mol, & Murray, 2008; Pyndt & Pedersen, 2006). Some studies show that outsourcing allows a firm to not only cut costs, but also focus on its core competences and help speed up its innovation processes (e.g., Florin, Bradford, & Pagach, 2005; Graf & Mudambi, 2005). In contrast, other research suggests that a firm that engages in outsourcing may lose control and flexibility, and potentially risk disclosure of proprietary knowledge to suppliers, who may become its competitors in the future (Harris et al., 1998).

While these contradictory viewpoints are equally appealing, yet no consensus is drawn in the literature as to the effect of outsourcing on firm performance. Nonetheless, more recent research has emerged in an attempt to provide a framework to integrate different theoretical lenses. Specifically, Kotabe et al. (2008) propose a dynamic perspective, which suggests an inverted U relationship between outsourcing and performance. They argue that outsourcing has nonlinear effects where too much or too little of outsourcing is harmful to firm performance. This perspective augments both sides of a coin and urges practitioners to evaluate pros and cons of outsourcing to optimize its benefits.

The purpose of this study is to provide empirical substantiation that links outsourcing to firm performance. In particular, we build on the dynamic perspective (Kotabe et al., 2008) and contend that the nonlinear effects of outsourcing likely result from different conditional factors embedded in outsourcing decisions. The heterogeneity across outsourcing decisions that leads to mixed consequences of outsourcing has been overlooked by previous research. “Sourcing decision-making is multifaceted and entails both contractual and locational implications,” (Kotabe et al., 2008: 38), which deserves more in-depth understanding. Hence, this study proposes that, (1) contract duration, i.e., the length of an outsourcing contract, (2) outsourcing functions, i.e., types of services processes outsourced, and (3) outsourcing locations, i.e., outsourcing to a firm located domestically or overseas, are three primary dimensions individually and jointly to determine the impact of outsourcing on firm performance.

Our research contributes to two important fronts. First, from a theoretical standpoint, we extend the recent literature on outsourcing by disentangling the impact of different outsourcing aspects on firm value. In particular, we draw on the dynamic perspective (Kotabe et

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al., 2008) to develop an empirical framework to examine the financial implications of outsourcing. Second, from a managerial point of view, our research serves to provide guidelines to purchasing managers and industrial buyers who are increasingly facing the dilemma between insourcing and outsourcing. We suggest that outsourcing remains a viable alternative. But managers ought to pay attention to the different dimensions of outsourcing discussed in this study. In addition, while extant research has focused on specific outsourcing types such as outsourcing information technology (e.g., Florin et al., 2005; Hayes, Hunton, & Reck, 2000), our research attempts to include other important facets of an outsourcing decision, and compare their financial implications so that practitioners can be more informed of the financial consequences of their outsourcing decisions. Our findings are further expected to help resolve the controversial argument over the performance implications of outsourcing accrued to different outsourcing firms.

We organize the remainder of the article as follows. We first outline our conceptual framework and hypotheses. Subsequently, we describe our research method and data, and provide findings based on outsourcing announcements collected from Lexis-Nexis and the *Wall Street Journal* between 1995 and 2005. In general, our results show that outsourcing creates positive cumulative abnormal returns. However, such positive outcomes depend upon contract duration, type of outsourcing functions (i.e., business processes vs. IT), and outsourcing locations (i.e., onshore vs. offshore). We close by discussing the results and their implications to practitioners.

2. Conceptual framework and hypotheses

Acknowledging the importance of service processes outsourcing, many firms have begun to view outsourcing at a strategic level, which has long term implications to their performance (e.g., Florin et al., 2005; Graf & Mudambi, 2005). Similar to other strategic decisions such as new product introduction, mergers and acquisitions, and changes of CEOs or company names that firms frequently make such information available to the public through announcements, service processes outsourcing, being an emerging trend that allows a firm to improve efficiencies and profitability, is often featured in public announcements.

