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Consequences of outsourcing for organizational capabilities

Some experiences from best practice

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Abstract

Purpose – The research on effects of outsourcing tends to focus on financial effects and effects at a country level. These are not the only consequences of outsourcing, though. When firms outsource functions previously performed in-house, they risk losing important competencies, knowledge, skills, relationships, and possibilities for creative renewal. Such non-financial consequences are poorly addressed in the literature, even though they may explain financial effects of outsourcing. Therefore, the purpose of this paper is to develop a model that enables the study of non-financial consequences of outsourcing.

Design/methodology/approach – Based on a review of the literature on interdependencies between organizational functions, a main proposition is developed: given that savings gained from outsourcing are not reinvested in the organization, outsourcing of any function will negatively impact the capabilities of that and other functions in the organization. This proposition is broken down into sub-propositions, which are tested through a focus group study. Respondents include purchasing professionals with experience from best practice outsourcing.

Findings – The initial proposition is developed through identification of variables mediating the proposed negative consequences of outsourcing. Mediating variables are broken down into four categories: variables relating to the outsourcer, the outsourcee, the relationship between the parties, and the context.

Research limitations/implications – By developing a model for the study of non-financial consequences of outsourcing, this paper takes a step towards opening up an important avenue for future research.

Originality/value – This paper contributes to the outsourcing field by not only considering non-financial effects, but also by drawing on examples of best practice outsourcing to identify ways in which potentially negative consequences of outsourcing may be managed.

Keywords Outsourcing, Organizational effectiveness, Best practice, Focus groups, Modelling

Paper type Research paper

Introduction

Currently, one of the most prominent global economic trends is outsourcing of activities previously carried out in-house. Owing to economies of scale and scope as well as differences in factor costs, some actors can carry out certain activities more cost efficiently than other actors (Cachon and Harker, 2002; Jennings, 2002). In line with this reasoning, much of the research on the outcomes of outsourcing focuses on economic effects for society and financial effects for firms, such as reductions in number of



employees, lower overheads, greater share of purchasing in relation to value of sales, and profit margins. While most studies have found no negative economic effects for society, e.g. in terms of job dislocation (Ekholm and Hakkala, 2005; Soo, 2005), some studies have found negative effects for firms, e.g. that internal sourcing of non-core services is negative for performance, as is foreign sourcing of services (Kotabe *et al.*, 1998).

Economic and financial effects, however, are not the only outcomes of outsourcing. By definition, outsourcing refers to the purchasing from an external supplier of a function previously carried out within the company (Axelsson and Wynstra, 2002; Shekar, 2008). When a firm no longer carries out an activity formerly undertaken in-house, logically that firm risks losing competencies, knowledge and skills related to that function. It might also lose business relationships and opportunities for creative renewal arising in interaction between different functions. In effect, the firm's capabilities, i.e. abilities to perform certain functions, are reduced as a consequence of outsourcing.

This might not be a problem if the outsourced function has very limited bearing on the firm's core business processes. Increasingly, however, we see firms outsourcing functions that are traditionally not seen primarily a support functions, such as R&D and purchasing (Bardhan and Kroll, 2003; Chiesa *et al.*, 2004; Fernandez and Kekale, 2007). Outsourcing these functions may have more detrimental consequences for organizational capabilities. Interestingly, non-financial outcomes of outsourcing appear hardly to have been studied at all (Nordin and Agndal, 2008). In particular, what happens inside firms that actually explains financial effects is poorly addressed in research. Thus, the question "what are the mechanisms that explain long-term effects of outsourcing?" remains to be answered. The aim of this paper is to begin addressing that gap. More specifically its purpose is "to develop a model that enables the study of non-financial consequences of outsourcing."

At this stage, we make an important delimitation. Most studies on effects of outsourcing focus on the outsourcing of relatively standardized activities such as manufacturing, ignoring that increasingly other functions in firms are outsourced (Agndal *et al.*, 2007; Amiti and Wei, 2006; Bardhan and Kroll, 2003; Nordin, 2008). Therefore, we focus on the outsourcing of functions other than manufacturing.

The remainder of the paper breaks down into six sections. First, we review the literature on interdependencies between firm functions and organizational capabilities to begin constructing a framework of the consequences of outsourcing. Drawing on these discussions, we formulate a main proposition and four sub-propositions. The method of an empirical study to test the propositions, the study's findings and a revised model are presented in three separate sections. The final section of the paper contains some implications, suggestions for future research, and limitations.

Framework and propositions

A basic premise of this paper is that the outsourcing of an activity or function might hamper the firm's ability to perform or maintain control over that function (Barthélemy, 2003; Bettis *et al.*, 1992). For example, if the information technology (IT) function is outsourced, helpdesk routines may change and some of the people who work in the IT function may have to leave the organization. Thus, the outsourcing organization's IT capabilities may be negatively impacted.

