The Affect factors of SMEs' outsourcing decision making

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Abstract

The focus of this paper is to develop a framework for SMEs' outsourcing decision making, this paper will review recent studies of related dimensions to identify the factors affect outsourcing decision which are including two main categories, the outsourcing benefits and the risks of outsourcing .the benefits factors for outsourcing are cost reduction, transfer fixed costs to variable, improve service quality, Increase speed, increase flexibility, access to latest technology, increase focus on core competencies. The risk factors of outsourcing are hidden costs, loss of core competence, less flexibility, loss of knowledge, supplier problems and low morale. The study found that the framework for SMEs' outsourcing decision making, based on the factors found from this study, is including four factors affect outsourcing decision which are outsourcing benefits, outsourcing risks, core competencies and vendors (suppliers).

Introduction

Outsourcing is useful for business because there are certain situations that can be avoided through it. For instance, firms that perform all their business activities may have to spend huge amounts on replacing obsolete technology. However, when that business function is outsourced, then organizations will not even the feel the pinch. This means that organizations can dedicate their resources to productive activities alone and thus enhance their effectiveness and efficiency (Frayer *et al*., 2000). Successful implementation of an outsourcing strategy has been credited with guiding to cut cost (Greer *et al.,* 1999), increase capacity, improve capacity, improve quality (Kotabe *et al.,* 1998), increase profitability and productivity (Casale, 1996), improve financial performance (Dean Elmuti, 2006), lower innovation costs and risks (Quinn, 2000), and improve organizational competitiveness (Steensma and Corley, 2000).

SMEs have the similar business aims as larger organizations, but may have more limited resources. Among these goals are delivering cost-savings, raising customer satisfaction, achieving high performance, extending service offerings and having access to the best people, skills and technologies. (Amel and Hayat, 2016).

Outsourcing Benefits

According to Kakabadse and Kakabadse, (2000), there are three main categories of benefits for outsourcing: cost, strategy, and politics. The first two commonly drive outsourcing by private business. Political agendas often drive outsourcing by public organizations. In the context of this study, cost perspective and strategic perspective are discussed in more detail in the following sub-sections.

Cost perspective: Several of the secures identify the desire to save costs as an explanation for why outsourcing occurs (Lacity *et al*., 2017). In theory, outsourcing for cost reasons can occur when suppliers' costs are low enough so that even with added overhead, profit, and transaction costs suppliers can still deliver a service for a lower price (Kakabadse and Kakabadse, 2000).

One may consider how an organization can achieve enough savings to cover an additional layer of overhead and still meet profit requirements yet perform a function for less than another organization already doing the function. Specialization and economies of scale are systems used to accomplish this level of proficiency (Kakabadse and Kakabadse, 2000; Quinn *et al*., 2000; Roberts, 2001). In fact, cost savings due to outsourcing can be quite significant. Some organizations outsource to achieve better cost control, to improve profitability, to improve operating efficiency, and to add value to the product (Hayes *et al*., 2000; Al-Gharbi *et al*., 2009). Others try to shift fixed costs into variable costs (Kakabadse and Kakabadse., 2000; Lacity *et al*., 2017).

This reduced investment in manufacturing capacity lowers fixed costs and convert them into variable costs (Kakabadse and Kakabadse, 2000). Converting fixed costs into variable have a direct effect on companies' business indications, for example a return on assets (ROA) and a net profit can be improved (Kumar & Eickhoff, 2005). Transferring fixed cost into variable entails short-run cost improvements and encourages companies to outsource (Gilley & Rasheed, 2000).

Table (1) show factors of the outsourcing benefits.Table 1: Outsourcing benefits

Article	Author	Year	Cost perspective		Strategic perspective				
			Cost reduction	Transfer fixed costs to variable	Improve service quality	Increased speed	Increased flexibility	Access to latest technology	Increase focus on core competencies
New strategies let companies concentrate	Krizner	2000	√			√			√
Information systems outsourcing announcements	Hayes *et al*.	2000	√				√		
Critical review – outsourcing	Kakabadse and Kakabadse	2000	√	√	√	√	√	√	√
Managing strategic outsourcing	Roberts, P.	2001	√		√		√	√	√
OIS: Drawing lessons from a banking	Baldwing *et al*.	2001	√		√		√	√	√
Market viewpoint: outsourcing is no-claims bonus	Wright	2001						√	√
The effects of outsourci	Alner	2001	√					√	√

ng in Information Security									
Outsourcing: assessing the risks and benefits	Harland *et al.*	2005	√			√	√	√	√
IT/IS Outsourcing from Omani organizations	Al-Gharbi *et al.*	2009	√					√	√
Motivations for IT outsourcing in public Sector	Cox *et al.*	2011	√		√		√		√
The Benefits of the outsourcing strategy	Smadi and Al- Jawazneh	2016	√		√			√	√
Review of 23 years of empirical research	Lacity *et al.*	2017	√	√		√	√		√

