

## Effect of Outsourcing Typologies on Organizational Performance of Small and Medium Enterprises in Kenya.

Author Details: Lagat Dorcas C.

### Abstract:

*The study determined the effects of Business Process Outsourcing on SME performance, effects of knowledge Process Outsourcing on SME performance. The study was guided by Resource-based View, Agency Theory, and Transaction cost Theory. This study used a combination of cross sectional and explanatory research design using a sample size of 440 SMEs. This study deployed the use of a questionnaire as a data collection technique. Descriptive statistical procedures including frequency distributions; means, standard deviation multiple regression, and correlation as a form of inferential statistical analyses were used to test hypothesis respectively. Study findings showed that business process outsourcing and knowledge Process Outsourcing have a positive effect on SME performance. It is, therefore, necessary for SMEs to outsource so as to cut on costs, focus on core business, secure business flexibility, and develop core competencies, inimitable resources and capabilities within the firm. There is a need for SMEs to embrace business process outsourcing in order for SMEs to improve their performance.*

**Keywords:** Business Process Outsourcing, Knowledge Process Outsourcing, Small and medium enterprises, Performance

### 1.1 Introduction

In order to survive and be profitable in the current globalized era, organizations have pursued continuous improvement, lean production, reengineered business processes, and integrated supply chains (Brannemo, 2006). Over the past decades, there has been a growing realization of the important contribution of outsourcing strategy on organizational performance (Cousins *et al.*, 2006). The Resource Based View (RBV) on the other hand indicates that firms that have a rich competence base can have their activities internalised. Those firms that are less well prepared internally find outsourcing more viable. Well placed useful internal capabilities for an activity reduces the likelihood the activity will be outsourced (Leiblein *et al.*, 2002). The most used relevant comparison to determine the strength of firm capabilities is with potential suppliers, not with competing firms.

Organizations are using Outsourcing to increasingly improve efficiency (Vining and Globerman, 2000). As a management strategy, Outsourcing is used by organizations to delegate major, non-core functions to specialized and efficient service providers. According to Corbett, 1999, outsourcing is nothing less than the holistic restructuring of corporations around core competencies and outside relationships. Yankelovich, 2003, indicated that two-thirds of companies world-wide outsource at least one business process to an external third party. This practice appears to be most common in the U.S., Canada, and Australia, where 72 percent of outsourcing is being sought. Javaligi, 1998, noted that a successful implemented outsourcing strategy had been credited with helping to cut down costs, increase capacity, enhance and improve quality.

Previous research on outsourcing (Jacobides, 2005) has largely explored the financial implications of outsourcing and mainly presents parent organizations with dissatisfaction with the ongoing projects which are often terminated before expected maturity date (Kavcic and Tavcar, 2008). Despite the growing interest in the phenomenon of outsourcing, which has recently raised increasing attention among researchers in India (Pandey and Bansal, 2003) and China (Choy *et al.*, 2005), it is difficult to trace a comprehensive strategy for preventing or resolving problems of outsourcing projects. Studies (Thoms, 2004; Schniederjans *et al.*, 2005; Taylor, 2006) often reveal that hidden costs are the most problematic segments of outsourcing, in which problems usually occur when organizations are already heavily involved in the outsourcing projects and the termination of contract in that phase would inflict large financial losses for both sides. It is surprising that research is rarely dealing with other negative consequences of outsourcing that may pose a potential threat. In that case, hidden costs will remain a part of outsourcing.

Empirical studies show that SME's outsource business functions such as book keeping to external accountants (Carey *et al.*; 2006; Everaert *et al.*; 2010). However, gaps still exist in that the empirical studies conducted are in more developed economies where the outsourcing of business functions is more elaborate. Mashayekhi and Mashayekh, 2008, argue that empirical evidence from the most developed economies may not be relevant to the economies such as Kenya due to differing institutional context and level of state intervention in economic activities. Garengo *et al.*, 2005, has strongly indicated that both empirical and theoretical studies in performance measurement in SMEs have not been known very well because of lack of publications. In addition, a study of outsourcing of business functions relative to the Kenyan SME's is missing.

Given that the nature of business service as noted by Everaert *et al.*, 2010 is people- intensive, compounded by the internal resources gap and competitive environment faced by SME's, it is, therefore, necessary to examine the contributions made by BPO and KPO towards the performance of SME's in the context of the Kenyan economy since SMEs account for 20% of the country's GDP (GOK, 2011). The ultimate aim of this study was therefore to determine the effect of outsourcing typologies and organizational performance of SMEs in Kenya. Thus, the study hypothesised that:

$H_{o1}$ : *There is no significant effect of business process outsourcing on SME performance*

$H_{o2}$ : *There is no significant effect of knowledge Process Outsourcing on SME performance*

