

# Offshore Outsourcing of Services: An Evolutionary Perspective

Wendy L. Tate<sup>1</sup>, Lisa M. Ellram<sup>2</sup>, Lydia Bals<sup>3,\*</sup>, Evi Hartmann<sup>4</sup>

<sup>1</sup> Assistant Professor, Department of Marketing and Logistics, University of Tennessee, Knoxville, TN, United States

<sup>2</sup> James Evans Rees Distinguished Professor of Distribution, Farmer School of Business Department of Marketing, Miami University, Oxford, OH, United States

<sup>3</sup> Visiting Scholar, Center for Strategic Management and Globalization, Copenhagen Business School, Frederiksberg, Denmark

<sup>4</sup> Assistant Professor, Supply Management Institute SMI, EBS European Business School, Wiesbaden, Germany

## ABSTRACT

Offshore outsourcing is gaining increasing importance and attention in both theory and practice.

The purpose of this research is to use nine in-depth case studies to analyze the evolution of offshore services outsourcing with regard to how expectations and governance structures change over time. Five testable propositions are presented, building on institutional theory, transaction cost, and resource-based perspectives. The cases demonstrate that offshore outsourcing is initiated because of increasing internal and external pressure to conform and reduce costs. Moreover, companies “chase” efficiency improvements in other geographic locations. But after reducing costs, companies discover more strategic benefits such as the potential to increase quality and market share. Importantly, as buyer-supplier relationships move from tactical to more strategic, expectations and governance structures change.

## KEYWORDS

Offshoring; offshore outsourcing; institutional theory; resource-based view; transaction cost economics

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\* Corresponding author.  
P: +49 1520 2180478, F: +49 6196 52 41 459 , E: [lydia.bals@web.de](mailto:lydia.bals@web.de).

# Offshore Outsourcing of Services: An Evolutionary Perspective

## 1. Introduction

The offshore outsourcing phenomenon has gained increasing importance and attention in both theory and practice and has been coined “the next wave of globalization” (Dossani and Kenney, 2007). Companies are increasingly offshore outsourcing internal business processes to low-cost locations outside of the buying firm’s country of origin (Drezner, 2004) that satisfy their requirements for highly competitive, well-educated employees. As such, offshore outsourcing is perceived as a way to reduce labor costs for services that are highly dependent on skilled labor for efficient delivery (Ellram et al., 2008). Overall, offshore outsourcing of services is a rapidly growing phenomenon in global business and there has been relatively little research to date in this area (Vivek et al., 2008; Lovelock and Yip, 1996). Therefore, offshore outsourcing affords an interesting research opportunity. The specific focus on *offshore outsourcing* limits the scope of our analysis to the “buy” arrangements in the realm of offshoring (Jahns, Hartmann and Bals, 2006), thus allowing for more in-depth analysis.

Recent large-scale empirical research has indicated that in practice companies’ motives for engaging in offshore outsourcing change over time (Lewin and Couto, 2007). Nevertheless, in-depth company level case study and theory-driven research concerning this phenomenon is still relatively scarce. Therefore, the first purpose of this paper is to provide detailed insights into the evolution of the offshore outsourcing phenomenon through case study research with a particular focus on what motivates companies to offshore outsource and the governance structures these companies employ. This specific focus affords an interesting research opportunity because the company-level dynamics of offshore outsourcing are not yet well

understood. The second purpose is to further advance the understanding of offshore outsourcing using three different theoretical lenses to frame propositions based on the case results:

institutional theory, transaction cost economics (TCE) and resource-based view (RBV). These three theories were selected, because of the demonstrated applicability in extant research on offshoring. With this background, we set out to address the following two research questions:

- 1. How does the governance structure and expectations for offshore outsourcing change over time?*
- 2. How do institutional theory, transaction cost economics and the resource based view provide insights into the phenomenon of offshore outsourcing of services?*

The three theoretical lenses of institutional theory, TCE and RBV will be further detailed in the literature review section, providing the basis for the later proposition development. Next, we present the research methodology. The results section then provides findings from nine case studies and presents five associated propositions, highlighting how the governance structure and expectations change in the case study firms. It is within this section that the evolutionary pattern of offshore outsourcing of services at the company level is described and linked with theory-driven, testable propositions. This section is followed by discussion and conclusions encompassing managerial and theoretical implications, limitations, and suggestions for future research.

## **2. Literature review**

Offshore outsourcing is motivated by a combination of environmental pressure, efficiency, and competitive pressure. Looking at the phenomenon from a theoretical perspective, a number of factors motivate organizations to begin, and continue, to offshore outsource. From

an institutional theory perspective, organizations are influenced by pressure from external sources (Zucker, 1987). If they behave accordingly, they are rewarded through increased legitimacy, resources, and survival capabilities (Scott, 1987). Therefore, we apply institutional theory as a theoretical lens to understand the environmental factors that drive offshore outsourcing. TCE focuses on the situation where firms choose to use the market rather than hierarchy. TCE has been applied only recently in the offshore setting (Ellram et al., 2008; Madhok, 2002; Jahns et al., 2006). In the context of TCE, if firms that offshore outsource services perceive the offshore outsourced market to be more efficient, we would expect offshore outsourcing to grow. An RBV perspective considers whether certain resources or capabilities contribute to a firm's competitive advantage. If enhanced capabilities are experienced in offshore outsourcing, we would expect offshore outsourcing to proliferate.

Figure 1 shows an initial overview of the three theoretical lenses. These intersection points are key in the evolution from initial offshore outsource efforts to the integration of offshore outsourcing as an important strategy in identifying the appropriate resources and gaining competitive advantage.

[Please insert Figure 1 about here]

Prior attempts to analyze some combination of two of these theories to gain a deeper understanding of outsourcing decisions can be found in the literature. TCE and RBV have a considerable history of application to outsourcing (e.g. Lyons 1995; Murray et al., 1995 for TCE; Aubert et al., 2004; Leiblein and Miller, 2003 for RBV) and are increasingly being discussed together (e.g. Holcomb and Hitt, 2007; Arnold, 2000). For Information Systems (IS) outsourcing, for example, Miranda and Kim (2006) focused on a combination of institutional theory and TCE, in order to embed the more TCE-based decision making procedure into an institutional context.

In the context of HR outsourcing, Cooke et al. (2005) found initial evidence that both RBV and TCE provide insight into decision-making, influenced by the institutional context. This provides support that these theories can provide interesting insight into offshoring outsourcing either separately or in combination.

### *2.1 Institutional theory*

Institutional theory provides a rich, complex view of organizations (Zucker, 1987). Institutional theorists believe that organizational decision-making is influenced by normative pressures that arise from both external sources (i.e. government, industry alliance) and internal sources. These normative pressures and assumptions determine what constitutes appropriate or acceptable behavior for the organization (Oliver, 1997). External factors which affect organizations such as social and cultural systems are the foundation of institutional theory (Scott, 2001). As stated previously, organizations that conform to these accepted norms and assumptions are rewarded through increased legitimacy, resources, and survival capabilities (Scott, 1987).

