

Factors Affecting the Decision to Outsource Human Resource Management: Evidence from Two Multinational PEOs

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ABSTRACT

This paper is an exploratory investigation into the relationship between a PEO's capabilities, its client's ability to assess these accurately, and the decision to outsource HRM in a multinational context. The literature review highlights that while the capabilities of a PEO are a known factor in successful outsourcing decisions, there has been little discussion of an organisations ability to identify such capabilities. Thus it is argued that not all PEOs possess the 'full spectrum' of HRM capabilities, and furthermore, that a contracting firm is more unlikely to be aware of this when the relationship is transacted across international borders. This hypothesis is supported by case study investigations of two international PEOs and six of their clients, carried out during 2006. The paper discusses significant ramifications for organisations, which are in growing numbers, deciding to outsource some or all of their HR function.

Keywords: Outsourcing, Human Resource Management, Multinational Corporations, Case Study

INTRODUCTION

A useful business axiom is: any decision that brings about a reduction in cost, while maintaining at-least equal levels of quality and strategic focus, will increase the competitiveness of an organisation. It is unsurprising, then, that if an organisation thinks it can lower the cost of one of its functions by outsourcing provision, all other things being equal, it will do so. In the field of Human Resource Management (HRM) this simple truth has lead to an exponential growth in the use of external providers for HRM functions (Hirschman, 2000), predominantly in the last 15 years.

In the context of this phenomenon, several questions become pertinent: Of what benefit is outsourcing HRM? What factors influence the decision and moderate the outcome? And, do HRM outsourcing firms really deliver the same functionality of a traditional employer (in both the short and the long term)?

The corresponding growth in academic research in response to these questions is significant (see: Greer et al., 1999; Hendry, 1995; Klaas et al., 1999, Klaas et al., 2000; Klaas et al., 2001; Klaas, 2003; Lepak and Snell, 1999; Lepak et al., 2005; Lever, 1997). While not wholly convergent, this literature has provided a fairly robust list of factors that explain the decision to, the success of, and possible drawbacks resulting from HRM outsourcing.

Drawing extensively on the existing literature, this paper argues that current models designed to explain the outsourcing phenomenon overlook two significant factors: there is precious little mention of the ability of the outsourcing firm to provide the HRM practices that form the basis of the decision to outsource, and even less examination of the contracting firm's ability to assess such skills. Furthermore, transacting such outsourcing relationships beyond national boundaries further compounds such problems.

BACKGROUND

In the past large organisations, both public and private, were able to achieve significant cost and differentiation advantages (Porter, 1980) through complex organisational structures, systems, and processes. Following the tradition of classic organisational design (Fayol, 1930), departments delivered functional support for operations carried out in much the same way year after year. Such configurations grew into organisational 'pyramids' where strategic information coalesced and was crafted into more specific tasks and goals. Because these configurations represented proprietary knowledge, and due to the amount of time invested in their development, it was unlikely that an outside organisation would be able to duplicate the specialised provision internal departments delivered as routine (Hendry, 1995). Furthermore, the cost of transportation, information, and communications technology of the time dictated that any non-standardised (i.e. external) communication and/or collaboration were inherently expensive and thus reserved for high value transactions such as sales.

So what has changed? The centralised 'organisational pyramid' was arguably a historical solution to the problem of strategic communication and control given the constraints of the time. Today the relative costs of communication, transport, and market

information are all significantly lower. This has removed the need for large 'middle management' populations within organisations, who had historically managed such processes. Using terminology from Economics, 'transaction costs' (Williamson, 1975) have been reduced, and so the value of centralised organisational systems has, in many cases, become less.

These changes in transaction cost have also resulted in a greater intensity of competition across national borders. In a marketplace where access is cheap: goods, services, and information with market value no longer need a centrally located organisational superstructure for effective delivery and control. So, while in the past any business function might shelter its cost under the auspices of necessary operating expenses, today a department's expense will only usually be justified by a concurrent contribution to competitive advantage. As Hendry (1995) points out, an organisation might not monitor year-to-year changes in transaction costs, but they do respond to commercial and competitive pressures, from which changes in organisational structure follow. Looking back 15 to 20 years, the forces of international competition and western economic recession only served to exacerbate the pressure on organisations to cut costs and link any capital expenditure to measurable returns on the investment. This is the background from which the debate over the role of HRM begins.

