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AUTHORS	Rhona E. Johnsen Thomas Johnsen Rafael Angeli Arab
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Coping with Outsourcing: An Interaction and Network Perspective

Rhona E. Johnsen, Thomas Johnsen, Rafael Angeli Arab

Abstract

Many companies that have undertaken outsourcing projects have found themselves struggling to control the activity they once controlled in-house. This paper proposes that the root of the problem is often that companies fail to recognise the importance of managing the relationship between the outsourcing organisation and the service provider, or supplier, which performs the outsourcing activity. Adopting an interaction and network perspective on outsourcing, the authors argue that both parties involved need to take appropriate measures to manage the outsourcing relationship and focus on developing trust and commitment as a key part of the outsourcing process. The authors draw on an illustrative case study of two companies involved in a complex outsourcing relationship that eventually failed. The case illustrates how trust and commitment supported by an atmosphere and culture conducive to developing close, strong relationships, is required to achieve long-term, mutually beneficial outsourcing relationships. The paper concludes with a discussion of key factors in the outsourcing process.

Key words: Outsourcing, Relationships, Interaction, Network, Trust, Commitment.

Introduction

Many recent studies have emphasised the importance of outsourcing, however, outsourcing means very different things to different people. From a European manufacturing perspective outsourcing is often, and increasingly, directly associated with moving component production to low cost countries, such as China (e.g. Bettis *et al*., 1992)[1]. In service industries, the trend towards setting up operations, such as call centres in India, is likewise considered the way forward for companies to remain competitive. More generically, outsourcing can be seen as procuring something that either was originally sourced internally (i.e. vertical disintegration) or could have been sourced internally, but the decision was made to go outside (Gilley and Rasheed, 2000; Harland *et al*., 2005). Following this definition, outsourcing is often closely associated with the make-or-buy decision. The current belief seems to be that such decisions should directly follow from a core competence analysis and that only those activities that are definitely non-core should be considered for outsourcing. However, in an age of co-makership and collaboration the divide between make or buy is far from clear. Indeed, the current trend appears to be to get as close to the core as possible e.g. insurance companies outsourcing risk assessment to third parties. Apart from the strategic importance of appropriate core competence analysis, this highlights the need for careful development and management of outsourcing relationships.

The problem is that many companies that have undertaken outsourcing projects have found themselves struggling to control the activity they once controlled in-house (Greaver, 1999). As a consequence many organisations have ended up either bringing the activity back in house (Gadde and Håkansson, 2001) or micro-managing the supplier or service provider to such an extent that the latter no longer has the flexibility to deliver the expected results.

This paper proposes that the root of many outsourcing problems is often that many companies fail to recognise the importance of appropriately managing the relationship between the outsourcing organisation and the company that performs the outsourcing service and balancing control and independence between the parties in the relationship.

[1] See also a recent Productivity/Outsourcing survey of Danish industry conducted by Anpro Management Consultants, February 2005 [http://www.anpro.co.uk/survey].

A Relationship and Network Perspective on Outsourcing

Outsourcing has traditionally been presented as a 'make or buy' decision that is usually taken to achieve immediate cost savings. Astute observers have suggested that outsourcing must be considered as a strategic long-term decision, which includes an assessment of risks and benefits in relation to both core and complementary competencies (Harland *et al*., 2005; Ford and Håkansson, 2002; Momme and Hvolby, 2002).

Our perspective on outsourcing is derived from interaction and network theory (e.g. Easton, 1992). This view implies that a company cannot develop a strategy for outsourcing and implement it discretely, without an understanding of the embeddedness of individual relationships within wider networks (Gadde and Håkansson, 2001; Ford and Håkansson, 2002; Knight and Harland, 1999).

A business network may be defined as a set of connected exchange relationships between firms (Forsgren and Johanson, 1992). Håkansson and Snehota (1995) propose a network model formed by actors, activities and resources, where companies develop networks of relationships through connected activities, linked resources and bonds between actors, all of the elements being interconnected and interdependent. The actors in a network are defined by the activities they perform and by the resources they possess. Through exchange processes with other firms' activities and resources, bonds are created and developed. Naudé and Turnbull (1998) affirm that managers need a better understanding of their own company's core skills and technologies and those of their suppliers, customers and service providers since business relationships and network connections are tools through which companies can have access to others' capabilities and resources. In addition, these authors suggest that those resources acquire value when they are used by and become useful to other firms.

