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## Outsourcing Failure and Reintegration: The Influence of Contractual and External Factors



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This paper discusses the reasons that drive organizations to interrupt outsourcing, reverse their previous decision, and then reintegrate activities formerly delegated to providers. Contractual approaches, mainly derived from Transaction Costs Economics, offer some plausible explanations for reintegration originating from outsourcing failure. These explanations are mainly related to asset specificity, poor contractual design, and deficient monitoring. The study of a real case of outsourcing interruption in industrial maintenance illustrates these different factors. However, some other determinants might complement the contractual and strategic background, namely bandwagon behavior and institutional pressure exerted by external actors. Finally, we propose an integrative framework that combines micro- and macro- levels of organizational analysis. We argue that some existing complementarities between the different theories we use here can shed some light on real organizational problems. Besides the implications for theory, our work can help managers to understand the dynamics of organizational boundaries, thus allowing them to make better choices in both outsourcing and reintegration decisions.

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*“Kellwood’s multimillion dollar IT outsourcing deal with EDS served it well for many years. But after significant organizational changes and intense investigation of the 13-year deal, it became clear that insourcing was the best way for the apparel maker to save money moving forward.”<sup>1</sup>*

### Introduction

Reintegration of activities that were outsourced before costs companies and results in significant organizational difficulties.

After years of outsourcing corporate processes and operational functions, many factors have now led to a rethink and the reincorporation of previously outsourced processes. One of the biggest dilemmas involved in an outsourcing initiative is how to mitigate the risk of failure. Why has outsourcing traditionally failed? In general, both clients (those who purchase outsourced services) and providers (those who perform the service) face threats and drawbacks, a) parting without having achieved their objectives; b) encountering difficulties that result in contract renegotiation (or even remediation); c) prematurely ending their arrangement; or d) changing their initial objectives.

Naturally, decisions concerning organizational boundaries occupy significant room on the agenda of company executives in charge of strategy, IT, logistics, or management operations (Mol and Kotabe, 2011). Some companies also combine internal provision with outsourcing to external suppliers (Parmigiani, 2007) and take advantage of comparing between different modes of organization.

However, although outsourcing may bring several benefits to organizations, empirical evidence shows that there are some cases of reintegration. Despite there being well-known cases of outsourcing interruption<sup>2</sup>, academic literature focusing on reintegration is scant, probably because companies hardly ever report unsuccessful stories (Barthélemy, 2003). Nevertheless, what is reintegration? Three main features dominate. In our context, reintegration in short refers to, first, a reversal of a former strategic decision. Second, it assumes the breaking of a contract with a provider. Finally, it involves the rehabilitation of the activity within the client company. Therefore, reintegration represents a shift in organizational company strategy that

<sup>1</sup> CIO, February 18, 2010 – [http://www.cio.com/article/549463/Company\\_Saves\\_Millions\\_By\\_Ending\\_IT\\_Outsourcing\\_Deal](http://www.cio.com/article/549463/Company_Saves_Millions_By_Ending_IT_Outsourcing_Deal).

<sup>2</sup> Such as the reintegration of maintenance functions taken by rail companies in the United Kingdom (McIvor, 2005) and J.P. Morgan’s decision to perform IT functions that it had previously outsourced (King, 2005).

affects the sourcing structure. Moreover, the analysis of the underlying reasons of reintegration can help to understand better how organizational boundaries evolve (Cacciatori and Jacobides, 2005).

This paper analyzes some factors that might influence the reintegration decision. In order to understand the reasons why companies interrupt outsourcing, we use a single case study concerning the reincorporation of industrial maintenance activities in a metallurgy company in which outsourcing was discontinued after more than a decade of external provision and outsourcing. Then, we develop some propositions and offer an integrative framework for factors explaining the reintegration decision.