There has been some recent research that looks at how institutional norms and assumptions influence offshore outsourcing (Kshetri, 2007; Bunyaratavej et al., 2007). In this research, existing laws and rules play a key role in the offshore outsourcing decision. The organizations adhere to these rules so that they do not suffer penalties for non-compliance (Hoffmann, 1999). There are also researchers who propose that organizations will adapt to the norms and assumptions of the local institutional environment or locate only in areas where organizations have similar institutional beliefs (Kostava and Roth, 2002). Without insight into the operating environment, business models proven to work in some institutional settings may fail in others (e.g. Wal-Mart's failure in Germany (Christopherson, 2007)).

There are a number of benefits that an organization can gain by taking an institutional perspective. For example, an organization can benefit by being a follower and waiting to see if other organizations are successful in a given location (Westphal et al., 1997) thereby lowering its risk of entering that market. A firm can also adapt to pressures in order to gain power and control over the resources they need to be successful (Brito, 2001).

There are also a number of risks in offshore outsourcing associated with an institutional theory perspective including looser legal and regulatory environments and different cultural norms in other countries related to issues such as data security and privacy laws (Kshetri, 2007). Further, public views in the United States on offshore outsourcing can be negative because of the perception that jobs are being lost to other countries (Gregory Mankiw and Swagel, 2006; Kuttner, 1997). Therefore, an organization that offshore outsources may risk the opportunity of lost market share in its home country. In some recent research it was found that one in three respondents would not do business with a bank if it offshored its call centers overseas (Alster, 2005). Thus, from an institutional perspective, companies must trade off the social and competitive pressure towards outsourcing with the potential risks.

## *2.2 Transaction Cost Economics (TCE)*

TCE has been traditionally concerned with outsourcing, or the make or buy decision (Williamson, 1979). Transaction costs can be differentiated into ex-ante (before contracts are closed, as in the identification of suppliers) and ex-post (after contracts are closed, as in supplier monitoring) transaction costs (Williamson, 1979). The focus is particularly on costs and efficiency rather than revenue. Applying transaction cost theory, higher asset specificity favors the hierarchy (make) decision.

In the context of general organizational design choice, the advances in information technology are changing the nature of transaction costs, favoring contracting and outsourcing more than when Williamson's (1975) first work was published (Lajili and Mahoney, 2006; Jahns et al., 2006). These advances have lowered previous barriers (Stratmann, 2008), as information asymmetries have decreased, which is particularly relevant for service offshoring, since most service transfers will rely on information or telecommunication technology. For example in the case of offshoring of accounting, call centers or information technology services.

The basic benefit of offshoring, cost advantages due to less costly talent and facilities (Gupta et al., 2007), is also named as a key reason for implementing offshore outsourcing decisions (Clott, 2007). Nevertheless, the consideration of "hidden costs" is important, and recent literature suggests that these are contingent upon interaction intensity and interaction distance (Stringfellow et al., 2008).

TCE cautions of a number of risks that act as barriers to offshore outsourcing, such as potential loss of control, uncertainty in supplier behavior and performance, particularly in services (Brouthers and Brouthers, 2003), and dependence. Also, TCE provides insight into how task uncertainty and specificity may affect the attractiveness of offshore outsourcing.

### *2.3 Resource Based View (RBV)*

The RBV is concerned with explaining how organizations strive to acquire a unique combination of strategic resources and gain sustainable competitive advantage. These resources can be physical resources, human resources and organizational resources (Barney, 1991). In essence, RBV puts forward that competitive advantage is not a function of just opportunities in

the external environment but also a function of which resources the firm can identify, develop, deploy, and protect (Barney, 1991; Penrose 1959; Wernerfeldt 1989).

In the context of increasing global competitive pressure, companies are advised to concentrate on their core competencies and utilize outsourcing to capitalize on the expertise of others (Domberger, 1998; Porter, 1990; Prahalad and Hamel, 1990). RBV has been empirically supported in the context of outsourcing (Aubert et al., 2004; Leiblein and Miller, 2003; Klaas et al., 2001; Argyres, 1996; Teng et al., 1995). There is support that firms outsource non-strategic items when they believe suppliers have superior capabilities (Argyres, 1996). Doh (2005, p. 700) points out that “Offshoring, both as an internal process and business strategy, could be an outcome of successful management of resources, and may itself represent a direct application of firm-level capabilities as envisioned by the RBV. At the same time, however, offshoring may reflect the commoditization of a production function and erode benefits derived from management of resources and capabilities if it becomes an activity that is widely imitable and not unique to a firm or confederation firms”.

In the context of RBV, offshoring may provide access to new resources (Jahns et al., 2006) in the form of both defined services and untapped human potential. In India, a well-educated workforce provides potentially distinctive capabilities (Anon, 2004) in highly human resource dependent services. An example of one such valuable resource is innovation, which has been cited as a reason that companies turn to offshore locations.

### **3. Methodology**

The overall research questions pursued were, “*How does the governance structure and expectations for offshore outsourcing change over time? and How do institutional theory,*

*transaction cost economics and the resource based view provide insights into the phenomenon of offshore outsourcing of services?*” Therefore the research questions focused on the “how” aspects of the phenomenon. Due to the open-ended, exploratory nature of the research questions, a multi-case research strategy is appropriate here (Eisenhardt, 1989; Ellram, 1996; Miles and Huberman, 1994; Yin 2003). Rather than test existing theory or develop new theory, the goal is to use the theories described in the previous section to frame the propositions. This approach represents an elaboration of existing theories (Vaughan, 1992; Lee, 1999; Gilbert, 2005; Zott and Huy, 2007; Ketokivi, 2006).

We draw on nine case studies, eight conducted in the United States, and one conducted in Germany. The overall research design is shown in Table 1.

[Please insert Table 1 about here]

The cases conducted in the United States were derived from a research project exploring when and why organizations offshore outsource services, and how outsourcing relationships evolve over time. The case conducted in Germany came from a research project focused on varying types of offshoring arrangements, such as captive shared services and joint ventures. The representation of multiple firms is likely to result in more robust theory elaboration (Eisenhardt and Graebner, 2007; Yin, 2003), due to the grounding in empirical evidence from a variety of perspectives and circumstances (Eisenhardt and Graebner, 2007).

The interviews were conducted with high-ranking supply chain employees, and also included others involved in offshore outsourcing decision-making and execution, as appropriate. An open-ended protocol was used to interview multiple informants with varying functional backgrounds, from nine large multinational corporations (please see Table 2).