## 1.1 Theoretical Framework

Resource-based view model states that resources and capabilities can vary significantly across firms and that these differences can be stable (Barney and Hesterly, 1996). If resources and capabilities of a firm are mixed and deployed in a proper way, they can create a competitive advantage for the firm. RBV is popular in the strategic management literature. It focuses on the internal characteristics of the firm and views the firm as a collection of resources (Barney, 1991). When applied to outsourcing, the RBV suggests that the internal resources and capabilities are strengths that should guide the firm's strategies (Grant, 1991). This theory has been used to analyze the relationship between the sourcing strategy and the external environment which in turn defines the boundaries of the firm (Rodriguez and Robaina, 2006). Some of the research questions examined with the help of the theory include the reasons for firms to turn to outsourcing (Gilley and Rasheed, 2000; Teng *et al.*, 1995) and its impact on organizational performance (Murray *et al.* 1995). This theory suggests that firms do not necessarily have to depend on internal resources but can also acquire complementary resources from outside geographic and organizational boundaries (Argyres, 1996). According to resource-based theory, a firm could be considered a collection of productive resources, and the growth of the firm is dependent on how slack resources are utilized (Penrose, 1959).

## 2.1 Review of Literature

## 2.2 Effect of Business Process Outsourcing on SME Performance.

Cullen, (2003) in his study argues that business Process outsourcing for SMEs is an essential business strategy that drives operational process efficiency, at a low risk and without the need for capital investment, enabling growth and allowing key personnel to focus on core business activities thus improving SME performance.

SMEs have the same business goals as larger organizations but may have more limited resources. Among these goals are delivering cost-savings, raising customer satisfaction, achieving high performance, extending service offerings and having access to the best people, skills, and technologies. Business process outsourcing brings all of these benefits to SMEs at a low cost and with mitigated risk thus improving organizational performance (Feeny, 2005).

Business Process Outsourcing (BPO) has traditionally been used to outsource the processes peripheral to the key business strategy, in order to use time, money and resources more effectively thus allowing more organizational performance. Some of the most common outsourcing activities include human resource management, financial services and accounting, information technology and legal process management. An austere economic climate has seen the BPO contract count climb to an all-time high, as organizations look to cut costs in an effort to survive (Wilson, 2005).

BPOs now offer cloud-based solutions that provide SMEs with greater customization in addition to the ability to scale quickly. The cloud can also help the automation and standardization of processes and solutions as well as reduced manpower costs. Further, the proliferation of Business Process as a Service is giving SMEs the advantage of flexible pricing models like service based subscription models. In addition, development of new and innovative trends like outcome-based pricing guarantees an enterprise results from its outsourcing engagements (Kehal, 2006).

Tompkins, (2005) argues that the increasing use of business outsourcing is also making it easier for organizations to adopt and deploy BPO solutions with minimum fuss thus improving firm performance. The standardization of processes that it achieves encourages SMEs to work with a single BPO service provider that offers differentiated services. This builds consistency in process execution alongside trust and loyalty with the vendor. Furthermore, BPO solutions enable companies to dynamically scale vendor dependence based on fluctuations in revenue and changing customer demands.

While cost reduction and increased efficiency are the upsides of business process outsourcing, SMEs could run into a few challenges as well as confidentiality threats, operational dependencies and divided loyalty are things to watch out for. SMEs may also feel a loss of control with outsourcing business processes. Further, a difference in expectations between the enterprise and its BPO partner may have adverse effects on the quality of service (Yin, 2003).

Berry, (2005) asserts that the choice of a quality solution provider with a proven track record supplemented by clear communication of business needs and regular third party checks can help alleviate these challenges. Further, stringent SLAs along with calibration can ensure that business objectives are met without exception. Diligent implementation of outsourcing strategies combined with the right solution provider, accentuated by comprehensive technological advancements, can ensure that SMEs grow their businesses exponentially.

### **2.3 Effect of Knowledge Process Outsourcing on SME Performance.**

The paradigm shift in the economy from industrial to knowledge-based requires that there's knowledge intensity where efficient production relies on information and know-how. As observed by Skyrme (1997) and echoed by Stiglitz (1999) a highly skilled labour force is the key to success in the knowledge economy and knowledge industry. Knowledge process outsourcing involves knowledge intensive business processes that require specialized domain-expertise (Evalaveserve 2005; Sengupta, 2005; Sen and Shiel, 2006).

According to Evalaveserve (2006), knowledge processes outsourcing refers to the outsourcing of high-end complex tasks and processes like market research, investment research, legal and sourcing of information among others. KPO firms, therefore, provide domain-based processes and business expertise, rather than just process expertise. Evalaveserve (2006) further noted that technological processes and the rise of knowledge industries had created new business opportunities in the global scenario.

Similar to the positive contributions made by BPO, knowledge process outsourcing creates value for both clients and vendors. After outsourcing, variable costs are significantly brought down leading to higher profits margins. This leads to savings, which amounts to value creation for clients of KPO (Evalaveserve, 2005), and increase the competitiveness of firms. SME's suffer a shortage of skilled labour. Such shortage

can be solved through outsourcing. Apart from cost sharing and corresponding savings that are accrued, companies, as observed by Pandey et al (2004), are offshoring their services as to take advantage of the low wage structure in some countries. This helps them to reduce costs. KPO has immense opportunities for SME's. SME's can change their costs according to the short-term demands which can create new business models. Furthermore, small firms may find outsourcing relatively easy. Many external services are available and may be sourced to help achieve economies of scale.