Strategic perspective: More recently the main drivers for outsourcing appear to be shifting from cost to strategic issues such as core competence and flexibility (Krizner, 2000). The literature suggests that the focus on core activities to improve organizational competitiveness, to leverage the firm's skills and resources and to enhance customer satisfaction, plays an important role in attracting outsourcing (Baldwing *et al*., 2001; Harland *et al*., 2005; Cox *et al*., 2011; Lacity *et al*., 2017).

According to Quinn and Hilmer (1994) and Quinn (2000), the most strategic outsourcing reason is to allow the organization to better concentrate on its core activities, in addition to improving service quality (Kakabadse and Kakabadse, 2000; Roberts, P. ,2001; Baldwing *et al*.,2001; Cox *et al*., 2011; Smadi & Al- Jawazneh 2016). Other papers focus on increased speed to improve performance (Krizner, 2000; Kakabadse and Kakabadse, 2000; Harland *et al*., 2005; Lacity *et al*., 2017). Several studies focus on increased flexibility to reduce the constraints of organization's own production capacity, to increase responsiveness to market change and to reduce risks (Hayes *et al*., 2000; Roberts, P. ,2001; Baldwing *et al*.,2001; Cox *et al*., 2011; Lacity *et al*., 2017).

By outsourcing, organizations can increase flexibility in a many different ways. Basically, flexibility can manifest itself in two ways. First, flexibility refers to an ability to adapt capacity to demand shifts in the short-term (Quinn & Hilmer, 1995). When the demand peak occurs, external suppliers' capacity can be used to level these peaks (Jennings, 2002). Second, flexibility refers to an ability to adapt to changing business environment' in the long-run (Quinn & Hilmer, 1995). Furthermore, it allows access to latest technology to achieve competitive advantage (Wright, 2001; Harland *et al*., 2005; Al-Gharbi *et al*., 2009; Smadi & Al- Jawazneh 2016). Quality improvements can also be achieved by outsourcing, because organizations can in most cases choose the supplier whose quality is excellent (Gilley & Rasheed, 2000). Because suppliers have concentrated on their specific area and have specialized equipment and personnel, they can provide higher quality than an organization could ever achieve alone (Quinn & Hilmer, 1995).

Based on the articles analysis, Lonsdale & Cox (1998) categorize five main reasons why organizations outsource; cost reduction, focusing resources on core activities, converting fixed costs to variable, benefiting from supplier's innovation and investment and improving time to market. On the other hand, according to Quelin & Duhamel (2003), the most important factor of the outsourcing decision is to lower operational costs, the second is to focus on core activities and the third is to gain flexibility. Lacity *et al*., (2017) survey of 430 articles between 1992-2014 concluded that the factors service improvement, quality increase, flexibility and access to latest technology, motivated 100 % of the outsourcing decision. The factors of cost reduction, increase of focus on core competencies and transfer fixed costs to variable, motivated more than 94 % of the outsourcing decision.

The above findings are corroborated by Deloitte´s (2005) surveys. Most western companies outsource primarily for short-term cost savings (Kakabadse & Kakabadse, 2002; Deloitte, 2005).

Moreover, Forrester Survey, 2014, Canvassed 13,822 business and technology decision-makers located in Australia, Brazil, Canada, China, France, Germany, India, New Zealand, the UK, and the US from SMEs companies with two or more employees. It showed reducing costs motivated 64% of the outsourcing decision.

Risks of outsourcing

Outsourcing can provide many benefits and some managers even regard it as risk-free (Lonsdale & Cox, 1997). However, there is always the other side of the coin and many risks are related to outsourcing. In an ideal world, markets would operate effectively without any friction or transaction costs (Quinn & Hilmer, 1995). However, in the real world most supply markets are imperfect and encompass a great deal of risks (Quinn & Hilmer, 1995).