The view of networks as reflected in research by the Industrial Marketing and Purchasing Group (IMP) (e.g. Håkansson and Snehota, 1995; Gadde and Håkansson, 2001; Ford and Håkansson, 2002) is of individual relationships as parts of a larger whole – a network of interdependent relationships. Relationships are connected since what happens in one relationship affects positively or negatively the interaction in others. Hence, what happens in a relationship between two companies does not only depend on the two parties involved in the relationship, but also on a number of other direct or indirect relationships. This approach to networks, as advocated by Ford *et al*. (1998) suggests that as a result of the complex interdependencies of networks, organisations may only manage, rather than control or co-ordinate in networks.

The literature related to business networks suggests that more and more companies are outsourcing non-core activities, but that many are finding that this is problematic (Ford *et al*., 1998; Lonsdale and Cox, 1997; Greaver, 1999; Ellram and Billington, 2001; Lonsdale, 1999). Håkansson and Ford (2002) argue that it is critical to the survival of outsourcing relationships that the company involved creates the necessary capabilities and conditions to manage the relationships that emerge out of outsourcing decisions.

The network approach to relationship management suggests that companies are specialised in fewer of the activities that are necessary to meet the requirements of their customers (Ford *et al*., 1998), presenting potential problems in demonstrating and communicating the company's capabilities in customer relationships (Johnsen and Ford, 2002). Indeed this is supported by the core competence perspective on outsourcing, for example by Ellram and Billington (2001) who consider that core competencies (Quinn and Hilmer, 1994) should not be outsourced, as this would be detrimental to the development of the company's unique capabilities and its ability to leverage these capabilities in its business relationships. Therefore, the activities that may be considered as outsourcing possibilities should therefore be those, which do not constitute the company's unique capability (Ellram and Billington, 2001; Quinn, 1999).

However, network theory implies that the boundary between competencies developed and nurtured in-house and those deployed through external relationships becomes blurred (Gadde and Håkansson, 2001). Hence, the question of core competencies becomes more difficult as it is no longer an either/or decision; external actors may play a key role in core competence development and maintenance. Granstrand *et al*. (1997) have shed some light on this management problem and argued the case for distributed rather than distinctive core competencies. In their view "*the challenge for management is to give more attention to the distribution of corporate technological competencies beyond the core, the enhancement and integration of new competencies, and the potential for related new product markets… While the emphasis in production has been on increasing focus and outsourcing, large firms have at the same time been spreading their technological competencies beyond their distinctive core. These competencies include the capacity to improve and to co-ordinate change in complex production systems and supply chains as well as to explore and exploit emerging new technologies*". (pp. 15-16)[1]. Hence, their view (*ibid.*) implies that the management of the critical network relationships that form part of and add value to core competencies and core technologies becomes critical. Indeed, it has been suggested that the ability to leverage a complex network of companies – or 'network competence' – is by itself a critical core competence (Ritter, and Gemünden, 2003). Consequently, the transfer of ownership of a business process to a supplier is an important and complex strategic decision and makes outsourcing a challenging process.

Relationship and network researchers have tended to take the view that in practice neither outsourcing decisions themselves, nor the management of outsourcing, is ever simple. Consequently, outsourcing has led to an increase in the importance of managing the logistics on which outsourcing depends, rather than focusing on the outsourcing relationship *per se* (Gadde and Håkansson, 2001). Ford *et al*. (1998) suggest that the development of outsourcing relationships will affect other aspects of a company's internal operations and may influence the nature of a company's connected relationships with its customers and suppliers. The effects of outsourcing on a company's costs are also complex. Suppliers or service providers may possess superior specialised capabilities that complement those of the outsourcing organisation; supplier capabilities may thus outweigh their charge for costs profit margin. Thus, the assumption is that competition will exercise a healthy pressure on suppliers and drive them to be more efficient than internal operations. This has driven organisations towards low risk sourcing strategies such as dual or multi-sourcing and strict monitoring of key performance indicators.

Other authors have highlighted that to enable a company to capture the benefits of outsourcing requires it to integrate its supplier relationships more closely, even to the extent that they be considered 'quasi-firms' (e.g. Lamming, 1993). However, as Ford *et al*. (1998) point out, close relationships require investment and are thus costly. So the balance of advantage in increasing the scope of a company's suppliers by outsourcing may depend both on the structure of the company's supply network, and on its ability to develop and manage its supplier relationships effectively. This in turn highlights the need for development of two key relationship variables that will be further investigated in this paper: trust and commitment.