According to Doh, (2005), quality is also a concern due to the complexities of operating businesses in different geographical locations. KPO, therefore, enables firms to access expertise that they do not own which may be useful during their operations (Full and Viser, 2000). Firms, therefore, boost their performance from gaining from outsourcing as they can choose suppliers whose products and services are considered among the best (Laabs, 1996) and meet the firm requirements.

Carmel and Schumacer, (2005), indicates that KPO improves a firm's operational efficiency by giving the firm access to large and skilled labour supply to improve the speed of completing projects. External sourcing through vendors also improves the speed of the research and development in a firm (Kessler *et al.*, 2000), as observed by Quinn (2000), KPO speeds up the innovation process since suppliers tend to have greater knowledge depth and innovativeness at a faster rate. Holcomb and Hitt (2007) concurred by pointing out that outsourcing organizations can be faster because they focus on a narrow range of activities, furthermore, KPO can help businesses to be more efficient and focused on their key success factors, and work on their unique capabilities thereby creating new high-value employment in the business (Mierau, 2007). Despite the notable benefits that accrue from KPO, most SME's do not have the capacity to assess the contributions from an outside advisor accurately. The researcher, therefore, proposes that knowledge process outsourcing may not significantly contribute to the performance of SME's considering that the contributions of outsourced staff may not be evaluated.

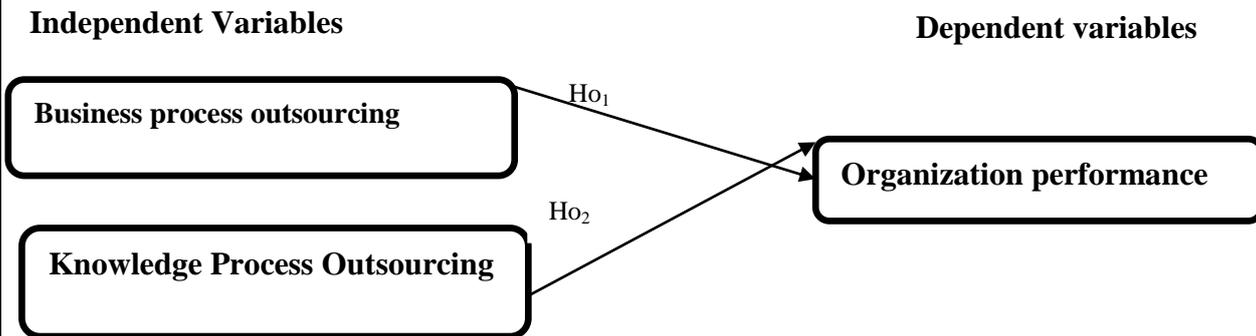
The present day world is witnessing a rapid change from an industrial to a knowledge-based economy. Through knowledge process outsourcing, there is knowledge intensity where efficient production relies on information and know-how in order to help improve firm performance. The highly skilled labour force is the key to success in the knowledge economy and knowledge industry (Stiglitz, 1999). The knowledge professionals involved in the knowledge economy are referred to as knowledge workers.

Knowledge process outsourcing enables those workers to have higher levels of education, and their work is the output of their skills thus improving organizational performance in SMEs (Overby, 2007). Also in a knowledge economy, the sustainable comparative advantage of a country lies in its intellectual resources in comparison to its natural resources or cheap labour force (World Development Report).

Sachdev, (2006) argues that knowledge Process Outsourcing involves outsourcing of high-end complex tasks and processes like market research, investment research, patent filing, legal and sourcing and information amongst others. It includes legal process outsourcing. These are both high-value-added forms of business process outsourcing (BPO). KPO firms provide domain-based processes and business expertise, therefore, improving organization performance. Firms gradually move from low end to high end outsourcing. The IT industry started from Programming and maintenance. It has gradually evolved to IT led business strategy. The Insurance industry has evolved to Underwriting and Asset Management from Contact centres and customer support.

Technological progress and rise of knowledge industries have created new business opportunities in the global scenario. One major business opportunity is that of outsourcing. KPO includes research and works on intellectual property, equity, and finance, analytics, market research and data management thus helping improve firm performance (Evalueserve 2005).

Sargeant, (2006) in his study identified the importance of the customer vendor relationship as an indicator of successful outcomes in Knowledge process outsourcing. Jiang and Quereshi (2006) reviewed the literature on knowledge process outsourcing and argued that it tends to increase the expertise with which workers do their work thus improving organizational performance. The above literature has attempted to explain the link between business process outsourcing, knowledge process outsourcing and organizational performance which is diagrammatically explained in figure 1 below.



