ABSTRACT

The researcher examines the Information Technology (IT) outsourcing risk avoidance tolerance of managers by measuring the effect on organizational performance. IT outsourcing risk avoidance factors were partitioned by the value of long-term versus short-term and high-value versus low-value contracts. The sample was obtained from the financial archival data of 79 firms during the period of 1986 to 2009. The risk-avoidance effect was evaluated in terms of financial metrics. Cost efficiency, productivity, profitability, growth, cash management, and market ratio were calculated to measure each company’s performance. Organizational performance was the dependent variable, which was measured by comparing fluctuations of the stock’s market value. The findings indicate that manufacturing firm performance was better with short-term and low-value contracts. However, the results are mixed for service firms. In manufacturing firms, the market reacted positively when managers announced long-term and high-value outsourcing contracts to avoid IT risks. By contrast, the market reacted positively when low-value and long-term outsourcing contracts were selected by service firm types in the sample.

Keywords: Information Technology (IT), Manufacturing and Service Firms, Outsourcing, Risk Effect of IT Outsourcing

INTRODUCTION

Industries have seen significant changes in the business environment, including considerable reduction in: Transportation costs and development along with the rapid diffusion of information technology into work processes (Agrawal, 2010; Arvanitis & Loukis, 2012; Dou & Sarkis, 2010). Additionally we have witnessed an increase of economic globalization, availability of services in various locations at lower prices, and the disintegration of enterprise value chains that have become uncoupled from providers or customers (Agrawal, 2010; Arvanitis & Loukis, 2012; Dou & Sarkis, 2010). In addition to the opening of markets at national and global levels, technological developments have compounded these changes. Megatrend socio-economic changes have impacted organizational risk taking or avoidance strategies, including the domestic and international outsourcing of information systems (Gonzalez, Gasco, & Llopis, 2010).

There has been a continuous rise in the number of Information Technology (IT) outsourcing agreements beyond infrastructure and
functional applications. Gartner predicted that the global IT outsourcing market would reach $288 billion in 2013, a growth rate of 2.8 percent over 2012 (The Economic Times, 2013). IT outsourcing firms are those that relocate their IT functions and processes to external providers, either at home or abroad (Hesmati, 2003; Olsen, 2006). Vendors manage clients’ assets and staff to provide a range of IT functions in outsourcing arrangements.

**Problem Statement**

The benefits of outsourcing are well known and include cost reduction, access to new technology, ability to focus on core competencies, and improved system quality. There are, however, a number of issues that make it less attractive in some situations. The risks of outsourcing, such as hidden costs, violations of the outsourcing contract, loss of customers/opportunities, and potentially conflicting interests, are equally important (Salanta, Lungescu, & Pampa, 2011). In offshoring, additional risks are cultural differences, language barriers, geographical and time-zone related barriers (Chen, Tu, & Lin, 2002; Evaristo, Nicolas, Prikladnicki, & Avritchir, 2005), foreign exchange risks, political risks, and legal risks (Dou & Sarkis, 2010).

There are several risks because of uncertainty, especially when projects are large and for longer periods of time (Agrawal, 2010; Hall & Liedtka, 2005). Most of the studies on risks are based on managers’ subjective judgment because objective decision criteria may not be easily available in a reasonable manner for IT services, which are complex, intangible, and heterogeneous in nature (Boehm, 1981; Lacity & Hirschheim, 1993). The subjective judgments depend on input information, and sometimes that information is neither accurate nor timely, but is biased, ambiguous, and inconsistent.

In this study, I evaluated the risk effect of IT outsourcing on the performance and value of manufacturing and service firms, using audited financial data. The measures applied in the literature for this type of research included: Cost efficiency, productivity, profitability, growth, cash management, and market ratio, as well as market value, using financial metrics (Agrawal & Haleem, 2012). I measured a contract’s risk level by its value and term. Researchers believe that higher-value and longer-term contracts are more complex than lower-value and short-term contracts (Agrawal, 2010; Hall & Liedtka, 2005).

**LITERATURE REVIEW**

**Risks of IT Outsourcing**

Firms that make the decision to outsource their IT activities may have to make changes to tasks, structures, processes and systems that involve people at different levels of management. These changes may create clashes within IT and management systems. Outsourcing firms may lay off employees or transfer employees to vendors, which can result in industrial disputes between employers and employees.

This in turn can damage employee morale and productivity and result in loss of IT or business expertise (McCarthy & Anagnostou, 2004). Outsourcing can create operational dependency on vendors and may cause a leak of confidential information (Shi, 2007). Furthermore, outsourcing firms may become too dependent on vendors for day-to-day performance of vital business functions, which carries risk, because they do not have the same management direction and control over the vendor as they have over their own employees (Lacity & Willcocks, 1996).

Transaction cost theory suggests that two main costs are considered in the production of goods and services: production costs and transaction costs (Williamson, 1975, 1979). Outsourcing is more efficient than performing IT activities in-house when production costs are lower, because of economy of scale and the lower salaries of vendors’ staff (Apte, Sobol, Hanaoka, Shimada, Saarinen, Salmela, & Vepsäläinen, 1997; Ravichandran & Ahmed, 1993). But at the same time, different types of hidden costs exist in the outsourcing process, such as the search for vendors and hiring, costs linked to provider control and coordination, and transition
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