[Please insert Table 2 about here]

The interviews from all of the cases were transcribed and then coded along the theory-based aspects highlighted in Figure 1. In analyzing the data, we followed techniques for cross-case analysis and tabular displays (Miles and Huberman, 1994; Eisenhardt and Graebner, 2007). Tests of construct validity, internal validity, external validity, and reliability were used to assess the quality of the research design (Flint et al., 2002; Voss et al., 2002; Yin 2003). According to Ellram (1996) and Yin (2003), construct, internal and external validity, and reliability need to be assessed throughout case study research. Case study tactics and brief descriptions of their implementation to ensure validity and reliability of the findings are presented in Table 3.

[Please insert Table 3 about here]

#### **4. Case results and proposition development**

The offshoring context reflects the institutional theory notion that companies are enacting similar strategic choices and patterns (Lee et al., 2004; Greenwood and Hinings, 1996). In support of this, “competitive pressure” has been identified as a key reason for implementation of offshore outsourcing decisions (Clott, 2007, p. 483). In this sense, companies that engage in offshoring in the same offshore location, potentially experience similarities in success and failures.

In the case studies, Software, Technology1, Air, and Technology2 observed as other organizations successfully began to offshore customer contact centers to India. Packaging and Finance3 watched while others outsourced information technology. Technology1, Software, and Finance3 waited until others had already established successful contact center or information technology outsourcing in India and were admittedly “late to the offshoring game”. Packaging waited until its management demanded cost cuts before it looked into outsourcing information

technology. Therefore, we found substantial support among the case studies that the firms were paying attention to and following the lead of others in offshore outsourcing. Thus, they observed the mistakes and tried to learn from them. However, when these decisions succeeded, they were under competitive pressure to do the same. Thus, we offer the following proposition from an institutional theory perspective:

**Proposition 1:** Companies will make offshore outsourcing decisions following patterns of firms in the same or similar industries.

However, these companies were not blind followers. They did their own research based on their requirements. Software monitored industry trends and noted that customer service levels for firms that outsourced to offshore locations remained high, while the company gained significant cost savings. The company needed to find a location where highly educated agents could complete the customer calls and create an excellent customer experience. However, Software also wanted to minimize the costs associated with operating the call center so that the savings could be reinvested into generating additional sales or improving the overall customer experience. As illustrated in Figure 1, a firm's concern about how much to outsource and where to outsource is represented by the intersection of institutional theory and TCE.

Technology1, Air, Automotive, and Finance1 followed very similar patterns. Finance3 in general wants to be a fast follower, not a first mover. Finance3 specifically noted that it looked at the influence of companies in its industry with regard to its offshore outsourcing decision. It considered political, legal, and cultural issues, looking at the economics, language, GNP growth, risk factors, and potential disruptions. It considers its operations strategy and the overall benefits of being involved in a given country.

Finance2 did not take an institutional theory perspective to offshore outsourcing. As a leader in its field, it identified offshoring of services as a potential area for cost savings at least a decade before most firms, and quietly went about moving many of its backroom operations offshore. As suggested by TCE, Finance2 surmised that the global market was more efficient than internal hierarchy for backroom services labor. Thus, looking first at the more tactical aspects of efficiency and effectiveness posited by TCE, we propose:

**Proposition 2:** The initial focus when offshore outsourcing services is primarily on cost efficiencies.

As in most outsourcing decisions, cost savings or price is the most significant consideration (Ellram et al., 2007), and was the only common reason provided by all of the case study firms as an early motivator for offshore outsourcing. The primary cost of running a call center or performing information technology functions is labor. Companies move offshore to take advantage of the wage cost differentials, also known as the labor arbitrage (Deutsche Bank, 2004). Some specific support for cost as a motivator from the cases is included in Table 4. Software, Technology1, Technology2, and Automotive explicitly point at better value for the money spent. Each of these companies mentions that quality remained at an equivalent level, while costs actually decreased.

[Please insert Table 4 about here]

As the firm recognizes that suppliers can add value beyond simply lower costs, the firm comes to look at suppliers more strategically, as a source of capabilities. This is represented in Figure 1 by the intersection of TCE with RBV. For example, the establishment of such 24/7 arrangements was also named explicitly by four companies as a key reason for implementation

of offshore outsourcing decisions, and is supported in the literature (Clott, 2007). Also identified in the literature and by three of the case firms is the ability to access “untapped markets” (Gupta et al., 2007). One case identified the opportunity to increase market share in these new markets. The literature notes that this is another important benefit from offshoring, since many of the principal destinations, such as China and India, have large consumer markets (Salmi, 2006), with potential to become important sales markets (Frear et al., 1992; Kotabe and Murray, 1990). Table 5 highlights many additional non-cost benefits. Thus, from an RBV standpoint, this gives the offshore outsourcing decision a strategic dimension from the sales perspective, which previously was not prevalent in the (domestic) outsourcing decision. Based on this line of thought we offer the following proposition from an RBV perspective.

[Please insert Table 5 about here]

**Proposition 3:** Over time, as companies gain enhanced non-cost benefits from offshore outsourcing of services, the expectations of future non-cost benefits increase.

The data shows that all the case firms experienced the same or better quality levels on some aspects of service from the offshore providers. Eight of the nine case companies explicitly stated that they used offshore outsourcing to India as a way to gain access to educated employees. Technology2 participants mentioned that because the agents in India had higher education levels, they were more likely to “think out of the box” and develop creative solutions to problems.

Seven of the nine companies indicated that they experienced process improvements as a result of offshore outsourcing. Finance1 noted that its offshore outsourced suppliers use “fresh eyes” to look at processes that have always been done a certain way, and then apply strong six sigma disciplines to make improvements or recommend changes. Automotive stated that its

offshore provider is better at quality management and documentation than available onshore providers.

It was clear from the case study firms that service offshoring decisions are of a dynamic nature, creating the potential for shifts from one governance and operating model to the other, for example from using a third party to manage offshore outsourcing to managing the arrangements with the firm's own co-located employees. From a TCE perspective, "...firms and markets are *alternative* modes of governance (Coase, 1937), and the allocation of activity between firms and markets is not taken as given but is something to be derived" (Williamson, 1996, p. 7).

In further support of risk assumptions in TCE, and the external pressure exerted in institutional theory, the case material reveals that most of the firms did consider risks. They did so at least implicitly, before outsourcing. They waited until they had seen other firms succeed in similar ventures before participating. For example, Packaging noted that "the key to our success is to have the right scope plotted out. Don't give too much away. Never outsource anything you could not do yourself, or you are at risk. Never outsource items with high uncertainty."

Finance3 notes that there are unique assets or investments required by the suppliers to support its services. For call centers, the work is physically separated, with dedicated spaces and assets, in order to reduce their risk. While they note that physical resources and training are significant versus the total cost of the service, "You have to make additional investments to track results, and many people don't realize that. With call centers control is (needed) due to lack of maturity, concern with brand and customer perceptions, (and call centers) will always be mission critical. There is customer specific training and even a dedicated training space. These costs are percentage points; in the United States this would be significant. Because there is so much being

saved in costs from going to India, this sort of additional cost of business is allowed and ignored.”

