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Journal of Supply Chain Management; Fall 2007; 43, 4; ProQuest Central
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A Multidimensional Framework for Understanding Outsourcing Arrangements

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SUMMARY

The growth of outsourcing has resulted in numerous different outsourcing arrangements, ranging from out-tasking and managed services to business process outsourcing and transformational outsourcing. The growing lexicon of outsourcing terminology has caused confusion for many managers and academicians alike, who tend to view outsourcing as a fixed, discrete event or a simple make-or-buy decision. In reality, outsourcing is an umbrella term that includes a range of sourcing options that are external to the firm. Understanding these options, their characteristic differences, and how they serve to meet differing business objectives is the focus of the current research. Based on in-depth interviews with 19 senior executives experienced in outsourcing, as well as a thorough synthesis of available research, this article provides a framework clarifying the broad spectrum of outsourcing arrangements, and their inherent risks and advantages. Managerial guidance related to outsourcing is also provided.

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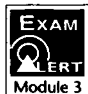

INTRODUCTION

Outsourcing has become a megatrend in many industries, most particularly in logistics and supply chain management (Feeney, Lacity and Wilcox 2005). The overall scope of outsourcing is continuing to grow, as companies focus on their core competencies and shed tasks perceived as noncore (Lindner 2004). For example, recent data indicate that the outsourcing of human resources (HR) functions is pervasive, with 94 percent of firms outsourcing at least one major HR activity, and the majority of firms planning for outsourcing expansion (Gurchiek 2005). Research assessing the outsourcing of sales, marketing and administrative functions provides parallel results, with at least portions of these functions now being outsourced in 15–50 percent of sampled firms (The Outsourcing Institute 2005; GMA 2006). Similarly, the third- and fourth-party logistics industries are booming, with between 65 percent and 80 percent of U.S. manufacturing firms contracting with or considering use of a logistics service provider in the last year (Langley, van Dort, Ross, Topp, Sykes, Strata and Dengel 2006). Thus, managers are increasingly feeling pressure to make the right sourcing decision, as the business consequences can be significant (McGovern and Quelch 2005). Good outsourcing decisions can result in lowered costs and competitive advantage, whereas poorly made outsourcing decisions can lead to a variety of problems, such as increased costs, disrupted service and even business failure (Cross 1995). Poor outsourcing practices can also lead to an unintended loss of operational-level knowledge. Consider the case of Toyota Motor Corp., which by outsourcing the design and manufacture of electrical systems for its automobiles, surrendered its own capability to understand the processes required for this highly specialized work. As a result, Toyota is no longer able to leverage

The authors would like to thank Mr. Tony Farinacci, Senior Vice President of IT Infrastructure, J.P. Morgan Chase & Co. for his valuable comments.

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its own technological advantage with respect to these systems during product development (Lindner 2004). Problems such as these and others related to the outsourcing of goods[1] and services are prevalent when outsourcing arrangements are not well understood by managers in the contracting firms.

Making the right outsourcing decision requires a clear understanding of the broad array of potential engagement options, risks and benefits, and the appropriateness of each potential arrangement for meeting business objectives. Many variations of outsourcing alternatives exist, resulting in a lexicon of terms, such as out-tasking, colocation, managed services and business process outsourcing. This has led to confusion for many managers, who feel pressure to make the right decisions and often view outsourcing as an all or nothing proposition to offload and bring down the costs of noncore activities. In fact, one of the biggest misconceptions about outsourcing is that it is a fixed event or a simple make-or-buy decision. In reality, outsourcing is an umbrella term that encompasses a spectrum of arrangements, each with unique advantages and risks. Understanding the relative risks and benefits of each of the potential alternatives is critical in making the right outsourcing decision.

Numerous outsourcing frameworks have been proposed to date. However, these frameworks have typically focused either on a narrow set of activities involved in the outsourcing decision, albeit in great detail, or on a narrow and nonexhaustive range of outsourcing options. Regardless of the frameworks, practicing managers have tended to adopt a one-size-fit-all perspective on outsourcing, with the belief that commodities and services are either handled in house, or allocated to a service provider, with little or no variation in the type of outsourcing arrangement. To remove the confusion surrounding this falsely perceived unidimensionality of the outsourcing decision, and simultaneously address the ambiguous and constantly changing terminology used to characterize outsourcing phenomena, this article develops a comprehensive framework depicting the full range of outsourcing engagements. The framework provides a typology of outsourcing arrangements, as well as their characteristic differences, appropriateness for use and inherent risks. The framework is based on findings from in-depth interviews with 19 senior executives experienced in outsourcing, as integrated with a thorough synthesis of research available to date. The overarching goal of the framework is to provide a generalizable classification system for the broad spectrum of outsourcing arrangements under which many of the popular terminologies are subsumed. Following the framework development, the article further explicates key decision points to help managers with their outsourcing decisions and provide researchers with a future research agenda related to the topic of outsourcing.

BACKGROUND

Outsourcing involves choosing a third party or an outside supplier to perform a task, function, or process, in order to incur business-level benefits. Outsourcing issues have been recognized and studied for many years using such nomenclature as "make-or-buy" (Hendrick and Moore 1985; Zenz 1987; Dobler and Burt 1996), vertical integration (Coase 1937; Stuckey and White 1993; Maltz 1994) and transaction cost analysis (Williamson 1985; Heide and John 1990; Maltz 1993; Stuckey and White 1993). Although the financial aspects of outsourcing continue to be important, outsourcing is increasingly taking on a broader organizational conception. Consequently, outsourcing has resource and strategic implications, in addition to the financial (e.g., transaction costs) concerns.

