



Ahmad H. Juma'h, Ph.D., C.P.A.

Business Service Outsourcing: An Evolution of Concentration on Core Business Concepts and Transaction Cost Economies

Introduction

Transaction cost theory plays a central role in defining the boundaries of the firm (Williamson, 1975) and the identification of the firm's core businesses is important to achieve competitive advantage (Prahalad and Hamel, 1990). Business service outsourcing (BSO) is defined as the transfer of a service function to a third party supplier. BSO is seen as an evolution of transaction cost and core business concepts. The main objectives of the article are to explore the functional importance of BSO reflected in the literature. Also, the article discusses the factors and the drivers suggested as influencing companies to outsource as well as the strategic outsourcing and when a company should outsource.

In evaluating BSO, the article is organized as follows: The following section provides an overview of BSO concepts. The third section discusses the emergence of BSO. The fourth section covers the outsourced function type and the relationship between the outsourced functions and the functions that remain in-house. The

Abstract

Present and evaluate the literature with respect to business service outsourcing (BSO), with a particular concentration on a common form of BSO, information technology (IT). The review defines the issues with respect to BSO in terms of drivers and motivations, as well as internal and external implications for BSO companies and their contractors. BSO is an evolution of transaction cost theory and concentration on core business concepts. Although there are several attempts to explain when a company should outsource, these theoretical frameworks are difficult to apply in practice since satisfaction is a function of expectation and the identification of activities as core or commodity is not straightforward.

* Associate Professor of Accounting, Interamerican University - San Juan P.R.

fifth section discusses particular BSO drivers and motivating factors such as cost reduction, concentration on the core business, problems with meeting performance standards, obtaining new technologies and skills. Section six summarizes BSO disadvantages. In the seventh section, the decision to outsource is discussed. The summary and conclusions are given in the eighth section.

BSO concept

BSO has been defined as the provision of services to an unconnected organization by an outside supplier or consultant who performs those services on the client's behalf (Earl, 1991, Huff, 1991, Friedberg and Yarberr, 1991). Lacity and Hirschheim (1993) consider the definition of BSO even more widely by defining it to include the purchase of goods or services that were previously provided internally, and also including internal BSO in the form of obligation contracting where a specialist in-house entity is established within a multidivisional company to provide a contracted service to other parts of the company. Lacity and Hirschheim, by including the term purchase omit the rather important concept of strategic delegation, which is needed to define BSO in the definition used by most other authors.

Using the generally accepted definition, BSO only occurs where an outsourcing company specifies performance criteria, but leaves considerable discretion about the way the performance is delivered to the outsource suppliers. The service agreement terms and conditions then provide a framework to encourage the supplier to develop (and share) cost effective solutions with the client. Without the strategic dimension in BSO there would be little to distinguish it from a purchase or supply contracts where specification rather than performance provides the basis to the agreement.

Total vs. partial outsourcing

Lacity, Willcocks and Feeny (1996, p. 14) distinguish between 'total outsourcing' and 'total insourcing', by defining 'total ... outsourcing' as "Transfers ... assets, leases, staff, and management

responsibility for delivery of ... services from internal ... functions to third-party vendors, which represents at least 80 percent of the ... budget", and by defining 'total ... insourcing' as "... retains the management and provision of at least 80 percent of the ... budget internally..."

The definition of total BSO as distinct from partial BSO is somewhat subjective. BSO does not mean to outsource 100% of the activities. In most BSO agreements, BSO companies retain at least some of their essential employees to manage the relationship. Also, in-house provision does not mean that companies retain 100% of the activities internally; some parts of the activity may be acquired externally. Companies may select sub-functions to be outsourced and retain other functions. The aggregate number of selected sub-functions in partial BSO is substantially less than the total number of sub- functions that could have been included in total BSO.

The use of 'insourcing' as a reference to in-house provision by Lacity *et. al.* (1996), Jennings (1996) among others introduces a certain amount of confusion. This is because 'insourcing' more logically would refer to a company that maintains a function internally and provides the service of this function to other companies. Effectively the company is an outsource or service provider with respect to the externally provided service, but differs from an outsource provider in having an internal requirement to support. Also, the use of "outsourcer" in the literature reviewed may refer to either the service buyer or the service seller.

