Chapter 16
Do Expectations Match Reality When Firms Consider the Risks of Offshoring? A Comparison of Risk Assessment by Firms with and Without Offshoring Experience

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Abstract The risk associated with offshoring is a recurrent theme in research. However, previous research has mainly given a static picture of offshoring risks even though the strategies of offshoring firms, including their views on risks, may change as they gain experience in the field. In this chapter we investigate the influence of organizational learning on firms' perceptions of the risks in offshoring. We use survey data from firms in Scandinavia and compare the risk assessments of firms without offshoring experience with firms that engage in offshoring. The findings show that firms without offshoring experience particularly stress exogenous risks while firms with offshoring experience see the endogenous risks as important. We offer two different interpretations of these results.

Keywords Offshoring · Offshore outsourcing · Risks · Organizational learning

16.1 Introduction and Background

In the wake of the offshoring "hype" (Lewin and Peeters 2006) at the turn of the century, skepticism arose in the business press about the real costs and benefits of relocating business operations to low-cost destinations (see e.g. BCS 2009; Blum

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2004; Davison 2003). The general contention was that the presumed benefits of offshoring were greatly exaggerated and the expected costs and risks grossly underestimated (Deloitte 2008). In other words, expectations about the economic and strategic benefits of offshoring did not match a reality of unforeseen operational, contractual, and strategic problems as well as risks of uncontrolled knowledge leakage and loss of competencies.

This chapter addresses the questions of how firms' expectations match—or mismatch—reality when it comes to the operational and strategic risks of offshoring. We compare the risk assessments of Scandinavian (i.e. Danish, Norwegian and Swedish) firms *currently* engaged in offshoring of administrative and technical tasks (popularized as "white collar services") with those of Scandinavian firms that so far only are *considering* offshoring of these tasks. The reason is to assess whether the risk assessment changes as firms gain their own experience in offshoring. We measure the risk assessment of these two groups of firms in relation to a wide range of risk parameters including both external and internal risk factors. Hence, the chapter is organized as follows:

In the next section (Sect. 16.2) we present facts about the Scandinavian survey which makes part of a larger, multinational and repetitive survey of firms that are currently offshoring technical and administrative tasks or considering doing so. The academic institutions conducting the surveys on national or regional basis (such as Scandinavia) are organized in the Offshoring Research Network (ORN) anchored at the Fuqua School of Business, Duke University, USA. Section 16.3 presents the results of the part of the Scandinavian ORN survey that pertains to firms' perceived business risks of offshoring. In Sect. 16.4 we discuss these results. In particular, we suggest potential explanations and causes of the observed mismatches between risk expectations and risk reality. These causes include overconfidence in the firm's coordination and contract design capabilities as well as bounded rationality of managers, but also methodological issues such as reliability and construct validity. The final section concludes and discusses managerial implications.

16.2 The International Business Literature and the Benefits and Risks of Offshoring

Although our focus in this chapter is on the risks associated with offshoring it is clear that a firm's strategic considerations concerning which value chain activities to offshore, where to offshore, and how to organize the offshoring operations (i.e. firm-internal vs. firm-external operations) rest on an assessment of the expected risk-return tradeoff associated with the specific offshoring operation. Potentially, engaging in offshoring offers considerable returns from arbitraging differentials in global factor endowments and from exploring knowledge and capabilities in offshore locations, but it also entails significant risks. Any manager has his/her own risk-return tradeoff point in investments, including the investments in offshoring operations. The research literature on offshoring and outsourcing is founded on

different (and to some extent competing) theories which also reflects that there are different views on the benefits, costs and risks associated with offshore outsourcing (Hätönen and Eriksson 2009; Kotabe et al. 2009). So far there is no clear indication of what specific activities are particularly advantageous or risky to outsource offshore (Hätönen and Eriksson 2009), including capabilities (resources) that are "close to core" (Quinn 1999). Therefore, there is no standard recipe for decision-making which firms may use, as the idiosyncrasies of the individual firm, activity attributes, in-house capabilities, industry context, managerial preferences, altogether shape the risk-return tradeoff in each specific case. Rather, there is a range of frequently cited potential benefits and risks in the research literature which firms may take into consideration and then decide which of these to give special attention.