More recent research has increasingly focused on the strategic implications of the outsourcing decision (e.g., Brandes, Lilliecreutz and Brege 1997; McIvor 2000; Gould 2003; Lindner 2005). This research stream has recognized that financial implications of outsourcing are only one aspect to be considered and that outsourcing decisions must also be made with firm-level strategic goals in mind. Thus, this research has focused to some extent on the dangers of outsourcing, pointing to the risks that can result from loss of control and potential for opportunistic behavior (Amaral, Billington and Tsay 2003; Mentzer 2006). The findings from these articles indicate that outsourcing has the potential to serve as both the well-known and traditionally recognized cost-reduction calculus mentioned in the early literature, as well as a profit-generating activity base that, when aligned appropriately with the overall strategies of the firm, serves to enhance revenues by allowing for greater focus on those activities that the firm (and its customer base) consider most important. For example, a term frequently used in connection with outsourcing is "core competencies," evolving from the work of Hamel and Prahalad (1990). These authors' contention is that core competencies represent the true sources of competitive advantage on which firms should exclusively focus, and that firms should outsource all other activities deemed to be noncore (Venkatesan 1992; Quinn and Hilmer 1994; Hamel and Prahalad 1996; Quinn 1999).

[1]The bulk of our discussion refers to outsourcing of services, processes, and functions. Manufacturing of parts, sub-assemblies, etc. is already subsumed within the framework. Recent research (Vargo and Lusch 2004) indicates that the services rendered by products such as these are in fact the value-adding component of the offering. Hence, firms really do not outsource parts; they outsource the manufacturing of parts. Thus, tangible goods are implicitly included in the "functions" category above (i.e., manufacturing operations is a firm-level function). We have clarified this further in the text. We would like to thank an anonymous reviewer for raising the issue.

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In light of the relative importance of outsourcing to business, numerous frameworks have been suggested to date by researchers describing outsourcing arrangements. The earlier frameworks focused on outsourcing from the view of the purchasing function (i.e., Kraljic 1983; Leenders and Nollet 1984; Ellram and Billington 2001), attempting to explain why and how purchasing might want to seek specific commodities externally when attempting to satisfy the internal customer. More recent frameworks have addressed a wide array of related subjects from the supply chain management perspective, ranging from outlining the process of carrying out the outsourcing function (McIvor 2000) and understanding the drivers of the outsourcing process (Maltz and Ellram 1999), to estimating the total cost of the outsourcing relationship (e.g., Total Cost of Ownership or TCO), which incorporates nonprice considerations into the make-or-buy decision (i.e., Maltz and Ellram 1997).

Fueled by the growth of the supply chain management paradigm and the understanding of the importance of relationship building, numerous frameworks have also been presented discussing partnership development within the outsourcing context (i.e., Lambert, Emmelhainz and Gardner 1996, 1999; Knemeyer, Corsi and Murphy 2003; Moberg and Speh 2003; Lambert, Knemeyer and Gardner 2004). Though these frameworks provide in-depth understanding of the respective issues they focus on, they are insufficient in that they look at only a small number of aspects of outsourcing, albeit in great depth. As such, even when integrated, they do not provide a comprehensive yet workable framework useful for practical implementation.

METHODOLOGY

Due to the lack of conceptual specifications for outsourcing in the current literature, a qualitative structured interview methodology (e.g., Schaeffer and Maynard 2003) was utilized. Qualitative methods are suggested as more appropriate for exploratory studies where conceptual discovery, clarification and interpretation of meaning is the research focus (Sayre 2001). Qualitative research has a longstanding tradition in the social sciences with abundant applications appearing across many subdisciplines. Such methods are most commonly employed when there is a need to discover underlying dimensions or relationships for a research concept (Rubin and Rubin 1995; Charmaz 2000), and/or where an inductive design is needed for the purposes of theory building (Creswell 1994; Locke 2001). Each of these conditions applies for the purposes of the current outsourcing project.

The initial step of the analysis used for developing the outsourcing framework involved a review and synthesis of the literature on outsourcing, focusing on the field of supply chain management and other related business disciplines. Following a comprehensive review of this literature base, a second, subsequent phase consisted of interview data collection directly from practitioners to elicit their views on the key issues involved in the outsourcing decision. This step included structured interviews with 19 senior executives experienced in outsourcing, all at the rank of Senior Vice President. The in-depth interview approach was selected to provide the best opportunity to identify and examine the outsourcing issues being experienced in practice by the sampled firms. Participants were specifically selected to provide a sampling of corporations having significant experience in outsourcing. Diversity was introduced into the sample by varying industries and sizes of the firms, types of products sold, and types of markets served. Descriptive data for the respondents' companies is provided in Table I. The criteria for executive selection included a minimum of 15 years of corporate experience, with a minimum of 5 years involved in outsourcing in their current corporation. Thus, the goal was to target and select seasoned executives with years of outsourcing experience, i.e., those who would best be able to provide information related to the focal research topic.

The primary objective of the interviews was to gather information supporting the development of a usable framework that would encompass the full range of sourcing options, and thereby help to clarify and delineate the conceptual domain associated with outsourcing. In addition, a secondary goal was to capture the collective wisdom of executives having a great deal of experience in the outsourcing process, such that the framework could be built comprehensively and with external validity. To guide this process, an interview guide was developed to ensure that consistent information fields were gathered across sessions with the executives. The interview guide used was constructed and applied according to the guidelines set forth by Schaeffer and Maynard (2003) and Rubin and Rubin (1995). The specific issues addressed and identified during the interviews included the following:

- Criteria used to differentiate outsourcing engagements.
- Risks and benefits of different outsourcing engagements.
- Appropriateness for use of different outsourcing engagements.
- Reasons for outsourcing and how they relate to different types of engagements.
- Role of supplier relationships in outsourcing engagements.
- Unexpected issues/outcomes with different outsourcing engagements.
- Satisfaction with outsourcing.
- Advice they would give to others when making the outsourcing decision.