The terminology used in the article is that in-house provision occurs when a company provides a function internally, irrespective of whether in-house provision has involved considering BSO alternatives or even the cancellation of pre-existing BSO contracts and re-establishment of the required services internally. BSO company and outsource contractor are used in the article to refer to the company who acquires external services and the company who provides the services, respectively. It follows that a company that is 'insourcing' is simultaneously an in-house provider and an external service provider.

BSO, subcontracting, strategic alliances, and partnership

BSO, subcontracting, strategic alliances and partnerships are used interchangeably in the literature. Indeed the same basic ideas are recycled in a more fashionable guise under a new label. However, describing BSO as a form of subcontracting does not convey all the aspects and features of the BSO phenomenon. Subcontracting would not adequately describe the complexity of the outsourced functions, the questions of interdependency with other activities that have to be resolved and the need to develop incentives to generate synergy which would not generally arise with subcontracting. Also the relationship between BSO parties that may create dependency between BSO companies particularly where assets are specific or alternative suppliers/customers are few.

Authors' use of partnership (e.g., Willcocks and Choi, 1995) to describe BSO is also misleading. Usually they do not mean the strict definition of partnership or that any legal form of partnership or joint venture. The use of partnership is common in describing fee or commission based arrangements that have some of the aspects of BSO but no legal form. Airlines, for example, describe their relationships with each other (code sharing) or hotel or car hire arrangements as partnering although there is no suggestion that any part of their operations is to be conducted by profit sharing partners or that any of their internal capabilities will be altered as a result of their partnership.

An important issue in evaluating the relationship between BSO companies and outsource contractors concerns BSO motivations and drivers. BSO may have tactical motivations as well as strategic motivations (Antonucci and Tucker, 1998). Tactical motivations occur where there will be no presumption that the relationship will be continued/permanent, so BSO may be simply an enhanced form of subcontracting. If BSO is used as a strategic tool, it will generally be linked with re-engineering considerations, alliance strategies and a concentration on core business (Quinn and Hilmer, 1994).

In the article, BSO is defined as the replacement of inputs or value added previously created in-house by the provision of an external provider within a long-term contractual relationship within

which only some of the expected mutual benefits and obligations are formally defined. Thus BSO may be distinguished from a supply contract with respect to:

- 1) The length of contract (BSO uses long contracts with strong expectation of renewal).
- 2) The completeness of contract (BSO contracts are not complete. They define the purpose of the contract and performance standards relative to this purpose but do not seek to define the way in which the contractor delivers the performance).
- 3) The organic or negotiable framework within which benefits and obligations are to be created and shared.
- 4) The service level. BSO is generally characterized by the use of service level agreements, which reflects the need to manage an ongoing process. This contrasts with subcontracting where contracts focus on strict specifications.

The definition also distinguish BSO from alliances and joint ventures with respect to:

- 1) The scope of agreement- the outsource agreement with respect to component or service and unlike an alliance does not involve sharing benefits and obligations arising in the value chain in which the component or service is engaged.
- 2) The completeness of contract- the outsource agreement utilizes service (performance) level agreements to control the contract. Alliances use corporate control and governance procedures.

The emergence of BSO

BSO had its roots in the 1960s, when companies started to contract service suppliers to take responsibilities for processing accounting applications such as payroll, general-ledger transactions, and facilities management services (Markus, 1984). As an example, Electronic Data Systems (EDS) contracted to provide Frito-Lay and Blue Cross with data processing services in 1963 (Mason, 1990). Also, in the 1970s,

specific processing services such as applications and programming were outsourced.

Although in the 1980s the cost of mainframe computers declined and most companies had acquired mainframes or minicomputers, companies had growing confidence in the possibility of BSO and in particular the opportunities it provides to achieve efficiency (Caldwell, 1989). Such efficiency consideration would logically indicate that small and medium sized companies suffering comparative scale disadvantage would find BSO a logical and advantageous option. However, there are examples in the literature indicating that BSO arrangements, at least those that are announced, are concerned with large companies. As an example the decision made by Eastman Kodak in 1989 to contract IBM to consolidate and operate their data centers on a 10-year contract was followed by a number of similar arrangements by other large companies (Loh and Venkatraman, 1992a, b).

