

# The Perilous Effects of Capability Loss on Outsourcing Management and Performance

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**ABSTRACT:** *The recent industrial revolution has witnessed outsourcing of manufacturing and business activities as a pivotal business practice. But alarmingly high proportion of outsourcing activities is not generating optimal results. To achieve dramatic cost saving objectives, many outsourcing activities are interconnected with the organization's resources, and cause the dismantling of the resources which direct the organization to an operational capability loss on account of an outsourcing firm. Amazingly, very little research has been conducted regarding this issue if capability loss which is intermittently correlated with the outsourcing firm. The purpose of this study is to deal and pursue with this contrition.*

*It is possible to avoid the seven deadly sins of outsourcing by a dynamic evaluation of the initiatives of outsourcing activities. Outsourcing provides us the advantage of double out the net income while the revenue remains the constant.*

**Keywords:** Knowledge-based theory of the firm, Relationship management Capability loss, Outsourcing performance, Capability evaluation

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This research article addressed the recent global trend of outsourcing and its adverse effect on the capabilities of the outsourcing organization. This research has dug deeper into this problem to find out the reason of outsourcing and the basic objective of it.

Every business industry has tried to outsource their businesses specifically in manufacturing (sturgeon, 2002; Tully, 1994; Wilhelmsson, 2004) and also in Information technology. (Couto et al., 2006; Corbett, 2005). From this outsourcing trend growth it is clear that outsourcing is suitable, but if we see the results of outsourcing they are not much satisfactory (Doig et al., 2001; Landis et al 2005; Robinson et al., 2008),

According to Deloitte consulting study reported that the 64% of the total outsourcing firms realized their loss in outsourcing services. It has created a large number of dissatisfied customers. The 44% of the firms have not yet realized their cost loss and now a days it is also a topic of research by many industries that whether the set objectives of the outsourcing organizations are being achieved in practice. (e.g. Masten et al., 1989; Monteverde and teece, 1982; Novak)

And in somewhat the research has proved that the theoretical prescribed strategies are compatible with practical results. (Gopal et al.,2003; Lee et al., 2004 Leiblein et al., 2002; Poppo and zenger, 20020. The worst results of outsourcing are demanding to conduct more research on the drivers of outsourcing. Various studies and researches in the past depicts that the majority in driving of outsourcing is the cost saving objective and in order to find cheap labor and even in many cases they choose to layoff there staff or employees, in some cases their employees are transferred to outsourcing destinations.

The consequences of the internal capability loss (human & physical assets) which are being at their use are usually treated bad and are directly affected by this entire process

The outsourcing (management & performance) and the research is an attempt to figure it out.

The capability of the firm and outsourcing are highly interrelated because the (internal) capability of any firm has a deep impact on the firm's decision.

Specifically this current study creates the better understanding in how to make a better and long lasting communication and relationship between the outsourcing service provider and the outsourcing company to cope the situation with capability loss.

## The Seven Deadly Sins of Outsourcing

Outsourcing means, to use someone else capabilities outside the organization to work for another organization partly or completely considering in the benefits provided. In the manufacturing industry all the operations activities of manufacturing can be outsourced, but in service industry only the basic service activities can be outsourced not all of service activities. Now a day's every company is outsourcing their activities to save the cost in comparison to previous eras, where companies use outsourcing only in the bad financial era whereas is outsourcing now a days is a recent trend.

According to latest research, that if outsourcing activities are planned carefully then it could result better performance of an organization while the outsourcing is not providing the result according to expectation of outsourcing due to carelessness. Outsourcing provides us the advantage of double out their net income while the revenue remains the constant. Outsourcing is a powerful tool to increase the performance of the organization.

Through outsourcing, the organization can transfer its weak departments or weak production capabilities to an expert outsourcing provider and by transferring their activities, whereas company focus on its core activities. At one point the outsourcing seems to be a profitable tool by cutting costs, but on the other hand the outsourcing fails to come up with the expectations of management and results all the failed efforts of outsourcing.