Given the importance of data quality to interpretative research, additional validity checks were executed as

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Table 1

PROFILE OF INTERVIEW RESPONDENTS

FIRM	Industry	Annual Revenues (in millions of dollars)	No. of Employees	Industry Type
No. 1	Personal computer manufacturer	79,905.00	151,000	Manufacturing
No. 2	Health care service provider	72,380.00	122,000	Service
No. 3	Banking and financial services	56,931.0	160,968	Service
No. 4	Software developer	36,835.00	57,000	Manufacturing
No. 5	Package delivery company	36,582.00	384,000	Service
No. 6	Telephony service provider	30,537.00	47,600	Service
No. 7	Soft drink manufacturer	29,261.00	153,000	Manufacturing
No. 8	Auto parts manufacturer	28,096.00	190,000	Manufacturer
No. 9	Banking	25,168.00	175,000	Service
No. 10	Internet equipment manufacturer	22,045.00	34,000	Manufacturing
No. 11	Retailer	16,267.00	152,000	Service
No. 12	Enterprise software developer	10,156.00	41,658	Manufacturing
No. 13	Telecom equipment manufacturer	9,045.00	31,800	Manufacturing
No. 14	Automatic teller machine manufacturer	5,984.00	28,500	Manufacturing
No. 15	Insurance provider	4,180.20	5,000	Service
No. 16	Retailer	3,121.00	5,210	Service
No. 17	Printer of business documents	890.20	4,070	Manufacturing
No. 18	Retailer	540.20	3,120	Service
No. 19	Delivery service provider	10.60	150	Service

advocated by Erlandson, Harris, Skipper and Allen (1993), and Halldorsson and Aalstrup (2003). Per these authors, a trustworthiness approach approximating the quantitative concepts of internal validity, external validity, reliability and objectivity is achievable. The parallel qualitative concepts are described respectively as credibility, transferability, dependability and confirmability. Data credibility refers to the congruence between data responses and researchers' perception of intended meaning. Similar to Lambert et al. (2004), credibility was established in this study by confirming semantic meaning of ambiguous terminology and clarifying unexpected responses with the participants via follow-up questioning. Transferability refers to the potential that phenomena occur broadly or across contexts. This was addressed via sample frame design, which contained respondents having diverse industrial and experiential backgrounds. Dependability refers to the stability of measurement across the respondent pool; this was enforced in the current study by choosing the structured rather than un- or semistructured response format. In addition, an adequately large sample was observed (c.f., Lincoln and Guba 1985 for this determination process). Confirmability refers to the ability of theories or concepts to be confirmed through data analysis. Interpretations of qualitative data should be traceable to their origins (Erlandson et al. 1993). The current study was well monitored and recorded. Full responses were written out and notes were kept recording the executive meetings, and any required edits generated through follow-up questioning were duly noted.

In order to establish meaning from the outsourcing executive interviews, content analysis was applied to the notes and transcripts taken during the interview process. Content analysis is a common technique used to classify written qualitative information (Krippendorff 1980). Two researchers acting as coders independently examined the data for each question, per the suggestions of Kolbe and Burnett (1991), and identified themes at the sentence level of analysis. The data was examined contextually versus corresponding questions on the survey instrument. The coders went through this process independently to ensure independence in the identification of themes across responses. After coding the themes, the coders discussed the responses and themes that had been identified to determine their level of agreement/disagreement.

When utilizing content analysis, it is important for researchers to remain objective in analyzing and describing the content in question. As recommended by Kassarjian (1977), two measures of reliability (i.e., category and interjudge) were incorporated to minimize subjectivity.

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Category reliability depends upon the development of categorical outsourcing definitions such that independent researchers agree on which items should be grouped together and which should not. After the researchers independently evaluated the content of each response, the categories of outsourcing were discussed in order to determine the true meaning of the concept and to ensure that coded statements were assigned to the appropriate categories.

Interjudge reliability refers to the consistency in which independent coders categorize content and is usually reported as a percentage. Interjudge reliability was calculated by summing the number of coding decisions the researchers agreed on and dividing by the total number of coding decisions, which is a common approach as identified by Kassarjian (1977). The first round of discussion of the coding decisions led to an interjudge reliability of 80.0 percent. Where disagreement between researchers occurred, items were discussed further such that the interjudge reliability on classification of responses rose to 100 percent.

DIMENSIONS OF OUTSOURCING

Based on the data collected in the qualitative interviews, two key categorical dimensions were identified by the executives as differentiating outsourcing engagements and serve as the foundation of our framework. The first is the *scope* of the outsourcing engagement, or degree of responsibility assigned to the supplier. The greater the scope of the outsourced task, the larger the relinquishing of control by the client. The second differentiating characteristic is *criticality* of the outsourced task to the primary activities of the client organization. Criticality is defined as the extent to which the task in question impacts the ability of the organization to perform its core competencies. The greater the criticality of the outsourced task, the greater the consequences of poor performance to the client and the greater the requirement for supplier management. These dimensions are now viewed in more detail and then built on in developing the research framework.

Scope

The primary differentiating characteristic between categories of outsourcing engagements is the *scope* of the function assigned to an outside supplier. At the simplest level it is the degree of responsibility assigned to a supplier, and associated relinquishing of control by the client, that differentiates types of outsourcing. At one extreme outsourcing can involve only one task outsourced from many possible tasks that comprise an entire function, such as outsourcing the replenishment of only MRO inventories (maintenance, repair and operating items). At another extreme it can involve outsourcing the management and even strategic direction of an entire operation or process. An example would be the comprehensive outsourcing of all aspects of the logistics function to a third-party logistics (3PL) service provider.

Based on feedback from executives and the comprehensive literature review, four broad categories of outsourcing engagements are identified that differ in terms of scope. These include *out-tasking, co-managed services, managed services* and *full outsourcing*. Numerous characteristic differences exist between these categories, and many variants of each arrangement are subsumed under each respective category. Nevertheless, creating a framework for the range of available outsourcing alternatives and their characteristics can help managers identify and develop the outsourcing strategy appropriate for their business. These categories of outsourcing are described in greater detail below.