A wide array of outsourcing risks has been identified in literature and risks range from minor setbacks to catastrophic consequences. The risks may result from the supplier, from the business environment or from the outsourcing organization itself (Aron et al, 2005). These risks are discussed in more detail in the following sub-sections:

Table 2: The risks of outsourcing

Article	Author	Year	Hidden costs	Losing opportunities	Loss of knowledge	Supplier problems	Less flexibility	Low morale	Loss of core competence
Critical review – outsourcing	Kakabadse and Kakabadse	2000	√	√	√	√		√	√
Managing strategic outsourcing	Roberts, P.	2001		√	√	√	√		√
A Validation of measures associated with the risk factors in ITO	Bahli *et al.*	2002	√			√			√
Validating measures of ITO risks factors	Bahli and Rivard	2005	√			√			√
Risks factors associated with offshore IT outsourcing	Tafti M.	2005	√	√	√		√		
Outsourcing contracts as instruments of	Ngwenyama and Sullivan	2007	√	√					√

risks management									
A comparative study of important risks factors	Nakatsu and Iacovou	2009	√				√	√	
Identifying risks factors of IT outsourcing	Fan, Suo and Feng	2012	√			√	√		
Analysis and application of an outsourcing risk framework	Abdullah and Verner	2012	√	√				√	√

Hidden costs: It is not certain that outsourcing could lead to cost savings for SMEs. (Kakabadse & Kakabadse, 2000; Bahli *et al*., 2002; Bahli and Rivard,2005; Tafti M., 2005; Ngwenyama and Sullivan, 2007; Nakatsu and Iacovou, 2009; Fan, Suo and Feng ,2012; Abdullah & Verner ,2012). According to Barthélemy (2001) many organizations underestimate costs related with activities to setup, transition to, and manage an outsourced environment.

These hidden costs can easily undercut expected benefits of outsourcing. For example, reducing the cost of wages after outsourcing does not always lead to lower organizational overall costs. Therefore, it is important to know that there are other costs associated with the transaction (subcontracting). These could be the cost of the contract, the cost of monitoring or performance. At the end of the day when we combine and compare all these costs of outsourcing with insourcing, outsourcing could be more expensive.

Loss of core competence: Many researchers argued that losing core activities is the most important risk of outsourcing. (Kakabadse & Kakabadse, 2000; Roberts, P, 2001; Bahli *et al*., 2002; Ngwenyama and Sullivan, 2007; Bahli and Rivard,2005; Abdullah & Verner,2012)

According to Lonsdale & Cox, (1998) there are two ways of losing core activities. First is the case that management unintentionally outsources a core activity, such as when the primary target for outsourcing is short-term cost-cutting or headcount reduction (Leavy, 2004). In addition, suppliers may at first offer overoptimistic cost savings which can misguide managers (Lonsdale & Cox, 1998). Second is the case where outsourced activity did not seem to be a core activity at the moment of outsourcing decision, but later on turned out to be such one (Lonsdale & Cox, 1998). Managers fail to recognize the sources of competitiveness in the future and long-term competitive advantage is traded off for short-term advantage (Leavy, 2004).

The core activities for a business change over time, activity which is or appears to be non-core at the moment may become a core in the future (lbid).

Less flexibility: Flexibility is one motive for outsourcing and indeed flexibility is often increased. On the other hand, outsourcing does not always lead to greater flexibility (Lonsdale & Cox, 1998). Instead, some researchers have argued that, in some occasions, outsourcing can lead to loss of strategic flexibility. (Roberts, P, Tafti M., 2005; Nakatsu and Iacovou, 2009; Fan, Suo and Feng, ,2012) In addition, the existence of dependency does not make things any easier (Lonsdale & Cox, 1998).

Loss of knowledge: In case an organization outsources an activity, it inevitably loses some knowledge and skills (Kakabadse & Kakabadse, 2000; Roberts, P, 2001; Tafti M., 2005; Abdullah & Verner,2012). This is on intrinsic by-product of the process of outsourcing (Aron et al, 2005). When an organization ceases to conduct an activity, knowledge and skills related to it fade away (lbid). However, losing knowhow does not happen overnight. Instead it may happen over the years (Chen, 2004). When an organization outsources too much, it can turn into a hollow one (Belcourt, 2006). When an activity once minor for the business becomes someday important, the organization may not any more possess the needed skills for conducting that activity (Aron et al, 2005; Belcourt, 2006; Leavy, 2004).

Supplier problems: Another branch of studies focuses on Supplier problems as the most important risks of outsourcing. (Kakabadse & Kakabadse, 2000; Roberts, P, 2001; Bahli *et al*., 2002; Fan, Bahli and Rivard,2005; Suo and Feng,2012). supplier problems can manifest in many ways. First, supplier ceases supplying. Dependency issue is related to the risk of supply interruptions (Lonsdale & Cox, 1998).