**Figure 1 Conceptual Framework of BPO and KPO Outsourcing and Business Performance**

### 3.0 Material and methods

This study used a combination of cross sectional approach and explanatory research design. From the target population of 1489 SMEs, Yamane (1973) sample size formula was used to select a sample size of 440 SMEs. A similar approach was adopted by Norizan (2005). The study used a stratified sampling technique to select the SMES where SME managers/owners were picked from. Therefore, SMES were stratified into 10 strata's where the sample size was distributed according to Neyman allocation Methodology. This study deployed the use of questionnaires as a data collection technique. The questionnaires were calibrated with a five point Likert Scale, with anchors ranging from 'strongly agree' (SA) to 'strongly disagree' (SD). Likert scale/summated scale consists of statements that express either a favorable or unfavorable attitude towards the object of interest. For this study, Cronbach alpha was used to measure the internal reliability of the structured questionnaire.

Factor analysis was used to test internal consistency. Factor analysis is important because it gives identification of groups of inter-related variables, to see how they are related to each other. Factor analysis is used mostly for data reduction purposes. To get a small set of variables (preferably uncorrelated) from a large set of variables (most of which are correlated to each other) and to create indexes with variables that measure similar things, the study used Varimax method for rotations. Varimax, which was developed by Kaiser (1958), is the most popular rotation method by far. For varimax a simple solution means that each factor has a small number of large loadings and a large number of zero (or small) loadings. This simplifies the interpretation because, after a varimax rotation, each original variable tends to be associated with one (or a small number) of factors, and each factor represents only a small number of variables (Abdi, 2006). In addition, the factors can often be interpreted from the opposition of few variables with positive loadings to few variables with negative loadings. Data obtained from the field was coded, cleaned, and entered into the computer for analysis using the SPSS. Descriptive statistical procedures including frequency distributions, means, standard deviation, Skewness, and kurtosis were used to summarize the data findings and presentations. Pearson product moment correlation Coefficient was used to measure the strength of the linear relationship between independent variables and dependent variables. Multiple regression models were used in testing hypothesis

### 4.0 Findings and Discussion

This section presents the results of data analysis for the following descriptive statistics for the study variables and actual analysis by exploring relationships between variables using multiple regression techniques.

#### 4.1 Entrepreneur Characteristics

The demographic profile of the respondents is presented by gender, level of education and managerial experience, which altogether remained fundamental to interpret and discuss outsourcing functions in firms. The gender distribution of the respondents is presented in table 1. The information in the table implies that men at 52.3% were more represented in the sampled small businesses as compared to women at 47.7%. Results of the distribution shown in Table 1 indicates that majority of the respondents (56%) were of secondary level. The remaining 29.5% were of the tertiary level, and 3.2% of the respondents were uneducated. This clearly shows that the sampled entrepreneurs had lower levels of education. In regards to managerial experience, 41.3% (154) of the respondents had an experience of 6-10 years. It is clear from the results (Table 1) that the SMEs have attracted and retained skilled employees as evidenced by their experience.

**Table 1 Sample Characteristics**

		Frequency	Percent
Gender	Male	195	52.3
	Female	178	47.7
	Total	373	100
Level of education	Primary	42	11.3
	Secondary	209	56
	Tertiary	110	29.5
	None	12	3.2
	Total	373	100
Managerial experience	1-5 yrs.	37	9.9
	6-10yrs	154	41.3
	11-15yrs	151	40.5
	Over 16 yrs.	31	8.3
Total		373	100

#### 4.2 Business Process Outsourcing (BPO)

In most cases, Business Process Outsourcing is done with the intention to improve the quality of product/service being offered and also to share the cost. Through BPO, SMEs are able to use time, money and resources more effectively hence improving their performance. Consequently, the researcher found it necessary to establish the effects of Business Process Outsourcing on SME performance in Eldoret town. The results of BPO descriptive statistics are presented in Table 2.

**Table 2 Business Process Outsourcing (BPO)**

	Mean	Std. Deviation	Skewness	loading	Cronbach Alpha
My firm contracts firms/individuals to perform purchasing functions	2.76	1.104	0.261	0.937	0.754
Sales in my firm are performed by outsourced experts	2.58	1.076	0.535	0.919	
Manufacturing functions in my firm are performed by contractors	3.02	1.322	0.052	0.662	
My firm has outsourced to experts to provide maintenance services.	2.42	1.046	0.389	0.552	
My firm's Logistics services are outsourced from outside experts	2.41	1.1	0.388	0.844	
The firm After-sales are contracted to external experts	2.51	1.02	0.364	0.868	
My firm Legal services are provided by registered legal firms	2.49	1.263	0.522	0.798	
Security services in my firm are outsourced	2.47	1.228	0.424	0.607	
<b>Business Process Outsourcing (BPO)</b>	<b>2.5834</b>	<b>0.69684</b>	<b>0.848</b>		

Business Process Outsourcing scored a low mean of 2.5834 standard deviations of 0.69684 and Skewness of 0.848. This infers that process outsourcing has not been fully established among the SMEs in Eldoret, Uasin Gishu County. This could be due to the fact that the SMEs feel a loss of control with outsourcing business processes. Particularly, the enterprises and the BPO partners have different expectations hence hampering the quality of service (Yin, 2003).