However, not only those activities or functions that are outsourced are impacted by the outsourcing decision; While early models of organizations tend to portray these as

consisting of a set of separate departments carrying out activities in a sequential manner with limited interaction, more recent depictions of firms reject this notion (Tuominen *et al.*, 2000). Rather, nowadays firms are seen as relatively complex entities with numerous connections between functions and departments (Hillebrand and Biemans, 2003; Kahn, 1996). There are also frequent discussion in the literature concerning the need for using cross-functional teams in organizations (Jassawalla and Sashittal, 1998), e.g. as a means of developing better products. With this understanding of a firm, we argue that the outsourcing of a function might not only negatively impact on the ability to perform the outsourced function, but other functions as well. Thus, we contend that the implications of outsourcing are often more far-reaching than anticipated.

The motive for outsourcing primarily tends to be an economic one (Shekar, 2008). That is, firms outsource to save money. Naturally, this may free up capital that can be used to strengthen other functions in the firm. Often, the purpose of outsourcing is to reduce operating costs, though, to simply improve the bottom line (Quélin and Duhamel, 2003). Thus, outsourcing means that capabilities are drained from the firm and, if the money saved is not reinvested in the organization, the capabilities of the organization as a whole deteriorate. Kotabe and Murray (2004, p. 12) argue that:

[...] it can be anticipated that companies using a transactional purchasing behaviour and arms' length relationships with their suppliers will lose sight of emerging technologies and expertise, and thus their ability to manufacture, for instance, and their competitiveness.

In line with these discussions, we formulate the following main proposition:

Main proposition

Given that savings gained from outsourcing are not reinvested in the organization, outsourcing of any function will negatively impact the capabilities needed to perform that function as well as other functions in the organization.

This overarching proposition requires further qualification, though. In particular, it is necessary to define what a function is. Drawing on a simplified version of the value chain framework (Porter, 1985), we focus on five functions. These include R&D, purchasing, manufacturing, marketing and sales, and customer service (Note that in accordance with our earlier delimitation, we do not focus on the effects of outsourcing of manufacturing, but are, nonetheless, interested in the effects of outsourcing of other functions on capabilities relating to manufacturing).

Outsourcing of R&D

Increasingly, there are reports of firms outsourcing the R&D function (Calantone and Stanko, 2007; Chiesa *et al.*, 2004). This may have a variety of effects on the outsourcing organization. For example, connections between R&D and manufacturing are well described in the literature. Deep knowledge about a product might be lost if R&D is outsourced. This might be negative if changes have to be made to a product during the manufacturing cycle. Further, the advice often given as a result of many studies focusing on the manufacturing and R&D interface (Sussman and Dean, 1992; Wheelwright and Clark, 1992) is to move from using "functional silos" to coordinating the two functions or work more "concurrently," because of their close interdependence. Similar conclusions have been drawn regarding the interface between R&D and other

functions. For instance, since marketing and R&D typically share responsibilities for setting new product goals, identifying new product opportunities, and resolving engineering and customer-need tradeoffs, cooperation is needed throughout the entire product development process (Griffin and Hauser, 1996), if the capability to carry out the different functions is not to deteriorate. Likewise, Goffin (2000) highlights another factor that companies often neglect, namely the importance of ensuring that products are easy and economical to service and support. To ensure supportability of products, cooperation between R&D engineers and customer service personnel is, therefore, important. Additionally, since outsourcing arguably increases the physical and cultural distance between the two functions, outsourcing of R&D may negatively impact the capability to develop supportable products. Hence, the following proposition can be stated regarding outsourcing of R&D:

- P1.* Given that savings gained from outsourcing are not reinvested in the organization, outsourcing of R&D will negatively impact capabilities needed to perform R&D as well as other functions in the organization.

Outsourcing of purchasing

Purchasing is increasingly recognized as an important strategic function and a source of innovation in firms (Holcomb and Hitt, 2007; Mol, 2003). The reason is that proactive purchasing managers understand their firm's business strategy and seek opportunities upstream that may support that strategy. The purchasing function may also be strongly related to much of the firm's technical skills (Franceschini *et al.*, 2003). Therefore, outsourcing of purchasing may lead firms to miss important innovations that could make manufacturing more efficient and products more competitive. Also, if a strategically oriented purchasing function (Carr and Pearson, 2002) is outsourced, this might impair knowledge in the firm regarding materials and other technical aspects, and important opportunities for new market knowledge, e.g. regarding new business opportunities in countries overseas, may be lost. Purchasing practices can also influence the degree of manufacturing flexibility through, e.g. supplier involvement and by using cross-functional purchasing teams (Narasimhan and Das, 2000). The adoption of such practices might be more difficult if the purchasing function has been outsourced, and, thus, the capability to handle manufacturing effectively and efficiently may be negatively influenced. Hence, the following proposition can be stated regarding the outsourcing of purchasing:

- P2.* Given that savings gained from outsourcing are not reinvested in the organization, outsourcing of purchasing will negatively impact capabilities needed to perform purchasing as well as other functions in the organization.