As Kotabe and Mudambi (2009) note, there are opposing views on the long-term implications of foreign sourcing strategies which are related to the sustainability of firms' core competencies, particularly when firms begin to increase reliance on independent parties (Kotabe and Mudambi 2009; Mol 2007). Taking Kotabe et al. (2009) as the starting point, we may summarize a range of the frequently cited potential advantages and risks related to offshoring and list a selection of research contributions that focus on these aspects.

Regarding the potential benefits of offshoring, in particular the cost advantages stemming from lower labour costs in developing and emerging economies stand out throughout the research literature as the main benefit (see e.g. Amiti and Wei 2009; Farrell 2005). As for the collaboration with external partners in offshore outsourcing arrangements, other authors (Kedia and Lahiri 2007; Quinn 1999; Quinn and Hilmer 1994) have stressed that the home/client firm may complement and leverage own capabilities through partnering. In other studies based on data from the ORN database, Manning et al. (2008) and Lewin et al. (2009) have emphasized that offshoring is an opportunity to compensate for skills shortages in the domestic labour market and enhance existing firm resources, or build new resources, through access to complementary human resources at host destination. By extending similar arguments regarding resource complementarities to inter-firm linkages, a number of scholars have described the potential value for home firms in building close and long-term relationships with other firms so that these partnerships have much in common with strategic alliances (Kedia and Mukherjee 2009; Mudambi and Tallman 2010; Vivek et al. 2009). In addition, the offshoring destination itself, i.e. an entire country or a city/industry cluster, may be of value to foreign firms as these firms get access to specific, locally embedded skills and knowledge at offshoring destinations (Bunyaratavej et al. 2008; Dossani and Kenney 2007; Jain et al. 2008; Jensen and Pedersen 2011; Zaheer et al. 2009).

While there appears to be consenting views as regards the potential benefits associated with offshoring, the nature and magnitude of the risks are more unclear yet intensely debated, and there are still only limited empirical data underpinning these debates (Bunyaratavej et al. 2011). Furthermore, it adds to the challenge for managers that the potential benefits and risks are linked and thus form a double-edged sword. For example, aggressively pursuing and investing in knowledge

exploration through offshoring might bring great value to the resources of the home firm but the firm might also risk knowledge slippage and erosion of critical knowledge resources. In particular for outsourcing arrangements this risk of resource erosion (a notion which is also referred to as the "hollowing-out" of the home/client firm; Kotabe (1989), whereby the critical resources of the firm would be gradually destroyed, stands out as a major strategic risk that may threaten the long-term competitiveness and survival of the firm (Kotabe 1989; Kotabe et al. 2008; Lei and Hitt 1995).

Second, prior research has pointed out that the perception of risks may vary from one firm to the other. Organizational risk perception is defined as the organization's assessment of how risky a situation is in terms of probabilistic estimates (Mitchell 1995; Sitkin and Weingart 1995; Harwood et al. 2009). As an example, two organizations may be equally risk tolerant, but their assessments of the risks associated with offshoring advanced IT services at an Indian service provider may differ significantly. Organization *A* may be overly pessimistic in its risk assessment and therefore put aside any plans of offshoring its IT services, whereas organization *B* underestimates the risks and consequently embarks on the offshoring venture without concerns. Obviously, the accuracy by which an organization carries out its risk assessments depends on its available resources in terms of in-house expertise as well as its financial capacity to hire consultants from outside. However, the risk assessment accuracy may also be influenced by the risk tolerance of the organization, that is, the organization's current tendency to take or avoid risks (Sitkin and Weingart 1995; Harwood et al. 2009). Therefore, a risk willing organization may be complacent and/or too optimistic (overconfident) when assessing offshoring risks (Brockhaus 1980; Vlek and Stallen 1980), and vice versa.