Another factor that may affect the governance structure within the buyer-supplier relationship is increasing supplier dependence. Companies may want to exert more control over the supply of the resources involved, thus investing in relationship management, or finally turning to a captive model, reintegrating service delivery. Table 6 illustrates a number of adaptations to governance found in the case studies. In Figure 1, this is represented by the intersection of TCE, institutional theory, and RBV where the recognition by the firm of the increased value-added by suppliers and dependence on suppliers gives rise for the need to change the supplier governance structure, to better leverage and retain the value. This leads us to the fourth proposition which lies at the intersection of TCE, RBV and institutional theory:

**Proposition 4:** Increased dependence on offshore suppliers in order to gain added benefits will lead to changes in governance structure.

[Please insert Table 6 About Here]

As companies realize the potential for value-added and risk reduction, they may have their own employees co-locate at the supplier’s facilities. Finance2 is concerned about its growing dependence on suppliers, as suppliers’ increased expertise and knowledge gives the supplier considerable potential power over Finance2. Thus, Finance2 provides project management for very unique items. It uses the supplier’s resources, guiding the supplier and working hand in hand with solution centers, co-locating with and managing the contractors.

Technology2 and Software also co-locate operational experts at the supplier sites to participate in management, facilitate problem solving, and expedite decision making.

Technology2 found that co-locating its employees on-site to deal with day-to-day challenges and

issues has minimized problem escalation and reduced the number of incidents. Automotive co-locates some of the outsourced service provider's employees at its location, in order to ensure close cooperation and fast problem solving, and to retain knowledge created in cooperation with the supplier.

Further, continuous supplier improvement has become an expectation of many of the buying firms. For example, Finance2 requires that the suppliers have documented processes for continuous improvement in place with the results presented to senior management on a quarterly basis. Software and Finance1 both insist on a measurable continuous improvement plan from the supplier. Air and Software have a documented continuous improvement process during the final phase of supplier selection and evaluation. Software believes that a focus on continuous improvement eliminates costly offshoring mistakes. Thus, firms that are offshore outsourcing are changing the governance structure to take more control as they come to expect benefits beyond lower cost from their suppliers.

Also in line with this, Technology1 participants believe that further improvements in the process of purchasing services from offshore providers can ultimately lead to greater success in meeting the company's established goals. Air notes that "there have been a number of improvements made since our early offshoring efforts. This includes a focus on the organizational structure, processes, and the governance mechanisms for offshore services suppliers. We have to have a robust governance structure in place, which is another learning that we are starting to incorporate. We thought the ones that were outsourced – we could let them do their own thing. Now we realize that they are important part of our business and they need interaction with a number of people in the organization, not just the group that is responsible for supplier outsourcing".

Despite the investments that the case firms had made in their suppliers, and the acknowledgement of these suppliers' contribution to their success, many of the cases also acknowledged a need and a willingness to look for the next low-cost country. This leads us to formulate the following proposition, building equally on all three theoretical lenses of IT, TCE and RBV:

**Proposition 5:** There are shifts in geographical location of offshore outsourced services to “chase” advantage in efficiency and effectiveness.

This proposition is based on a combination of IT, TCE and RBV, as the evolution in the offshore outsourcing perspective comes full circle. From an institutional theory perspective, when the external conditions and pressures change, preferred offshore outsourced locations may or may not change, depending on the perceived advantage. India is still considered an attractive outsourcing location, although many other geographical locations have emerged that offer the opportunity to gain an educated resource pool with lower labor costs. TCE encourages looking at the most efficient and effective location. Automotive explicitly felt that China would be competitive with India in the long-run. Air, Technology2, Finance2, Technology1, and Software all claim that the labor market in India has become incredibly competitive and the wage rates are rising rapidly. Throughout discussions with the case company representatives, one of the key objectives of the purchasing process was that of environmental monitoring or trying to understand new markets and new opportunities. Most of the case companies identified a number of other locations that are currently being considered, including the Philippines, China, Malaysia, Russia, and Ireland. A goal of each of the case companies is to better understand the culture and specialized skills of each geography. Each of the case companies develops strong relationships

with its suppliers, clearly defines its specifications and requirements, and has clear channels of communication.

According to the Technology1 participants, to maintain the positive outcomes achieved thus far requires continued monitoring of emerging and established markets to determine the next trend. Due to the competitiveness of the industry in which Technology1 operates, members of the organization feel a need to position the company to be flexible and adaptable to changes in the business.

Air is also constantly evaluating its offshoring mix, “You can get a 10% savings in Canada with very low risk and it’s easy to travel, or you can get a 40-50% savings in India with the risk associated with being in another country that is half way around the world. Would you take less of a savings to have 10% of your calls in a nearshore location? What is that perfect blend of geographic dispersion that changes your risk profile combined with changes in economics? That is something that we are kind of just working through but without as much science. We have reached a point where we have enough in India, we need to go somewhere else, but we couldn’t tell you why enough in India is enough. I would love to see some more rigor around what is the perfect blend of financial benefit and geographic risk.”

Interestingly, from the RBV perspective, Finance2 participants feel that the company knows how to offshore and how to migrate functions, interpreting it as a capability. In fact, this ability is viewed as a core competency, rather than relying on specific suppliers for unique sources of competitiveness, which can be replicated by the supplier’s other customers. As Finance2 moves to different offshore locations it believes it can use its lessons learned to select the most competitive suppliers, to reduce costs and reduce time to market.

## 5. Discussion

This section highlights the key findings and the intersections of the theories (shown in Figure 2). First, the intersection of institutional theory and RBV points to the opportunity for the right mix of internal and offshore outsourced labor in the human resource base. The intersection of RBV and TCE highlights that it is essential to recognize supplier dependence risk, due to specific assets developed by suppliers adjusted to the particular needs of the company. The intersection of TCE and institutional theory emphasizes how companies recognize external environmental pressures and have to react to these, by changing the way in which suppliers are managed, and perhaps even the location of the offshore outsourced suppliers.

[Please insert Figure 2 about here]

The intersection of all three theories points out that there are various aspects to simultaneously consider in the offshore outsourcing decision, such as balancing the opportunities of offshore locations and the associated threats, with appropriate governance mechanisms. This analysis highlights the power of combining theoretical perspectives to gain additional insight into complex phenomena.

As expected, the case studies showed an evolutionary pattern in regard to offshore outsourcing of services. These patterns have been translated into theory-driven, testable propositions. Highlighting the relationship among the propositions, Finance3 noted that it followed a phased approach in its call center transition, essentially moving through the first three propositions in the order shown in Table 7.

