



# A multi-theory approach to understanding the business process outsourcing decision



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## ABSTRACT

This paper proposes a framework for understanding location distance and governance model choice in the business process outsourcing (BPO) decision. Much of the current international business (IB) literature employs location-specific factors alone to explain the BPO decision, and this literature is dominated by studies of the offshore location option, with limited attention given to the local and nearshore location distance options as alternatives to offshoring. The framework proposed here was developed from integrating firm-level and process-level factors with location attractiveness factors, and undertaking in-depth case study analysis of a number of German companies. The findings highlight the value of integrating firm-level and process-level factors with location attractiveness factors to understand location distance and governance model choice in the BPO decision, and support those who have argued that existing frameworks in this area cannot fully explain the complexities of the BPO decision. Moreover, the findings provide important insights into how these factors interact to influence location distance and governance model choice. The proposed BPO framework also provides a useful basis for practical prescription.

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## 1. Introduction

Outsourcing has become a strategic imperative as organisations seek to reduce costs and specialise in a limited number of core areas. Developments such as globalisation, more demanding consumers, corporate restructurings and advances in information and communication technologies (ICTs) have been important drivers of business process outsourcing (BPO) (McIvor, 2010). For example, ICTs have facilitated the dis-aggregation of business processes into smaller standardised tasks, which has facilitated outsourcing to lower cost vendors (Sako, 2009). BPO is an important aspect of information technology (IT) enabled processes such as human resource services, and involves the vendor taking responsibility for executing a process and delivering it to the client as a service (Mani, Barua, & Whinston, 2006).<sup>1</sup>

BPO has grown as organisations have been transferring responsibility for entire functions such as human resources,

logistics, customer contact, and IT services to both local and foreign vendors (Sako, 2006). Organisations have been employing specialist vendors in distant locations such as India to reduce costs and improve performance (Lahiri & Kedia, 2011; Schmeisser, 2013). Whilst the first wave of outsourcing involved outsourcing labour-intensive manufacturing processes, the current wave of BPO has expanded to include knowledge-intensive professional services such as accounting and legal support (Blinder, 2006; Sako, 2009) – sometimes referred to as knowledge process outsourcing (Currie, Michell, & Abanishie, 2008).

Organisations have a range of location options to select from including local, nearshore, and offshore when outsourcing services. Local outsourcing involves outsourcing to a vendor located in the client's home nation, and offers the advantages of the same culture, language, time zone, and physical proximity (McIvor, 2008). Nearshore outsourcing allows an organisation to outsource to a location that is relatively close in distance, time zone, culture, or language, whilst at the same time offering the benefits of lower labour costs relative to the client's home nation (Rottman & Lacity, 2006). Although offshore outsourcing involves outsourcing to a distant country, where there are significant cultural or language differences, an organisation can benefit from significant lower labour costs (Aron & Singh, 2005).

Organisations have been pursuing a number of governance models to manage BPO arrangements. The captive model is a

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<sup>1</sup> Information technology outsourcing refers to the use of external vendors to deliver the IT-element of the business process, which includes programming, application services and infrastructure. It is often referred to as a subset of BPO (Lacity, Solomon, Yan, & Willcocks, 2011).

common governance arrangement where the client builds, owns, staffs and operates the facility to avail of skills and lower labour costs (Aron & Singh, 2005). As a more flexible alternative to the captive model, organisations have been using independent vendors in foreign locations for outsourcing business processes, which is likely to involve adopting a collaborative relationship with the vendor where the requirements of the client are not standardised and frequent changes are required (Rottman & Lacity, 2006).

Although the BPO phenomenon has been attracting the attention of international business (IB) scholars (Doh, Bunyaratavej, & Hahn, 2009; Graf & Mudambi, 2005; Hätönen, 2009; Jensen & Pedersen, 2011; Kedia & Mukherjee, 2009; Schmeisser, 2013), the current literature has a number of limitations. Much of the literature is dominated by studies of the offshore location option (Kumar, van Fenema, & von Glinow, 2009; Lahiri & Kedia, 2011; Lampel & Bhalla, 2011), with limited attention given to the local and nearshore location distance options as alternatives to offshoring (Hahn, Bunyaratavej, & Doh, 2011; Schmeisser, 2013). A further limitation is that many of the studies in the IB literature use Dunning's (1977, 1988) eclectic paradigm alone to analyse how host country variables influence location choice in the BPO decision (Bunyaratavej et al., 2008; Graf & Mudambi, 2005; Kedia & Mukherjee, 2009).