In the international arena, BSO has also become a more global phenomenon. Improved and cheaper communication has increasingly allowed many companies to outsource data processing functions overseas (Anthes, 1991b). The BSO is simply not an issue of competitive advantage in terms of scale and scope but large differences in international costs become relevant to adopt BSO internationally. Financial telecommunications and software companies have been prominent in this process of international transfer with telecommunications companies outsourcing their international communication management to cheaper locations (McClelland, 1992). At the same time many service suppliers have re-engineered their business to become partners to multinational companies. For example, British Telecommunications (BT) established a network of alliances to provide multinational companies with a single point of provision for all their international data communications requirements (Booker, 1991).

Core business and outsourced functions

The concept of core business, functions that give competitive advantage and the relation between outsourced function and

remaining functions are important in evaluating BSO. The next section discusses the core-competencies concept and its influences on BSO.

Core business concept

Concentrating on the core business can be considered as a factor that influences companies to outsource non-core activities. In identifying core business, Prahalad and Hamel (1990) introduce three tests to identify core competencies as follows:

- 1) A core competence provides potential access to a wide variety of markets,
- 2) it should make a significant contribution to the perceived customer benefit of the end product, and
- 3) a core competence should be difficult for competitors to imitate.

They argue that building core competencies is more ambitious and different from integrating vertically, and cultivating core competence does not mean outspending rivals on research and development. Identification and separation between core and non-core functions is not an easy task. However, this does not mean that the core business is not an important concept. In distinguishing core competencies, Quinn and Hilmer (1994, p. 45) argue that the effective core competencies are associated with the following characteristics:

- 1) Skill or knowledge sets, not products or functions,
- 2) flexible, long-term platforms, capable of adaptation or evolution,
- 3) limited in number,
- 4) unique sources of leverage in the value chain,
- 5) areas where the company can dominate,
- 6) important to customer in the long run, and
- 7) embedded in the organization system.

Even so it is difficult for a company to identify its core competencies, but this does not imply that the concept is not relevant

to BSO decision-making. Also, companies' views about their function as core or non-core activities are not static and the boundaries between core and non-core activities are not static. One of the functions that believed that they are core business is IT.

Core business implications

In evaluating changes in market environment effect on company's strategies, Prahalad and Hamel (1990, pp. 80-81) conclude that rapid changes in market boundaries, and dramatically shifting patterns of customer choice in established markets, make it increasingly important for management to concentrate resources on core activities in which they can generate competitive advantage. By implication this means then reducing diversity by product and/or reducing diversity by activity.

Quinn and Hilmer (1994), and McFarlan and Nolan (1995) suggest that by concentrating resources on a set of core competencies and outsourcing other activity managers can leverage the company's skills and resources. The specific out-turns from such, as a policy would be to:

- Maximize returns on internal resources by concentrating investment and energy on the company's best (most profitable) activities,
- providing barriers against present and future competitors that seek to enter into the company's area by increasing the competitive position of well-developed core competencies,
- re-engineering activities by using external suppliers' to give access to investments, innovations, and skilled personnel that may not be available or not available at reasonable cost internally, and
- through BSO reduce complexity and allowing BSO companies to be more effective in controlling risks, shorting cycle times, improving asset utilization and creating better responsiveness to customer needs.

Type of outsourced functions

IT and related areas are the most commonly reported outsourced functions. A number of other finance functions ('New directions in finance', The Economist Intelligence Unit, 1995) are subject to BSO arrangements, especially tax (overall or part), payroll processing, asset appraisal/valuations, training, leasing, internal audit, treasury, pension administration, sale and purchase ledger, and management accounting. Only rarely is a total BSO of the accounting system reported.

Type of IT outsourcing functions

Apte (1991) states that BSO is an umbrella term, which covers a variety of information services functions that range from leasing a whole information system or just acquiring one function. Possible examples are:

- Information processing services such as data entry that constitute well defined, and routine activity. Such activities require little interaction between BSO companies and service supplier. They also can easily be separated from other IT activities.
- Contract programming such as software development and maintenance activities. Again these will stand alone, off other activities.
- Facilities management (FM) contracts that replace the responsibility of operation and support of a system or data center.
- System integration (SI) service such as hardware, software, and networking. This covers the functions from design to implementation.
- Support operations for maintenance/services and disaster recovery.

Selecting BSO candidates

Identifying business functions that are likely to generate advantages if outsourced and are, therefore, prime candidates is clearly beneficial for companies. Lacity, Willcocks, and Feeny (1996) identify and distinguish four categories of potential BSO activities.

