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Outsourcing practices and profitability levels of manufacturing firms in Uganda

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Abstract

Outsourcing has been growing as an important component of business operations in Uganda today. Manufacturing firms in Uganda have not been exempted in this development, hence the need to establish whether the outsourcing practice has any impact on the profitability level of manufacturing firms of Uganda. A survey covering 80 manufacturing firms was carried out using self administered questionnaires. Specifically, two respondents at management position were contacted purposively for representation of the company views. A total of 160 respondents turned up but only 153 respondents fully responded to the questionnaires. This represented 95.6% response rate. Findings indicated that outsourcing has a positive significant association with the level of profitability of manufacturing firms in Uganda (0.514**). The findings further indicate that whereas there is a strong and significant association between outsourcing and profitability, outsourcing is not yet pronounced enough to cause significant influence onto the profitability levels of manufacturing firms in Uganda. Thus the need for outsourcing companies to look into the actual aspects that manufacturing companies would like to be assisted into so that they can be able to cause significant influence onto the profitability levels of these companies. This is likely to be able to mark another phase in the development of manufacturing industries in Uganda since the management in these industries will be enabled to focus on the more core activities leading to their growth and expansion. This however, also creates an avenue for further research to be carried out in this direction.

Key words: *Outsourcing, Outsourcing practices, Manufacturing firms, Profitability levels*

1. Introduction

The concept of outsourcing has been widely used in many countries in the developed world (Gutman 2004). In Uganda, this concept is quite new and its applicability is not as common yet. New and young as it may be portrayed, it is considered to have some effect as a result of coming up of many companies to provide non-core activities in the country. This prompted this study to establish whether outsourcing could have any influence on the profitability levels of manufacturing firms in Uganda, which is the focus of this paper.

2. Theoretical review

Outsourcing is a practice among both private and public organizations, and is a major element business strategy. Most organizations now outsource some of the functions they used to perform themselves. Due to widespread outsourcing practices, it has become a frequent topic in literature (Tibor, Oya and Walter, 2006). While Lysons and Gillingham (2003), define outsourcing as the strategic use of resources to perform activities traditionally handled by internal staff and their resources. They view it as a management strategy by which an organization contracts major non-core functions to specialized efficient server providers. Outsourcing is a process of contracting with an outside party to handle a portion of a client's business Compared with traditional make or buy decisions (Espino and Padrón, 2006).

Strategies for outsourcing appear to be based on the desire to focus on fewer, more manageable core activities and gaining benefit from outsourcing non-core to specialist providers that will improve the firm's performance, Kistner (2002). In the single vendor outsourcing strategy, the outsourcer develops a strong relationship with one vendor. Although the single vendor leaves the organization open to opportunistic bargaining performance failure vulnerability, some have argued that it can be effective in some situations. However, multi-sourcing creates higher transaction costs than outsourcing to a single supplier and too many suppliers' means those individual contracts may be too small to successfully attract and excite good suppliers. Jennings (2000), proposes that the decision to outsource needs to focus upon the consequences for competitive advantage through core competence, critical knowledge integration, capability, cost, technology and impact on the quality. All these factors impacts on the profit levels of manufacturing firms.

Ford (2000) points out the reasons for outsourcing decisions as cost reduction, leveraging to make businesses focus on their core functions leaving operations details assumed by an outside expert. However, Kakabadse (2003) states that quality is an important driver not just from a scale perspective but also regarding the customer's perception of your product or service resulting to customer loyalty hence improving the firm's performance. Outsourcing can provide access to the "best in the world" quality for particular activities or components that will increase your market share (Quinn, 1999).

Outsourcing is an important element of business strategy for most companies in Europe and the United States (Kakabadse and Kakabadse, 2002). The argument is that outsourcing can reduce costs and hence improve the bottom line as long as contractual hazards do not dominate. Outsourcing can also influence product quality and thus affect firm revenues. This possible revenue influencing effect of outsourcing and how it influences profits jointly with cost reduction arguments is strategic for manufacturing (Walker, 2007).

Although outsourcing is such a widely applied business strategy, evidence on performance, its implications are surprisingly rare with majority of literature on vertical integration focusing on the governance choice (David and Han, 2004).The empirical literature dealing with performance implications of outsourcing mainly considers the impact on perceived performance (Gilley et al., 2004, Tiwana, 2008, Weigelt, 2009, Mani et al, 2010).

Outsourcing influences profits of manufacturing firms through cost reductions as argued by (Walker, 2007) supported by Crandall et al., 2009. David and Han (2004), argue that even though outsourcing is such a widely applied business strategy, evidence on performance implications is surprisingly rare, with the majority of the literature on vertical integration focusing on the governance choice .This is also in line with Gilley and Rasheed (2000) who revealed that literature dealing with performance implications of outsourcing mainly considers the impact on perceived performance.