Outsourcing of marketing and sales

While outsourcing of marketing and sales has perhaps not been studied to the extent of many other functions, a similar logic can be applied when interdependencies between functions are considered. For example, the management of customer relationships, or "CRM," is often seen as an important capability in generating competitive advantage (Hennig-Thurau and Hansen, 2000). In essence, CRM refers to the firm's ability to create and maintain appropriate relationships with customers in order to improve

shareholder value (Payne and Frow, 2005). While outsourcing of activities relating to marketing and sales may, of course, lead to better quality and lower costs (McGovern and Quelch, 2005), the outsourcer's ability to address and segment customers may be partly lost. This does not necessarily mean that important customers are not given sufficient attention, but may mean that too much time and resources are spent servicing less-important customers. Outsourcing customer-facing activities such as marketing and sales may also hamper the firm's abilities to design unique solutions to individual customers' problems, i.e. the connection between R&D and marketing may be partly lost, as argued above.

Market channel management capabilities relate to CRM capabilities, but concern the management of relationships across several channel levels. Outsourcing of marketing may mean that the ability to find and manage information further down the market channel is lost, which means that important feedback to R&D and production – e.g. regarding quality concerns – may fail to be generated (Lancaster, 1993; St John and Hall, 1991). It may also mean that firms lose the ability to identify and communicate market needs, both through formalized market research and through a “feel for what goes on,” and their “market sensing capabilities” (Day, 1994) deteriorate. For similar reasons, capabilities related to purchasing and supply may also deteriorate with outsourcing of marketing, since this will make it more difficult for buyers, for instance, to keep in touch with changing customer demands (Williams *et al.*, 1994). Based on these examples and conceptual arguments, we propose:

- P3. Given that savings gained from outsourcing are not reinvested in the organization, outsourcing of marketing and sales will negatively impact capabilities needed to perform the marketing and sales as well as other functions in the organization.

Outsourcing of customer service

Finally, we are also concerned with the effects of outsourcing of customer service. Here, logic similar to other functions can be applied, where an outsourced customer service function may, e.g. lead to difficulties in designing supportable products (Goffin, 2000). Like outsourcing of marketing and sales, this may also generate less feedback to the firm regarding customers' operations; information often needed to develop new products, to adjust manufacturing systems and similar (Armistead and Clark, 1992; Nordin, 2005, 2006). In particular, providing customized services such as integrated solutions, consulting or full-services typically renders possible relatively deep insights into customer needs (Storer *et al.*, 2002; Tuli *et al.*, 2007) and thus facilitates marketing and sales activities. Another reason for keeping customer service activities and other customer-facing activities in-house is that internal employees are believed to have a better network within the company, something that is considered important to solve customers' problems (Åhlström and Nordin, 2006, p. 83). We, thus, propose the following:

- P4. Given that savings gained from outsourcing are not reinvested in the organization, outsourcing of the customer service function will negatively impact capabilities needed to perform customer service as well as other functions in the organization.

Summary and initial model

Our arguments so far have focused on the potentially negative effects of outsourcing for various functions. In summary, we present a model based on these arguments (Figure 1).

We recognize that the model regarding effects of outsourcing is somewhat simplistic and naïve, however. In fact, if we adopt a contextual perspective on organizations (Lawrence and Lorsch, 1967) it is evident that outsourcing effects are also a result of various other internal and external factors. Among those suggested in previous studies are degree of product complexity (Loomba, 1996; Nordin, 2005), product maturity (Armistead and Clark, 1991; Nordin, 2005) service revenues (Mathe and Shapiro, 1993; Nordin, 2005), service intensity (Armistead and Clark, 1991; Nordin, 2005), environmental dynamism (Gilley and Rasheed, 2000; Nordin, 2008), quality of the relationship with the supplier, including information sharing (Lee, 2001; Li *et al.*, 2006), and learning (Lee, 2001) and knowledge management (Drejer and Sorensen, 2002) abilities. While most of this research is not concerned with effects of outsourcing on organizational capabilities, it nonetheless implies that there are a number of variables that may mediate the effects of outsourcing. Therefore, to test the relevance of the conceptual model and to identify mediating factors, an empirical study was undertaken.

Method

Owing to the exploratory nature of the research objectives of this paper, a qualitative research approach was chosen. More specifically, the propositions were tested on a group of experienced senior procurement managers in what is commonly referred to as a focus group study.