There are some deadly sins in choosing outsourced services; due to these it doesn't provide the results according to the expectations.

1. The outsourcing activities which were not supported to outsourcing are being outsourced.
2. Selecting the wrong outsource service provider.
3. Writing the weak term and conditions of the outsourcing contract.
4. Failing to address the personnel and job insecurities of outsourced organization' employees.
5. Losing the command over special capabilities of the outsourcing organization.

6. The outsourcing organization is neglecting the hidden costs of outsourcing activities.
7. Failing to plan the ending contract strategies. In this case organization fails to end the contract in time and switch the other vendors.
8. Organizations need to minimize the seven deadly sins by using expertise and better decision making in choosing the best vendor for their activities.

### **Literature Review**

Elements of capability literature are resource base view; knowledge base view and relationship view and inter organization competitive advantage. These three perspectives states that management firms specific resources or capabilities are the main drivers of firm's sustainable competitive advantage. In addition to the traditional resource based perspectives, the relational view states that combinations of firm's strategic resources within and beyond the boundaries create a different competitive advantage or specific capabilities. Our main purpose is not to provide a whole review of impressive bodies of literature but to discuss the prominent element of these theoretical perspectives, as they have a relationship with outsourcing performance and management.

### **Capability Evaluation**

It is defined as an extent to which the outsourcing team evaluates the strategic value and importance of the capabilities and resources associated with the business activity. The prominent theoretical perspective being used to determine the decision making within firm boundaries is the resource based view of the firm. Resource base view theory tells that the precious capabilities of the firm are very important to get a sustainable competitive advantage. These sustainable advantages can be extracted from the possession of assets, which are valuable that improve efficiency and effectiveness, and are rare or they have not many close strategic substitutes. The firms should only outsource those activities in which the firm capabilities are weak or normal. The basic competency of the firm is to utilize effectively all the resource combination. The organization should develop some of core competency internally and should outsource remaining activities.

Before outsourcing any activity firm should evaluate the strategic value of the capabilities needed for those activities which are being outsourced. Firm's capability and strategic value evaluation should be forward looking

because less important capabilities of firms can be basic capabilities in the future. Capability evaluation is the extent to which the outsourcing team evaluates the strategic value of capabilities and resources associated with business activities considering the organization current and anticipated resources of competitive advantage.

### **Capability Loss**

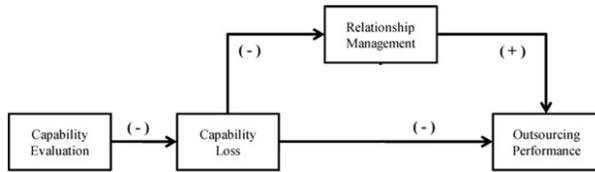
Outsourcing is also a cause of bearing losses of internal operational activities of the firm, which are linked with the outsourced activities. Outsourcing decision permanency is based on capability loss. Outsourcing also eliminates all departments of the firms as well as associated resources i.e. Human and physical resources. Many authors say that assets are wasting, layoff and downsizing of employees are due to outsourcing. It also causes a loss of human resource. The organization believes that the resources related to outsourcing activities don't contribute to basic competency of a firm.

For example. An outsourcing contract was made between the IBM and GEODIS in 2003. IBM transferred its 1, 20,000m of warehousing to logistic provider. The present trend is to acquire the whole production facility to outsource provider. In many cases the big human resource loss is done due to outsourcing. When outsourcing firms do not transfer their employs it results in a mass layoff of employees. It can be a huge capability loss for a firm and it loses important and expert employees.

### **Relationship Management**

For this study purpose relationship management is the extent to which outsourcing firms has develop committed, cooperative relationship with the outsourcing provider. Many marketing and supply chain management researcher showed in their results that the building of relationship management is multidimensional in nature, including elements cooperation and commitment between two parties. Many firms are investing in relationship management but many of these firms dissatisfy in investing relationship management unless a high level of trust and mutual commitment are not present. Commitment is very much important in the effective cooperation in relationship management. In prior studies effects of cooperative and committed relationships on outsourcing performance has been investigated but the impact of capability loss on outsourcing firms, capability to establish and maintain such relationship has not been addressed.