1. *Out-tasking*. In the simplest form of outsourcing the responsibility for the performance of a specific task is assigned to an outside supplier. Here only one aspect of the total function is assigned to an outside party, rather than responsibility for the entire function. Responsibility assigned to the supplier is relatively small, confined and specific. In logistics, an example might be a supplier assigned to handle a client's returned inventories, arranging for item disposal or restocking.
2. *Co-managed Services*. This type of arrangement involves assigning a larger scoped task or function to the supplier compared with the previous engagement, however, under direct client control. Here client and supplier share responsibility for managing the tasks and assets, and in many cases work collaboratively. Although the overall function can have strategic impact, it is the tasks with lesser strategic significance that are typically performed by the supplier.
3. *Managed Services*. The responsibility assigned to the supplier is larger in scope than that of the previous engagements. Here the client typically engages the supplier to design, implement and manage an end-to-end solution of a complete function, such as the complete management of a client's transportation systems. The supplier is now responsible for all aspects of the function, including equipment, facilities, staffing, software, implementation, management and ongoing improvement.
4. *Full Outsourcing*. In this arrangement, the client assigns total responsibility to the supplier for the design, implementation, management and often the strategic direction of the function, operation, or process. The services are typically highly customized to the business environment of the client.

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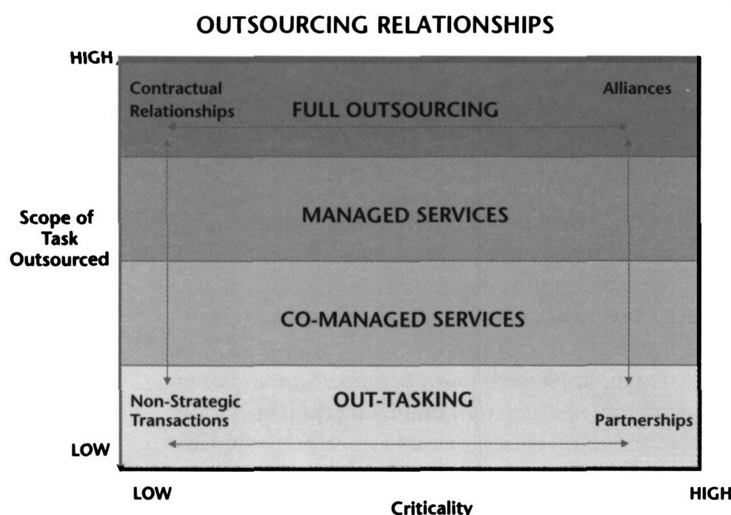
Criticality

The second differentiating dimension for outsourcing arrangements is the criticality of the outsourced task or function. Out-tasking, at the one extreme, often involves assigning responsibility of a more tactical task or function to the supplier, rather than a strategic function. The task, therefore, typically has lower criticality to the organization. Full outsourcing, at the other end of the spectrum, often involves outsourcing a strategic and more critical responsibility. For example, a firm may outsource transportation, but retain control of all aspects of design, implementation and ongoing management of the logistics function. Although the degree of criticality often corresponds to task scope, this is not always the case. It is certainly possible to fully outsource a function or process with little critical importance, and it is possible to outsource one highly critical task as in the out-tasking engagement. However, such cases would be extremely rare and atypical.

The executives interviewed underscore that the higher the criticality of the outsourced function the greater the business risk to the client organization. For example, one executive stated: "*We are aware that we incur a higher risk to our organization by outsourcing functions that are critical to our business. For that reason we have even brought critical functions back in-house that were outsourced in the past.*" As a result, this directly impacts the degree of supplier management required and the nature of the supplier–client relationship. When tasks with low criticality are outsourced, the relationship between client and supplier is primarily contractual and the client firm is focused on the transactional nature of the function outsourced. As criticality increases, the relationship moves from being solely contractual to becoming more relational. In simple out-tasking, when there is low criticality, the supplier has operational responsibility over a select nonstrategic task. The relationship is contractual and the client firm continues to have operational and managerial responsibility of all internal functions and process. As the outsourcing engagement becomes more comprehensive, however, the supplier increasingly becomes responsible for managerial and ultimately strategic aspects of the function.

Figure 1



EXPANDING THE FRAMEWORK: CLIENT–SUPPLIER RELATIONSHIPS

Considering task scope and criticality independently provides for a unidimensional perspective of outsourcing. A more comprehensive framework of outsourcing engagements is developed when both dimensions are considered simultaneously. For example, a large scope of outsourcing activity coupled with high criticality leads to more comprehensive outsourcing engagements and to different types of managerial requirements than are necessitated by the outsourcing of smaller scope and for less critical tasks. This framework results in differences in the nature of the client–supplier relationship and the responsibilities of each party. We identify four categories of relationship types that correspond to the four various combinations of levels of the two outsourcing dimensions. These are shown in Figure 1. The four outsourcing relationship types are described below.

1. *Nonstrategic Transactions*. This category encompasses the outsourcing of low criticality tasks with small or limited scope, resulting in outsourcing engagements that are solely transaction oriented, such as a simple commodity exchange. The product provided by the supplier is typically standardized and alternative sources of supply or market access are readily available.
2. *Contractual Relationships*. Contractual relationships reflect the need for greater control over business activity of suppliers (Rinehart, Myers and Eckert 2005). The scope of the outsourced task is higher than with nonstrategic transactions, though the function is still of low criticality to the organization. Moderate levels of communication frequency characterize this relationship, and unlike the case of the transactional relationship, dependence exists between the client and supplier.
3. *Partnerships*. This relationship type is characterized by the outsourcing of a critical task or function, albeit low in scope. The term "partnership" is used to connote strong and enduring trust between client and supplier, as well as a strong commitment to the relationship although the parties may not interact frequently. A variety of specific partnership arrangements are identified by Contractor and Lorange (1988). An example of this relationship could be the outsourcing of just-in-time replenishment of a critical manufacturing component.