According to the finance literature (Fama, 1970; Fama, 1991), firms use public announcements to signal investors and shareholders their future earnings and thus, influence their stock value and returns. Since stock return is based on investors' expectations of a firm on the change in its future cash flows, abnormal stock returns result when the expectations of the firm's future cash flows are beyond what the investors normally anticipate for the firm in a specific period of time. When events, such as service processes outsourcing announcements in our study, are unexpected by the stock market, firms that make those announcements will result in unexpected returns on their stock value, so-called abnormal returns. Abnormal returns are often considered as an indicator to reflect future cash flows of strategic decisions. As in the case of service processes outsourcing, industrial marketers who increasingly rely on information technology to carry out their procurement decisions of supplies and communications with vendors may get involved in such outsourcing decisions. Thus, purchasing managers must be informed of the consequences of IT and business processes outsourcing.

In line with previous event studies that manifest firm value as cumulative abnormal returns (CARs) in stock value, this study uses CARs to capture the financial implications of outsourcing announcements (e.g., Hayes et al., 2000; Oh, Gallivan, & Kim, 2006). If investors and shareholders are favorable (unfavorable) toward such announcements, positive (negative) CARs result. Although extant research recognizes the strategic importance of service processes outsourcing, there is a dearth of systematic evidence in the literature that relates different facets of outsourcing to firm value. To make headway in this direction, this study builds on the dynamic perspective (Kotabe et al., 2008) and argues that the magnitude of the change in firm value in response to outsourcing is subject to the differential impacts of each of the outsourcing dimensions illustrated in Fig. 1 and discussed below.

2.1. Direct effects of service processes outsourcing announcements on firm value

According to some previous research, service processes outsourcing in general creates positive abnormal stock returns (e.g., Florin et al., 2005; Hayes et al., 2000). This stream of research suggests that outsourcing allows firms to focus on their own core competences by relocating limited resources to strengthen their core product or service offerings, and thus it should positively signal to the market (Jiang, Belohlav, & Young, 2007).

Nevertheless, other counterarguments exist, suggesting that outsourcing may hurt a firm's long term competitive advantage. For example, previous research shows that although outsourcing may help the firm cut costs, it creates a situation where its proprietary knowledge can be disclosed to external suppliers, allowing other

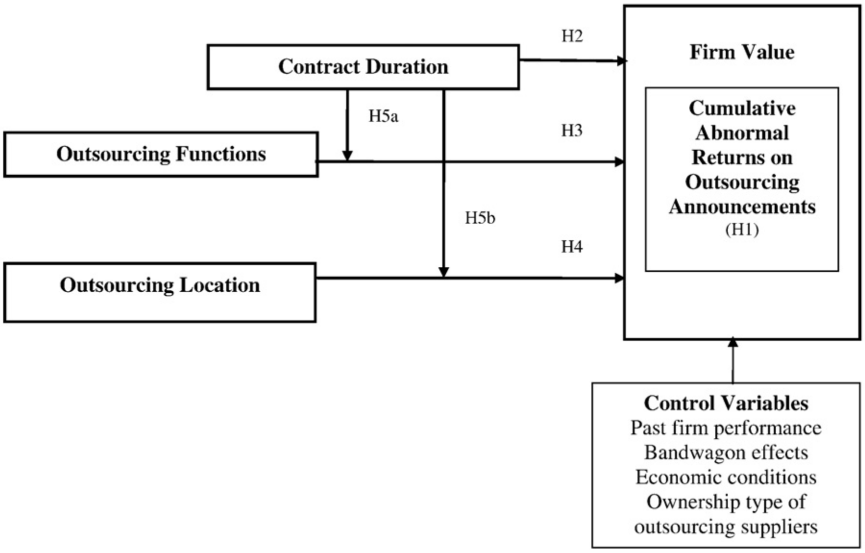

Fig. 1. Conceptual model.

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