- 1) Activities that are critical differentiators: These are of high strategic importance since they help managers to distinguish the business from its competitors and gain a competitive edge over their rivals.
- 2) Activities that are critical commodities: These are critical to fulfilling business operations but fail to distinguish the business from its competitors in that all business in the sector must perform them.
- 3) Activities that are useful commodities: These provide incremental benefits to the business but are not essential. Nor will they distinguish it from its competitors.
- 4) Activities that are useful differentiators: these distinguish the business from its competitors in a way that is not critical to success.

In evaluating activities that are candidates for BSO, Lacity *et. al.* (1996) state that companies do not have an exclusive choice between total BSO or not BSO at all but should consider options relative to these categories. The decision to outsource should depend on which activities are critical to competitive advantage and which are essential or useful to business operations. Typically IT is likely to be contributing not only to competitive strategy but also to essential business operations.

Perhaps in theory all the company's functions can be considered for BSO. However, in practice not all functions can be straightforwardly outsourced. Lacity and Hirschheim (1993), in examining the particular case of IT BSO, split types of contracts into three categories.

- "Body shop" BSO. This deals with the hiring of supplementary research capacity. It is short-term BSO such as the use of contract

programmers to cope with particular peak requirement and does not replace internal activities.

- "Project management" that is used for a specific project or portion of information system work such as developing a new system, supporting an existing application, handling disaster recovery, providing training, and managing a network.
- "Total BSO" where the service supplier is responsible for a significant portion of information system work such as data center, telecommunications, and total hardware or software support.

The first two categories may be considered as traditional sub-contracting, although if the contractors were able to develop their own solution and know how, have an incentive to do so and operate under a performance contract, which allows them to easily share the benefits of innovative solutions with the client, the arrangement would be more like BSO than contracting. However, the third category is more clearly BSO, since longer term creates a dependency between the BSO company and the service supplier and the arrangement involves strategic delegation, insofar as the outsource supplier makes all decisions about meeting service level requirements.

BSO motives

The combination of variables that influence the decision of managers to outsource part of the service functions differs from one company to another (Loh, 1992). The decision of a company to outsource or not depends on subjective internal factors such as the impact on corporate culture and effects on internal power as well as objective factors such as the relative cost and quality of the services located and it also depends on how the results are to be measured and how the service supplier is managed by the service provider.

Tactical and strategic motives

BSO may be driven by tactical or strategic motives (Jones W., 1997, p.p. 67-68). Antounucci and Tucker (1998, pp.18-20) summarize the

BSO drivers identified in a survey of more than 1200 US companies made by the BSO Institute in 1997. The top five short-term tactical BSO drivers are:

- 1) Reduce operating costs,
- 2) increase the availability of capital funds,
- 3) achieve cash infusion,
- 4) gain access to resources, and
- 5) eliminate functions that are difficult to manage internally.

The top five strategic drivers are:

- 1) Improve business focus,
- 2) improve access to world-class capabilities,
- 3) achieve reengineering benefits,
- 4) shared risks, and
- 5) free resources for other purposes.

Appropriate BSO enables a company to reach new heights in enhancing and delivering the company's core competencies into the market. The important point is building a relationship that gives the company access to best business practices, professional knowledge and practical information, and has the potential to benefit all stakeholders.

Cost savings

Williamson (1975) recommends that companies should subcontract their activities only if the outsider provides the same service for the same or less cost than would be incurred by the company; it should provide the services in-house if subcontracting is less efficient. Most literature reviewed concentrates on short and long term cost reduction as the primarily BSO drivers (Huff, 1991 and Earl, 1991).

Positive view of cost saving achieved by BSO

Through BSO, companies may avoid paying additional employment costs such as marginal benefits and profit sharing. Cost savings allow companies to concentrate on core activities that generate more benefits. Service suppliers are likely to offer cost benefits where there are substantial experience effects or economies of scale (Earl, 1991).

BSO, in particular outsourcing IT, is a route to avoid paying for future capital investments and software. Moreover, BSO gives the companies an opportunity to liquidate assets tied up by in-house provision such as equipment and software. Companies can see in BSO an opportunity to minimize development and research costs, and to avoid a stream of capital investments in the future. More importantly, they can try to turn a largely fixed cost into a variable one and this takes substantial risk out of the capacity commitment problem. All these aspects can enable a company to strengthen its financial position (McFarlan and Nolan, 1995).