Dependency and the lack of alternative suppliers are the key factors which determine the level of the risk. However, shortage of supply can occur without the dependency (lbid). Second, Poor quality of supply. Again, issue of dependency plays a role with this risk (Lonsdale & Cox, 1998). In the case of high dependency, supplier may take an advantage of it and supply only at that level of quality, which only just satisfies the buyer (lbid).

Low morale: The effect on employee morale as one of the primary risks of outsourcing. (Kakabadse & Kakabadse, 2000; Tafti M., 2005; Nakatsu and Iacovou, 2009).
Outsourcing always results in displaced employees (Belcourt et al, 2006; Power et al, 2004). Basically, there are three options for the employees that previously carried out the outsourced activity: they are either transferred to the outsourcing company, transferred internally to other functions or they are laid off (Belcourt et al, 2006). Probably, most of the employees are not happy with any of those options (Lonsdale & Cox, 1998).

Furthermore, Low morale may affect productivity of the company and it can lead skilled workers seeking a new job (lbid). Outsourcing always incorporates changes. Most people have a natural tendency to resist changes (Kumar & Eichhoff, 2005). Consequently, in outsourcing, managers will always encounter a wall of resistance (lbid). Fortunately, most of these problems can be avoided with proper management (Lonsdale & Cox, 1998).

Conclusion

Many benefits and risks of outsourcing have been identified. The following outsourcing decision framework was hence developed, Figure (1). The framework for SMEs' outsourcing decision making , based on the factors found from this study, is including four factors affect outsourcing decision which are outsourcing benefits, outsourcing risks, core competencies and vendors (suppliers).

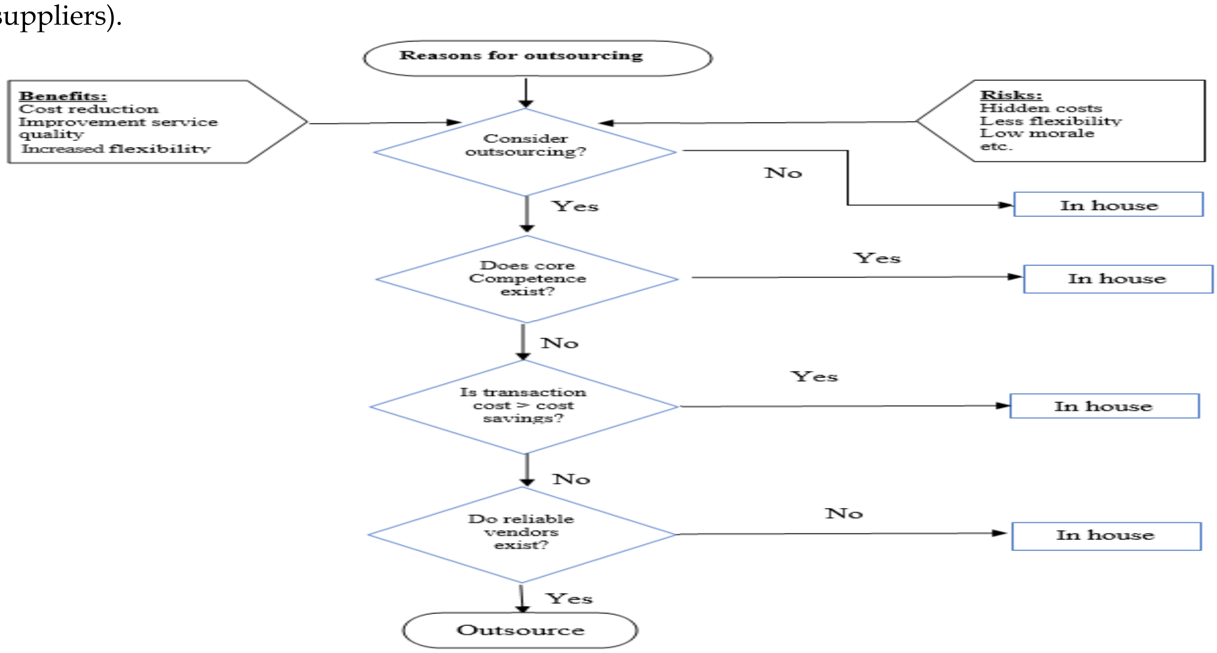

Figure 1: Framework for making outsourcing decisions

Source: Adapted from Ghani and Rana (2005), Tibor and Oya (2006)

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