**Hypothesis**



**Influence of Capability Evaluation on Capability Loss**

A Deloitte consulting study of 300 managers and executives showed that only 37% of firms conducted business assessment plan, when they outsourced, and the results also showed that 62% outsourcing firms need more management resources than they actually have.

While making a buying decision, the firm should understand the strategic value of all activities of outsourcing organization and outsourcing activities should be taken according to importance. The sustainable competitive advantage comes from the strategic value of capability and resourcing. This evaluation showed that the previously important capabilities can be relevant but not of great importance now.

It is incurred from different theoretical foundations that those firms which don't evaluate the strategic value of capabilities and resources properly related to the business activities are at more risk of disposing the capability. It actually should retain with it for its well being, and before the outsourcing organization should identify the outsourcing experienced personnel team, who will deal or manage outsourcing properly. In this evaluation the capable personals should be identified without considering the exit strategy, the layoff of these employees can be a great capability loss for an organization.

Same with the good and thorough evaluation, the organization can better understand the resources it needs to better manage the outsourcing activities, while lack of capability evaluation will result in the loss of those important capabilities and resources.

**H1: Capability evaluation has a negative effect on capability loss, ceteris paribus**

Outsourcing firms that have mostly experienced capability losses in the form of employee layoff, or transferred to the outsource provider, means that the

employees who are more experienced are usually being outsourced or laid off. It is a difficult situation to manage for the outsourcing firms. Firms should retain those most capable people, that are the boundary spanners and plays an important role within the firm and between both firms. The firm should be careful before losing those capable personals. This kind of teams should be retained which has all types of knowledge and effective communication skills with the outsourcing provider. By losing these key employees outsourcing firms cannot evaluate fairly. The value of work done by the outsourcing provider cannot be properly administered or evaluated in absence of these highly skilled professionals. So when the firm suffers from this important capability loss, and suffer losses in the form of boundary spanner significance, commitments and mutual co operations, relationships cannot be developed between outsource providers and outsourcing firms. Whereas committed and cooperative relationship and significant relationship is beneficial for the both outsource provider and outsourcing firm.

**H2: capability losses have a negative effect on relationship management, ceteris paribus**

Economic values can be generated by extreme relationship, which cannot be separately generated. The relational rent of this relationship management is supernormal profit. All concepts lead towards the synergy approaches. This relational view shows that the relationship exchange adds more economic value, more wide range knowledge sharing and minimum cost of the transaction and also superior operational performance of the supplier or outsource provider. This relationship not only gives economic value but also increases the learning between the both firms. They build the committed and cooperative relationship between the buyer and supplier and it results in extraordinary performances.

**H3: Relationship management has a positive effect on outsourcing performance, ceteris paribus**

This hypothesis can be supported with the multiple theoretical perspectives e.g. Transaction cost theory, Knowledge base view, Resource base view and Relational view of the entire organization. In transaction cost theory the concept is a small number of bargaining means, the outsourcing firm decreases its alternative getting supplies. By doing so outsource provider organizations can be opportunistic and outsourcing firm is in loss. For this problem outsourcing organization should have complete monitoring of the outsource provider which increases the outsourcing cost.

The second alternative is to get back the outsource work/activity which is very difficult and expansive after losing the resources and capabilities. In resource base view, the outsourcing firm can lose its many capabilities. In knowledge base view, by delivering the outsourcing firm core knowledge to the outsource provider is very harmful and by doing so a same service business can be initiated by the outsource provider. In relational view of inter organization, outsourcing firm should retain its skills with it because two firms make relational rent while working in a committed and cooperative relationship but this relation is destroyed it decreases to zero.

