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Disclosure of outsourcing in the annual report: Causes and market returns effects☆

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ABSTRACT

Firms increasingly are utilizing outsourcing to enhance or maintain their competitiveness. Prior research shows that capital markets value a firm's decision to outsource. This study uses a sample of firms announcing outsourcing arrangements in a press release to examine which factors are associated with the subsequent decision to voluntarily provide or withhold information about outsourcing in their annual report. The paper also examines whether annual report disclosure is a reliable signal of future market performance. We find that underperforming firms, larger firms, and firms experiencing negative outsourcing announcement market returns and negative long-term market returns are more likely to disclose outsourcing in their annual reports. There is also evidence that firms' disclosure of outsourcing in the annual report signals an improvement in market performance that is credible to the capital markets. We contend that the disclosure and subsequent firm performance issues we investigate apply to any type of outsourcing arrangement, and therefore our results are relevant to future information systems research on this subject. Our findings also suggest that regulatory standards could reduce private information search costs for investors by providing a common disclosure methodology for outsourcing activities.

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1. Introduction

It is estimated that about 34% of total services purchased by businesses in the U.S. in 2004 were outsourcing-related, up from 31% in 1997 (Yuskavage et al., 2006). Sia et al. (2008, p. 407) state that, “outsourcing is now a strategic option that few organizations can afford to ignore.” In spite of the economic and strategic significance of outsourcing and the potential impact on firm performance, firms are not required to disclose outsourcing activities in annual reports or other regulated filings. Of course, firms may decide voluntarily to disclose outsourcing activities through other media including press releases, conference calls, forecasts, and the annual report itself. Prior research finds that capital markets value information about firms' outsourcing activities (Hayes et al., 2000; Florin et al., 2005). In general, informative voluntary disclosures assist investors and creditors in understanding firms' operations, thereby enhancing the efficiency of the capital allocation process. Past studies have shown significant variations in disclosure practices when regulations regarding required financial statement disclosures of important firm activities are ambiguous; such variations can cause firm annual reports to be less informative (Mauldin and Richtermeyer, 2004).

Given that outsourcing is an important economic activity in the U.S., and given that information about a firm's outsourcing activities is valuable to investors, knowing how outsourcing is disclosed in the annual report and knowing what factors drive the voluntary disclosure decision not only are important in its own right but also can inform deliberations about possible mandatory outsourcing disclosure regulations. At the same time, given that firms do outsource, evaluating the effects of outsourcing on future performance, including market returns, is also relevant to these deliberations. As is described in greater detail below, while this manuscript does not specifically examine IT outsourcing, it does examine broad types of outsourcing and similar accounting disclosure issues which could apply to any type of outsourcing arrangement; therefore, the results of our study are relevant to and could inform future AIS research in general, and IT outsourcing research in particular.

We first analyze the voluntary disclosure choice by examining the determinants of a firm's decision to disclose outsourcing in their annual report. To this end, we search Lexis-Nexis press releases from 2000 to 2002 and identify a sample of 189 announcements by U.S. publicly traded firms disclosing an outsourcing agreement. A subsequent search of annual report filings from 1999 to 2003 finds that 81 of the 189 outsourcing arrangements are disclosed (with a varying degree of specificity) in the corresponding fiscal-year annual report.[3] Using logistic regression and controlling for firm size and other factors, we find that the decision to report outsourcing in the annual report is more likely when (a) the stock market reaction to the outsourcing press release announcement is negative, and (b) a firm experiences a negative market-adjusted stock return for the announcement year.

Then, given that firms do outsource, we test what effect the annual report disclosure potentially has on future firm performance, including the investor's perceptions of the future value of the firm. In these additional tests, we find that the decision to disclose outsourcing in the $t=0$ annual report is associated with a significantly greater improvement in market-adjusted firm performance in year $t=1$ compared to the group of firms choosing to withhold disclosure in $t=0$. This latter finding holds while controlling for the contemporaneous change in firm-level accounting return in $t=1$. Thus, annual report outsourcing disclosures in $t=0$ appear to be associated with subsequent abnormal investor returns. Our findings are consistent with the predictions of economic theories related to a firm's decision to make voluntary disclosures.

The remainder of this paper begins with a review of theory pertaining to the role of voluntary disclosure, and then develops expectations related to voluntary outsourcing disclosure practices and the potential for mandatory regulations. The next section explains the rationale behind covariates included in the disclosure choice models. This is followed by a discussion of the research methodology and statistical design. After describing the results and robustness checks, the paper ends with our conclusions, discusses limitations, and offers suggestions for future research.

[3] The corresponding annual report is the report where the fiscal year includes the press release announcement date.