



Failing to estimate the costs of offshoring: A study on process performance



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ABSTRACT

This article investigates cost estimation errors in the context of offshoring. It is argued that an imprecise estimation of the costs related to implementing a firm activity in a foreign location has a negative impact on the process performance of that activity. Performance is deterred as operations are likely to be disrupted by managerial distraction and resource misallocation. It is also argued that this relationship is mitigated by the extent to which firms use modularity to coordinate the activity but worsened by the extent to which ongoing communication is used. The results, based on a hierarchical regression analysis of a unique survey on Danish and Swedish firms, support these arguments.

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1. Introduction

What happens when firms underestimate the costs of offshoring? Offshoring describes the relocation of organizational activities to foreign locations for reasons such as comparative costs benefits, access to new talent, and market proximity (Jensen, Larsen, & Pedersen, 2013). However, while the pursuit of offshoring strategies has been a prolific experience for many firms (Dossani & Kenney, 2003), recent research has pinpointed how firms often incur substantial “hidden costs” when implementing activities abroad (Dibbern, Winkler, and Heinzl, 2008; Larsen, Manning, & Pedersen, 2013; Stringfellow, Teagarden, & Nie, 2008). For example, firms experience that local labor costs increase beyond expectations and that offshoring operations require substantially more knowledge transfer and control than originally anticipated. Firms are unable to foresee the full consequences of offshoring, and are, as a result, incapable of making precise estimations of the costs of implementing offshoring activities abroad.

The purpose of this article is to investigate the consequences of such hidden costs. Specifically, while prior research has focused on the drivers of offshoring cost estimation errors—emphasizing factors such as complexity (Larsen et al., 2013), interaction distance and intensity (Stringfellow et al., 2008) and contractual incompleteness (Dibbern et al., 2008)—little is known of the

consequences. This is an important gap in our understanding of offshoring, as firms need to make important cost estimations of the changes in the organization and the environment so that future resource allocations can be planned and aligned (Durand, 2003; Eisenhardt & Martin, 2000; Makadok & Walker, 2000).

Supported by hierarchical regression analyses of unique survey data reported by Danish and Swedish companies, I argue that firms’ inability to effectively estimate the costs of implementing an activity in an offshore location (i.e., cost estimation errors) negatively impacts the process performance of that activity. The operations of the activity are likely to be disrupted by resource misallocation and managerial distraction as a consequence of inaccurate offshoring cost estimations. At the same, I argue that the specific mechanisms employed to coordinate the offshoring activity influence the negative impact on process performance in important ways. Specifically, since cost estimation errors can be seen as a local problem that needs local accommodation, coordination through modularity provides local units with the autonomy to solve the problems caused by cost estimation errors internally and without interference from other units. It will therefore reduce the negative effect on process performance. Conversely, coordination through ongoing communication leaves the offshored unit with less autonomy to accommodate for the challenges caused by cost estimation errors, and therefore exacerbates the negative effects on process performance.

This research contributes to research and practice of offshoring by emphasizing the performance consequences of costs estimation in the offshoring processes (e.g., Lewin & Peeters, 2006; Mol, van

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Tulder, & Beije, 2005; Massini, Pern-Ajcharyawong, & Lewin, 2010). This study demonstrates that cost estimation errors eventually reduce the process performance of a given activity. This is an important insight as it provides an explanation for why firms often experience that the initial rationale for offshoring is undermined (e.g. Aron & Singh, 2005). Further, by uncovering the opposing moderating effects of modularity and ongoing communication on process performance, respectively, this article suggests that it may not always be relevant to invest in costly decision-making to estimate the costs of offshoring. Rather, depending on the coordinative requirements of the offshoring process, firms may choose to accept cost estimation errors and still uphold performance. In particular, this article suggests that when tasks are modular by design, the performance penalties of inaccurately estimating the costs of offshoring are substantially lower than when tasks require ongoing communication to coordinate work.

The article proceeds as follows: First, the literature on cost estimation and offshoring is discussed. Second, the hypotheses explaining the relationship between cost estimation errors, process performance and different coordination mechanisms are developed. Third, the dataset and methods used to explain process performance are introduced. Finally, the results are presented before the findings are discussed and related more broadly to research on offshoring and the role of cost estimation.

2. Theory and hypotheses

2.1. Estimating cost in offshoring

When firms decide to offshore certain activities to foreign locations, a number of important operational decisions must be made. For example, decisions has to be taken on issues such as the contractual ownership and relationship of the offshoring setup (Mudambi & Tallman, 2010), the host location (Graf & Mudambi, 2005), the level of disaggregation or 'fine-slicing' of the overall value chain to identify the specific tasks to be offshored (Contractor, Kumar, Kundu, & Pedersen, 2010), the choice of different coordination mechanisms (Kumar, Van Fenema, & von Glinow, 2009), and the overall coherence and integration of the globally dispersed organizational system (Srikanth & Puranam, 2011).

