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# Managing integration in outsourcing relationships — The influence of cost and quality priorities

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ABSTRACT

Outsourcing has become increasingly popular in the contemporary business context. This study aims to develop the understanding of outsourcing by addressing the management of integration in the outsourcing relationship between buyers and contract manufacturers. Specifically, we address the effect of strategic priorities of cost and quality on how different modes of integration are used both before and in the early phase of production. The paper elaborates the strategic contingency argument by analyzing qualitative data from eight cases in the food and electronics industries. The results indicate that managing the outsourcing relationship requires considerable resources after the decision to outsource has been made. The results show that integration in the outsourcing relationship evolves over time and the use of integration modes is contingent on the strategic priority. The study provides an understanding of the contextual nature of integration in the outsourcing relationship, as well as a contextualized understanding of buyer-supplier relationships. It also provides an illustration of theory elaboration research.



## 1. Introduction

Outsourcing is one of the key business trends and has become a common practice in manufacturing industries; for example, in the pharmaceuticals industry 60–70% of manufacturing activities were outsourced in 2005 (Brewer, Ashenbaum, & Carter, 2013). Explanations of the increase in outsourcing include specialization and a focus on core competencies while releasing capital to survive in an increasingly competitive market place (e.g., Gray, Tomlin, & Roth, 2009). Despite its prominence, outsourcing continues to pose significant challenges (Gadde & Snehota, 2000; Harmancioglu, 2009; Kroes & Ghosh, 2010) and many businesses fail to realize the anticipated benefits of their outsourcing initiatives (Gray et al., 2013; Handley & Benton, 2009; McIvor, 2000). For example, Lego outsourced most of its manufacturing activities to Flextronics in 2006 but brought them back in-house in 2008. As with the case of Lego, one major reason for the challenges posed by outsourcing is issues related to managing the outsourcing relationship (Ishizaka & Blakiston, 2012). Failing to manage the relationship with the contract manufacturer can have serious consequences for the buying firms' long-term performance and reputation and lead to the failure of the whole outsourcing initiative (Fan, 2000; Ishizaka & Blakiston, 2012; Lonsdale, 1999). The purpose of this study is to develop a further understanding of the management of the outsourcing relationship. In particular, the focus of the paper is on assessing how integration is managed in the outsourcing relationship.

While integration is one of the fundamental issues in buyer-supplier relationships and has been addressed extensively in prior research (e.g., Fang, Wub, Fang, Chang, & Chao, 2008; Terpend, Tyler, Krause, & Handfield, 2008; Sheth and Sharma, 1997), outsourcing relationships represent a special context. Outsourcing relationships are a distinctive type of buyer-supplier relationship, comprising the following key elements (Araujo, Dubois, & Gadde, 1998; Baraldi, Proenca, Proenca, & Mota de Castro, 2014; Handley & Benton, 2009, 2012, 2013; Harmancioglu, 2009; Narasimhan, Narayanan, & Srinivasan, 2010; Ndubisi, 2011; Sousa & Voss, 2007). First, outsourcing is a conscious decision *not* to carry out an activity in-house, which implies that there is always the option of in-house production. Second, when production is outsourced, the outsourced objects are specific to the client, which means that the buyer holds the brand rights. The buyer also uses the contract manufacturer as an extension of its own production structure and contrary to standardized interfaces, the contract manufacturer requires specifications and production schedules from the customer ex ante. Taken together, the degree of interdependence between the parties is reciprocal and the relationship is highly mutually dependent, making integration particularly critical in outsourcing relationships (Baraldi et al., 2014; Boulaksil & Fransoo, 2010; Handley & Benton,

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2009; Thompson, 1967; Van de Ven, Delbecq, & Koenig, 1976). Moreover, outsourcing relationships are highly complex as a result of high buyer power and task- and location-specific features, requiring a greater managerial emphasis on integration (Handley & Benton, 2012, 2013; de Vries, Schepers, van Weele, & van der Valk, 2014). The importance of understanding how to manage integration is increased by the significant costs associated with it (Galbraith, 1973).

This paper takes a theory elaboration research approach to develop a contextualized understanding of how to manage integration in outsourcing relationships. First, we build on the strategic contingency argument (Dean & Snell, 1996; Ketokivi & Schroeder, 2004) and the underlying assumption that integration in an outsourcing relationship is contingent on the strategic priority, referring to the main operational priority the buyer expects from the contract manufacturer when carrying out the specific activity (Gray, Roth, & Tomlin, 2009). We study the impact of cost and quality priorities as they have been identified as the main operational strategic priorities in the context of outsourcing (Gray, Roth, & Tomlin, 2009). Second, we take the temporal dimension into account and build on the assumption that integration in the outsourcing relationship is contingent on the phase of the outsourcing relationship because buyer-supplier relationships in general (e.g., Ambrose, Marshall, Fynes, & Lynch, 2008; Claycomb & Frankwick, 2010; Vanpoucke, Vereecke, & Boyer, 2014), and outsourcing relationships in particular (Benito, Dovgan, Petersen, & Welch, 2013; Handley & Benton, 2009; Narasimhan et al., 2010; Perunovic, Christoffersen, & Mefford, 2012; Willcocks, Oshri, Kotlarsky, & Rottman, 2011), evolve over time and also because the management of integration varies over time (Adler, 1995; Turkulainen, Artto, Kujala, & Levitt, 2013). Our focus is on the early phases of the relationship after the decision to outsource has been made because integration is particularly important in those phases (Boulaksil & Fransoo, 2010). To illustrate and elaborate the general proposition of a strategic contingency argument in the outsourcing context, we collected data with a multiple embedded unit case study design (Yin, 2009) and analyzed eight outsourcing relationship cases.