The Role of Trust and Commitment

The issue of trust and commitment in business relationships has been a dominant theme in much relationship research. According to Ring and Van de Ven (1992), trust primarily emerges on the basis that the other party will fulfil its commitments. Repeated personal interaction discourages attempts to behave in an opportunistic manner and to gain short-term advantages and thereby increases the level of trust. Trust is often used very loosely, although Sako (1992) provides a useful operationalisation. She defines trust by using three forms: Contractual Trust, Competence Trust and Goodwill Trust.

Contractual trust is defined as the trust that the other party will adhere to the explicit and implicit points of the contract as agreed. Contractual trust is based on moral standards of honesty and 'keeping your word'. It rests on the expectation that the other party will fully honour the agreements, whether put down in writing or not (*ibid.*).

As relationships evolve, competence trust becomes more important than the written formal agreement. Competence trust revolves around faith that the other party has the competence to be able to produce what is required. Competence trust may be acquired by purchasing an existing competence or by investing in its development. Competence trust can be found in the institutional

[1] Granstrand *et al*. (1997) make the important distinction between the diversification and distribution of products and technologies: their concept applies to the latter.

environment of a transactional relationship and may be built up during the relationship, through investments by both parties (Sako, 1992).

Ultimately, goodwill trust is the decisive factor in highly evolved relationships; it is the trust that the other party will perform tasks in excess of the agreed terms and conditions. Goodwill trust is based on the expectations that parties have an open commitment to each other. Shared values and norms are a necessary but not a sufficient condition for developing goodwill trust. What is needed is a norm of open commitment and reciprocity.

Many outsourcing relationships experience problems which have been attributed to issues such as control, internal resistance, poor communication or inflexibility with changing business needs (Greaver, 1999). The literature on outsourcing suggests that a vital characteristic of strong outsourcing relationships is that a significant commitment exists between the customer and the outsourcer (*ibid.*). Both parties in an outsourcing relationship may be required to make significant time and resource investments in the relationship, adapt to new, more collaborative business relationships and build interpersonal capabilities. Outsourcing relationships require continuous coordination and communication between the parties involved.

Social bonding can often contribute to higher levels of trust and commitment in a relationship. However, trust and commitment may also be influenced by the level of the investment in the relationship and the quality of available alternatives (Mummalaneni and Wilson, 1991). Close personal relationships between the parties to a relationship have been identified as enhancing their commitment to the future of the customer-supplier relationship (*ibid.*).

In the following section we discuss the research methodology. Then the problematic outsourcing experiences of a British company, Energyco and its outsourcing relationship with a global service provider, Finserve, focusing on the role of trust and commitment as influencing factors on the development and management of the outsourcing relationship are discussed.

Research Methodology

The data for the illustrative case study were collected through qualitative in-depth interviews, meetings and participant observations. Each firm was interviewed several times over the research period to be able to identify any significant changes taking place in the outsourcing relationship. The respondents comprised managers of both companies who were directly involved in the relationship and who possessed knowledge and experience of outsourcing relationships. All interviews for the study were tape-recorded and transcribed. Follow-up telephone and e-mail contact was made with the respondents to validate the findings. These subsequent contacts were opportunities to clarify details, address any ambiguities, and to validate observations, perceptions and conclusions.

The unit of analysis for the empirical work was the relationship between the two companies involved in the outsourcing relationship. Conceptually clustered and role ordered matrices (Miles and Huberman, 1984), were used as coding frameworks to reduce, structure and analyse the data, whereby the responses from interviewees were summarised, interpreted and tabulated from the transcripts, according to the themes and issues covered in the interviews. This enabled intra-case comparisons and highlighted similarities and differences between responses. As this study was exploratory, and therefore concerned with understanding the unique situations and experiences of the companies involved in the relationship, a level of explanation building (Yin, 2003) was also required in the drawing of conclusions and verification.

Illustrative Case: the Outsourcing Relationship Between Energyco and Finserve[1]

Background to the Energyco-Finserve Relationship

Energyco is a British company, operating in the oil, natural gas, electricity generation, petrochemicals, and engineering and oilfield services through its divisions or affiliated companies.

[1] All names have been made anonymous to preserve confidentiality. The information for this brief case was collected via in-depth interviews with senior managers on both sides of the relationship i.e. within Finserve and Energyco, and secondary material such as internal company reports. In addition, one of the authors was employed for two years at Finserve and had personal experience of the development and management of the outsourcing relationship.

Finserve is a global organisation operating in approximately 150 countries, providing finance and accounting outsourcing services to clients such as Energyco. Finserve was involved in providing a finance/accounting outsourcing service for Energyco from 2001-2004, offering the client an exclusive relationship whereby Finserve had no further clients in the same business sector as Energyco.