Third, in offshore outsourcing collaboration high hopes may transform into sour relationships as different problems between partnering firms accumulate over time. Earlier studies indicate that as many as half of the firms which engage in offshore outsourcing do not seem to find their expectations realized (Lacity and Rottman 2008), and managing a difficult inter-firm relationship, with e.g. problems related to the opportunistic behavior of the external partner, is costly and potential synergies are not likely to materialize (Ellram et al. 2008; Kern et al. 2006; Williamson 2008). In addition, the costs of managing an offshoring operation may increase further if there is a mismatch between the characteristics of the activities offshored, the attributes of the offshoring destination (e.g. skills, capabilities, cultural distance, language), interface and interaction between onshore and offshore personnel (Dibbern et al. 2008; Kumar et al. 2009; Stringfellow et al. 2008). In such cases the coordination costs, resulting from the "hidden costs" of offshoring, will be high and potential synergies consequently not likely to be realized.

This brief literature review shows that the risks associated with offshoring is a recurrent, and complex, theme. Simultaneously, research has shown that the experience with offshoring which firms build over time is an important determinant of learning and catalyst for change in the offshoring strategies of firms (Carmel and Agarwal 2002; Jensen 2009; Maskell et al. 2007). We may therefore

also expect that the perception of risk changes as firms gain experience with offshoring operations. For firms not involved in offshoring operations, the perception of risk is based on unknown factors and with practical experience and handling of problems, their assessment might change. However, extant research in the field does not shed much light on the change aspects of the firm and managerial risks associated with offshoring. Thus to our knowledge there is a gap in the literature in terms of models and theoretical approaches that can explain how firms' perception of risks change over time. In the following we address exactly this question as we compare inexperienced firms' (i.e. firms that are considering offshoring but not currently are engaged in offshoring) perception of risks with experienced offshoring firms (i.e. firms that implement offshoring operations at the time of data collection).

16.3 Methodology and Data

16.3.1 Facts About the Survey

The survey was launched in Scandinavia in 2008 as part of the ORN project where the same questionnaire is applied among US and European firms in order to track offshoring drivers, risks, and concrete implementations over time. The data in this chapter builds on responses for 125 implementations mainly in information technology, engineering services, and software development (making up about half of all Scandinavian implementations). An additional asset of the Scandinavian database is that it is almost equally split between firms that are considering to offshore and firms that already have experience with this type of foreign operation. The equal distribution makes the Scandinavian database well-suited for comparisons between the two groups of firms. The database includes very detailed information for each offshoring implementation on motives, strategic drivers, effects, etc. However, the focus in this chapter is on the differences in business risk perceptions among the—in terms of offshoring—experienced and inexperienced firms. In this chapter we define operational and strategic risks as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events, including reputational risks (damage to an organization through loss of its reputation or standing) and the risk of a loss arising from a poor strategic business decision.

16.3.2 Results from the Scandinavian Survey

Figure 16.1 shows the difference between firms that are *considering* offshoring and those that *currently* are offshoring in terms of the percentage that perceives various business risks—operational as well as strategic—as 'important' or 'very important'.