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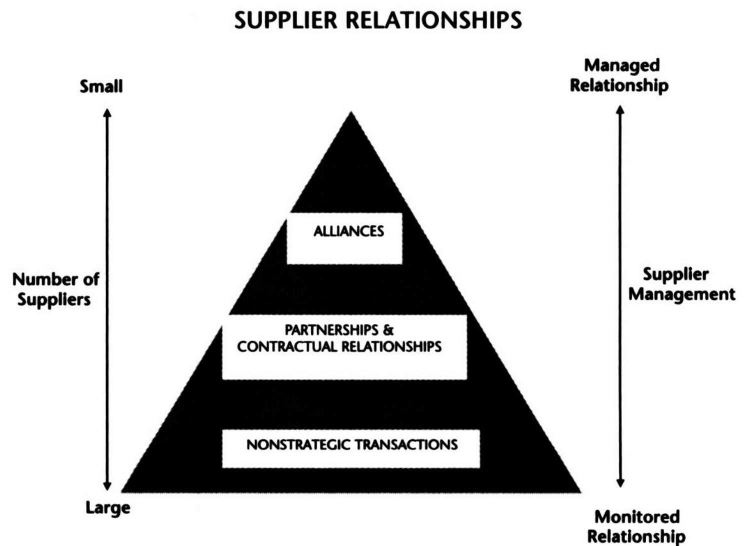
4. *Alliances*. The most comprehensive outsourcing relationships occur when both criticality and scope of outsourced task are high. These arrangements are defined as alliance relationships, and reflect high interaction frequency, significant trust and commitment between client and supplier. Alliances presume a high level of confidence in the capabilities and integrity of the other party, and require significant resource investment in ongoing relationship management.

All of the executives interviewed identified significant supplier management requirements as one of the less anticipated results of the more comprehensive outsourcing engagements. For example, the executives expressed that the time commitment required for relationship management was far greater than expected and cautioned that client firms should have an internal infrastructure prepared for this type of ongoing relationship management. This is not to say that full outsourcing, which requires comprehensive relationship management, should not be undertaken. Rather, it means that client firms should not expect to just "hand over" responsibility to a supplier, and need to anticipate the organizational requirement of close relationship management. By contrast, less comprehensive outsourcing engagements, as exemplified by nonstrategic transactions and contractual relationships, primarily require performance monitoring rather than full relationship management resource investment.

Managers should understand the relationship requirements of the different types of outsourcing engagements and make their organizational plans accordingly. The number of comprehensive outsourcing engagements, such as alliance type relationships, must be kept small due to the extensive relationship management requirement. Relationships such as nonstrategic transactions, on the other hand, can be numerous as only monitoring efforts are required. Outsourcing engagements requiring a blend of relationship management and supplier monitoring, such as partnerships and contractual relationships, fall in the middle of the scale as shown in Figure 2.

Figure 2



ALIGNING BUSINESS OBJECTIVES WITH OUTSOURCING STRATEGY

The type of outsourcing engagement selected should be developed to support the business objectives motivating the outsourcing decision. Organizations choose to outsource for a variety of reasons, such as cutting costs, accessing new skills, focusing on core competencies, or managing processes more effectively. Although many firms primarily outsource to cut costs and increase efficiencies (13 out of the 19 executives interviewed were primarily motivated by cost), the decision to outsource is far more complex and includes an increased focus on resource and strategic benefits. In fact, the remaining six executives identified these as the primary motivations for outsourcing. Outsourcing is increasingly becoming a strategic tool for many firms, as they engage the unique talents of highly skilled suppliers in strategically important tasks. In fact, outsourcing can enable client firms to acquire state of the art technologies and technical skills that would otherwise be unavailable to them (Lacity and Willcocks 1998). Three primary reasons for outsourcing were identified by the interviewed executives: *financial, resource based* and *strategic*.

Financial reasons focus on the minimization of costs, such as lowering labor cost, production cost, and increasing revenues. Unfortunately, the financial reasons possess two shortcomings. First, they typically focus on per unit cost and often overlook the true total cost of the engagement (Lynch 2005). Second, financial drivers are often shortsighted in nature — managers outsourcing for financial reasons are often compelled to do so in response to short-term financial indicators. When concerned solely with minimizing costs, these managers will tend to follow a reactive, rather than a proactive, management approach. Financial indicators tend to serve as symptoms of problems, rather than leading to an enduring strategic rationale for outsourcing.

Alternatively, resource-based objectives focus on using outsourcing to compensate for a lack of expertise, such as technical know-how, the ability to keep pace with regulatory requirements, and/or address technological change. They can also be used to compensate for a lack of assets. These types of objectives have a broader vision in mind as cost is viewed as a by-product of resource efforts such as process improvement.

Similarly, strategic objectives look at outsourcing as an opportunity to develop proficiencies that can provide

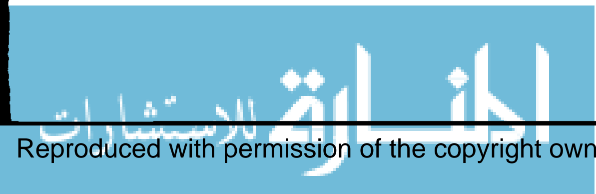

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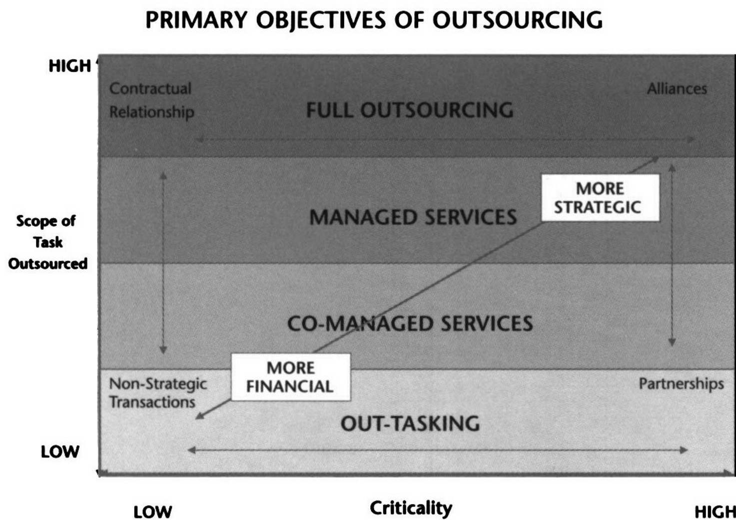
Figure 3

PRIMARY OBJECTIVES OF OUTSOURCING



competitive differentiation. These objectives have the broadest vision in that they are internally focused on maintaining and developing capabilities and externally focused on how these capabilities can be leveraged in the marketplace.