### 4.3 Knowledge Process Outsourcing (KPO)

Through Knowledge Process Outsourcing, a firm has access to a large and skilled labour supply which improves its operational efficiency (Carmel and Schumacer, 2005). Findings showed that SME had not enough competent personnel (mean = 2.25, SD = 1.04). There is a clear indication that SMEs have not embraced outsourcing to experts on the hiring of employees. Hence, SMEs have been unable to benefit from their expertise

**Table 3 Knowledge Process Outsourcing: balanced scorecard**

	Mean	Std. Deviation	Skewness	loading	Cronbach Alpha
My firm outsources financial accounting to experts	1.95	1.02	0.62	0.782	0.744
My firm outsources to management experts	2.07	0.8	0.3	0.712	
My firm outsources internal controls.	1.96	0.87	0.96	0.885	
My firm outsources to experts on hiring of employees	1.74	0.86	1.45	0.81	
My firm outsources to training experts to train my employees	2.13	1.06	0.49	0.873	
I have employed enough competent personnel.	2.25	1.04	0.37	0.901	
My firm outsources to outside experts on technology use in my firm for instance web design	2.11	1.04	0.59	0.821	

According to Evalauserve (2006) technical competence has created new business opportunities in the global scenario and has made flexible and scalable BPO solutions more accessible to SMEs. Thus the researcher sought to establish if the SMEs in Eldoret, Uasin Gishu County were technically competent. The results are presented in Table 4 showed that SMEs do not outsource to experts to file tax returns, to conduct customer satisfaction survey, conduct market research. The outsourcing decision is influenced by the ability of an enterprise to invest in developing a capability and sustaining a superior performance position in the capability corresponding to competitors (McIvor, 2009). Firms do not outsource to experts to operate computerization of information systems. Further, SMEs had outsourced to experts to do book keeping. However they did not outsource to experts to conduct employee performance appraisal, In general, Technical Competence summed up to a mean of 2.36, the standard deviation of 0.53, Skewness of -0.

**Table 4 Technical Competence**

My firm has outsourced to experts	Mean	Std. Deviation	Skewness	Loading	Cronbach Alpha
To design internet searching.	2.41	1.11	0.64	0.911	0.758
To operate computerization of information systems.	2.68	1.19	0.26	0.721	
To conduct employee performance appraisal	2.42	1.27	0.46	0.525	
To conduct customer satisfaction surveys	2.85	1.34	0.13	0.73	
To conduct market research	2.83	1.33	0.2	0.937	
To file tax returns.	2.98	1.19	-0.2	0.892	
To do book keeping.	2.59	1.02	0.35	0.5	
Technical Competence	2.36	0.53	0.00		

#### 4.4 SME Performance

This section focused on SME performance. As evidenced by Jiang *et al.*, (2006), the profitability of a firm can be enhanced through outsourcing. As a result, it was deemed important by the researcher to establish whether the SMEs in Eldoret, Uasin Gishu County have benefited from outsourcing. The results of the study are illustrated in Table 5. The outsourcing of services enables a firm's capabilities to be improved by better performance (Shang *et al.*, 2008). As a result, the researcher sought to establish whether services such as recruitment and payroll management were best handled from outside. From the findings, SMEs services such as recruitment and payroll management were best handled from outside. Generally, profitability summed up to a mean of 2.44, Standard deviation = 0.68, Skewness = -0.2 and Kurtosis = -1.1.

**Table 5 Profitability**

	Mean	Std. Deviation	Skewness	Kurtosis
Reduction in staffing has helped the business to cut down on costs	2.5	1.18	0.3	-0.4
As small as the business is, it has been able to employ experts without owning them	2.39	0.98	-0.1	-0.2
The business has been able to rent skills without adding to the payroll	2.16	1.03	0.74	1.29
The business has been able to achieve its targets at a minimum cost thereby increasing profit margin	2.3	1.09	0.31	-1.2
Services such as recruitment and payroll management are best handled from outside	2.87	1.19	0	-0.9
Profitability	2.44	0.68	-0.2	-1.1

#### 4.5 Factor Analysis

BPO were conceptualized to be measured using eight items. From a principal components analysis, all factors which together explained 30.205percent of the variance in BPO were extracted. The Kaiser-Meyer-Olkin value of 0.524 and the significant Bartlett's test of sphericity ( $\chi^2 (21) = 1557.601$ ,  $p < 0.001$ ) indicated that data were adequate for principal component analysis (Table 6). All factor loadings were greater than 0.5. This value was above the 0.5 value recommended by (Hair *et al.*, 2006). The BPO constructs were therefore found to be valid, and all the eight items were retained for further analysis. The Kaiser-Meyer-Olkin measure was 0.598, and Bartlett's test of sphericity was significant ( $\chi^2 (21) = 1264.348$ ,  $p < 0.001$ ). The data was, therefore, adequate for PCA. The seven items were therefore used in the further analysis involving the balanced scorecard. The Kaiser-Meyer-Olkin measure of sampling adequacy was 0.731 while Bartlett's test of sphericity was significant ( $\chi^2 (21) = 718.205$ ,  $p < 0.001$ ). This clearly shows that the data under technical competence was adequate for PCA. The six items were therefore deemed reliable for measuring technical competence and were therefore used for further analysis involving technical competence.