Increasing significantly the number of outsourced service functions alters the value chain of BSO companies, in particular providing, improving flexibility and eliminating sunk or orphan costs. If companies do not see IT or other activities as a core competence, they may find that BSO provides a way to delegate the time-consuming management of it. In this way, companies can focus scarce management time and energy on other business differentiators and it would be logical to do this even if outsource costs were above internal costs since they may be below unobservable opportunity costs. If managers perceive the outsource provider to be competent and they are able to transfer a non-core function to a reliable outsource provider, managers will choose the BSO option (McFarlan and Nolan, 1995).

Based on surveying chief information officers of Fortune "500", Collins and Millen (1995) find that the majority of the top level information system executives believe that BSO has had a positive rather than negative impact on information system costs, internal information system performance, and customer satisfaction.

Outsource contractors' ways of reducing costs

Management capability is an important factor in achieving cost savings. McFarlan and Nolan (1995) argue that IT outsource contractors reduce their costs by the following means:

- Establishing critical scale relative to overhead structures,
- benefiting from modern telecommunications,
- utilizing low-cost pools by moving data centers to low cost areas, possibly internationally,
- conducting effective purchasing and leasing arrangements for all aspects of hardware/software configuration,
- using efficient management of excess hardware capacity,
- improving control over software licenses, and
- using aggressive management of service through better management of resources such as inventories and supplies.

Misconception of cost reduction

In another line of research, Lacity and Hirschheim (1993), Lacity, Willcocks, and Feeny (1995), and Lacity *et al.* (1996) argue that cost reduction is not significant in BSO decisions, and that the BSO company, in the long run, pays more to the outsource provider than the cost of internal provision.

In evaluating outsourcing implications on companies' profitability and liquidity, Juma'h and Wood (2000) conducted a study of 29 large-size UK companies that announced outsourcing deals between 1991 and 1997. They found that the profitability and liquidity of outsourcing companies decrease in the year of announcement and increase in the following year. This is because outsourcing deals involve significant transactions cost associated with re-engineering and re-deploying internal activities in the year of outsourcing agreement.

In interviewing individuals who were directly involved in BSO decisions, Lacity (1992) conducted 36 interviews in 13 US companies that included 11 Fortune 500 companies. The main findings are as

follows: the public announcements show an optimistic early view of the likely benefits of information system BSO. Managers, though, often have misconceptions about the value of their information system, considering it a utility or comprising necessary activities rather than a major source of competitive performance. Also, it appears that BSO companies may be prompted by reasons other than cost savings. In particular, managers may consider BSO inevitable and initiate it for political reasons or because it gives more control than they could exercise over an internal department.

Lacity (1992) emphasizes that BSO supplier may not be inherently more efficient than an internal information system department. The conclusion is that the contract is basically motivated by risk considerations since it turns uncertain costs into certain (contractual) costs and fixed into semi-variable costs. If this is the case, it will be difficult to arrive at deterministic explanations for BSO decisions since it will be definitely impossible to compare relative costs of BSO against uncertain internal future costs.

Expanding their individual work, Lacity and Hirschheim (1993) interviewed managers of 14 Fortune "500" companies and they argue that applying the economic theory of efficiency to information systems BSO is an unsatisfactory proposition. Effective management of internal information systems achieves costs that are competitive with BSO vendors. Indeed, medium and small companies achieve almost all the available scale benefits on purchasing hardware even at a small scale of operations.

In similar studies, managers' views about BSO decision are seen as important factors to determine companies' motivations to outsource. Tengo, Cheon and Grover (1995) examined information system BSO by means of a survey questionnaire that was sent to top information system executives of US companies. Their findings suggest that companies are motivated to outsource on the basis of output and services, rather than financial and cost motives. Also, as the complexity of the information system function has increased, the decision to outsource information system functions has become more strategic and the complexity and impact of BSO contracts has increased. This complexity is handled through relationships or alliance arrangements rather than detailed contracts.

The existence of economies of scale in computing capacity is of interest to many companies. Barron (1992) argues that many medium-sized and most large companies already operate IT functions large enough to achieve most of the available economies of scale. Any economic efficiency gains have more to do with IT practices than inherent economies of scale and, therefore, BSO logic is based on comparative management advantage (Lacity *et al.*, 1995, 1996).