The respondents jointly represent numerous cases of best practice in sourcing and have been active for many years as senior executives and consultants in different private and public organizations. These range from information and communication technology (ICT), automotive, construction, pharmaceuticals, energy, logistics, and chemical firms. Owing to reasons of confidentiality, and since the focus of the analysis is on practices of experienced managers as opposed to practices in particular firms, no specific company names are revealed here.

All respondents were responsible for buying a wide range of business services, from administrative services and logistics to IT consulting and marketing services. The focus group allowed for gathering detailed data and enabled a deeper understanding of the views and experiences of these highly qualified executives, all working at firms that may be considered leaders in their respective industries. As such, it was judged a suitable arena for discussing our initial model.

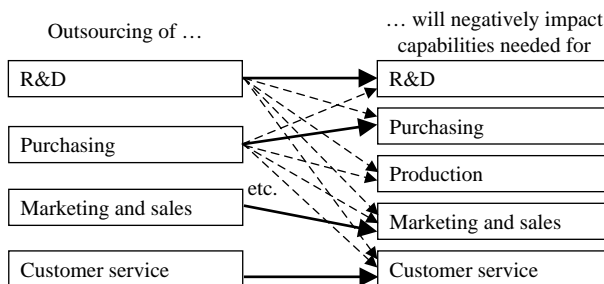


Figure 1.
Initial research model

During the focus group session, one of the authors first introduced the theme of the session while the other author introduced the literature-based propositions regarding consequences of outsourcing, in line with the conceptual model (Figure 1). A moderator form guided the discussion of the propositions, which took about two hours. A third, senior researcher acted as participant observer.

In an attempt to stimulate discussion, all statements were deliberately somewhat simplistic, and emphasized negative effects only, all in line with the *Main proposition*. The respondents were then allowed to discuss each statement while both authors asked for explanations and concrete examples of practical experiences of the participants. The focus group format allows the researcher to interact directly with respondents and allows respondents to react to and build upon the responses of other group members (Stewart and Shamdasani, 1990, p. 16). By using this method, the participants could, thus, benchmark their practices against the others' practices. In other words, the focus group session constituted an opportunity for learning from others, something which many authors describe as a central feature of benchmarking (Fernandez *et al.*, 2001; Razmi *et al.*, 2000).

However, the focus group method also has some limitations, such as the difficulty in interpreting the open-ended and often messy nature of the data (Kidd and Parshall, 2000; Stewart and Shamdasani, 1990). Because of the exploratory nature of the research, it was, nonetheless, seen as an efficient and sufficiently effective way of gathering data.

The focus group session was recorded and transcribed in detail directly afterwards. The two authors then independently content analyzed the material to search for general themes. In practical terms, this entailed making detailed notes and highlighting central sections of the material. In particular, evidence in support of or contradicting the propositions was marked, as well as factors influencing the effects of outsourcing different functions. After a discussion of the initial analysis, the transcript was reduced into relevant text sections and factors were clustered into four categories, in line with the research purpose. Statements and examples given by the respondents in support of and against the propositions were separated. A manual approach was used to condense the material. A new document was created, which was read and discussed by both authors to check on the analysis process and to form consensus on the clustering of data. Subsequently, a revised version of this document, as well as the original detailed transcriptions, served as the basis for creating a revised model of the consequences of outsourcing.

To further assess the validity of the research, the revised model was discussed with the third senior researcher that participated in the focus group session.

Focus group findings

In the following sections, the results of the empirical investigation are presented with a focus on the most pertinent findings. To bring life to the presentation, we make frequent use of quotes.

The respondents largely agreed with the main proposition stated, although provided examples of activities undertaken at their firms to reduce or eliminate the potentially negative effects of outsourcing. In particular, regarding the four sub-propositions numerous specific examples of successful as well as failed outsourcing projects were provided by focus group participants. While respondents recounted examples of good practices in preserving capabilities regarding individual outsourced functions, they found it more difficult to identify ways in which they mediated potentially negative effects on the abilities to perform other functions, though.

Outsourcing of R&D

The focus group discussion began by addressing the outsourcing of R&D. The respondents generally agreed that outsourcing R&D can have broad and negative effects on different capabilities, but also mentioned a number of factors that mediated such effects. For instance, a procurement consultant emphasized the role of specifications in R&D outsourcing and drawing on appropriate competencies in the firm. He said:

Nowadays companies in general are less and less afraid to outsource, but specifying the [R&D] service remains a major challenge. What type of development work should be delivered? Often, pretty much anyone can be involved in specifying [R&D] services, but they may not be accustomed to procurement work.

The discussions proceeded to the topic of the relationship between the outsourcer and the outsourcee, which was seen as an important variable influencing the outcome of outsourcing. While this was emphasized as an important aspect of outsourcing, it was nevertheless not always managed well. One respondent noted:

You must not underestimate internally managing the relationship. Myself I've been involved in cases where it did not turn out well. Who should take over and maintain the contractual relationship in the long-term? You often fail in that respect.