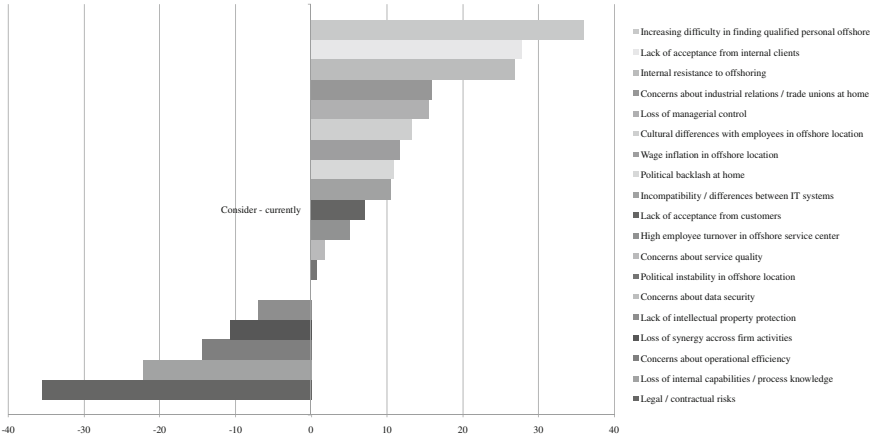

Fig. 16.1 the difference between firms that are *considering* offshoring and those that *currently* are offshoring in terms of the percentage that perceives various business risks—operational as well as strategic—as 'important' or 'very important'

If we use a 10+ percentage points difference as a threshold for 'significant' divergence between expectations and reality—"reality" defined here as the risk perceptions of firms that currently are offshoring—four risk parameters stand out as being strikingly different from the perspective of firms that are considering offshoring. As an example, among the firms *considering* offshoring only 10.53 % indicate "Legal/Contractual risks" as 'important' or 'very important' against a high 46.15 % of the firms *currently* offshoring. The difference is then $-35.62\ \% > 10\ \%$—and thus indicating significant underestimation of this risk factor. These business risks are either related to internal factors or associated to third party service providers. The two risk factors that by far are the most underestimated—"Legal/Contractual risk" and "Loss of internal capabilities/process knowledge"—are presumably mainly assumed in relation to third party service providers, i.e. offshore outsourcing. One might therefore speculate if the gap between the two groups of sample firms can be explained by differences in terms of the expected and realized use of offshore *outsourcing*. If the group of firms that are considering offshoring mainly anticipate carrying out this offshoring as a captive/in-house operation this group of firms would be less concerned about contractual risks and risks of losing capabilities. However, the two groups differ only slightly as to the ownership structure—and definitely too little to explain the risk perception gap.

Two noticeable *internal* factors are "Concerns about operational efficiency" and "Loss of synergy across firm activities". The firms that currently are offshoring perceive these two business risks as much more important than those firms that are still in the process of considering offshoring. Hence, firms with experience in offshoring have underestimated what it takes to reach operational efficiency and achieve cross-functional synergies. The inexperienced firms underestimate how

difficult it is to reap these benefits, while the experienced have "learned the lesson".

As regards risks, that firms without offshoring experience to a greater extent see as important, nine risk factors stand out. In relation to these nine risk factors, firms that are still considering offshoring are much more 'worried' than firms with offshoring experience. It is interesting to see that most of these 'exaggerated' risk factors are associated with exogenous factors (e.g. wage inflation in offshore location) and relationships to various stakeholders (such as employees, trade unions and clients).

There seems to be a clear pattern in which firms considering offshoring are more concerned by external factors, that is, how the offshoring venture will be judged by external parties and their concomitant response. In contrast, those firms that have experience with offshoring are more concerned about internal competencies and their ability to manage third party relationships, as well as own operations. In general, these figures indicate that offshore *in*experienced firms seem to *over*estimate exogenous risks, but *under*estimate endogenous risks.

16.4 Discussion

There are several potential explanations of the observed discrepancy, or mismatch, between risk perceptions of offshore experienced and offshore *in*experienced firms. Of course, one may ask to what extent the differences are 'spurious' and not 'real'—i.e. false images due to research design fallacies. We will discuss this methodology issue later, but first we will make two suggestions to explanations of (presumed) real gaps between risk expectations and risk reality. The two explanations are complementary rather than competing and revolving around the concepts of *overconfidence* and *bounded rationality*, respectively.