LITERATURE

Much has been made of the value of outsourcing HRM to Multi-National Companies (MNCs) in the practitioner literature (see: Davidson, 2005; Morton and Wilson, 2003, and Pollitt, 2004, among many others). From the Anglo-American business perspective, a reduction in short term costs coupled with the ability to contractually oblige prescribed service levels has, of late, meant that many organisations view outsourcing HRM as a relatively uncomplicated choice. If the debate over HRM outsourcing were as simple as enumerative measurement of HRM provision costs, then the discussion would be short lived. Large HRM outsourcing organisations, usefully termed 'professional employer organisations' (PEOs) by Cook (1999), have invested huge sums to ensure that the HRM they provide is, on a per unit basis, cheaper than hiring an in-house human resource (HR) manager. In point of fact, it is the basis for their competitive advantage! While this might encourage some organisations to outsource, all but the most fiscally driven managers would admit there is more to the debate than short term cost advantage. Thus before dismantling the HR department, it seems important to

question what factors influence the decision.

Cost

As briefly discussed in the introduction, cost is the major influence on the decision to outsource HR. As Klass (2003) points out 'economies of scale make it difficult for SMEs [small and medium size enterprises] to maintain a professional HR staff and to internally develop required HR programs and services.' So in the first instance it can be argued that employee expectations of service may force employers to outsource services that they could not (cost effectively) develop with their own resources.

This argument is not only limited to SMEs though. As provision of specialised 'transactional' (Klaas, McClendon, and Gainey, 1999) HR services such as payroll and pensions have become easy to administer electronically, their market value has dropped. So in many ways traditional 'personnel' services have become more expensive relative to the market. Without outsourcing provision the over-all cost basis of an organisation would therefore rise relative to the competition.

Beyond simple development costs or market comparisons, HR departments may also be seen as expensive if one accepts a narrow definition of 'core capabilities' (Prahalad and Hamel, 1990). As Barney (1999) argues, core capabilities play an important role in defining the boundaries of the firm. In this narrow definition, the 'core' of the firm is that which is its unique contribution to the marketplace, and therefore, should be the focus of all management's attention. Thus if it is more costly to develop a capability (in terms of management time) then the value of this ability (in unique competence) the firm will not gain any competitive advantage by doing so (Gilley and Rasheed, 2000).

Organisational capabilities

While cost is at the forefront of thought in western economies (arguably due to the link between market value and senior management compensation), it is far from proven that outsourcing has a direct benefit on the overall performance of an organisation (Gilley and Rasheed, 2000). To extend the argument on the drivers of outsourcing HR, it is also important to consider organisational capabilities.

Existing arguments suggest that HRM departments should deliver in-house those services that are core to their organisation's competitiveness, and outsource those services that are considered peripheral (Klaas et al., 2001; Lepak et al., 2005). This

argument is based on the resource-based view (RBV) of the firm (see: Espino-Rodriguez and Padron-Robaina, 2006 for a significant review), which posits that an organisation's profitability stems from unique abilities and resources. Argyres (1996) suggests that organisations tend to outsource when suppliers demonstrate superior capability. In the UK obvious examples would include high-street recruitment agencies, of which there are paucity. Such agencies practice daily the HR functions of attracting and selecting staff, a task that even very large firms would do much less frequently. Given adherence to the Psychometric model of recruitment (Newell and Shackleton, 1993), it can be argued that such familiarity would constitute a superior capability, due to the wealth of data that a specialist HR provider would accumulate in relation to their activity (predictive statistics being the cornerstone of the Psychometric Model). Furthermore as Leiblein and Miller (2003) point out, in an ever-changing market economy there may be some services that are either so new, or so infrequently used, that a firm of any size will not be familiar with the activity. In this case a specialised external provider is almost the de-facto choice. In MNCs the problem is compounded as they become responsible for delivery of HRM to a disperse and diverse employee base. As such a company becomes represented in more nations it becomes increasingly likely that their HRM function will not be as effective or as knowledgeable as local or regional PEOs or HRM outsource providers.