**Table 6 Factor analysis results**

Eigen values	1.416	2.825	2.788
%age Variance explained	30.205	22.812	22.346
KMO and Bartlett's Test			
Kaiser-Meyer-Olkin Measure of Sampling Adequacy.	0.524	0.598	0.731
Bartlett's Test of Sphericity	1557.601	1264.348	718.205
P Value	0.000	0.000	0.000

Rotation Method: Varimax with Kaiser Normalization.

#### 4.6 Correlation statistics

The results regarding these were summarized and presented in Table 7. Also, the correlation results indicated that profit is positively related with performance as shown by a coefficient of  $r = .487$  which is significant at  $p < 0.01$ . Further, KPO (Knowledge Process Outsourcing) was also positively related to performance as evidenced by a coefficient of  $r = .350$  which is also significant at  $p < 0.01$ . Finally, BPO (Business Process Outsourcing) exhibited a positive relationship with performance as indicated by a coefficient of  $r = .626$  which is significant at  $p < 0.01$ . From the foregoing, there is a linear relationship between cost, flexibility, profit, KPO and BPO with performance.

**Table 7 Correlation statistics**

	Performance	Profit	KPO	BPO
Performance	1			
Profit	.487**	1		
KPO	.350**	.279**	1	
BPO	.626**	-0.049	.229**	1

\*\* Correlation is significant at the 0.01 level (2-tailed).

#### 4.7 Hypothesis Testing/Multiple Regression Statistics

Table 8 illustrates the model summary of multiple regression models, the results showed that all the two predictors (knowledge process outsourcing and business process outsourcing) explained 43.7 percent variation of performance., 43.7% of it was due to the model (or due to change in independent variables) and 43.3% was due to error or some unexplained factor. Study findings in Table 8 indicated that the ANOVA value of determination was the goodness of fit or significance of R squared as evidenced by F ratio of

143.319 with p value  $0.000 < 0.05$  (level of significance). This means that none of the parameters was equal to zero. Thus, the model was fit to predict performance using knowledge process outsourcing and business process outsourcing. From table 8, the VIF for all the estimated parameters was found to be less than 4 while tolerance was above 0.2 which indicated the absence of multicollinearity among the independent factors (Hair, *et al.*, 2010). This implied that the variation contributed by each of the independent factors was significant independently and all the factors were included in the prediction model.

Findings in table 8 showed that business process outsourcing had coefficients of the estimate which was significant basing on  $\beta_1 = 0.576$  (p-value = 0.000 which is less than  $\alpha = 0.05$ ) thus the study conclude that business process outsourcing has a positive and significant effect on performance. Basically, SMEs acquire the ability to access new and more valuable capabilities by establishing outsourcing relationships with firms that have specialized capabilities (Holcomb and Hitt 2007). Thus, outsourcing in SMEs is a means to reduce costs by getting rid of problems and giving it to experts that have the knowledge to handle them effectively and efficiently. Additionally, with BPO, there are no direct overhead costs and compensation of personnel thus improving organizational performance (Brown, 2005). Tompkins, (2005) argues that an increase in BPO makes it easier for organizations to adopt and deploy solutions to pertinent outsourcing issues that an Organization can adopt in order to cut down costs and make profits that in turn improve Organizational performance. In conclusion, Business Process Outsourcing is the way to go in SMEs.

Research findings also showed that knowledge process outsourcing had coefficients of the estimate which was significant basing on  $\beta_2 = 0.218$  (p-value = 0.000 which is less than  $\alpha = 0.05$ ) implying that knowledge process outsourcing has a positive and significant effect on performance. This indicates that for each unit increase in knowledge process outsourcing, there is 0.218 units increase in performance. As evidenced in the findings KPO has a positive and significant effect on SME performance. Just like Business process outsourcing, knowledge process outsourcing leads to higher profit margins, cost-saving and increased the competitiveness of firms (Evalauserve, 2005). Accordingly, KPO helps firms to be more efficient and work on their unique capabilities thereby creating new high-value employment in the business (Mierau, 2007). On the same note, KPO enables firms to access expertise that they do not own which may be useful in enhancing performance (Full and Viser, 2000; Bunyararatave *et al.*, 2008). As well, firms boost their performance from gaining from outsourcing as they can choose suppliers whose products and services are of the best quality (Laabs, 1996). Concurrently, Alexandra and Young (1996) noted that KPO has the potential to reduce costs and reduce capital invested by accessing external competencies and resources thereby improving firm performance. Consistently, KPO offshores expertise that helps to improve firm performance (Evalueserve 2005, Sengupta 2005, Sen and Shiel 2006). In a similar vein, Jiang and Quereshi (2006) argued that KPO increases the expertise with which workers do their work thus improving organizational performance.