The Role of Trust in the Energyco-Finserve Relationship

Energyco's view of the relationship was that Finserve was expected to fulfil, but not exceed, its contractual obligations. Energyco was happy to keep Finserve at arm's length, with the expectation of being in control of when and how Finserve's services were required. In other words, the Energyco-Finserve relationship was built primarily on contractual trust. Nevertheless, Finserve was keen to build a more wide-ranging relationship. Finserve's Managing Director believed that the key to extending the relationship into new territory was through developing a 'partnership mentality instead of client-vendor relationship'. This, he believed, could be achieved by openness of communication and sharing of knowledge and activities.

From Energyco's perspective, on the one hand, trust was critical to the success of the outsourcing relationship, as demonstrated by the confidence that they showed in Finserve's ability to perform outsourced tasks without the need for 'constant or excessive monitoring' to ensure performance levels. This was shown in Energyco's faith in Finserve's monitoring systems, especially in relation to Finserve's structures, systems and mechanisms for ensuring the outsourcing tasks were performed to the required standards.

On the other hand, Energyco's trust in Finserve's competence did not extend into areas that would encompass Finserve's abilities to evolve or enhance the outsourcing tasks or extend them into new areas. Energyco had reservations about extending its relationship with Finserve because of frequent 'organisational changes and a high turnover of key players' within Finserve. Thus, Finserve was unable to extend the level of goodwill trust from Energyco because of its corporate instability and its difficulties in sustaining key personnel who could further develop the relationship with Energyco. Moreover, the instability in the relationship coloured Energyco's perceptions of Finserve's outsourcing performance, thus further eroding Energyco's trust in Finserve.

Trust broke down between Energyco and Finserve at a critical point in their relationship when it became clear to Finserve that there were few avenues for expansion or diversity because of Energyco's limited input of its own activities and resources, whilst it kept a tight rein on Finserve's performance. Furthermore, Finserve's instability meant that it was unable to offer sustainable and consistent input to building trust with Energyco. Finserve effectively gave up trying to win the trust of its counterpart, making the situation irretrievable, when it became clear that Energyco had reservations about the long-term nature of the relationship and was not committed to building stronger bonds with Finserve.

The difficulties in building trust in the Energyco-Finserve relationship could therefore be attributed to issues related to people – weak actor bonds and a failure of personnel involved in the relationship to commit time and energy to building a shared future for the relationship that could encompass further linkages across their activities and sharing of resources in new areas that would support the development of the outsourcing relationship. Furthermore, the atmosphere of the relationship appeared to be one in which trust was not easily created. This could be attributed to the imbalance in control and decision-making between the two firms, with Energyco being in charge of the direction of the relationship and Finserve experiencing loss of control over the more important and strategic aspects of the relationship.

The Role of Commitment in the Energyco- Finserve Relationship

Despite difficulties in establishing and maintaining trust in the Energyco-Finserve relationship, ongoing communication between the client and supplier had sustained the relationship through some difficult periods. This involved clear and frequent communication of objectives and goals, commitment to improving processes and facilitating the smooth running of operations, together with design incentives related to successful performance. Finserve's Managing Director believed that 'people and processes' were essential ingredients that had sustained the commitment of both parties in situations where conflict had occurred over Finserve looking to minimise costs while Energyco's priority was maintaining committed service levels.

Energyco felt that Finserve would potentially try to hide behind the small print of the contract that was sometimes not clearly understood by personnel on either side of the relationship. It appeared that only managers directly involved in the relationship had a clear understanding of the contract details, while those at the frontline of providing the service in Finserve and receiving the service in Energyco were only aware of the contract at a very general level. This further aggravated difficulties in building trust and commitment when the frequency of change in personnel involved was high.

According to Finserve's Project Manager, there was 'a natural tendency for both sides to close ranks' when a problem arose, and that this could destroy the commitment already built up in the relationship and create communication problems. Furthermore, differences in Finserve and Energyco's corporate cultures meant that each side had different approaches to dealing with problems or conflicts and different perspectives on what commitment involved. Energyco perceived commitment as being reflected in the exclusivity of their relationship with Finserve, whereas Finserve's view was longer-term, focusing on commitment as a product of Energyco's enthusiasm (or lack of) to extending the relationship into new areas.