BSO on average lasts for more than five and often ten years (Saunders, Gebelt, and Hu, 1997). Service providers expect to replace hardware in the future at costs that are substantially below the current costs. Therefore, BSO companies that make long-period BSO or total BSO arrangements need to consider the dynamics and incentives of the agreement and their implications for the future. The cost of hardware is not static and indeed it certainly seems to continue a pattern of long-term relative decline. The BSO service supplier may also be able to share resources acquired for one contract across subsequent contracts. As an example Y2K diagnostic procedures may service many customers. Also, the business environment is not static and this is reflected in general inflation and the particular cost of the specialist staff involved. This makes it hard for long-term agreements to anticipate all the possible changes in scope in contractual form.

Low-technology culture

The company's position relative to technology best practice is also important to the BSO decision. Companies with a low-technology culture appear to have difficulties attracting and training high-technology staff. BSO offers a way to access skills without becoming involved in complex and unfamiliar management issues. In other words, managers see in BSO a substantial risk reduction, a way of accessing specialized knowledge and skills in order to be competitive with other companies (McFarlan and Nolan, 1995). The fact that there might be considerable risk involved in building in-house capabilities in areas outside the present competence of the managerial team adds to this logic.

Solution to problematic departments

Companies may consider BSO as a solution to an unmanageable, non-productive, or otherwise problematic department. If a department within the company fails to achieve target objectives and standards or where objective outputs are difficult to measure, companies may see BSO as an easy route to obtaining a more manageable or perhaps better service. An example where opportunity cost rather than direct cost seemed critical was the decision of Massachusetts Blue Shields to outsource to Electronically Data System as a result of the failure of their major systems development projects and the considerable losses that ensued (McFarlan and Nolan, 1995).

Financial pressures

According to McMullen (1990), financial pressures force companies such as Kodak to focus on those most profitable activities. However, financial pressures may be so strong that companies may seek a purely economic package based on financial manipulation rather than on rational of best practice or efficiency. Effectively they use BSO to escape financial difficulties. When a company faces negative profits for several years, a BSO contract could by selling IT assets improve liquidity. Thus the company could generate funds from the sale of assets, and reduce its operational expenses by transferring its employees to the outsource vendor. In this way, by means of the BSO contract the company pays only a fixed fee to obtain similar services, or better services than those obtained in-house (Lacity *et al.*, 1996).

As described above, the literature provides a variety of BSO motivations and drivers. However, BSO has a variety of disadvantages and these are considered in the next section.

Disadvantages from BSO

Bettis, Bradley, and Hamel, (1992) argue that BSO may be contributing to a continuing competitive decline of many Western firms. Their comparative study of Western companies (in particular American companies) with Japanese and Korean companies suggest that although individual BSO may make economic sense, the general or widespread use of it may indicate an inability to compete or the lack of any clarity about what long term core competencies actually are. Only if BSO is properly understood and managed within the company's strategy do they accept it can help the company's competitiveness.

A summary of the argued disadvantages of BSO are as follows:

- The outsource provider has access to the company's confidential information
- The future costs could become relatively high because technology/ scale/ experience improvements may not be passed on to the client or passed only partially.
- Both the company and the outsource provider want to maximize their utilities. Their interests are not the same and confusion and opportunism may occur.
- The company is vulnerable to outsource provider's instability.
- The company may become dependent on the outsource provider. If the company chooses not to renew its contract with the outsource provider, the transition period could be disruptive and structuring costs may be high and these are unlikely to be considered in the initial evaluation.
- Current employees could lose their jobs or be transferred to the outsource provider, eliminating some of the specific business system knowledge that is currently held by the staff. This knowledge may be contingent, i.e. of particular value in conditions that differ from present conditions but that nevertheless may occur. A particular current example arises with the millennium problem where the originators of code generated by outsource providers are not available to make corrections.

(See for example, McMullen, 1990, Friedberg and Yarberry, 1991 Quinn and Hilmer, 1994, Earl, 1996, and Antonuci and Tucker, 1998).