Nature of HR activity

An important outcome of the 'organisational capabilities' argument for those considering outsourcing HRM is an understanding of the need to examine nature of HR activity. Before outsourcing a function, organisations might consider whether or not it is likely to contribute to the organisation's core competency, or instead takes up management time better spent on core activities. But how do we determine what will and what won't? Lepak et al. (2005) argue that the delivery (internal or external) mode is determined by contingent factors of the HR activity. They draw on Carrig (1997) who suggests that HR practices may be viewed as 'transactional, traditional, or transformational.' In this vein payroll administration might be considered transactional, recruitment as traditional, and strategic planning as transformational. Lepak et al. go on to argue that 'At a general level, a parallel exists between the transactional-transformational HR activity continuum and core-peripheral continuum...Consequently, we anticipate a greater reliance on outsourcing for transactional practices' but note that it 'is the manner by which HR practices are used that determines whether they are

transformational or transactional, rather than the practice itself.'

What are some of the reasons why an organisation might keep HR in-house?

Following the argument so far, if a department is to be kept 'in-house' then an organisation must justify its expense with a concurrent intake of value. But if value is measured then immediately problems are encountered. In most literature value is examined through measurement of the formal business processes. Not only are such business processes easy to measure but they also form the basis of intra and inter firm comparisons, which as has already been discussed, have driven the outsourcing phenomena. The difficulty, as Hendry (1995) points out, is that formal operating systems form only one side of the information processing mechanism of the organisation. Hendry (1995) argues that organisations also include two further systems: 'the Infra-System... are largely informal, and are rarely recognised explicitly. They consist of casual conversations and personal interactions, of implications and inferences, feelings and intuition, symbolic gestures and value-based interpretations,' and 'Adjusting systems...which help provide direction and underlie decision making.' So a significant drawback to outsourcing may be to overestimate the returns gained by value judgements of the operating system, and ignoring the inherent disruption of socio-cultural systems that will undoubtedly result.

If the social system underpinning the decision-making process of the organisation is stripped of its cohesion, what will this mean for strategic decision-making? Following the core-competency argument, a major advantage of outsourcing transactional HR tasks is that HRM can become strategically focused (SHRM). But how strategic is HRM? As Millmore (2003) argues, many large organisations that have the resources to consider strategically integrating HR activity with strategic policy have failed to do so. Thus, it must be asked if removing HRM as part of some larger focus on the core, will actually remove one of the few remaining 'adjusting systems' which aide strategic decision making? It is well recognised that such systems have, in the past, been the buffer between top-down driven change and those responsible for operationalising it. In MNCs HRM is one of several such adjusting mechanisms that allow for a two-way flow of information; providing regional offices with best practice and senior executives with local context based insight.

As one of the few voices for dissent, Hendry (1995) offers a four part summery list of outsourcing's risks and rewards: Element one 'the balance between efficiency and

learning.’ ‘Efficiency is the prime goal of outsourcing...but learning, which depends on culture and community, is equally essential for longer term survival,’ a view reinforced by Blackler (1995), Nonaka (1994), and Senge (1990). Element two, the requirement ‘to balance focus and awareness.’ ‘Without focusing on core activities it is impossible to concentrate resources where they are most needed.’ But, ‘Without the awareness made possible by more reaching informal communications systems it is impossible to change focus and redirect resources when that becomes appropriate.’ Element three ‘there needs to be a balance between motivation and control. Control allows you to specify what is done ...This conflicts with the demands of motivation, which ensures the tasks are carried out effectively...in a way that is appropriate and beneficial to the organisation.’ Element four ‘autonomy needs to be balanced with coordination: autonomy to ensure that each unit responds to the circumstances...coordination to ensure that it does so in a way that is consistent with the organisation as a whole.’

What is likely to make the outsourcing decisions a success?

In the first instance it is important to point out that very little empirical research has been carried out examining the effect of the decision to outsource. Furthermore, much of the HRM outsourcing literature has concentrated on modelling factors that predict the outsourcing decision, rather than examine its success. Therefore to discuss what might make HRM outsourcing successful is to examine outsourcing success in general and to engage in conjecture.