The Managing Director of Finserve believed that his company's familiarity with outsourcing as a core business process made relationships easier to develop. This contrasted with Energyco's view; of the outsourcer being the professional superior to the supplier because it 'held the cards' in the outsourcing relationship. Therefore, despite the requirement for high levels of professionalism and skill from Finserve in providing finance outsourcing services to Energyco, the companies appeared to be fundamentally at odds with each other on the issue of who held the key to increasing commitment in the relationship. Finserve believed that through providing highly professional services they were in a position to steer the establishment of commitment in the relationship, whereas Energyco's position as the outsourcer made them believe that they controlled the extent to which commitment to the relationship could extend into new contexts.

Key Factors in Managing Outsourcing Relationships

A key issue highlighted by the Energyco and Finserve example is the importance for companies of considering to what extent and in which ways other forms of trust, rather than merely contractual trust (Sako, 1992), can be built into the outsourcing relationship (Barthélemy, 2003). Furthermore, conflicting views by partners in the relationship of where the emphasis should be placed on different types of trust, may be a hindrance to establishing fruitful longer-term outsourcing relationships. The example also highlights the importance of stability and the continued support of personnel from both companies who have experience of, and understand the dynamics of, the relationship in forging the full complement of goodwill, competence and contractual trust (Sako, 1992) in outsourcing relationships.

The experience of Energyco and Finserve suggests that companies seeking to develop and manage their outsourcing relationships may reach higher levels of commitment by investing in people and processes (Mummalaneni and Wilson, 1991). Actor bonds were found to be a critical aspect of the investment in outsourcing relationships through sustaining the involvement of managers who can understand and articulate the details of outsourcing contracts to their own staff, and who can negotiate the further development of the outsourcing relationship with the other party involved. Moreover, the openness of managers to the perspectives and priorities of the 'other side' is critical in maintaining sound communication and ensuring that commitment already established is not destroyed when problems in the relationship arise.

Investment in new technology, development of simplified information flows, and improvement in controls, may also benefit the delivery of the outsourcing relationship in terms of efficiency, quality and reliability, and enable better management of the relationship from both parties' perspectives (Greaver, 1999). Nevertheless, although technology clearly has a key role in the development of good outsourcing relationships, it does not replace the core relationship development process – it is simply an enabler in the process (Harland *et al*., 2004).

Finally, the experience of Energyco and Finserve suggests that differences in corporate culture are an important but problematic factor in an outsourcing relationship. A culture that is used to outsourcing may make life easier for the supplier and the client. A critical factor in ensuring that commitment is sustained in the relationship and ensuring that one corporate culture does not dominate the other is the alignment of cultural priorities in the relationship. It is therefore important that companies consider the development of a culture conducive to, and supportive of outsourcing. Both parties may find benefits in aligning and developing their behaviour to facilitate their interaction, by establishing joint, mutually acceptable rules, routines or modes of conduct for the outsourcing relationship (see also Harland *et al*., 2005).

Conclusions

As product and service offerings become increasingly complex and multi-dimensional they require the input of more and more technologies and competencies. It is therefore of little surprise that companies have felt the need to outsource not only non-core low value activities but also those activities that lie in the grey area between core and non-core. The ability to leverage a complex network of companies is therefore increasingly a critical core competence (Ritter and Gemünden, 2003).

We have relied on relationship and network theory (e.g. Gadde and Håkansson, 2001; Ford *et al*., 1998) to argue that outsourcing is a logical yet problematic process, which requires the development of trust and commitment between the outsourcing parties. We have discussed the challenges of evolving different forms of trust, including contractual trust, competence trust, and goodwill trust. The example of Energyco-Finserve showed both how trust was essential in the early development of the outsourcing relationship, and how trust was eventually ruined due to different perceptions of contractual obligations and agreed levels of commitment, weak actor bonds, frequent organisational changes in key personnel dealing with the customer-supplier interface, and differences in corporate cultures. Indeed, the example showed that even if the cultures of the two parties are compatible, they may still have fundamentally different goals and objectives that are difficult to harmonise. A clear understanding of differences in culture and how to manage and respond in cross-cultural outsourcing relationships may therefore be a powerful weapon in outsourcing relationship development, and one which has not been fully explored in the literature on outsourcing to date.

In this paper we have focused merely on two factors involved in the management of outsourcing relationships: trust and commitment. There is a need for future studies to examine a wider range of characteristics of relationships that could potentially influence the conditions in which outsourcing relationships evolve. We have only built our discussions on one illustrative example of outsourcing relationships. Therefore, it would be important for future research to empirically examine different outsourcing relationship situations across a variety of industries and countries. Furthermore, the importance of aligning the cultures of the two parties involved in the outsourcing relationship is an aspect that deserves further investigation.

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