It is increasingly recognised in the IB literature that location attractiveness factors alone cannot fully explain the BPO phenomenon (Doh et al., 2009; Hätönen, 2009; Hätönen & Eriksson, 2009; Jensen & Pedersen, 2011), and the analysis should be extended to include factors at the process- and firm-level to explain location distance and governance model choice (Hätönen, 2009; Jensen & Pedersen, 2011). Analysis at the process level is particularly important given that the unique features of services, such as the involvement of the customer in service delivery, and the intangible nature of services make BPO more complex than manufacturing outsourcing (Doh et al., 2009). Moreover, firm-level factors such as the level of outsourcing experience, relationship management capabilities with vendors, and corporate restructurings are also important influences (Hätönen, 2009; Jensen & Pedersen, 2011; Maskell, Pedersen, Petersen, & Dick-Nielsen, 2007).

This study seeks to address this gap in the literature by enhancing our understanding of how firms decide between the local, nearshore and offshore location distance options, and captive and independent vendor governance model options. Undertaking in-depth case study analysis of BPO arrangements by a number of German companies, and employing the eclectic paradigm, transaction cost economics (TCE) and the resource-based view (RBV) as a theoretical basis, the study integrates location attractiveness factors along with process- and firm-level factors to develop a framework for explaining the BPO decision in relation to location distance and governance model choice.

The research makes a number of important contributions. Firstly, integrating firm- and process-level factors with location attractiveness factors has allowed us to better understand location distance and governance choice. The findings have shown how firm-level factors are an important influence on the local, nearshore, and offshore location options. Firm-level factors such as the presence of in-house human resources with foreign language and culture skills act as an important influence on the offshore option. Employees with foreign language and culture skills can mitigate the negative effects of cultural distance in the offshore location option. Process-level factors were also important influences on location distance choice. The offshore location option was more likely to be chosen for processes that were highly standardised, and low requirements uncertainty. The findings have also highlighted how firm-level, process-level, and location attractiveness factors interact to influence location distance and governance model choice. For example, firm-level capabilities in

process improvement techniques were employed to redesign and standardise processes, which allowed organisations to outsource processes to more distant locations.

Secondly, the research highlights the value of integrating TCE and the RBV with Dunning's eclectic framework to enhance our understanding of the BPO decision. The logic of each of these theories was present, as the organisations standardised and outsourced processes to vendors with lower production costs in lower labour cost locations, whilst at the same focused on core capabilities and accessed the specialist capabilities of vendors. However, the findings have revealed the contradictory nature of TCE and RBV in BPO decisions, which is identified as an important area for further research. Moreover, further research is required to enhance our understanding of how organisations develop firm-level capabilities to leverage the benefits BPO offers.

Thirdly, the research in this paper has addressed an important area for practitioners. As organisations increasingly outsource more critical business areas such as design and customer relationship management, they are seeking to leverage a greater level of value from BPO. Although cost concerns are still important motivations for BPO, the implications for the long-term capabilities of the organisation have to be considered. The BPO framework developed in this paper provides a valuable basis for practical prescription, which integrates firm, process and location attractiveness considerations. In particular, it provides a mechanism for understanding which processes should be internalised or outsourced, based on firm and process level considerations rather than on location attractiveness influences alone.

## 2. Literature review

Much has been written in the IB literature on the motives for the offshore outsourcing of business processes, and the associated benefits and risks for firms and nations outsourcing to offshore locations (Jensen, 2012). Location choice in the BPO decision has become an important strand of the IB literature with a number of scholars examining the influence of host country variables such as human capital, infrastructure, country risk and government factors (Bunyaratavej et al., 2008; Graf & Mudambi, 2005; Kedia & Mukherjee, 2009). For example, Bunyaratavej et al. (2008) analysed host country attractiveness in the context of BPO, and found that countries are more attractive where they offer efficiencies in wages, infrastructure, and education. Similarly, Bunyaratavej, Hahn, and Doh (2007), using a parity perspective of home versus host country factors, found that firms are more likely to offshore processes to locations with lower but increasing wages towards home country parity and to those with a similar culture and education level.

Governance model choice is another element of the BPO decision, and this area has also been attracting the attention of a number of IB scholars (Demirbag & Glaister, 2010; Hutzschenreuter, Lewin, & Ressler, 2011). Demirbag and Glaister (2010) have found that home and host country factors determine the location choice for the captive offshoring governance model in the case of research and development services. Moreover, Hutzschenreuter et al. (2011) examined the factors that influence a firm's governance model for offshoring business processes, and found that it was influenced by the institutional environment, firm-specific characteristics, and the individual settings of a particular implementation.

Although research in location and governance model choice has been increasing, the current IB literature has a number of shortcomings. Much of the literature is dominated by studies of the offshore location option (Kumar et al., 2009; Lahiri & Kedia, 2011; Lampel & Bhalla, 2011), and insufficient attention has been given to the local and nearshore location distance options as

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