The study contributes to the research on outsourcing by developing an understanding of the management of the outsourcing relationship in the operations context by illustrating how it depends on the operational strategic priority related to the specific object of outsourcing (Boulaksil & Fransoo, 2010; Handley & Benton, 2009, 2012, 2013; Ishizaka & Blakiston, 2012; Narasimhan et al., 2010; Ndubisi, 2011; de Vries et al., 2014). Moreover, the study contributes to research on more generic buyer-supplier relationships by developing a contextualized understanding of the management of buyer-supplier relationships (e.g. Ambrose et al., 2008; Gadde & Snehota, 2000; Terpend et al., 2008); in an outsourcing relationship, integration practices need to be adjusted dynamically and depending on the strategic priority. While research on buyer-supplier relationships places significant emphasis on integration, it tends to assess buyer-supplier relationship management at a general level without distinguishing between potentially different relationships that a buyer might have with different suppliers (e.g., Das, Narasimhan, & Talluri, 2006; Dyer, Cho, & Chu, 1998; Krause & Ellram, 1997; Krause, Handfield, & Tyler, 2007; Terpend et al., 2008). However, in each buyer-supplier relationship, integration is an investment in the relationship and not every relationship warrants similar types of integration practices (Gadde & Snehota, 2000). Finally, the study contributes to the marketing research by illustrating a theory elaboration research approach. Such an approach has not been common among marketing researchers, and yet it is well established among social scientists (Merton, 1968; Vaughan, 1992).[1] The results also have practical relevance and provide guidelines for managers on how they could direct their efforts in managing outsourcing relationships.

[1] The authors thank one of the anonymous reviewers for pointing this out.

## 2. Theoretical background

### 2.1. Research on outsourcing

While research on outsourcing is both broad and plentiful, it has mainly focused on the outcomes and implications of outsourcing. For the purposes of this study, we divide the existing outsourcing research into two streams: strategic focus and relationship focus. Research on outsourcing with a *strategic focus* has especially addressed the strategic decision of why and what to outsource, both at the firm level and at the level of the decision-making process (e.g., Bhalla & Terjesen, 2013; Jiang et al., 2007; Kakouris, Polychronopoulos, & Binioris, 2006; McIvor, 2000; Prahalad & Hamel, 1990; Quélin & Duhamel, 2003; Vining & Globerman, 1999). This view concludes, for example, that organizations should focus on their core competences and consider potential opportunism related to outsourcing and the availability of suppliers when making decisions about outsourcing (McIvor, 2000, 2009; Prahalad & Hamel, 1990).

In this study, we adopt a *relationship focus* on outsourcing, which can be considered as a complementary approach to the strategic view, addressing how to manage the outsourcing relationship after the decision to outsource has been made. Prior research on the management of the outsourcing relationship has studied, for example, practices for managing the relationship in different contexts (e.g., Baraldi et al., 2014; Levina & Vaast, 2008; de Vries et al., 2014; see Appendix 1). Overall, this stream of research concludes that the management of the outsourcing relationship, including integration, is critical for successful outsourcing (e.g., Boulaksil & Fransoo, 2010; Harmanciouglu, 2009; Narasimhan et al., 2010).

### 2.2. Integration in outsourcing relationships

We approach integration from the information-processing point of view; integration is defined as the sharing and processing of information between organizations (Galbraith, 1973). In order to achieve integration, managers have a variety of integration practices (Lawrence & Lorsch, 1967; Turkulainen et al., 2013). Companies have differentiated portfolios of relationships with suppliers and adopt different management practices to fit those relationships (Gadde & Snehota, 2000; Lambert & Cooper, 2000). The information processing view makes a distinction between three modes of integration: impersonal integration mode, personal integration mode, and group mode (Galbraith, 1973; Turkulainen et al., 2013; Van de Ven et al., 1976). These are defined and examples are given in Table 1 below. Importantly, the information processing view argues that integration practices offer different capacities to process information and simultaneously also create different costs for the organizations (Galbraith, 1973). Impersonal practices facilitate the processing of information to a lesser extent and are less costly, while personal and group practices facilitate information processing better. Group mode is the most resource-consuming but also the most efficient in information processing. Because of the inherent costs of implementing integration practices, the information processing view suggests that impersonal mechanisms are implemented first, whereas personal and group modes are used to complement those only when the information processing needs are high (Galbraith, 1973).

In outsourcing relationships, integration aims at treating the contract manufacturer as an extension of the buyer's operations, creating a continuum between the buyer's own production and the contract manufacturer's production as the boundaries become blurred as a result of mutual dependency (Baraldi et al., 2014; Sousa & Voss, 2007). While prior research concludes that the management of the outsourcing relationship is critical (e.g., Baraldi et al., 2014; Handley & Benton, 2009; McIvor, 2000), little attention has been paid to *integration* in the outsourcing relationship (Willcocks et al.,