Another respondent continued along the same lines, and reported experiences from both successful and less-successful relationships and different ways of managing them:

[Undisclosed] and [undisclosed] are a great example of successful collaboration. [The two firms] are *dependent* [respondent's emphasis] on each other, but this is not always the case, like when we outsourced services. It works better when there is strong joint interest in collaboration.

A point made by several respondents was that in close and mutually rewarding relationships with a high degree of trust and cultural compatibility, some potential problems, such as the risk that the outsourcee gradually takes over important capabilities from the outsourcer, is often relatively low.

Discussions then moved on to competencies in the procurement function, where they stressed the importance of not outsourcing too much R&D and, thereby, losing important competencies. A respondent currently working in a Swedish municipality said:

To strengthen the procurement function generally means that competencies must remain with the buying firm. The procurement officer can never become an expert in all the different processes [i.e. the procured services as such]. You must [...] ensure that competencies remain in the firm. But that's not easy if you say 'This is no longer our thing.' Then you easily lose competence.

Another issue mentioned by respondents was the structure of the procurement market, in particular its maturity. In markets where the roles and responsibilities of different actors have not stabilized and suppliers lack in experience, respondents noted that effects of outsourcing R&D are more difficult to survey. One respondent said that this could be a problem, "since there are so many more issues to deal with on an immature supply market, which makes it [outsourcing R&D] even more complex." Similar reasoning was used regarding the ambition of suppliers, where some suppliers act more as competitors than others, and are thus more likely to steal important knowledge if they are awarded a contract.

Outsourcing of purchasing

We then discussed the outsourcing of the purchasing function as such. Although not all respondents had experience from this, some strong opinions were aired. Respondents were not entirely unanimous, though, and there was a vivid debate regarding the effects of outsourcing the purchasing function. A procurement consultant emphasized that outsourcing may actually increase the need to develop certain aspects of purchasing, such as handling requirements and dealing with problems. She said:

I outsourced part of my purchasing department at [undisclosed firm name]. I spent a lot of time thinking about this. At first I felt sure it would not work, and 3-4 years later I am still not 100 per cent sure. But what struck me is that this forced us to become really good buyers.

Others reported negative experiences from outsourcing purchasing. One respondent said that they had recently insourced previously outsourced purchasing activities, since the suppliers “were not particularly keen on listening to our specific demands” and “were too focused on achieving economies of scale.” He also mentioned that the interaction with the purchasing function had not worked as well as before, even though the buyers were the same. “There was a lack of information and sometimes we were not allowed to participate in meetings,” he said. In this instance, purchasing was outsourced to a separate firm that handled purchasing activities for a number of organizations of different sizes. The respondent continued: “[The respondent’s organisation] is so incredibly much larger and has completely different needs than [some of the smaller organizations] so it becomes really tricky and there are different specifications.”

Regarding the connection between outsourcing R&D and losing purchasing capabilities, most did not report any negative experiences. Indeed, one respondent stressed:

I have no negative experiences there. It is important to define the interfaces. [...] You can also chose [to outsource] products of less strategic importance. [...] The level of purchasing maturity in the company is also important, if you work in cross-functional teams involving both the outsourcer and the outsourcee you [can avoid negative effects].

Along the same lines, another respondent pointed out the importance of the physical location of the outsourcee’s representative: “Another important issue is whether the outsourcee should be placed inside or outside your organization. That *really* [respondent’s emphasis] affects your capabilities.” It was noted, though, that this also depends on the nature of the service in question, where services such as field services and training cannot easily be centralized.

One respondent also emphasized that there is a difference between outsourcing operational and strategic purchasing activities. Although operational purchasing – such as handling orders – is more suitable for outsourcing than strategic activities such as specifying requirements, operational and strategic activities are also closely interrelated, he noted, continuing:

We outsource operational aspects of sourcing; what’s important when you develop your sourcing strategies is that you communicate these strategies; there is a greater risk that a gap will appear here if there is an external party [managing operational purchasing] compared to if you work in the same organization. You must actively communicate everything [i.e. strategies] or there is chance you miss something.

Outsourcing of marketing and sales

In line with our proposition, discussions regarding the effects of outsourcing marketing and sales were mainly negative and highlighted problems in maintaining customer contact. One respondent described a case he had been involved in:

[We lost] customer contact. [...] This we have to compensate for. Basically we save a tremendous amount of money. For our customers, availability increased tremendously, but [we] lost something!

A respondent from the ICT industry made similar observations and also hinted at how the negative consequences may be moderated:

All operators [list of company names] outsource sales to the customer segment. There is incredible interactivity in this, the systems, communication and so on, but the customer contact is “out there,” and this means that we have to get a lot of information back, not to lose [contact with the market].