Given the above review, the following conclusions can be made about outsourcing;

i) Outsourcing is subcontracting a process, such as product design or manufacturing, to a third-party company. Outsourcing has been described as the assignation of services from one company to another (an activity as old as the first firms). It is essentially a division of labor. The term has come to encompass the specific trend of importing services from low cost providers located offshore which is a decision to outsource often made in the interest of lowering cost or making better use of time and energy costs, redirecting or conserving energy directed at the competencies of a particular business.

ii) Outsourcing involves the transfer of the management of day to day activities of an entire business function to an external service provider. The client organization and the supplier enter into a contractual agreement that defines the transferred services. Under the agreement, the supplier acquires the means of production in the form of a transfer of people, assets and other resources from the client. The client agrees to procure the services from the supplier for the term of the contract. The firms normally outsource information technology, human resources among others.

iii) Outsourcing is one of the most important advantages of organizations because it is increasing a company's flexibility. This process enhances the flexibility of an organization in different ways.

A company becomes more flexible by transforming fixed costs into variable costs and this is possible because most services provided by outsourcing vendors are offered on a fee for service basis. A variable cost structure helps a company responding to changes in required capacity and does not requisite a company in investing in assets and hereby making the company more flexible (Tas and Sunder, 2004). Outsourcing may provide a firm with increased flexibility in its resource management and reduce response times to major environmental changes and enables the firm to focus on its core competencies without being burdened by the demands of bureaucratic tendencies (Tas and Sunder, 2004). Thus, key employees are herewith released from performing non-core or administrative processes and can invest more time and energy in building the firm's core businesses.

Another way in which outsourcing increases organizational flexibility is by increasing the speed of business processes. Outsourcing therefore allows firms to retain their entrepreneurial speed and agility, which they would otherwise sacrifice in order to become efficient as they greatly expanded. It avoids a premature internal transition from its informal entrepreneurial phase to a more bureaucratic mode of operation (Willcocks, Hindle, Feeny and Lacity, 2004).

It is obviously in the interests of profit maximizing firms to outsource activities as this will have the effect of reducing costs and hence increasing profitability (Leavy 2004). The benefits of outsourcing should therefore translate into higher productivity levels and output for the firms benefiting from outsourcing.

According to Gilley and Rasheed (2000), organizations that outsource are seeking to realize benefits or address issues such as lowering of the overall cost of the service to the business. This will involve reducing the preoccupation, defining quality levels, re-pricing, renegotiation and cost restructuring, andthus resources are focused on developing the core business. Hence, operating leverage as a measure that compares fixed costs to variable costs and as an approach to risk management and for some types of risks is to partner with an outsourcer who is better able to provide the mitigation. This is in line with a vast amount of research that has been done on the benefits and risks of outsourcing (Lacity et al., 2008, Yang et al., 2007, Kremic et al., 2006, Garg and Deshmukh 2006, Bailey et al., 2002 and Gilley and Rasheed, 2000).

When outsourcing does not work out as planned the company might well experience the way in which outsourcing makes a company very dependent on a vendor and therefore very inflexible. Consequently, these challenges need to be considered before a company decides to engage in outsourcing (Brabham, 2008). Rushing with outsourcing can lead to back-sourcing, which means reversing the outsourcing decision. Back-sourcing is often very challenging and costly (Quélin and Duhamel, 2003).

The profitability of outsourcing decisions has been studied in previous literature (Jiang and Qureshi, 2006), however, measuring it has proven challenging. Various theories have been developed to support academic research, but there are few tools available to use for practical decision-making situations (Harland et al., 2005). Many firms may outsource for various services for over a long time, but this may result into reducing benefits as supported by (Dekkers, 2011) who observed that outsourcing is a onetime operation and not as a process calling for continuous follow up.

Close competition has increased the practice of industrial companies to focus on their core competences (Rulangaranga, Ntayi, & Muhwezi, 2013), which rarely include maintenance. Together with many other supportive activities, maintenance gets often outsourced to service companies (Redondo and Canet, 2010) and (Espino and Padrón, 2006). Profitability of firms as a result of an outsourcing decision have been studied before, but not as widely as outsourcing motives and the process of outsourcing (Jiang and Qureshi, 2006). Dekkers (2011) states that in practice it is often assumed that additional value can be achieved through outsourcing, even though this has not been measured in any way. According to Bertolini and Bevilacqua (2004), most outsourcing decisions are made on the basis of predicted cost savings. However, previous researchers have found the process of assessing the cost effects of an outsourcing decision problematic (Saunders et al., 1997).

Outsourcing may provide a viable strategy if firms aim to save on labour costs (Abraham and Taylor, 1996), exploit production differentials both within the services sector and between services and manufacturing (Fixler and Siegel, 1999), or take advantage of globalization (Feenstra and Hanson, 1999). According to Bhuyan (2002), a fundamental question to ask is whether outsourcing is value enhancing and, in particular, whether the firm that undertakes outsourcing shows higher profitability. Essentially this question renders down to the transactions cost question regularly posed to manufacturing firms that will help them decide whether they should manufacture their own inputs by some form of merger or should it seek to obtain possibly more competitively priced inputs on the open market.