[Please insert Table 7 about here]

This pattern and the associated relationships among the propositions are shown in Figure 3. As in Proposition 1, from an institutional perspective, the possibility of offshore outsourcing came to seven of the nine case firms' attention because other firms were doing it. They felt some pressure to get involved, or be left behind. There are some exceptions to this pattern among two of the case firms. Finance2 was an early adopter which acted primarily from a transaction cost perspective. A leader in the area of offshore outsourcing, it focused largely on total cost of ownership savings opportunities as a driver, without regard to what the rest of the industry was doing. On the other end of the spectrum was Packaging. While it saw firms around it offshore outsourcing, it had no plans to follow. It only became interested in offshore outsourcing when it was under *internal* pressure to reduce costs dramatically. It was the information technology function, rather than top management or other external institutional pressure that caused Packaging to finally offshore outsource, and then in a very limited scope. In line with TCE theory, Proposition 2 highlights that cost was a key driver for outsourcing for all the case firms.

[Please insert Figure 3 about here]

Among the other firms who felt the institutional pressure, it was this pressure *combined* with the potential for savings, a transaction cost perspective that convinced each of them to offshore outsource. As in Figure 1, they specifically examined the governance question, "What is the right balance of what our organization should do internally, versus when it should rely on the market?"

Once the organizations began offshore outsourcing, all of them except Packaging discovered opportunities to gain more than just cost savings, as shown in Table 6 and Proposition 3. From a resource based view, these companies began to see a way to acquire a unique combination of strategic resources and gain competitive advantage. They began to rely on their

suppliers for improvements in areas such as quality, innovation, process improvement, risk reduction, and flexible capacity. They came to see the supplier's capabilities as an important part of their organization's competitive capability. Packaging chose to keep its offshore outsourced supplier at arm's length, limiting its contributions to very routine programming maintenance, and very encapsulated tasks. At the intersection of Institutional Theory and RBV in Figure 1, this is shown as focus on "What is the best source of labor for our services?" Here, the firms had gone beyond just low cost, to also consider their industry competitiveness.

Along with that capability came new risks. While initially the governance focus was on the market or hierarchy, it now focused on how to manage the relationship and the service delivery process itself. The suppliers were developing new capabilities, improving processes and expertise, at the intersection of RBV and TCE in Figure 1. This increased the buying firm's dependence on them. Firms came to understand that in order to retain and grow the supplier's capabilities, while minimizing the risk to their organizations, new governance structures were needed, as in Proposition 4 and Table 6. Packaging was again an exception to this, as were Technology<sup>1</sup> and Finance<sup>1</sup>, as they chose to limit their risk by limiting the suppliers' contributions, and by using a third party to interact with the supplier rather than interacting directly.

At the same time that the buying organizations were realizing the risk of their dependence on suppliers, they were also observing that because so many firms were following the same pattern as they were in offshore outsourcing that the competitive advantages they gained were not sustainable, but required for parity. They needed to move on to other countries, as highlighted in Proposition 5, and shown at the intersection of TCE, Institutional Theory, and RBV in Figure 1.

## 6. Conclusion

At the beginning of this paper, the following two research questions were introduced: “*How does the governance structure and expectations for offshore outsourcing change over time?*” and “*How do institutional theory, transaction cost economics, and the resource based view provide insights into the phenomenon of offshore outsourcing of services?*”.

Concerning the first research question, the case study results have shown that companies’ governance structures and expectations change over time. The findings associated with this question are summarized in Tables 4 and 6. Regarding the second question, we have provided support that these three theories hold particular potential for application in the offshoring context.

Both of these topics are discussed at more length below, in the theoretical and managerial implications. These implications are then followed by a presentation of limitations and potential future research.

### 6.1 Theoretical implications

This research contributes to theory by examining the combinatorial potential of institutional theory, TCE and RBV. The specific insights and findings were presented in the discussion above, and the main insights from the theoretical lenses were summarized in Figure 2. We developed five propositions based on explicit theoretical foundations, which can be addressed in further research. This directly speaks to the lack of theory-driven research that still prevails in offshoring literature. Furthermore, by studying the 9 in-depth case studies we have sought to provide more detailed knowledge of how companies’ expectations in offshoring change over time and how they adapt their governance structures accordingly.

In the area of expectations, we note that companies have received a wide variety of benefits from offshore outsourcing (Table 5), starting from a cost perspective (Table 4). As these often unexpected benefits accrued, companies came to expect them, change the way that they viewed the relationship (Table 7), and change the corresponding governance structures (Table 6). These governance structures have received little attention in academic literature on offshoring, but provide an interesting arena to transfer and compare insights from other governance related research.

The overall intersection of all three theories points out that there are various aspects to be considered simultaneously in the offshore outsourcing decision, such as balancing the opportunities of offshore locations and the associated threats, with appropriate governance mechanisms. This analysis highlights the power of combining theoretical perspectives to gain additional insight into complex phenomena.

## *6.2 Managerial implications*

One of our observations was that industry and cost pressure combine to “push” many firms into following leaders into offshore outsourcing as indicated in Proposition 1 and 2. As discussed with Proposition 3, once they have engaged in offshore outsourcing, they generally realize benefits beyond cost that may contribute to their competitive advantage. However, as competition follows them into offshore outsourcing, this advantage can turn to parity, and even disadvantage as other firms move on to additional countries and services. Consider the example of call centers in India, where skilled low-cost labor was initially in abundance: this labor is now considered a scarce resource with many organizations struggling to maintain and even develop their suppliers’ workforce. Practicing managers need to be aware that offshore outsourcing is a

dynamic, continuously evolving process. To be successful requires constant monitoring to stay ahead of trends and a strategic focus to gain advantage beyond cost. This includes closer scrutiny of supplier relationships, and generally more monitoring and hands-on involvement than the simple concept of “business process outsourcing” many firms may envisage when they first undertake offshore outsourcing of services.

The relationship with the offshore outsourced service provider is also not static. As the relationship evolves, managers may find it necessary to adapt existing governance structures, as noted in Proposition 4. Building flexibility and adaptability into the process of purchasing and managing the offshore service will improve supplier performance and ultimately increase the contribution that the supplier makes to the service delivery. However, buyers should also consider the additional risk inherent in both the supplier’s geographic location and in a relationship with a culturally dissimilar supplier. The case companies found that more control and “hands-on” participation diminished the risk. These controls involved added investments in the process and increased the total cost of doing business. These controls also helped the companies achieve additional benefits beyond the low cost that they initially experienced. Some of the controls mentioned included co-locating employees, involving knowledgeable experts in the process, and rewarding the supplier’s employees to reduce turnover and increase commitment. Offshore outsourcing is a strategic process that requires a “value chain” perspective versus a price focus. Practicing managers should consider embracing offshore outsourcing as strategic in nature, focusing on the relationship with the offshore suppliers instead of focusing strictly on service performance. Continuously improving the process may allow these managers an extended opportunity to enjoy the efficiency and effectiveness inherent in a

region with highly educated, low cost labor (see Proposition 5) which in turn will improve the offshore outsourcing results.