The type of outsourcing engagement selected has to account for the reasons for outsourcing and the nature of the objectives the firm is trying to attain. When considering the decision to outsource, managers need to put time toward identifying the objectives they wish to accomplish with the outsourcing decision. Questions that need to be asked include: What business problem are we trying to solve? Is reducing cost or capital outlays the primary driver? Do we want access to technology? And, do we want a strategic partnership with a world-class provider of a core technology? Understanding the reasons behind the outsourcing decision is a key to providing a better fit with the type of outsourcing engagement selected.

More tactical-level outsourcing, as seen in out-tasking and co-managed services, is generally intended to meet financial cost objectives, overcome a short-term lack of capital necessary for asset acquisitions, or access a non-core capability. These arrangements can also be used to address a near-term capability gap. Out-tasking is also often used to broaden geographic reach, called geographic-based out-tasking. Rather than hire full-time employees to cover a large geographic region, companies often find that out-tasking can provide a lower cost and better time to market. Tactical outsourcing engagements such as these can move from financial to resource objectives for firms with a solid strategic direction and process management systems, but that need to reduce the costs and cycle time of deploying new capabilities. However, tactical outsourcing generally addresses financial and sometimes resource objectives; it does not address a firm's strategic requirements. This is shown in Figure 3. More comprehensive outsourcing engagements, as seen with managed services and full outsourcing, tend to have a strategic objective where the firm may be willing to forego short-term financial benefits for long-term strategic positioning. These strategic goals may include developing a source of competitive advantage that may require an initial outlay of funds before profitability is realized.

Although more comprehensive outsourcing arrangements typically involve strategic objectives, the decision for any type of outsourcing engagement has a financial component, regardless of the primary reason for outsourcing. The interviewed executives identify that a major issue for companies is correctly evaluating the costs of their sourcing strategies. Most companies cannot effectively determine the cost of goods and services consumed internally, including tangible and intangible costs. Ironically, outsourcing can facilitate greater understanding of cost structures for companies, as many suppliers have developed sophisticated mechanisms for monitoring the work they perform and reporting associated expenses.

COMPLETING THE FRAMEWORK: RISKS OF OUTSOURCING

In addition to identifying key reasons for outsourcing, client firms need to consider certain risks as part of the outsourcing decision making process. Risk is an inverse function of control. As a firm relinquishes more control through outsourced arrangements, it takes on more risk. In general, more sophisticated outsourcing engagements bring greater benefits, but also involve significantly higher risks (Manuj and Mentzer 2007). As shown in Figure 4, a number of risk factors were identified by the executive respondents that should be considered before a firm passes more responsibility to external suppliers. These are outlined below.

Ability to Retain Control of Task

As the scope of the task passed to the supplier increases, the ability to retain control of the task or function decreases. Indeed, the sole purpose of outsourcing is to tap into the talent and unique capability of the supplier. Unless very specific outcome expectations are set up, however, the final outcome may not meet client expectations. Identifying key performance metrics and their values is a challenge, particularly for service types of tasks where the final "product" is intangible and often difficult to quantify. For small firms this can be particularly damaging as internal processes are less insulated from disruption.

This transfer of task control is a significant risk factor to consider. The decision to enter into an outsourcing engagement should include a thorough evaluation of the client firm's own capabilities versus that of the supplier. Often large client firms may find that they are equally

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effective at meeting expectations as an outside supplier, due to their large scale (Adler 2003).

Potential for Degradation of Critical Capability

One of the tenets of a well-run business is that it understands its core capabilities and how those capabilities help the business create value. Therefore, as a general rule, firms do not outsource activities that directly contribute to their strategic, competitive advantage. Firms that are considering the outsourcing of such capabilities should recognize that they are putting execution at risk. Firms should also understand the relationship between core competencies and other related activities that provide no direct competitive advantage, but are highly interdependent with those that do. The company of one of the executives interviewed did precisely that. The company, a large national bank, brought IT services back in house that had been outsourced in the past. Although IT is not its core capability, it was impossible to separate IT services from its core capability, which was creating and delivering financial service products.

A company should also carefully consider outsourcing any function that may provide a competitive advantage in the future. Instead it should allocate resources to building this capability, even if outsourcing seems like an attractive option at the moment. Outsourcing is a good option, however, for functions that will not provide the company with a sustainable advantage or do not directly support core capabilities.

Dependency Risk

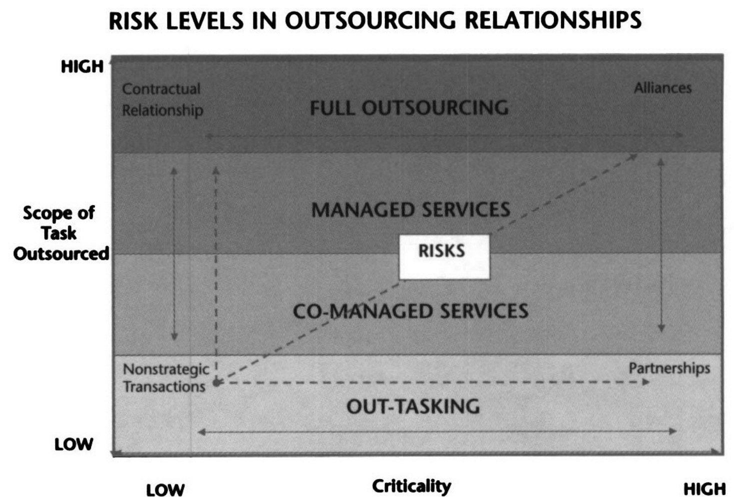
As a firm engages in more sophisticated outsourcing engagements it often customizes its operations to match those of its supplier. By doing so the firm may benefit by taking advantage of the supplier's economies of scale. This is particularly true in cases that require specialized technology and equipment, and specialized training of staff. However, customized arrangements are risky in that the firm can become overly dependent on the supplier. This can result in short-term problems, such as lack of performance on the part of the supplier that disrupts operations, and can also have strategic consequences, as the firm's future direction is tied to that of the supplier. The decision of whether to outsource should be based on the interdependence of the outsourced function with other internal processes (Aftuah 2003). Companies should avoid outsourcing highly integrated functions, particularly when significant adaptation with a supplier is required.