**H4: Capability losses have a negative effect on outsourcing performance, ceteris paribus**

**Methodology**

The overall research objectives after choosing a local outsourcing organizations and conduct a complete analysis of that organization by interviewing the top hierarchical staff

Research objectives

1. To evaluate Influence of Capability Evaluation on Capability Loss,
2. Influence of capability loss in relationship management,
3. To find that if capability losses have a negative effect on relationship management,
4. If capability losses have a negative effect on outsourcing performance.

The research conducted would be qualitative in nature. The instrument designed would contain all the basic questions to prove the hypothesis generated in order to get a better insight of decision making & logic and reasoning for choosing an outsource provider. Snow ball sampling technique was used to conduct the research.

The maximum sample size was be around thirty executive class personals altogether.

Likert scale is used in measuring the target population’s response. The present study consists of the survey questionnaire. Our sample size was 33 managerial groups of decision makers in various production firms. The instrument designed was divided into a) Capability evaluation b) Capability loss c) Relationship

Management. d) Relationship-specific management. e) Competitive differentiation. f) Outsourcing performance.

Hierarchal regression is used to test the hypothesis.

**Results and Discussion**

**Correlations**

	Cronbach $\alpha$	Mean	Standard deviation	Capability Evaluation	Capability Loss	Relationship Management
<b>Capability Evaluation</b>	.688	3.7879	.57626	1		
<b>Capability Loss</b>	.727	3.4343	.61512	.513(**)	1	
<b>Relationship Management</b>	.811	3.2374	.62226	.053	.489(**)	1
<b>Outsourcing Performance</b>	.809	3.4545	.64182	-.266	.038	-.318

**Interpretation of Correlation Matrix**

According to the Pearson correlation there is a positive relationship between capability evaluation and capability loss is 0.513. It shows near to the moderating relationship between two variables. It is a significant relationship and is statistically acceptable. Capability evaluation presents positive relationship between relationship management is 0.053 it is positive relationship but not significant. The capability evaluation has a negative relationship with outsourcing performance is -0.266 which is not significant and hence statistically rejected. The relationship between capability loss relationship management is positive and significant 0.489. It is statistically acceptable. The relationship between the capability loss and outsourcing performance is positive but not significant. Its value is 0.38. The relationship between relationship management and

outsourcing performance is -0.318 so it is not significant and hence statistically rejected.

**Measurement Assessment**

As shown in table 1 Cronbach’s alpha’s value was calculated for each construct. Cronbach’s alpha’s value of four constructs; Capability loss, Capability evaluation, relationship management, and outsourcing performance is more than the suggested level of 0.60 hence no value is less than 0.5, so it shows a high level of reliability in data.

**Testing Hypothesis Results**

Our research results show that regression analysis of 33 outsourcing decision results in insufficient capability assessment can direct to more substantial capability loss.

**Capability Loss**

The research finding discussed shortly as a result in this study shows that the capability loss has a negative impact on the outsourcing performance and also it has a negative impact on the firm’s ability to develop, cooperate and build a committed relationship with outsourcing provider. This shows that the factors which contribute to the capability loss are much valued as we generated a hypothesis that the lack of an extensive capability evaluation results in the higher capability loss when outsourcing.

The reason of higher capability loss is that the firms do not conduct a comprehensive capability evaluation, so they can’t recognize the organization’s strategic values.

**Capability Loss and Relationship Management**

As our second hypothesis was that the capability loss in relationship management, this is also shown in the results as more a capability loss occurs by the outsourcing firm, it is more difficult for the firm to develop a cooperative and committed relationship with an outsourcing provider. As the prior research results show that some of the outsourcing firms employ plays the role of boundary Spanners.

Theses boundary Spanners have special skills of various kind to negotiate with the outsourcing provider.

