Evaluating Business Process Outsourcing using Coordination Theory

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ABSTRACT
Increasingly organizations are outsourcing their business processes to offshore locations. The goals cited include cost savings, achieving strategic focus, alleviating skills shortages and seeking to implement best practices. Current reports from actual outsourcing case studies indicate that many organizational goals remain unfulfilled. This paper proposes to study the impacts of BPO on the client organization using Coordination Theory. A case study of an organization, which outsourced its service delivery process and subsequently insourced parts of it, is presented. The case study supports the existence of strategic and operational gaps between the client and vendor organizations, which negatively impact the BPO. A follow up empirical study is being pursued to quantitatively measure the success of BPO using three costs - vulnerability, coordination and production for different categories of processes. The results of this study will have implications for the selection of business processes or functions that can fare better when outsourced.

Keywords
Business Process Outsourcing, Coordination Theory

INTRODUCTION
The concept of transferring (often offshore) the operational ownership and execution of one or more business processes is referred to as business process outsourcing (BPO). The organization pursuing the outsourcing of its business processes is referred to as the client firm. The firm that provides the workers to operationalize the process is referred to as the outsourcing vendor. Examples of BPO are seen in several industries today with both core and supporting processes in the value chain. The offshore BPO market is projected to grow 60% year over year and is the fastest growing segment of the overall outsourcing market (Trapper, 2003).

Research Goals
The research premise of this paper is that while BPO on the surface may promise to offer substantial cost savings and operational benefits to the client firm, hidden costs to the organization need to be fully evaluated. In fact, Lacity and Willcocks (1998) reveal that the risks of an outsourcing effort can be significant. Their study reported that only 54% of the outsourcing agreements realized cost savings. Not all organizations and not all processes are good candidates for a BPO. There may be a strong clash between the strategies and operational climate of the client and vendor firms resulting in unexpected results.

The goals of this research are:

• Evaluate the cause of strategic and operational misalignments between the client and the vendor firms in a BPO and the impacts on costs.
• Evaluate the hidden costs of outsourcing using coordination theory to assess the full impact of a BPO on the client firm’s strategy and operations.
• Develop a categorization of organizational processes and identify which processes are better suited for a BPO.

THEORETICAL BACKGROUND
Levina and Ross (2003) have used economic theory to suggest that outsourcing relationships are successful in the cases where the client firm develops a complementary set of core competencies from the relationship. Their findings support the need for the client firm to develop and maintain proper organizational structures to manage the relationship between the
client and vendor. This study has also reported that the information processing requirements for the client organization need to be matched with the level of uncertainty facing the organization. Soh, et. al. (2003) studied the misalignments between the companies existing business processes and the semantics of the workflows embedded in the software package, when firms adopt enterprise packages such as ERP. These misalignments result from such factors like structural norms, underlying organizational culture and changes in information processing needs. Similar issues are also seen in a BPO.

Lacity and Willcocks (1998) also studied the allocation of resources. Their study reports that resources must be properly distributed to meet organizational requirements and emphasized vendor selection and relationship management as contributors to outsourcing success. They propose three different models with varying degrees of client-vendor alliance – partnerships, technical supply or pay-per service. A loose alliance creates a fragmented internal environment, which can hamper information flow and cause the BPO client to be vulnerable to market changes. Similar results are reported for loosely coupled environments (Orton and Weick, 1990).

A literature review on prior IS outsourcing research reveals several important studies that have investigated outsourcing using different theories. However, no prior study was found that used coordination theory to study the impacts of BPO on the client organization. Coordination theory has been used to study the impact of information technology on organizational structure by modeling organizational subunits and their interactions (Malone, et. al., 1999). Such a model sheds light on the effective flow of information and the allocation of resources, both of which are critical components of a BPO (Malone and Crowston, 1994). Hence, applying coordination theory to study the BPO interactions between the client and vendor holds promise.

The literature indicates the importance of the two factors – information flow and resource allocation on the client-vendor interaction model in a BPO. Both of these factors can be studied using coordination theory.

COORDINATION THEORY

Coordination theory offers a vehicle to study organizations through business processes – referred to in the theory as coordination structures (Malone, 1987). A coordination structure is defined as a pattern of decision-making and communication among a set of actors who perform tasks in order to achieve goals.

There are three kinds of costs.

- **Production costs** include the “resource” costs of running the outsourced processes and measures any efficiencies or deficiencies introduced. In the BPO scenario, these costs measure the client’s transaction costs.

- **Coordination costs** are the “information” costs to manage the communication between the client and the vendor firms. In the BPO scenario these are evidenced by the client’s management costs.

- **Vulnerability costs** are the “strategic” costs associated with a delayed response to a changed market situation. The client firm in a BPO is further removed from the market/end user resulting in missed market knowledge. This leads to additional vulnerability costs for the client.

RESEARCH MODEL AND HYPOTHESES

Figure 1 shows the research model. BPO creates misalignments between the client and the vendor over strategy and operations. Carmel and Agarwal (2002) note the client’s need to select the proper strategy to align with the BPO vendor. Risks of misalignment in strategy and operations in a BPO can lead to significant management concern in the future (Willcocks, et. al., 1999).

The components of strategic misalignment are due to the desire for flexibility and differentiation from the client’s perspective against standardization and efficiency on the vendor side. The operational misalignments in an offshore BPO result from the difference in organizational structure, information flow and the underlying cultures (Hofstede, 2000). Applying coordination theory, these misalignments result in higher vulnerability and coordination costs for BPO.