**Table 8 Multiple Regression Statistics**

	Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics	
	B	Std. Error	Beta	T	Sig.	Tolerance	VIF
(Constant)	0.887	0.112		7.954	0.00		
Business Process Outsourcing	0.442	0.031	0.576	14.359	0.00	0.948	1.055
Knowledge Process Outsourcing	0.221	0.041	0.218	5.45	0.00	0.948	1.055
R Square	0.437						
Adjusted R Square	0.433						
F	143.32						
Sig.	.000						

a Dependent Variable: performance

#### 4.8 Conclusion and Recommendations

From the findings, established if the firms contracted either individuals or firms to perform their purchasing functions. Moreover, there was also doubt if sales in their firms were performed by outsourced experts. However, it was established that security services, maintenance services, and logistics services were not outsourced to outside expertise.

In an attempt to establish if the SMEs had embraced knowledge process outsourcing, it was realized that the SMEs had not employed enough competent personnel. As such, there was a lack of knowledge intensity and efficiency in the process of improving business performance. Also, the firms lacked expertise on technology use and financial accounting. There was, therefore, lack of knowledge necessary to fulfill its accounting functions. Moreover, the firms had not outsourced internal controls and training to experts to train their employees. Consequently, the SME's capacity to sustain its competitive advantage was hampered due to the aforementioned constraints.

There is a need for SMEs to embrace business process outsourcing in order for manufacturing function to be taken care of by contractors who have the required expertise. There is also a need for SMEs to outsource legal services to registered legal firms so that they can obtain the capabilities and competences they need. It is also of utmost importance for firms to outsource security services, maintenance services, and logistic services for the sake of effectiveness in their operations. Finally, SMEs need to work with a single BPO service provider that offers differentiated services. In so doing, the SME will build consistency in process execution alongside trust and loyalty with the service provider. Though BPO has inherent risks, it also provides many benefits to the client. Apart from focusing on short-term cost savings and operational efficiencies, it is important that BPO is performed with a strategic mindset, whereby decisions are based on the wider business context in order to help in gaining competitive advantages in the tough external environment (Sparrow, 2003).

For BPO to be effective, an organization should segregate its business processes into two broad categories: the processes where their own core competencies are strong and which have strategic significance, and those that can be performed better by an outside vendor (Adler, 2003). In most cases, business processes that represent the client's core competencies and have high strategic stakes are best performed in-house. In order to identify its "core competencies," an organization needs to be very clear about where its own strengths lie and identify the processes that truly give the organization its business value. An organization needs to identify processes that are strategic so as to differentiate it from its competitors in the marketplace, or processes that give it the competitive advantage finally; the study has established that knowledge process outsourcing has a positive and significant effect on SME performance. There is, therefore, need for SMEs to employ competent personnel with the much needed knowledge to heighten efficiency in its operations. Further, SMEs need to outsource to experts in technology and financial accounting. Consequently, outsourcing accounting information will permit SME owners to manage their firms better and also have access to financial resources more easily. There is also a need for the firm to outsource training expertise to train their employees. It is also important to know what, where and how to outsource. This should be the subject of internal and external analysis, and training sessions should be conducted with outsourcing experts who have a deep understanding of the industry and who know how to create and manage outsourcing relationships.

The concept of the Resource Based View (RBV) of the organization (Barney, 1991) suggests that outsourcing could be productive to the development of the core competence of the organization specifically in relation to BPO and KPO functions. In this scenario, BPO and KPO outsourcing supports strategies of selectively building valuable skills through outsourcing non-core functions, which provides existing HR employees more time to focus on core and high skill functions.

Using the Transaction cost theory as a basis for understanding BPO firm performance helps avoid examination of simple bivariate relationships that might not have been truly characteristic of organizational performance. Since membership can predict which firm performed better than others on objective and subjective performance measures, the thesis provides a useful framework on how strategies and processes can be structured. This study is not without limitations. For instance, the generalizability of this study's findings may be limited to SMEs within Eldoret Town. Thus, future research should attempt to gather information from SMEs in the North-rift region or in major towns to establish if the results of the study hold. The study findings indicated that BPO and KPO both had a significant effect on SME performance.

In addition, the study was only limited to two types of outsourcing typologies BPO and KPO which had a positive and significant effect on SME performance; future studies should also examine the consequences of HR outsourcing on HR performance such as turnover rate, absenteeism, employee morale and other HR effective measures.