While such decisions may be motivated by reasons such as lowering labor and production costs (Dossani & Kenney, 2003) and accessing talent and qualified labor (Lewin, Massini, & Peeters, 2009), an important component of this decision-making relates to the accurate estimation of the costs of relocating activities abroad. Without an accurate estimation of the cost levels of offshoring firm activities, firms will not be able to invest in the required resources to arrange an efficient relocation and subsequent organizational reintegration (cf. Jensen et al., 2013; Mudambi & Venzin, 2010). This argument is supported by research on organizational reconfiguration that has emphasized that firms must successfully account for the additional costs of restructuring organizational activities to ensure that the objectives of the process will eventually be met (e.g., Lavie, 2006; Zollo & Winter, 2002). Lavie (2006: 161), for example, argues that a reconfiguration process entails costs relating to a number of areas—e.g., monitoring, evaluation, termination, learning, unlearning, adaptation, integration, deliberation, and codification—and suggests that “an *intendedly rational choice of reconfiguration mechanism takes into account the associated costs and risks*”.

Interestingly, recent research has paid attention to situations where firms are unable to account for the organizational requirements and demands of offshoring. In particular, in contrast to situations where firms effectively foresee and estimate the costs of implementing the activity in an offshore unit, there is evidence

that firms experience 'hidden costs' when they relocate activities to foreign locations (Larsen et al., 2013). For example, firms may experience that local labor and resource costs inflate beyond initial estimations. The offshoring implementation may turn out to require additional personnel and training than was originally anticipated and budgeted for to facilitate an effective offshoring operation (Lewin & Peeters, 2006). In a study on offshoring of software projects to India, Dibbern et al. (2008) identified unexpected offshoring costs relating to coordination, control, design, and knowledge transfer. In this article, I refer to the situation in which firms fail to effectively estimate the costs of offshoring as *cost estimation errors* (see also Larsen et al., 2013). Such 'postdecision surprises' (Harrison & March, 1984) therefore suggest the presence of boundedly rational decision makers who at the point of decision making are not able to foresee and estimate the true costs and consequences of implementing the activities abroad (cf. Simon, 1955).

2.2. Offshoring process performance consequences

While extant research has investigated the antecedents of cost estimation errors in offshoring (Dibbern et al., 2008; Larsen et al., 2013; Stringfellow et al., 2008), the focus here is on their performance consequences. In this respect, different studies have provided different financial and non-financial measures on the consequences of offshoring. On the one hand, research employing financial measures to investigate offshoring performance has looked at aspects such as corporate financial performance (Mol et al., 2005), cost savings (Lewin & Peeters, 2006), export performance (Bertrand, 2011), and sales growth (Murray, Kotabe, & Wildt, 1995). On the other hand, research employing non-financial measures to investigate offshoring performance has emphasized aspects such as learning and organizational transformation (Jensen, 2009; Maskell, Pedersen, Petersen, & Dick-Nielsen, 2007), innovation performance (Nieto & Rodriguez, 2011), market shares (Kotabe & Murray, 1990), and implementation time (Hutzschenreuter, Lewin, & Dresel, 2011).

In this study, I investigate how cost estimation errors affect the process performance of the activity after it has been relocated to a foreign location. Following Srikanth and Puranam (2011: 852), an activity's process performance is defined as “*cost reductions and/or performance improvements that occur in the immediate aftermath of moving the process offshore*”, and may relate to factors such as the cost demand, service quality improvements, and satisfaction with the service of a given activity. For example, firms may experience that the relocation of a given activity to a low-cost country will decrease the cost demand of the activity due to preferable labor, production and cost levels (Kedia & Lahiri, 2007; Manning, Massini, & Lewin, 2008). Firms may also experience that the operational flexibility and production quality will improve by moving the activity offshore due to superior technologies in the host location (e.g., Lewin & Peeters, 2006). Thus, process performance refers to the isolated performance of a given activity in the host location.

When firms fail to estimate the actual costs of implementing an offshoring activity abroad, a typical response would be to take different measures to best accommodate for these estimation errors. For example, a firm that experiences that the costs relating to knowledge transfer are substantially higher than initially expected may decide to down-scale the offshoring operations. A firm that experiences that the costs of coordinating and controlling a foreign activity exceed expectations may fail to implement an appropriate coordination mechanism. In some cases, firms may also decide to 'backsource' or re-nationalize the previously offshored activities due to exceeding levels of reconfiguration costs (Chadee & Raman, 2009).

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