However, practicing managers should keep in mind that whether the advantages of offshore outsourcing are truly sustainable is debatable, but the evidence here suggests that they are not. As Finance2 participants pointed out, it knows how to offshore and how to migrate functions. The accumulated offshore outsourcing experience allowed it to develop the knowledge and skill sets internally to get the most service and value out of its suppliers, creating what it believed was sustainable competitive advantage. In fact, it views this skill set as a core competency and a source of competitive advantage, not the service of the suppliers per se.

Following this last line of thought, as Charles Fine (1998, p. 76) states in his book “Clockspeed”, supply chain design is really about choosing the company’s capabilities. As such, supply chain design is the ultimate core capability. He notes that since no advantage lasts forever “[...] (a) company’s real core capability – the inner core, if you will – lies in the ability to design and manage the supply chain in order to gain maximum advantage, albeit temporary, in a market where competitive forces may change at lightning speed [...]”. We conclude that Fine’s statement provides excellent support for Finance2’s approach. Rather than depend on any specific supplier’s assets, it is much wiser to hone the ability to do a better, faster job of redesigning the outsourced supply chain. Such redesign should consider governance and costs (TCE) and location specific aspects (institutional theory and RBV), using internal expertise developed based on experience (RBV), which is a true source of competitive advantage.

### *6.3 Limitations and suggestions for further research*

There are several limitations of this research that the reader should keep in mind. Due to its in-depth, exploratory nature, only nine firms were studied, which limits the generalizability of the findings. Nevertheless, the generalizability of the results is facilitated by the cross-industry and cross-sector nature of the firms. With further regard to sample demographics, the case companies represented large firms, with gross revenue ranging from approximately \$3 billion to almost \$200 billion.

Moreover, the data was collected at a snapshot in time. As interviews were one of the main data collection methods applied, the information mainly relies on the memories of key informants, which are not infallible. Therefore, a fruitful avenue for future research would be to perform a follow-up longitudinal approach to see what has occurred since the inception of offshore outsourcing for these organizations.

Based on the research conducted here, as well as the inputs of the practitioners we studied, further research is also needed to test the choice of governance models among hybrid make and buy decisions. The questions should focus on both the prescriptive and descriptive aspects of offshore outsourcing. For example, trying to understand why firms select the particular model that they do. Also, what drives firms to change or adapt the models? Are certain models more successful under certain sets of circumstances? Are the patterns in offshore services outsourcing today truly unique, or can we learn much based on what has been done in offshore outsourcing of goods? Are today's service outsourcing firms much like the contract manufacturers that are so prevalent and well developed in electronics manufacturing and elsewhere?

More insight is also needed into how companies balance the potential risks of outsourcing versus the cost savings. Do companies have a formal process to identify and place a value on the different risks associated with offshore outsourcing? Does the cost of preventing or buffering these risks come into play when in the costs savings associated with offshore outsourcing?

Finally, looking at how offshore outsourcing relationships, governance, and geographical foci evolve over time using a longitudinal study could produce very managerially relevant insights. In 1986, Porter published his landmark work *Competition in Global Industries*. This collected work of research studies from a variety of authors explored patterns in global competition primarily from the perspective of owned resources. Such a collection needs to be replicated for the new world of offshore services outsourcing. There is much to learn about the emerging patterns in offshore outsourcing from both theoretical and practical standpoints.

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**Figures**

Figure 1. Drivers of offshore outsourcing.