Consensus among the respondents appeared to be that the outsourcing of marketing and sales is potentially very risky. The importance of not losing customer feedback was stressed by several respondents, for example. Our respondents, thus, implied that outsourcing marketing and sales could be potentially negative for most other functions. Different systems for handling customer feedback were suggested to counteract such effects, including developing partnership-type relationships with suppliers and/or having frequent supplier meetings, to reduce the risk of deteriorated capabilities. Overall, though, the general opinion was that outsourcing marketing and sales was so potentially risky that they mostly preferred to retain the function in the firm.

Outsourcing of customer service

Several of the focus group participants had been involved in outsourcing parts of the customer service function. Some positive and negative experiences were reported, partly depending on the perceived importance of customer service to the outsourcing organization. For example, one respondent noted:

In the past I was involved in outsourcing telephony and reception services. That improved greatly, but the telephony and reception services we have today I would not want to outsource. You just cannot be sure enough [that it will work].

The message given by the respondents was that the effects of outsourcing customer service vary depending on the importance of the service outsourced for the outsourcer's business. It also depends on the maturity and complexity of the service process. “Are there any competent suppliers available that can handle the task as well as or better than we do?,” a respondent said. Another respondent reported negative initial experiences, and how his company decided to manage this:

[Company name] outsourced all its telephony to a telemarketing firm in [name of city]. There were huge initial problems in interaction between the parties. Now we have actually developed a parallel web-based service that we manage ourselves, as a means of keeping in touch with our customers.

Again, the issue of customer contact – which was raised as the most important concern in outsourcing marketing and sales – was mentioned. In particular, the importance of

listening to and understanding changing customer needs was frequently mentioned. One respondent noted “You need to keep in touch with customer needs even if you outsource.” Another respondent argued:

The difficult thing is to seize the moment. You have to put into place systems and models from a strong buying organization. How can you make the outsourcee seize these moments? There has to be an incentive. I have experiences from customer service at [firm] and [firm]. This is constantly an issue. [...] You have to find models to capture the signals [from the market].

Respondents also noted that an outsourced customer service function is often less likely to skilfully handle customer concerns than an internal equivalent. One respondent argued:

You need continuous education, especially with an external supplier, because otherwise there is a risk that the customer service personnel become indifferent and stop collecting information regarding changing customer needs for new products, and so on.

Along the same lines, another focus group participant emphasized the importance of handling customer complaints:

Partly there is the moment when you make the sale, but then also when the customer calls and is less than happy. Then you have to be able to handle this and explain, so the customer isn't unhappy.

To conclude the discussion, another respondent continued along the same lines and stressed the importance of “incentives for the supplier to manage all these aspects, and to receive the signals from customers.”

Analysis and revised research model

As the summary of the focus group discussion reveals, our study yielded some support for the main and sub-propositions. However, respondents clearly provided many examples of outsourcing deals where they had been able to overcome potentially negative consequences through good business practices or where such consequences were perceived as irrelevant due to the outsourcing context. In a content analysis of focus group data, we identified four main categories of mediating variables: variables relating to the outsourcer, variables relating to the outsourcee, variables relating to the relationship, and (other) contextual variables.

Mediating variables relating to the outsourcer

A number of mediating variables relating to the outsourcer, or buyer, were identified. In particular, factors relating to knowledge management emerged as especially important (Drejer and Sorensen, 2002). Our observations from the focus group are in line with arguments that capabilities are developed through experience, articulation and codification of knowledge (Zollo and Winter, 1999) and that capabilities related to handling different functions are often interrelated (Hillebrand and Biemans, 2003; Kahn, 1996). By creating systems that facilitate learning and interaction between different functions, negative effects of outsourcing can apparently be mediated as capabilities are maintained and even developed in interaction with the outsourcee. In practical terms, continuous education, providing the purchasing function with more and more skilled staff and other support measures would seem crucial to develop the outsourcer's abilities as buyer. As several respondents implied, with increasing

outsourcing the outsourcer is forced to become a good buyer, or a “strong buying organization.”

Other abilities as a buyer were also stressed; even if a function is outsourced, all competencies relating to that function must not be lost, if purchasing competence is to be maintained. The purchasing organization must, for example, still be able to specify outsourced services and carry out quality control.

Strategies and policies of the buying organization also appear to be important factors. Respondents argued that services of high-strategic importance or strategic functions were less suited to outsourcing than operational functions. For example, at an operational level establishing systems for maintaining customer contact, even when marketing and sales and customer service are outsourced, is an important measure that a firm can undertake.