Gilley and Rasheed (2000) argue ‘the results [of their empirical study] indicate that firms pursuing more intense outsourcing strategies do not experience significant direct performance impacts... However, it is highly likely that outsourcing has an effect on the individual functional areas in which it occurs...Therefore, individual functional areas may experience performance improvements or declines as a result.’ This argument is usefully understood in two parts. First it is evident that for the outsourcing decision to be a success the provider would have to deliver service that was uncommon. In other words, if due to its tradable nature outsourced provision does not provide market advantage, then only an outsourcing relationship that leads to market beating provision will bring measurable gains in ‘success.’ Second, it is clear that outsourcing will only be successful if it meets goals on a departmental level. Whether it is the HRM department who manages the relationship or some other operational function, there will only be ‘success’ where the outsourcing service meets the needs of that department. This seems an area

worthy of further investigation!

If outsourcing does not provide over-all increases in firm performance, even given its well known cost and competitive focus advantages, then the decision to outsource must also consider whether the provider (in the case of HRM, a PEO) has market leading skills, and whether these skills are sufficiently understood by the contracting organisation in such a way that they form part of the outsourcing 'plan' in the first place.

What don't we know...or do we?

So what of the skills and core competencies of the PEO itself, and the contracting firm's ability to identify these? While this paper argues that such factors are probably overlooked in the decision to outsource, the literature to date does hint at their importance. Klaas (2003) states 'the efficient access to HR expertise offers mechanisms by which to improve the quality of HR programs and, in turn, HR outcomes.' Thus there is an implicit assumption in Klaas's work that PEOs are 'experts' in HRM provision. Furthermore Klaas (2003) states 'The degree to which an SME experiences improved HR outcomes as a result of PEO utilization will depend on the degree to which its PEO service provider possesses knowledge about the business processes and conditions at the SME.' This implies that it is not just the skill of the PEO that an organisation needs to acquire, but also the development of some broader relationship based on a mutual understanding of one another's capabilities and needs. Clearly in the negotiation process needs and cost would be at the forefront, but in such circumstances do (especially western) organisations gloss over the extent to which they understanding each others capabilities? Furthermore, while Lepak and Snell (1999) argue that 'Outsourcing may... be a cost-effective option that allows firms to gain access to knowledge, skills, and abilities needed for low value-added practices' it would seem even more important to understand the PEO's skill level as firms increasingly choose outsourcing for provision further 'up' the transactional-transformational continuum.

Research questions resulting from the literature review

Approaching the HRM outsourcing decision, this paper hypothesises that: 1. 'PEO competency' is not one of the contingent factors included in a contracting firms decision-making process. 2. Contracting firm's do not have 'judging PEO level of HRM skill' as an organisational characteristic.

APPROACH

During 2006 a number of regional PEOs, and through them their MNC clients, were approached for open case study examinations. After initial contacts were made, the researcher negotiated access with those (available) senior staff best able to comment on issues of strategic direction, company policy, and operating methods. In the case of the PEOs this required access to senior staff at the organisation's HQ, and in the case of contracting organisations this meant access to those directly involved in the outsourcing decision. In the case of the contracting firms, the researcher specifically contacted those who authorised payment or managed the relationship, where possible.

Semi-structured (Saunders et al., 2003) techniques were used during the interview process due to their greater potential to understand relationships between variables; while also allowing the respondent expand on the nature of the variables, and add to those developed during desk research. The four pre-identified themes used in these interviews (for both types of organisation) were: discussion of the nature of HRM and its component parts; perception of ability with regards to these HRM practices; discussion of other abilities and (if understood) core competencies, and discussion of nature of outsourcing relationship. In addition contracting firms were asked to comment on five further question areas: how they chose the PEO they have contracted; what services they provide; what is their perception of the PEO's ability to provide HRM services; how did they generate that perspective, and why they chose to outsource the specified HRM provision.

CASE STUDY DISCUSSION

For the purposes of this paper discussion will concentrate on initial results from one large Anglo-American PEO, with 'Mancorp' as a moniker and a one small European PEO, with 'Focuscorp' as a moniker, along with several MNC clients of the respective firms.

Mancorp: is in terms of size and geographical presence, a leader in professional employment provision. Mancorp can be considered an innovator in this field, as it was one of the first HR outsourcing firms to actually take the role of employer. To simplify: Mancorp is asked to fill a position, or number of positions by a contracting firm; is paid directly to do so; uses this commitment as the basis to itself hire employees, which they later place on the contracting firm's site. From the recruitment and selection process right through to termination Mancorp is responsible for all what could be called formal

(explicit) HRM functions. It can be argued that Mancorp is one of the few complete PEOs, being responsible for so many facets of the employment relationship and for so many hundreds of thousands of employees across the world.