When to outsource

Quinn and Hilmer (1994) argue that if supplier markets were totally reliable and efficient, rational companies would take an extreme position and outsource everything except those special activities in which they could achieve a unique competitive edge, i.e., they should preserve a small number of activities based round core competencies. However, they recognize that in practice most supplier markets are imperfect and involve risks for both buyer and seller with respect to price, quality and time.

If as they say, BSO cannot assume totally reliable and efficient contractor markets, BSO involves managing the risks of these market imperfections. The key risks for a BSO companies and service supplier will be service quality and service response. These qualitative issues in defining performance create problems in evaluating both the potential and actual contribution BSO makes to the ongoing business (McFarlan and Nolan, 1995). They conclude there is no simple answer to the question when companies should outsource.

Competitive advantage vs. strategic vulnerability

Quinn and Hilmer (1994) state that three factors are crucial about any activity considered for BSO. These factors are:

- The potential for improving competitive advantage (improving cost/performance) in BSO activity, taking account of transaction costs,
- the potential vulnerability that could arise from various aspects of market failure if the activity is outsourced, and
- what managers can do to modify vulnerability by structuring arrangements with suppliers to provide appropriate controls and yet provide for necessary flexibility.

Quinn and Hilmer (1994) use a simple matrix to explain the effect of the degree of strategic vulnerability (the risk that results from the dependency on a service supplier) and the potential for competitive advantage. They suggest that when the potential for competitive edge and the degree of strategic vulnerability of the function are considered high, the company should produce it internally. When both are low, the company should buy from the market (outsource). If both competitive potential and strategic vulnerability are moderate, the company needs to consider special arrangements (BSO) that give some control over the way the outsourced function is delivered. Figure 1 demonstrates these relationships.

Figure 1:Competitive Advantage vs. Strategic Vulnerability

Potential for Competitive Edge	High	Strategic control (Produce internally)	
	Low		Low control needed (Buy off the shelf)
		Moderate control needed (special venture or contract arrangements)	
		High	Low
		Degree of Strategic Vulnerability	

Source: Quinn and Hilmer (1994, p. 48)

Quinn and Hilmer (1994) do not suggest any possible alternative for the remaining rectangles. That is, their matrix does not give solutions for all possibilities and effectively the vulnerability dimension seems redundant. This reflects the practical difficulties in emulating vulnerability where the market risk is not static and the potential contribution of BSO is subject to management perception (Lacity *et al.*, 1996).

Earl's IT sourcing strategies

Starting from the perspective that the BSO decision is jointly delineated by the type of functions to be outsourced and the associated cost. Earl (1996) uses a simple framework, to link operating performance with business value (costs). Figure 2 illustrates Earl's IT sourcing strategies.

Figure 2: Earl's IT Sourcing Strategies

Business Value of IT	Core	Market Test	Insource
	Commodity	Outsource	Best source
		Anxieties	Satisfaction
		Operational Performance	

Source: Earl (1996, p. 27)

These theoretical frameworks are difficult to apply in practice since satisfaction is a function of expectation and the identification of activities as core or commodity is not straightforward. This implies that companies' subjective views of the effectiveness of producing internally or buying from the market are important in adopting on BSO strategy and it is clear that unless internal provision can be market tested, the value of Figure 2 is questionable.

Summary and conclusions

The article discusses related issues to BSO. It starts by reviewing the scope of BSO and its definitions. Most previous research is mainly related to IT outsourcing. This is because large and international outsource contractors have given a high profile to the BSO trend. Other areas such as accounting and finance received very little attention despite the fact that these activities are very important in the value chain of any company and may have a major influence on

BSO companies' performance. Because they are less developed on BSO markets, the risks involved in non- IT outsourcing may present a less tractable problem than IT outsourcing. There will be less market information and possibly a thinner market for contractors.

Companies may enter into BSO contracts for tactical or strategic motives. Cost reduction, concentration on core business, failure to meet the standards of the company, obtaining new technologies and skills, strengthening the company's financial position and increasing market value are claimed to be the main motives (drivers) for BSO. BSO is also claimed to improve efficiency for the activities outsourced and for those remaining in-house. BSO is an evolution of transaction cost theory and concentration on core business concepts. There are several attempts to explain when a company should outsource such as competitive advantage vs. strategic vulnerability of Quinn and Hilmer and Earl's IT sourcing strategies. These theoretical frameworks are difficult to apply in practice since satisfaction is a function of expectation and the identification of activities as core or commodity is not straightforward.

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