H1- Significant strategic gaps exist as measured by the dimensions of organizational flexibility and differentiation between client and vendor firms in an offshore BPO scenario.
Centralized/Decentralized Processes

It is often seen that larger organizations need to be broken into multiple sub units and managed in discrete parts. This can be arranged functionally or across product lines. The former can be classified as centralized, while the later as decentralized (Malone, 1987). Clearly, a centralized organization is more efficient in terms of management and allocation of resources, but is slow in responding to market changes. This inflexibility is measured in increased vulnerability costs, though production costs are lower. When a process is outsourced, the effect is usually to make the process centralized.

H2- Significant operational gaps exist as measured by the dimensions of organizational structure, information flow and culture between client and vendor firms in an offshore BPO scenario.

In a BPO, the client firm seeks a variable cost structure and operational excellence in terms of process and technology in the chosen functional area. The vendor deals with a fixed cost structure and needs to reduce costs in a volatile environment. Hence, strategically, the vendor is attempting to consolidate process across industries and providing a “least common factor” approach. As a result, the client will experience greater vulnerability and coordination costs.

H3- Strategic gaps will have a significant positive relationship with vulnerability and coordination costs associated with the BPO.

Likewise, when a business process is outsourced, usually the client firm needs to establish a management function to oversee the vendor firm and create a structure to properly collect and process requirements from multiple business units and feed them to the vendor firm. Therefore the client firm will have higher coordination costs.

H4- Operational gaps will have a significant positive relationship with coordination and production costs associated with the BPO.

H5- Total BPO costs as measured by the sum of vulnerability, coordination and production costs of an outsourced process is higher than that for a process that is not outsourced.
Organismic/Mechanistic Processes

A major goal of organizational research is to understand the structures of organizations that best address market situations to achieve specific goals. Organizations can have different structures and characteristics and face different challenges. But the central goal is to allow the organization to respond to uncertainties. Some organizations have more organismic processes and face more uncertainty than others and have greater information needs. Mechanistic organizations have very rigid processes and strongly structured communication channels. They are intended to have less information flow and face less uncertainty than organismic organizations. The BPO of an organismic process will result in higher coordination costs (Tushman and Nadler, 1977).

Outsourcing vendors follow mechanistic processes with limited information flow. This strategic approach is used to counter the high turnover and the need to facilitate the servicing of multiple clients. Therefore, mechanistic processes of a client firm have a better match and a smaller “gap” when outsourced. Organismic processes have a larger gap and hence have less BPO success.

H6- Outsourced processes that are organismic will have significantly higher total BPO costs than mechanistic processes.

RESEARCH METHODOLOGY

The research methodology involves a case study to ground the theoretical findings, followed by subsequent quantitative analysis.

Case Study

A technical support organization that outsourced parts of its customer service delivery process was chosen to serve as a case study. The organization is a leader in the support of multi-vendor networking equipment, with capabilities including design, installation, monitoring, management and break-fix support.

Two key personnel, a business development manager (BDM) and a project manager (PM), at the company were interviewed for information on their outsourcing experience. The BDM and PM were responsible for the mobilization of a new managed service offer.

The questions posed include:

1. The reasons for pursing a BPO and the subsequent insourcing.
2. Their observations related to organizational issues resulting from the BPO decision.
3. Comparing the use of internal operational units and the use of BPO to support the business initiative.

Both managers responded to question #1, stating that increasing speed to market, lowering the operational costs and an organizational push to “try our hand” at BPO was instrumental in deciding to outsource.

As quoted by the BDM, “our business goals were to improve the service experience of a set of customers, who choose to pay us to manage the headaches of keeping their networking devices on the latest software release. It was impossible to get realtime response from our offshore partner. This was not another ‘canned’ call center app that they were accustomed to.”

The PM added, “the costs of getting modified requirements into the work program became very expensive. The BPO vendor was not flexible. Changes often led to more problems and follow on changes”.

The BDM mentioned in response to question #2, “while our plan was to position this offer as an add on option for existing customers, the BPO vendor preferred a clear separation between the operational processes of this offer and our other service offers in our pay per service model. It became hard to provide a unified view to our customers.”

Clearly, both managers noted the missed deadlines, the higher coordination costs and the inflexible support received from the vendor. The case also exposed the strategic and operational gaps between the two organizations.

Quantitative Analysis

A survey is being developed to collect data from additional organizations. Measurement instruments are being developed to measure the organizational capabilities of flexibility, differentiation, structure, information flow and culture as well as the
three coordination costs. The degree of centralization/decentralization and the degree of organismic/mechanistic character of the process will also be measured. This survey will be used to collect data across insourced and outsourced processes to test the hypotheses.

A path analysis is planned with PLS-graph to calculate the strength and significance of the relationships among the latent variables (Chin, 1998). The latent variables measuring “gaps” and “BPO costs” will be compared using ANOVA across different classes of processes – centralized/decentralized and organismic/mechanistic. Path coefficients for different categories of processes will be compared using the Smith-Satterthwait test.

**CONTRIBUTIONS**

The contributions of this study include: (1) a research model which evaluates vendor/client strategic/operational gaps; and the total costs of a BPO using coordination theory and (2) the evaluation of different types of processes and how successful they are in a BPO. This study will demonstrate that BPO activity impacts the client organization’s multiple costs and will be useful to practitioners and policy makers on their outsourcing decisions. Only judicious selection of BPO by organizations can sustain their competitive position.

**REFERENCES**