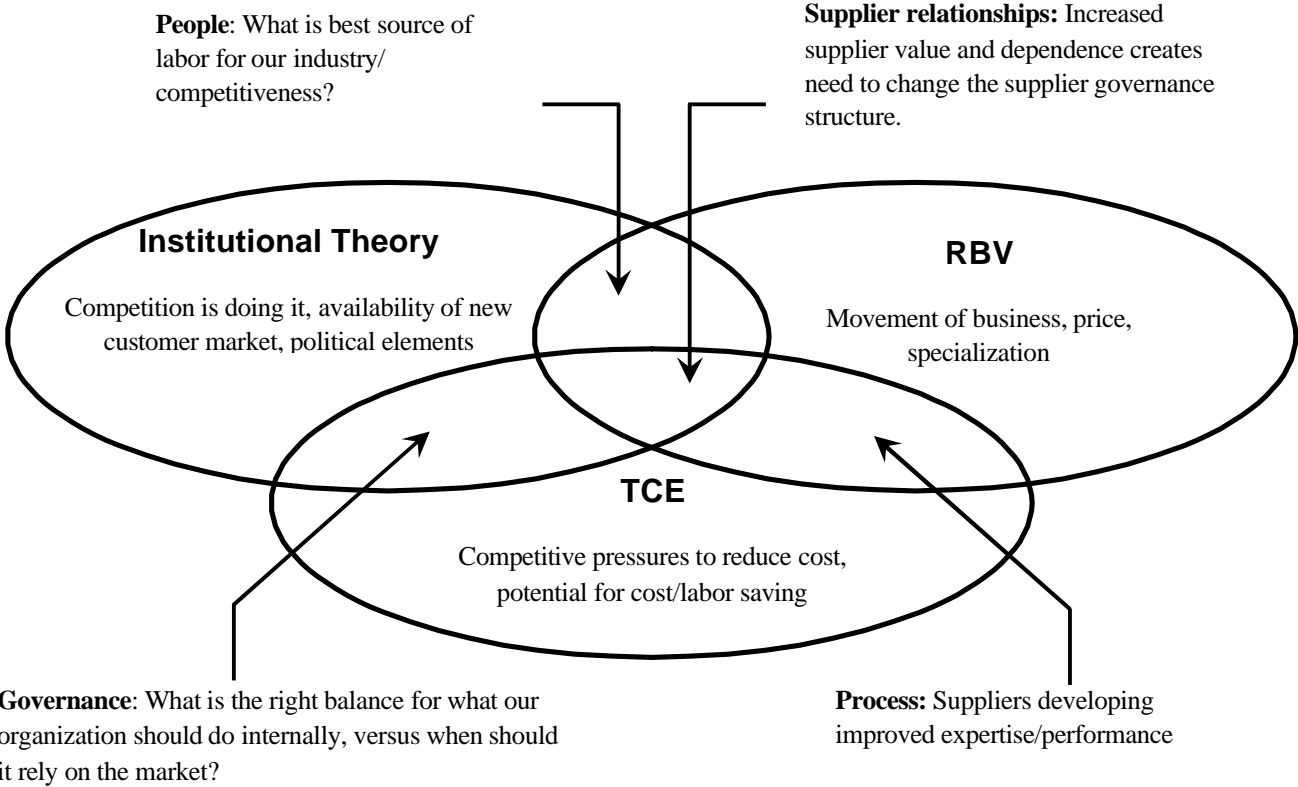


Figure 2. Application of theoretical lenses to offshore outsourcing

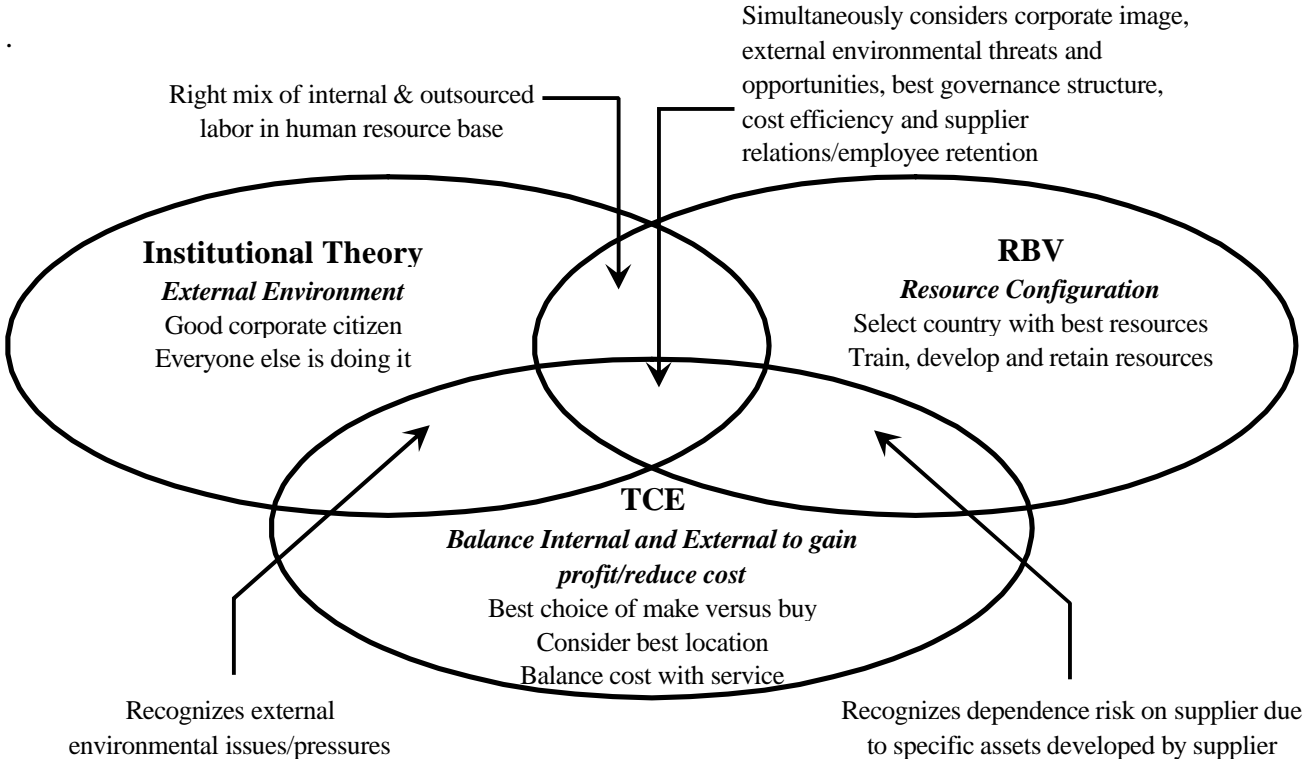
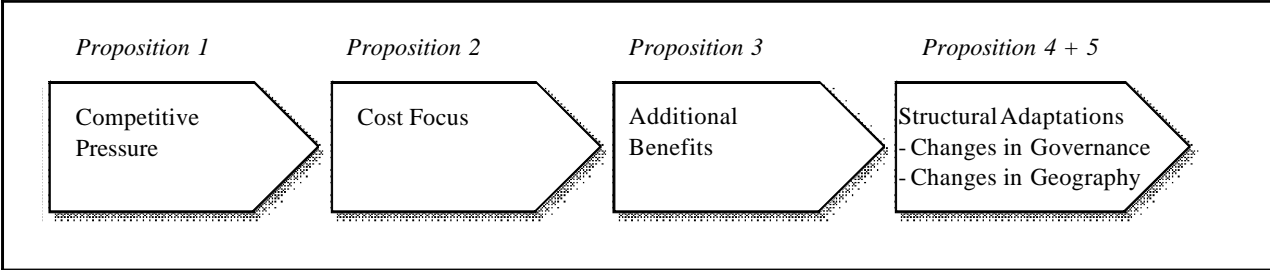


Figure 3. Evolution of offshore outsourcing.



## Tables

Table 1. Research Design

|                            |                                                                                                                                                                                                                                                                       |                                                                                                                                                                                                                                  |
|----------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Target organizations       | Organizations with experience regarding offshore outsourcing                                                                                                                                                                                                          |                                                                                                                                                                                                                                  |
| Interviewees               | Managers and experts of respective offshore outsourcing project                                                                                                                                                                                                       |                                                                                                                                                                                                                                  |
|                            | Selection criteria (managers and experts)                                                                                                                                                                                                                             | <ul style="list-style-type: none"> <li>- Individuals engaged in offshore outsourcing decision making</li> <li>- Individuals managing offshore outsourcing process</li> <li>- Individuals bringing in expert knowledge</li> </ul> |
| Data collection method     | <ul style="list-style-type: none"> <li>- Interviews; internal project documentation (e.g. project organization and phases); external company information (e.g. website)</li> </ul>                                                                                    |                                                                                                                                                                                                                                  |
| Structure of interviews    | <ul style="list-style-type: none"> <li>- Structured according to clarification of motivators of offshore outsourcing decision, pre-project expectations, outsourcing process phases and discussion of project outcomes</li> <li>- Duration: 1,5 to 3 hours</li> </ul> |                                                                                                                                                                                                                                  |
| Additional data collection | <ul style="list-style-type: none"> <li>- Internally and externally available documents concerning general company background and industry</li> <li>- Internal company documents regarding respective project</li> </ul>                                               |                                                                                                                                                                                                                                  |

Table 2. Case company sample

| Company     | Industry                       | Number of Participants | Services Offshore Outsourced      |
|-------------|--------------------------------|------------------------|-----------------------------------|
| Software    | Application Software           | 8                      | IT<br>Call Centers                |
| Technology1 | Technology - Telecom           | 5                      | Call Centers                      |
| Technology2 | Technology - Hardware          | 7                      | Call Centers                      |
| Packaging   | Manufacturing                  | 2                      | IT                                |
| Finance1    | Financial Services - Insurance | 6                      | Back Office                       |
| Finance2    | Financial Services - Credit    | 10                     | Call Centers<br>Back Office<br>IT |
| Finance3    | Financial Services - Credit    | 2                      | Call Centers<br>Back Office<br>IT |
| Air         | Airlines                       | 4                      | Call Centers                      |
| Automotive  | Automotive Mfg.                | 3                      | IT Services                       |