What does Mancorp perceive to be the core functions of HRM, and which does it feel its remit to supply? Mancorp's responses centred on: recruitment, management of benefits, management of behaviour and workload, and the employment contract. It feels that the most difficult problem facing organisations is dealing with turnover and short term staffing needs caused by projects and extended leave. They argued that most organisations don't have the time to follow the important steps necessary to recruit, select and contract short to medium term staff of a high calibre. It feels this is its unique contribution and core remit. Furthermore it argues that it offers a less expensive and quicker service than any internal HRM department might in this regard. It is aware that HRM may be more than the 'Resourcing' process, but argues that line managers are better placed to deal with those issues.

What does Mancorp actually supply, and what are the key skills of its executive team? From the researcher's perspective Mancorp is a recruitment agency that generates much of its profitability through access to a very large pool of potential employees and with its knowledge of the 'market price' for their skills. When visiting the UK HQ it was clear that the focus of the organisation was on placements per day in much the same way a car dealership focuses on sales. The senior staff, as recounted by those interviewed were mostly involved in marketing, strategy and sales activities. None of those interviewed had a formal or professional qualification in HRM or personnel, and there were few mentions of what academics might call 'soft skills.'

Why do Mancorp's clients choose Mancorp, and how do they see it operating? Contracting firms 'discovered' Mancorp through a variety of methods, but the most frequently mentioned was the location of a nearby branch or by reputation. After speaking with local Mancorp representatives, these potential clients tended to respond to a belief that Mancorp could fill vacancies in their organisation 'quickly.' Many of the clients appreciated that Mancorp would take much of the HRM burden for dealing with short term staff away from them. Finally, one of the client firms noted that they enjoyed the option to 'negotiate service levels' with Mancorp rather than with the employee once on site. These client firms see Mancorp as a full HRM provider, but one that is used for staff such as customer contact, administration, technical support, or low level manufacturing roles. None of the clients used Mancorp for filling what they called

‘management [middle to senior] roles.’

What information sources did these client firms use in choosing Mancorp, and how do they see their own skill in HRM delivery? While each responded with different terminology Mancorp’s clients all used cost as the primary evaluation tool. When asked about HRM skills a common response was that they didn’t really expect Mancorp to replace the soft traits of an experienced line manager, but prior experience with PEOs informed their position that Mancorp would at least source the ‘right kind of people.’ Smaller clients of Mancorp felt that they knew their business well but lacked the capital and experience needed to find staff in markets where ‘turnover is impossibly high.’ These organisations frequently reported that they had no formal HRM officers and that outsourcing areas such as IT and HRM provided them access to skills ‘available to larger organisations.’ The largest client of Mancorp interviewed reported that it had strict rules when contracting outside organisations for internal support provision. Interestingly when the material relating to this process was reviewed there was no mention of several key attributes of Resourcing functionality, such as ethics, law, validity of selection, or knowledge management.

Focuscorp: is by its own admission, not a full PEO. Focuscorp does not employ those it places on contracting firm’s sites. It is also a small firm, with fewer than 1000 contracts at any one time and less than 25 staff of its own, located across three countries. Focuscorp is in the business of specialist recruitment, placement, and development. While no two of its contracts are the same it could be summarised that it: is contacted by potential clients in technical, scientific, and small scale manufacturing organisations; spends time profiling potential employment needs, job designs, and job specifications; it builds a contract around the fulfilment of a business need rather than filling of a vacancy; it then carries out a detailed process of recruitment, selection, induction and sometimes development, and finally the contract is fulfilled when the client firms offers the employee a full time position. It could be said that Focuscorp is as much a consulting firm as it is a provider of HRM outsourcing. While Focuscorp’s services are tailored to the client, needs are examined rather than simply accepted.

What does Focuscorp perceive to be the core functions of HRM, and which does it feel its remit to supply? Focuscorp sees HRM as a set of ‘strategic choices’ not as a distinct functional speciality. Employees at Focuscorp recognise the normative HRM tasks but argued that these are really a function of efficient administration. Specifically, Focuscorp labels all of its activities ‘strategic.’ They state that while in some circles what

they do might be seen as staffing, the pre and post work needed for placement of highly educated, skilled and value generating staff they provide has a distinguishable impact on the competitive position of client organisations. They feel it is their remit to supply 'HRM as core capability' and believe it is the responsibility of the client to provide 'operational' support.