16.4.1 An Overconfidence Explanation

Although risk perceptions may differ between firms, as mentioned above, our first risk gap explanation is that managers in general are *overconfident* (Levitt and March 1988) about their cross-functional coordinating skills and their capabilities of designing, drafting and enforcing contracts (Argyres and Mayer 2007) in relation to offshoring. Managers and organizational members in general, may make erroneous (positively biased) attributions of their own capabilities, and of the resulting outcomes, for well-known reasons related to social desirability of competence and of performance (Zollo 2004). Perceptions of past success encourage complacency, or satisfaction with the status quo, and therefore reduce search efforts (March and Simon 1958; Nelson and Winter 1982). Overconfidence and superstitious learning, in turn, are contingent on the extent to which managers'

perception of homogeneity of the focal business operations is in line with the true homogeneity. Whenever organizations perceive business operations within a given category (e.g. similar business operations, but in offshore locations) as very similar, they might rapidly gain confidence in their ability to deal with such a business operation (Zollo and Gottschalg 2004). To the extent that search does occur, it tends to be in the same domain, exacerbating the problem of learning myopia (Levinthal and March 1993).

In our context managers would be at risk of overconfidence in their home country—in the sense that what has been learned about how to operate various business tasks at home is wrongly believed to be applicable to conducting business in the offshore location and across borders. In this situation an offshoring firm will underestimate the knowledge gap that has to be bridged in order to conduct an offshoring operation successfully. Or put differently, the firm is overconfident about the suitability of its knowledge pool in relation to offshoring. As unexpected problems arise during the offshoring operation the firm begins to realize the misconception.

More specifically, managers tend to see the emerging offshoring venture as a tactical and relatively simple logistics operation with no corporate strategy implications. Several researchers have described offshoring as basically being an opportunistic bottom-up process (Dossani and Kenney 2003; Lewin and Peeters 2006; Maskell et al. 2007) in which the initiative to the offshoring operation is taken by operational managers and not (top) managers responsible for the formulation and implementation of the corporate strategy. In other words, the offshoring operation is not initially seen as a strategic decision. As such, the offshoring operation does not trigger development of new managerial competencies—at least not during the first stages of the offshoring operation (Jensen 2009). Only as the offshoring operation unfolds the managers do realize the operational and strategic risks, as well as the potentials for learning, that are associated with its implementation.

This explanation is in line with the common view that Scandinavian management style is promoting a relatively flat organization (Schramm-Nielsen 2004) where most operational decisions are made on a fairly decentralized level. As a result, the operational decisions are not always so well coordinated between the involved decentralized units. The implication is that most offshoring decisions from the outset are taken at a decentralized level as tactically oriented decisions with a strong focus on short term savings. It is only when these decisions are moved up to the top-management level that firms start applying a more long-term and strategic approach to offshoring where the obtained operational experiences of the firms are stored and exploited in a systematic way.

16.4.2 A Bounded Rationality Explanation

Our second, complementary explanation of the gap between risk expectations and risk reality relates to the concept of *bounded rationality* (Simon 1957; March and

Simon 1958). Managers taking offshoring decisions are—like all decision makers—subject to cognitive limitations and limited information processing capability. Therefore, they have difficulties in overlooking all the potential risks involved in offshoring—comprising the reputational risks of announcing offshoring plans (with concomitant risks of strikes or negative reactions of customers) to strategic risks of losing internal capabilities or cross-functional synergies. In this perspective managers are myopic (Levinthal and March 1993) in the way they assess risks. Hence, managers find those risks important that connect to aspects of the offshoring operation getting their attention in a particular point in time. This attitude could explain why firms considering offshoring are more focused on external factors as these have more management attention in the planning phase of the operation. Conversely, firms that are already engaged in offshoring focus more on day-to-day management problems. Although this may sound reasonable it still reflects a rather myopic perception of risks.