Table 3. Overview of how validity and reliability were addressed in the nine case studies

| Test                              | Tactic                                                                                                                                                                         | Implementation in Cases                                                                                                                                                                                                                                                                                                          |
|-----------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Construct Validity Credibility    | <ul style="list-style-type: none"> <li>• Use multiple sources of evidence</li> <li>• Establish a chain of evidence</li> <li>• Key informants review draft of report</li> </ul> | <ul style="list-style-type: none"> <li>• Gathered multiple documents</li> <li>• Use of multiple informants with differing internal perspectives</li> <li>• Research team members gave input during data collection and analysis</li> <li>• Key informants and other members of the organization reviewed the write up</li> </ul> |
| Internal Validity Integrity       | <ul style="list-style-type: none"> <li>• Pattern matching</li> <li>• Explanation building</li> <li>• Rival explanations</li> <li>• Logic models</li> </ul>                     | <ul style="list-style-type: none"> <li>• Investigated patterns across the case studies</li> <li>• Examined decision making rationale in the Offshore Outsourcing process</li> </ul>                                                                                                                                              |
| External Validity Transferability | <ul style="list-style-type: none"> <li>• Use replication logic in multiple case studies</li> </ul>                                                                             | <ul style="list-style-type: none"> <li>• Conducted B2B multiple studies in different industries</li> </ul>                                                                                                                                                                                                                       |
| Reliability Dependability         | <ul style="list-style-type: none"> <li>• Use case study protocol</li> <li>• Develop case study data base</li> </ul>                                                            | <ul style="list-style-type: none"> <li>• Refined and implemented study protocol with all firms</li> <li>• Created a case study database</li> </ul>                                                                                                                                                                               |

Source: Ellram (1996), Flint et al. (2002), Voss et al. (2002), Yin (2003)

Table 4. Cost driven reasons for offshore outsourcing

| Case Firm   | Statement                                                                                                                                                                                                                                                      |
|-------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Finance (1) | The costs of doing business in India are significantly less than in the United States. Allows us to manage costs                                                                                                                                               |
| Software    | It was really the low cost of labor, hopefully high quality agent                                                                                                                                                                                              |
| Technology1 | Offshoring to India was seen as an opportunity to gain a well educated workforce at a price that was considerably less than the domestic environment                                                                                                           |
| Technology1 | There was a deficit in the budget where we had to do something to gain back cost and competitive advantage. The intent was to save money, to reduce the amount of money that was going out                                                                     |
| Technology2 | We have been able to realize substantial financial benefits by going to lower cost locations and being able to get the same service or similar enough service at lower costs. We save 70% of the cost, or we are able to triple the resources at the same cost |
| Air         | Given its post 9/11 financial situation, significantly reducing costs, was a very key driver in determining to move forward with outsourcing                                                                                                                   |
| Packaging   | When top management challenged each area of the company to reduce costs, the Information Technology group suggested we try India                                                                                                                               |
| Finance3    | Driven by the economic benefits                                                                                                                                                                                                                                |
| Automotive  | It is, of course, possible to achieve, at lower costs, a similar quality as compared to an onshore provider                                                                                                                                                    |

Table 5. Non-cost benefits of offshore outsourcing experienced

| Aspects                         | Example                                                                                             | Software | Technology1 | Technology2 | Packaging | Finance1 | Finance2 | Finance3 | Air | Automotive |
|---------------------------------|-----------------------------------------------------------------------------------------------------|----------|-------------|-------------|-----------|----------|----------|----------|-----|------------|
| Cultural aspects                | Foothold into new geography (includes integration of other cultures, global leadership perspective) | x        | x           | x           |           |          |          | x        | x   |            |
| Risk                            | Reduction of risk (redundancy of offerings across the globe)                                        |          | x           | x           |           |          |          | x        |     |            |
| Market entry into new economies | Geographic core competency-untapped markets                                                         |          |             | x           |           |          |          | x        | x   |            |
| Gain reputation                 | Promotion of products/services in new market                                                        |          |             |             |           |          |          |          | x   |            |
| Access to resources             | Increased quality                                                                                   | x        | x           | x           |           |          | x        | x        | x   | x          |
|                                 | Access to educated employees                                                                        | x        | x           | x           |           | x        | x        | x        | x   | x          |
|                                 | Scalability: Available resources to help growing customer demand and availability in demand         | x        | x           | x           |           | x        | x        | x        |     |            |
|                                 | Flexible delivery (24/7): Better service for all customers                                          |          | x           | x           |           |          |          | x        | x   |            |
|                                 | Flexible capacity                                                                                   |          |             |             | x         |          |          |          |     |            |
|                                 | Innovation                                                                                          |          | x           | x           |           |          | x        |          |     | x          |
|                                 | Organizational learning                                                                             | x        |             | x           |           |          |          |          |     |            |
|                                 | Capacity enhancement                                                                                |          |             |             |           | x        |          | x        |     |            |
| Process improvement by talent   | New/Improved technology                                                                             |          |             |             |           |          |          |          | x   |            |
|                                 | Process improvement/reengineering                                                                   | x        |             | x           |           | x        | x        | x        | x   | x          |
| Market potential                | Increased market share                                                                              |          |             | x           |           |          |          |          |     |            |

Table 6. Examples of governance changes

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| Example from Case Studies                                                                                      |
|----------------------------------------------------------------------------------------------------------------|
| Co-locate employees at the supplier site                                                                       |
| Co-locate employees at the employee site                                                                       |
| Project management using suppliers resources                                                                   |
| Treat suppliers like employees (or an extension of the firm i.e. strategic planning and regular communication) |
| Hand's on involvement at the supplier site                                                                     |
| Documented continuous improvement plans                                                                        |
| Differentiation to suppliers employees i.e. training, work environment                                         |
| Internal reorganization of the process – to make the process better                                            |

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Table 7. Example of evolutionary change in case company Finance3

|         |                                                                                                                                                                                                                                                                                             |
|---------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Phase 1 | Finance3 was growing very quickly. It ran out of capacity to do everything itself on a timely basis and was aware that competitors were outsourcing services extensively. Therefore, it got a few trusted suppliers to add significant call center capacity to help supports its expansion. |
| Phase 2 | Finance3 was feeling cost pressures from the market. It next moved into focusing on building an expanded network of offshore suppliers that could give it different cost options to support its competitiveness.                                                                            |
| Phase 3 | Finance3 was focused on improving capability beyond cost, with a desire to enhance service offerings. It thus focused on expanding relationships with suppliers who could do more than simply reduce costs.                                                                                 |