Pooling Risk

Many suppliers achieve economies of scale by aggregating the needs of different, sometimes competing, clients. Indeed, suppliers would not be able to offer a competitive advantage if it were not for the economies of scale that come from pooling the needs of many similar clients. However, this situation inherently creates certain risk factors. One such risk — *proprietary risk* — is the potential for client information to leak to an external party or be comingled with that of another client. This type of risk can be particularly damaging in the case of proprietary information, such as a unique technology or process. Proprietary risk increases when the function outsourced is strategic in nature and is designed to provide a competitive advantage to the firm. Although various mitigation strategies can be used to minimize this occurrence, companies should carefully evaluate proprietary risk when deciding which functions to outsource and exercise due diligence with respect to the supplier in extracting the necessary contractual commitments.

Figure 4

RISK LEVELS IN OUTSOURCING RELATIONSHIPS



Another type of pooling risk — *contention risk* — arises from the potential that a large number of clients may simultaneously compete for supplier services, which the supplier may then not be able to provide. This is especially true for suppliers with clients concentrated in a particular industry that may be suddenly subject to same government regulation or may want the same emerging technology. Suppliers do not have infinite capacity and resources, and thus typically balance these with the needs of many different clients. There is always the potential for lack of service at a time of critical need, if an external event forces a large number of clients to demand services. Although this is usually a relatively small risk due to the availability of subcontracting, its presence further underscores the importance of giving careful consideration to the outsourcing of critical functions.

Risk of Hidden Costs

This final risk is equally valid for all types of outsourcing engagements and relates to the risk of hidden costs associated with outsourcing. The executives interviewed

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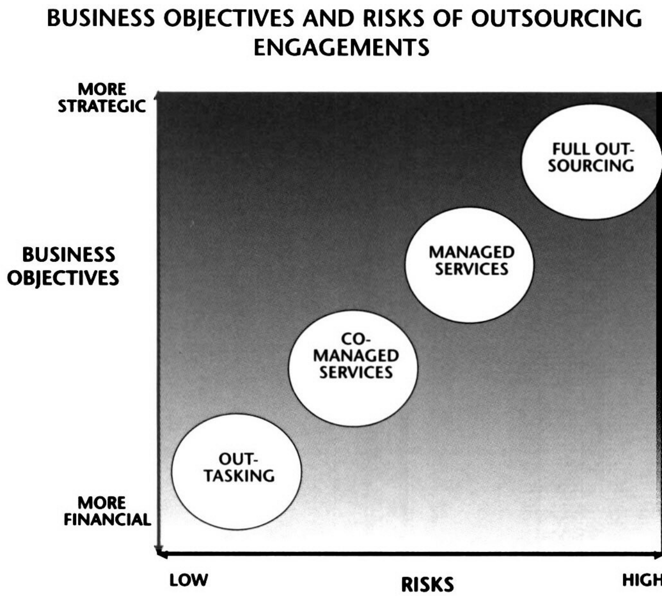
Figure 5

BUSINESS OBJECTIVES AND RISKS OF OUTSOURCING ENGAGEMENTS



all agree that unexpected costs are commonplace. The sheer number of variations of sourcing engagements creates ample opportunity for the client to omit, overlook, or underestimate many costs. One example is the omission of an important task in the contract of which the client was unaware or simply forgot to include. Here the supplier will perform the task, however, at an additional cost. Although this reflects more on poor contracting, it is still an unexpected cost. Another example is the underforecasting of work volumes by the client. In this case, the supplier may find the work volumes to be higher than anticipated by the client and charge accordingly. Hidden costs can also relate to unexpected communication technologies needed, particularly in the case of global sourcing, and the time requirement for relationship management (Artz and Brush 2000; Barthelemy 2001).

The potential for the discussed risks increases with the level of sourcing engagement, as do the potential benefits. This relationship is illustrated in Figure 5, which shows that less comprehensive sourcing engagements are more appropriate to meet financial or resource-based business objectives and they incur lower risks. By contrast, more comprehensive sourcing engagements are designed to meet more strategic business objectives but have the potential for greater risks.

MANAGERIAL IMPLICATIONS AND FUTURE RESEARCH

Only half of the executives interviewed were satisfied with their outsourcing engagements. This is consistent with recent research that reveals corporate satisfaction with outsourcing to be roughly at 50 percent (Gainey and Klaas 2003). Fifteen of the 19 executives expressed that a number of supplier management issues had been misjudged by their respective organizations. As these issues are paramount in formulating and executing a solid outsourcing strategy, our framework provides an approach to managing outsourcing arrangements effectively. A number of important additional considerations were also identified, and are discussed in closing.

Relationship Management

Our interviews reveal that the most underestimated issue in outsourcing is the challenge involved in managing the relationship. In fact, the executives state that the primary cause of failure of a satisfactory outcome is the inability to effectively manage the client-supplier relationship. This can be difficult despite clear contracts and preset service level agreements (SLA). It is not enough to simply hand over the task or function to the supplier. Rather, the ongoing collaboration ensures successful outcomes. A major concern for clients approaching an outsourcing engagement should be their ability to effectively manage a complex supplier relationship.

As criticality and/or scope of the outsourced tasks increase, the firm moves from a monitored relationship to a managed relationship (see Figure 2). Thus, relationship management is least important in out-tasking as the scope of the task is small, the product is standardized and the function is more tactical. Monitoring through good contractual agreements usually suffices at this stage. However, to engage in a more encompassing outsourcing strategy, such as managed services and full outsourcing, it is important for the client firm to first determine if it possesses the requisite relationship management skills, and to invest in building a "relationship architecture" for the purpose of ensuring that there is an appropriate underlying relational design or structure for the alignment between their organization and the supplier. Client firms should also take time to determine the type of relationship they seek to develop, such as whether it is purely cost driven versus focused on strategic partnering, and ensure that there is alignment within their organization in dealing with the supplier. For most companies, this is an unexpected requirement of the outsourcing engagement and is yet another "hidden cost."