Mediating variables relating to the outsourcee

Mediating variables relating to the outsourcee, or service provider, can also be identified. These relate in particular to the outsourcee’s delivery capabilities and ambitions/strategies and policies. Although this can be difficult to evaluate a priori (Shekar, 2008), a fundamental question is whether the supplier is really able to handle the outsourced processes effectively and efficiently. In line with previous literature (Armistead and Clark, 1991; Loomba, 1996; Nordin, 2005), the respondents mentioned that this depends, among other things, on the maturity and complexity of the service process being outsourced. The consequences of outsourcing also depend on the overall ambitions of the supplier, e.g. whether the supplier aims to be a niche leader or if the supplier aims to develop broader competencies. Also, it is sometimes better to contract a less-ambitious supplier to reduce the risk of losing important knowledge (Åhlström and Nordin, 2006).

Mediating variables relating to the relationship

In line with previous literature (Lee, 2001; Li *et al.*, 2006), our study implies that the relationship between outsourcer and outsourcee can strongly influence the consequences of outsourcing. As implied by some of the respondents the relative power is an important factor to consider, although the importance of joint interests and compatibility was stressed more often.

Mutual interests and dependence may lead to depth in collaboration, and this may moderate the risk of the various kinds of problems the respondents noted, such as the risk of losing important information to the supplier. In the same vein, trust also appears to be important. This may be based on prior experience, shared values and communication, but may be more difficult to achieve if the outsourcer and supplier are not sufficiently compatible, which may be the case if there are significant cultural differences, for instance. Related to all these factors is integration between the buyer and seller. The establishment of cross-functional and cross-firm teams (Jassawalla and Sashittal, 1998; Narasimhan and Das, 2000), where, for example, members of the outsourcee’s team are physically located at the outsourcer’s facilities can be one way to retain capabilities even if a function is outsourced.

Mediating contextual variables

A number of contextual variables were also mentioned, i.e. variables not directly connected to either of the parties in the outsourcing relationship. For example, several respondents noted that the physical location of staff was a crucial variable influencing the consequences of outsourcing. Location of service staff, however, depends on the nature of the activity being outsourced, where it is difficult to centralize services such as field services and training to the outsourcer's premises, for instance.

The structure and maturity of the market not only influences power relationship, but has other effects related to outsourcing. For instance, according to our respondents, effects of outsourcing on immature markets are less predictable since the roles and responsibilities of the players involved have not yet set. Such instability may be called "environmental dynamism." Worth noting is that, while our respondents implied that a high degree of dynamism makes the consequences less predictable and outsourcing, thus, less feasible or at least more difficult, others have argued that in dynamic environments outsourcing is a good way of increasing technology-related flexibility (Gilley and Rasheed, 2000) and of taking advantage of emerging technologies without investing large amounts of capital (Quinn, 1992). It has also been argued previously that the risk of losing important knowledge to external organizations is greater in more stable and mature environments. One reason for this is that the causal ambiguity (Dierickx and Cool, 1989) between resources and skills and firms' success in the industry (and, thus, competitive advantage) may be much less pronounced in stable environments. To conclude, the influence of environmental dynamism on outsourcing outcome appears to be significant albeit multifaceted.

Revised model

In summary, we propose a revised research model that takes into consideration these four groups of mediating variables (Figure 2).

In addition to theoretical implications, the revised model has implications for managerial practice. It should be seen as a framework constituting a system of central factors that need to be considered, adjusted, and adjusted to. As such, it serves as a broad guideline for managerial decisions. In particular, it implies that by thorough vendor selection and careful management of outsourcing projects, outsourcing may not result in negative effects on organizational capabilities. In practice, this means that companies should ensure that important functions are not outsourced unless appropriate processes and systems for learning and transfer of knowledge between outsourcer and outsourcee have been established. This applies in particular to the outsourcing of strategically important functions to ambitious and powerful suppliers. Establishing cross-functional teams incorporating both outsourcee and outsourcer is a tangible measure firms can undertake to handle knowledge management issues. For certain functions, even physical co-location of staff from both organizations may be an option.

Concluding discussion

This paper makes several contributions to the debate on outsourcing. First, two main arguments are developed as points of departure in dealing with an aspect of outsourcing largely ignored in extant research; effects of outsourcing on organizational capabilities:

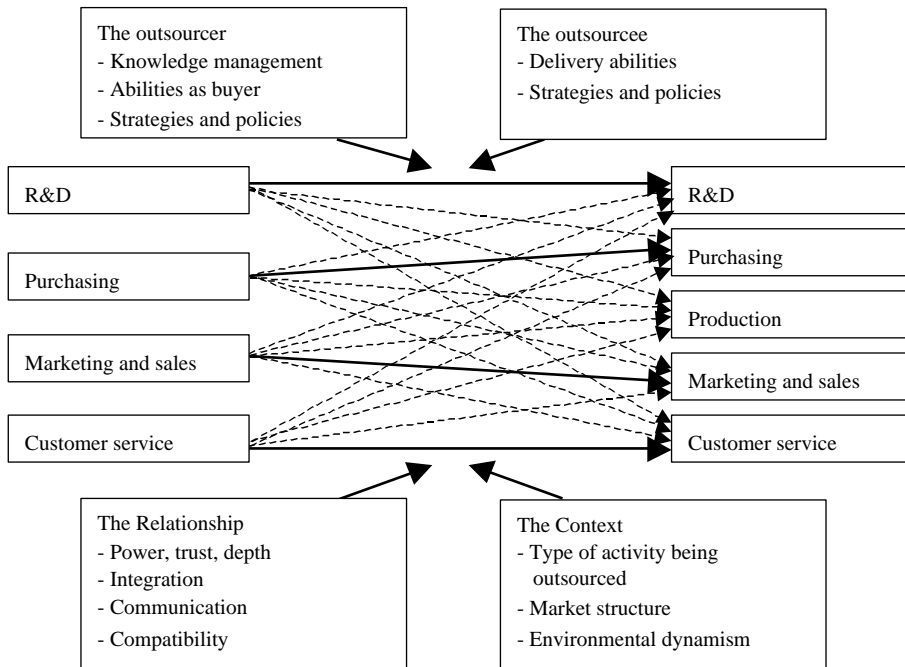


Figure 2.
Revised research model

- (1) When a function is outsourced, the ability to perform that function is partly or fully lost, as people leave the organization, start working with other functions, or when existing systems and routines are no longer employed.
- (2) Owing to the many interdependencies between functions in a firm, the outsourcing of one function may negatively impact on the abilities to perform other functions, i.e. the organization's capabilities.

Second, we conduct a focus group study, which finds some support for these arguments. Our research shows that the negative impact of outsourcing on capabilities may be mediated by managerial actions, though, and several examples of best practice were identified in the study. Therefore, a third and main contribution of this paper is the development of a model of such mediating variables. In particular, these include implementing systems for knowledge management, improving abilities as buyer, critically considering which functions to outsource, carefully selecting suppliers whose abilities and ambitions match the needs of the outsourcer, managing and developing the relationship with the outsourcee to ensure appropriate levels of integration, and putting into place interfaces for communication.

Whilst partly based on a focus group interview, this paper should be considered largely conceptual in nature, though, and its model remains to be tested. Other limitations of this research must also be recognized. Our study uses relatively few key informants, and cannot be said to be generalizable in any statistical sense. Further, a focus group study primarily draws on opinions of research subjects. In that sense, its findings represent a greater degree of subjectivity than, e.g. a multiple

case study. Additionally, while the format of the focus group is conducive to the exchange and in-depth discussion of ideas, as such it may be less well suited for truly exhaustive examination of a topic. Therefore, our study may have overlooked some relevant mediating variables.

To address some of these limitations and to extend the study of non-financial effects of outsourcing, we propose six specific avenues for future research.

First, we suggest that the specific and relative influences of the mediating variables on the outcomes of outsourcing be investigated. Are some variables more closely connected to certain functions? In other words, which variables mediate the effects of outsourcing of which functions and what is the strength of such associations?

Second, largely representing an analysis of the discussions during one focus group session, the revised model cannot claim to be completely exhaustive in terms of mediating variables. Are there additional variables not identified in our study that may mediate the effects of outsourcing?

Third, not all firms and industries operate according to the same logic. Can patterns regarding mediating variables be identified within and across industries?

Fourth, while we focus on the outsourcing of four specific functions, many other functions are performed in firms, even if these often take the role of support functions, such as logistics, IT, finance department, pay rolls, facilities management, etc. Future research should find out whether the outsourcing of such supporting functions also negatively impacts firm capabilities, if so to what extent, and whether these effects are also mediated by a set of relevant variables.

Fifth, we suggest that future research should identify and describe cases of best practice outsourcing in terms of managing potentially negative effects. While our study hints at effective ways of managing outsourcing, in-depth descriptions of best practice cases will be very valuable for managers contemplating outsourcing.

Sixth, this paper focuses on outsourcing from the buyer's perspective, activities the buyer may undertake to mediate potentially negative effects of outsourcing, and activities that buyers believe service suppliers should perform. However, each outsourcing deal includes at least two parties, and to get a more balanced picture of outsourcing management, future research should look at outsourcing also from the point of view of the provider.

As a concluding point, it should be stressed that this paper is not intended as being negative to outsourcing as such. To the contrary, it recognizes that the outsourcing of non-essential functions as well as of functions relatively close to core business processes has proved to be financially very sound for many firms. Even if the overall outcome for the firm is beneficial, there might still be negative non-financial consequences that managers would be wise to take into consideration, though.

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