16.4.3 Limitations of the Study: Methodological Issues

As already indicated there are reasons to be cautious about the results and our interpretation of these. We would like to point at three methodological issues.

First—and related to the bounded rationality explanation—the gap between risk expectations and risk reality may be fictitious in so far as our survey respondents have indicated the importance of the listed risks not as a ranking of importance to the company as such, but rather in the meaning of importance to the respondent *at the moment*. In other words, the answers reflect which managerial concerns were occupying the respondent managers at the point in time when they filled in the questionnaire. This 'social constructivism' bias is, of course, somehow related to the bounded rationality explanation, but has also a methodological aspect, inasmuch as uncertainty about the respondents' interpretations of the questions throws doubt about the construct validity of the study.

Second, the apparent gap between risk expectations and risk reality may be due to the before-mentioned bottom-up decision process that often seems to characterize offshoring ventures. Our respondents are typically top- and middle-managers—mainly occupied by stakeholder policy issues, and less with operational matters. Only when these matters become critical in the later stages of offshoring do they take the attention of the managers (=respondents) as a result of the bottom-up decision process. Hence, the risks associated with exogenous factors are taking the attention of managers in the early phases of offshoring and only later on do the managers/respondents realize the serious importance of endogenous risks.

Third, we should not ignore the dynamism of international business. What used to be the most important business risks yesterday may not be so today, and this may apply for offshoring business as well. There are strong indications that the today's competitive scene is changed rapidly in the direction of firms—in their quest for achieving competitive advantage—being more focused on having good

relations to their various stakeholders. In comparison with the fine-tuning of in-house operations, reputational effects and corporate social responsibility are gaining more importance in the global competition. If this development translates to offshoring, it may very well make sense to assess external risks higher than firms experienced in offshoring used to do just a few years back.

16.5 Conclusions and Managerial Implications

Our Scandinavian data points to a clear distinction in the business risk perception of experienced versus inexperienced firms in terms of offshoring. Those firms that have experience with offshoring perceive the risks related to own operation management inadequacies—including inabilities to reap the benefits from offshoring—as the most threatening. The firms that are still in the phase of considering offshoring perceive the external risks as the most serious. This gap in the business risk perception between experienced and inexperienced firms can be explained by overconfidence in own competencies and myopic behavior, where offshoring in the outset is seen as a mainly tactical operation. Only later on, as operational problems occur, is the offshoring venture recognized as a strategic operation that requires attention from top-management.

These findings have important managerial implications—namely that managers should be cautious about having to much confidence in their offshoring operation capabilities. In addition, firms should apply a more strategic approach to offshoring from the very beginning—and not later on as the problems arise. This implies that firms might prevent subsequent operational problems by gearing the internal organization to meet the demands of an offshoring operational mode before offshoring operations begin.

Essentially, offshoring involves the transfer of value chain activities, and knowledge, from the home organization to the offshore organization (internal or external), the integration of activities and knowledge in the offshore organization, and the transfer of outcome and knowledge generated back to the home organization. Compared with a situation where all value chain activities are undertaken onshore in the home organization, operations offshore involve interfaces and interdependencies between activities in each part of the exchange between onshore and offshore units. If these interfaces are not organized optimally, the outcome will be excessive transaction, coordination and communication costs, delays and possibly poor service/product quality. However, firms can avoid or minimize these through organizational measures such as establishment of communication channels and procedures, specification of actions and responsibilities in operational processes, or even standardization of activities and manuals for personnel involved, of course depending on the nature of the activities involved. In the extreme case, modularization, if possible, is a very effective strategy for addressing problems concerning the transfer between onshore and offshore because it reduces the interface between these units to an absolute minimum.

Therefore, effective management and prevention of the operational risks of offshoring starts in the home organization before the launch of offshoring operations. Nevertheless, on the positive side, managers can avoid the offshoring fallacies of overconfidence by learning from the mistakes of offshore predecessors who, presumably, have paid fairly high learning costs.

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