What does Focuscorp actually supply, and what are the key skills of its executive team? After speaking with Focuscorp's clients it appears to be much more a specialised head hunting service than a PEO. Focuscorp is not without ability though, and does take the client centred consulting role they had claimed to during initial discussions. Focuscorp's executives are all experienced HRM professionals, several possessed HRM postgraduate or professional qualifications, and there were even a few academic texts amongst the practitioner literature in the open plan office where the interviews took place. Focuscorp understand the Resourcing process, but beyond this have developed some of the soft skills needed to encourage trust and aide retention. Focuscorp are not involved with organisational learning, ethical practice, termination, or performance.

Why do Focuscorp's clients choose Focuscorp, and how do they see it operating? All clients interviewed had 'found' Focuscorp by recommendations of others in their industry or community of practice. In many cases clients saw Focuscorp as 'the only option' where they could not source a large PEO able to 'resource' in their field. Contracting organisations see Focuscorp as a temporary internal HRM department. They praised its willingness to work with them 'on-site' and their flexibility in service provision. They see it as an 'expensive but worthwhile' choice.

What information sources did these client firms use in choosing Focuscorp, and how do they see their own skill in HRM delivery? Focuscorp's clients use the cost vs. expected provision model of decision-making. This differs from the choice available at Mancorp as when Focuscorp is working on a client's site the client has multiple occasions to examine 'what is being offered and how much it will cost'. This being said Focuscorp's clients tended to use what an experienced practitioner might call 'superficial' information searches. This is unsurprising as many of the small and specialist organisations who contract Focuscorp have few or no dedicated HRM professionals of their own, and those that do 'tend to work on local compliance rather than strategy.'

CONCLUSIONS

With information collected from the first few case examples, this paper finds support for the following positions:

1. Some PEOs have developed extensive, specific, and cost-lead (Mancorp) solutions to a variety of HRM service needs. The Resourcing function is among the most common functions provided.
2. Some PEOs and other HRM outsourcing providers do not possess, and are not trying to develop, a 'full range' of skills traditionally attributed to HRM.
3. The leadership and management structure of the PEOs (Mancorp and Focuscorp) is, like many organisations, based on sales and not HRM. This tends to be less so in specialist HRM providers where the executive team are owner-operators. In these instances the HRM outsourcing organisations have developed around a specific HRM knowledge base rather than around the demands of the market (Focuscorp).
4. Client firms are for the most part not aware of PEOs skill sets, as is evidenced by responses from informants from the six contracting organisations. Client firms base the majority of their decision on cost and the information provided by the outsourcing organisation. This may stem from either a lack of awareness of HRM as a discipline, or more often a lack of choice due to the constraints of time and/or alternatives in an international context.
5. Client firms use superficial information searches. This problem is compounded when contracting PEOs across borders, which might allow a PEO's ignorance of key HRM knowledge to go unnoticed.

Given these arguments this paper proposes to amend the current framework for future examinations of HRM outsourcing decisions and HRM outsourcing success; to include 'PEO competency' as a contingent factor and 'Client firm's understanding of PEO skill' as an organisational characteristic.

IMPLICATIONS FOR MANAGEMENT

In the international marketplace of 2007, where short term profitability and share price are the major considerations of senior management teams, it is unsurprising that the decision to outsource the provision of HRM is often based on an organisation's knowledge of upfront costs and their immediate needs. Furthermore, it can be argued that this 'bounded rationality' (Cert and March, 1992) will become increasingly common

as the complexity of the HR services needed by organisations increases at a pace beyond their own capacity to learn. It might be asked whether it is even desirable to keep up to date with such knowledge given the lessons from the technological phenomenon known as ‘the bleeding edge.’

The question for management practitioners must then be ‘of what value is HRM,’ and in relation to the examples presented ‘what is the value of the Resourcing process.’ The answer? It seems reasonable to imagine a continuum where ‘success’ would result from an increasing investment of time and money in understanding what PEOs actually provide (and then choosing a competent provider), depending on a parallel increase in the value of the HR service or employee to the organisation. This position is surely nothing radical, but work to date indicates that it is not common in practice.

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