An important element of building an effective "relationship architecture" is a joint communication plan. The broader the scope of the outsourcing engagement, the more important it becomes to proactively communicate strategic intention, expectations, timeliness and business benefits to the client's employees and key stakeholders. In most cases the very people who will have to help the outsourcer integrate their activities into the client's are the ones most threatened by this new business arrangement. Addressing these kinds of concerns early and publicly (even if employees do not like what they hear) can

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improve the success of these arrangements by focusing employees on what needs to be done and minimizing the likelihood that employees will deliberately undermine the arrangement.

Our framework is especially relevant to research in the relationship marketing paradigm (Morgan and Hunt 1994) that currently dominates business to business marketing. This literature argues for the use of relational management for business to business transactions. However, we propose that the effectiveness of relational marketing techniques will be contingent on the criticality and scope of the task being outsourced.

Contract Management

All the executives agreed that contracting and negotiation are critical components regardless of the outsourcing engagement. Contracts with clearly specified service-level agreements are a must for a successful relationship, despite their potentially high cost to develop. Some supplier–client contracts are valued in the billions of dollars and need to be carefully crafted by skilled attorneys. In fact, of the 19 executives interviewed 13 were disappointed with the service levels provided and reported having had some degree of contractual dispute with their suppliers. The contracting process can be so resource intensive that some companies are in the business to manage it entirely, including evaluating sourcing alternatives, conducting negotiations and putting the contractual relationship in place.

As relationships move from monitored to managed, the specification of the change process becomes more important. This is essential as either party's organizational climate can literally change overnight with a change in leadership, as happened with some of the interviewed executives. Modifications to the initial contract are inevitable, usually in the form of addendums, as the business changes. When relying on more relationally oriented management of the supplier (e.g., alliances), it is expected that commitment and trust will develop through the process of transacting (Morgan and Hunt 1994). However, while contracts are important, the relationship will develop over time and change as needed. In addition to the initial cost of writing the contract, firms need to be prepared that ongoing change management will be an inevitable facet of the long-term relationship and should plan accordingly.

Our study also informs future alliance research, especially the ability of a buyer–supplier relationship providing a competitive advantage when task scope and/or criticality are low because the objective of the outsourced arrangement will be more financial (see Figure 3). As the objectives for the outsourced task move from financially oriented to more resource and strategic oriented, the degree to which the relationship could be a source of competitive advantage increases. Therefore, competitive advantage of a buyer–supplier relationship is contingent upon the degree of criticality and scope of the task being outsourced.

Firm Size

A number of executives noted the role of firm size in the outsourcing decision. Small and medium-size firms often have smaller budgets and an organizational infrastructure with less clear delineation between strategic and tactical functions. Outsourcing engagements can, therefore, be especially risky for smaller firms (see Figure 2). For smaller firms, all tasks will generally have a higher degree of scope and criticality. These firms may also lack specialized skills that may be required for more elaborate outsourcing engagements. In fact, a recent survey finds that small and midsize firms may have unrealistic expectations of the outsourcing experience (Brown 2003). In contrast, large firms may not have the same problem of getting the right amount of attention from large suppliers. However, larger firms may be frustrated to find that they have the required talent hidden internally due to their size, and could avoid some of the identified risks through internal sourcing, if their organizational structure facilitates the alignment of key people to critical processes. Future research should explore the effect of firm size on the degree of scope and criticality of tasks.

CONCLUSION

This article presents a comprehensive framework of outsourcing engagements, their characteristics, and variations. While there is a wealth of best practices and lessons learned, there is no "one size fits all" sourcing strategy. Rather, the selected sourcing strategy must always be based on the current and unique needs of the firm. As businesses evolve and develop greater capabilities, their sourcing requirements change. Consequently, the selection of outsourcing engagements should be flexible and dynamic, rather than a rigid and static decision process. In deciding on the best sourcing strategy firms should carefully consider their business objectives for outsourcing, carefully evaluate potential risks and not fall prey to the apparent momentum of the outsourcing movement. As results of our interviews demonstrate, there are many hidden costs and unexpected challenges, particularly as companies engage in more sophisticated outsourcing engagements.

Our outsourcing framework ties together the full range of outsourcing issues, including scope and criticality of outsourced tasks, type of supplier relationships, and risks and business objectives. Although simplistic, the framework is informative in showing that the achievement of specific business objectives is tied directly to the specific type of outsourcing arrangement selected, and carries with it associated risks. Although managers may ultimately decide to adapt the outsourcing categories

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presented to their own scenarios, the basic relationships between business objectives, risks, task scope and criticality will remain unchanged.

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Appendix

Structured Interview Guide

- Opening — Introduction of researchers and purpose of the study; assurance of confidentiality.
- Demographic Data Collection — Establishment of participant titles, background of organization, industry, number of suppliers and company's outsourcing history.
- Research Questions:
  - In your opinion, what are the different types of outsourcing engagements?
  - What criteria are you using to differentiate outsourcing engagements?
  - In your opinion, when is it appropriate for a company to use each of the different types of outsourcing engagements?
  - What are the risks of each of the different outsourcing engagements?
  - What are the benefits of each of the different outsourcing engagements?
  - In your experience, what are the reasons companies outsource and how do they relate to the different types of outsourcing engagements?
  - What is the role of supplier relationships in each of the outsourcing engagements?
  - What unexpected issues/outcomes can be experienced with each of the different outsourcing engagements?
  - What has been your company's overall satisfaction with outsourcing?
  - Based on your experience, what advice would you give to others to consider when making the outsourcing decision?
- Prompts:
  - Can you tell me more about that?
  - Can you give more detail?
  - Can you give an example?

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