Outsourcing can be used to economize on production cost, in particular labor cost (Abraham and Taylor, 1996) by substituting in house production with the buying in of components. The cost of outsourcing is not only determined by the price of the bought in components, but also by transaction costs due to transport and incomplete contracting costs, and the possible implications of asset specificity for supplier or customer. Grossman and Helpman (2002) show that the viability of outsourcing is determined by the distribution of bargaining power between the two parties involved, the degree of competition in the market, and the number of potential partners in the market. Görzig and Stephan (2002) who used German data for a sample of large companies to examine the benefits of outsourcing, found out that firms that engage in materials outsourcing experience benefits, in terms of increased returns per employee. Wilmot (2009) outsourcing Survey indicates that nearly three fourths of the (surveyed) executives believe that outsourcing enables firms to survive in today's global economy.

For example, Girma and Görg (2004) find that out-sourcing in the United Kingdom, which was at least in part a cost reducing strategy, raised productivity for some domestic manufacturing industries, especially for exporters. The greater impact of outsourcing on the productivity of exporters is also confirmed for Germany by Wagner (2011) and for Ireland by Görg, Hanley, and Strobl (2008). Egger and Egger's (2006) study of 12 European Union countries suggests that the impact of outsourcing can change over time. It can have a negative impact on the real value added on workers in the short run, but this impact can be positive in the long run. Barthélemy (2001) estimated that the cost of monitoring information technology vendors and the cost of bargaining and renegotiating contracts with them can be as high as 8 percent of the annual contract amount. Furthermore, it is difficult to estimate the costs of switching from in house information technology activities to an external vendor and switching from one vendor to another. The actual cost of managing the overall outsourcing process can, therefore, be considerably higher.

According to Corsaire, (2005), outsourcing reduces the need to invest capital funds in non-core business function. This makes capital funds more available for core areas, which can improve certain financial measurements by eliminating need to slow returns on equity from capital. Expected benefits of outsourcing may include realizing the same or better products and service at a lower overall cost, increased expertise, quality, access to the latest technology and best talents and the ability to re-focus scarce resources onto core functions. Potential Risks of Outsourcing, include formulating and quantifying requirements, lack of methodology is believed to cause some outsourcing failures (Lonsdale, 1999), unrealized savings with a potential dependence on a supplier, lost corporate knowledge and future opportunities, as well as dissatisfied customers. It is also noted that outsourcing may fail because of inadequate requirements definitions, a poor contract, lack of guidance in planning or managing an outsourcing initiative or because of poor supplier relations, (Kistner, 2000). There is also possibility of choosing a wrong supplier, loss of control over process, long lead firm/ capacity shortage and hollowing out of the cooperation (Moncka et al, 2006).

3. Methodology

To successfully carry out the study, cross sectional research design was used. This was combined with both descriptive and analytical designs. A list of 80 manufacturing firms was used from which 160 respondents were considered as an ideal sample for the study. Out of the 160 respondents only 153 respondents returned fully filled questionnaires reflecting a 95.6% response rate. The data collected was taken through the processes of cleaning and processing in preparation for the actual analysis. The data was also coded using a combination of alphanumeric symbols. The actual analysis was carried out using correlation and regression analysis techniques.

4. Data Analysis, results and discussion

Regression and correlation estimations were carried out using the SPSS software. These are further elaborated using the mathematical representations below.

4.1 Correlation results

Correlation analysis was carried out with an aim of establishing whether there is an association between the practices of outsourcing and profitability levels in manufacturing firms in Uganda displayed in a Table 1.

Table 1: Correlation results

	1	2
Outsourcing (1)	1	
Profitability (2)	.514**	1

Source: Primary data

Results in Table 1 indicate that there is a very strong and positive association between outsourcing practices and profitability levels of manufacturing companies in Uganda. This is an indication that improvement in outsourcing practices has a high chance of improving the profitability levels of manufacturing firms in Uganda.

4.2 Regression results

Following the correlation analysis, the regression analysis was carried out to establish the degree of influence that outsourcing has onto the level of profitability in manufacturing firms in Uganda. Results are displayed in Table 2.

Table 2: Results of Regression analysis

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
Outsourcing	0.075	0.068	0.115	1.089	0.280
Dependent Variable:	Profitability				
R:	0.514				
R square:	0.264				

Source: Primary data

Basing on the results in Table 2, it is obvious that outsourcing practices are not yet influential towards the profitability levels of manufacturing companies in Uganda. This therefore means that outsourcing practices have an association with profitability levels of manufacturing firms in Uganda though this association is not strong enough to cause a significant impact on the overall profitability of these manufacturing firms.

5. Conclusion

The research carried out has been in position to bring out clearly the influence that outsourcing practices have onto the profitability levels of manufacturing companies in Uganda. This influence signifies that outsourcing is there in Uganda, well practiced but not professional enough to be influential on the side of manufacturing firms in Uganda. This means that there is indeed need for outsourcing companies to look into the actual aspects that the manufacturing companies would like to be assisted into so that they can be able to cause significant influence onto the profitability levels of these companies. This is likely to be able to mark another phase in the development of manufacturing industries in Uganda since the management in these industries will be enabled to focus on the more core activities leading to their growth and expansion. This is however not automatic creating an avenue for a new research to be carried out in this direction.

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