Based on our case study, for which 19 interviews were carried out, our empirical findings show that contractual hazards may explain the reintegration, which fits relatively well with some conclusions in the few previous works on reintegration (Barthélemy, 2003; Cacciatori and Jacobides, 2005; Whitten and Leidner, 2006; Fréry and Law-kheng, 2007). Our paper's contribution lies in the identification of further complementary determinants of reintegration: bandwagon behavior and institutional pressure. Specifically, our paper refines Transaction Cost Economics (TCE) by exploring institutional theories and bandwagon behavior literature in an attempt to understand the dynamics of organizational boundaries. We find that the influence of external actors and the institutionalization of managerial practices also shape the behavior of decision makers in a complimentary fashion with contractual factors. These external influences may persuade companies either to outsource or reintegrate. Providing an integrative framework has led us to propose an innovative explanation of the main reasons why firms reintegrate.

Our work is organized as follows. The first section discusses the main theoretical reasons that might lead to reintegration from contractual and strategic management perspectives. We develop arguments based on TCE, incomplete contract and core competence theories. We also assume such a body of knowledge as being based on some theoretical arguments and information collected through a deep field study. Subsequently, we present our methodological stances and the results observed in our case study. Our sources involve face-to-face interviews and documentary analysis. Following this, we posit that although the existing theoretical predictions applicable to our case are interesting, they are not enough to explain the dynamics of reintegration entirely. Consequently, based on the matching between our empirical findings and theoretical discussion, we show that some other factors affect the decision to reincorporate activities formerly transferred to external actors. This integrative framework enables us to sketch a more comprehensive representation of reintegration determinants. The last section concludes and summarizes our main propositions.

## Why do firms reintegrate? Main theoretical reasons

We define the reintegration phenomena as the decision to reincorporate a given activity within a company that had formerly been transferred to an external supplier. The connections between outsourcing and reintegration are clear when considering the organizational boundaries choices. Indeed, we can understand outsourcing and reintegration as sides of the same coin, because the transfer of an activity by a firm implies its absorption by another outside entity. In the same vein, reintegration is associated with vertical or lateral disintegration (Lavington, 1927) and reintegration normally involves the breaking of outsourcing contracts and the reacquisition of resources, both human and material (Contractor et al., 2011). Thus, reintegration also requires the adaptation of organizational company structures to accommodate the undertaken functions or activities, which may pose problems to companies that depend on the supplier (or provider) for knowledge (Fine, 1998). This suggests that the costs of rebuilding formerly transferred capabilities may sometimes be significant. Indeed, re-enlarging the portfolio costs companies.

From the theoretical point of view, a considerable portion of the explanations for boundary choices, including reintegration phenomena, can be analyzed using TCE. Contractual maladaptation may lead to outsourcing failure, and thus undue outsourcing decisions are likely to be associated with future reintegration (Fréry and Law-kheng, 2007). Reintegration can also result from strategic behavior. Indeed, some organizations may attempt to reconfigure the institutional environment in which they are embedded according to their capabilities and strategic intents (Argyres, 1996; Jacobides and Winter, 2005) and external and environmental determinants may explain reintegration (Cacciatori and Jacobides, 2005). We further discuss the existing theories that shed some light on reintegration.

### *TCE and the intrinsic factors leading to outsourcing failure*

TCE is one of the main frameworks used to focus on subjects related to organizational boundaries (Klein et al., 1978; Anderson and Schmittlein, 1984; Williamson, 1991), outsourcing, and reintegration (Cacciatori and Jacobides, 2005).

Cost reduction is one of the major drivers of outsourcing decisions (Barthélemy, 2003; Greer et al., 1999; Quélin and Duhamel, 2003; McIvor, 2005). In situations involving specific assets, opportunism on the part of a supplier may arise. The safeguards to avoid ex-post hold-up are likely to increase contracting costs so that when assets are specific to transactions, firms tend to prefer internal forms of governance (Mayer and Salomon, 2006). Furthermore, the outsourcing of an activity related to organizational core competencies and to high levels of asset specificity (Javidan, 1998; Prahalad and Hamel, 1990, Williamson, 1991) can undermine organizational efficiency, among other factors, because in this case it is more difficult to find suppliers to perform the activity (Cabral and Azevedo, 2008).

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