So by combining this by our hypothesis it can be seen that these boundary Spanners must be taken great care and should be retained as an effective relationship team. Otherwise outsourcing firm can face the relationship management and communication problems with outsourcing providers. So by controlling this by our hypothesis it can be noticed that these boundary Spanners must be taken great care and should be

Model Summary						
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate		
1	.595 <sup>a</sup>	.354	.287	.54201		
Relationship between dependent and independent variable is .595 and rate of change of independent variable and dependent is .354.						
Coefficients						
Model		Unstandardized Coefficients		Standardized Coefficients		Sig.
		B	Std. Error	Beta	t	
1	(Constant)	5.541	.789		7.022	.000
	Capability Evaluation	-.607	.201	-.545	-3.022	.005
	Capability Loss	.629	.215	.603	2.922	.007
	Relationship Management	-.602	.183	-.584	-3.290	.003
The result shows that the capability evaluation has negative effect on outsourcing performance which is +60% and beta value is minus .545 and t= minus3.022. capability loss has positive relationship with outsourcing performance at 62% beta value is .603 and t=2.922. relationship management has negative effect on outsourcing performance at minus62% beta value is minus.584 and t=minus3.290.						

retained as an effective relationship team. Otherwise the outsourcing firm can face the relationship management and communication problem with outsourcing provider.

### **Relationship Management**

We generated a hypothesis that the relationship management with the outsourcing provider has a positive impact on an outsourcing performance. Our prediction was that the cooperative and committed, share the knowledge and information more extensively and makes customers help in jointly improving the products.

The results show a significant support for the hypothesis and other studies shows that a committed buyer and supplier relationship has a positive impact on changed performance. So a firm should emphasize tremendously in developing a cooperative and committed and mutual relationship with an outsourcing provider.

### **Capability Loss and Outsourcing Performance**

Our hypothesis was that a more capability loss has a negative impact on outsourcing performance and this hypothesis is being supported by our research data, because the direct impact of capability loss on outsourcing performance is significantly negative.

Theoretical model also tells that the relationship management has an effect on relationship between capability losses and outsourcing performance and the statistical results also shows that this effect is partial.

Further it is noted that these effects remain unchanged after controlling the potential modeling influence of relationship specific investment, core knowledge factors, competitive differentiation and volatility. So there is a significant support for the negative impact of capability loss on outsourcing performance, so the result of our analysis show that the capability loss on the base of transaction theory and knowledge based perspective in hypothesis four, it was argued that to credible due to the threat of bringing outsourcing activity back into home and knowledge transfer difficulty increases the risk of outsourcing provider opportunity because the outsourcing focus reduces the human assets and other assets utilized to perform the business activity which is being outsourced. These factors reduce the firm's ability of bargaining and increases the transaction cost. The outsourcing provider opportunities have a direct negative impact on exchange performance from buyer's perspective.

### **Conclusion and Future Research**

This research identifies four constructs; three are dependents Capability evaluation, capability loss, and relationship management " and one is independent; which is outsourcing performance. The theoretical model has been verified through qualitative practical data. This model was built up from various existing frameworks and shows initial effort to identify, set out and test various fundamental variables and constructs and their hierarchical order. The findings confirmed that SCM outsourcing conditions directly affect the SCM and determination of outsourcing performance.

Thus, on the base of results our recommendation to managers and organizations to evaluate the outsourcing process and decision making in SCM, they should follow the hierarchy of SCM antecedents

This above mention process obviously supports our proposed path model. Someone may ask, what is this paper all about? We have proved that through this research this model and the elements of four constructs have not been properly discussed and elaborated in the isolated literature of SCM as we have done and determined the flow of outsourcing decision making execution processes. Thus, we provide dynamic road map for full execution of SCM.

Practically, before participating with external supply chain partners, the firm should be implementing SCM inside, first and gets inside readiness for achieving significant cost saving from external supply chain partner's cooperation.

The sample size was 33 managerial personals within geographical boundaries of Faisalabad. There was no evidence of prior research found on this issue before conducting this research. There is a lot of potential in this segment of research. Further research would help immensely to dig deeper into perilous effects of outsourcing and capability loss and performance management.

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