## REFERENCE

- Abdi H., (2006). Factor Rotations in Factor Analyses. The University of Texas at Dallas
- Adler, P. S. (2003). Making the HR outsourcing decision. *MIT Sloan Management Review*, 45(1), 53-60.
- Argyres, N. (1996). Evidence on the Role of Firm Capabilities in Vertical Integration Decisions. *Strategic Management Journal*, 17: 129-150.
- Barney J.B., Hesterly W., (1996). "Organizational Economics: Understanding the Relationship between Organizations and Economic Analysis," in Clegg S.R., Hardy C., Nord W.R. (Eds.) *Handbook of Organization Studies*, Sage Publications, London
- Barney, J. 1991. Firm Resources and Sustained Competitive Advantage. *Journal of Management*, 17: 99-121.
- Berry, A. J., Sweeting, R., & Goto, J. (2005). The effect of business advisers on the performance of SMEs. *Journal of small Business and Enterprise Development*, 13(1), 33-47.
- Brannemo A (2006). How does the industry work with sourcing decisions? Case study at two Swedish companies. *J. Manufacturing. Technol. Manage.*, 17(5): 547-560.
- Brown, D. & Wilson, S. (2005). *The Black Book of Outsourcing How to Manage the Changes, Challenges, and Opportunities*. New York: John Wiley & Sons, Inc.
- Carey, P., Subramaniam, N., & Ching, K. C. W. (2006). Internal audit outsourcing in Australia. *Accounting and Finance*, 46, 11-30.
- Carmel, E. and Schumacher, P. (2005). 'Offshore strategy.' In Carmel E. and Tija, P. (Eds.) *Offshoring information technology: sourcing and outsourcing to a global workforce*. Cambridge: Cambridge University Press.
- Choy K.L., Lee W.B., Lau H.C.W., Choy L.C. (2005), A knowledge-based supplier intelligence retrieval system for outsource manufacturing, *Knowledge-Based Systems*, 2005; 18:1-17.
- Corbett, M.F. (1999). Multiple factors spur outsourcing growth. (Retrieved from [www.Outsourcing-Journal.com/issues/jan](http://www.Outsourcing-Journal.com/issues/jan). 1-6).
- Cousins, P. D., Lawson, B., Squire, B., (2006) . Supply chain management: theory and practice – the emergence of an academic discipline. *International Journal of Operations & Production Management*, 26 (7), pp.697 – 702.
- Cullen S., Willcocks L., (2003). *Intelligent IT Outsourcing: Eight Building Blocks to Success*, Butterworth-Heinemann, Oxford
- Doh, J.P. (2005) "Offshore Outsourcing: Implications for International Business and Strategic Management Theory and Practice." *Journal of Management Studies*. Vol. 42, No. 3. pp. 695-704
- Evalueserve (2005). Knowledge Process Outsourcing – A win situation, Analytics – India Desk Research, Evalueserve, 3 May. Evalueserve (2006). The next big business opportunity, Moving up the value chain- from BPO to KPO, Business Research, July 13, [www.evalueserve.com](http://www.evalueserve.com).
- Everaert, P., Sarens, G., & Rommel, J. (2010). Using Transaction Cost Economics to explain outsourcing of accounting. *Small Bus Econ*, 35(1), 93–112.

- Feeny D., Lacity M., Willcocks L., (2005). "Taking the measure of outsourcing providers," *MIT Sloan Management Review*, 46, 3, pp. 41-48
- Full, C. and Visser, E., (2000), The outsourcing dilemma : A composite approach to the make or buy decision, *Management Decision*, 38(1) p43-50
- G.o.K /CBS/ ICEG/ K-EP. (2011) National Micro and Small Enterprise Baseline survey Results. Nairobi: Government Printer Press
- Garengo, P., Biazzo, S. & Bititci, U. S. 2005. 'Performance measurement systems in SMEs: A review for a research agenda,' *International Journal of Management Reviews*, 7(1): 25-47
- Gilley, K., & Rasheed, A. (2000). Making more by doing less: An analysis of outsourcing and its effects on firm performance. *Journal of Management*, 26(4), 763-790
- Grant, R. M. (1991) "The resource-based theory of competitive advantage: Implications for strategy formulation," *California Management Review*, 33(3): 114-135.
- Hair, J.F., Black, W.C., Babin, B.J., Anderson, R.E., Tatham, R.L. (2006) *Multivariate Data Analysis*. Pearson Prentice Hall, Upper Saddle River, N.J.
- Holcomb, T. R., M. A. Hitt. 2007. Toward a model of strategic outsourcing. *Journal of Operations Management* 25, 464-481.
- Huang, X.-Y., Yan, N.-N., Qiu, R.-Z., (2009). Dynamic models of closed-loop supply chain and robust HN control strategies. *International Journal of Production Research* 47 (9), 2279–2300
- Jacobides, M. and L. Hitt, L. 2005. Losing the Forest for the Tree? Productive Capabilities and Gains from Trade vs. Transactional Hazards as Drivers of Vertical Scope. *Strategic Management Journal*, 26: 1209-
- Jacobides, M. and Winter, S. 2005. The Co-Evolution of Capabilities and Transaction Costs: Explaining the Institutional Structure of Production. *Strategic*
- Jiang, B., and Qureshi, A. (2006) Research on outsourcing results: current literature and future opportunities. *Journal of Management Decision*, 44(1), 44-55.
- Kaiser, H. F. (1958). The varimax criterion for analytic rotation in factor analysis. *Psychometrika*, 23, 187-200.
- Kehal, H., Singh V.(2006). *Outsourcing and Offshoring in the 21st Century: A Socio- Economic Perspective*. Idea Group Publishing.
- Kessler, E. H., Bierly, P. E., & Gopalakrishnan, S. (2000). Internal vs. external learning in new product development: effects on speed, costs, and competitive advantage. *R & D Management*, 30(3), 213-223
- Laabs, J.J. (1996), "Duke's newest power tool," *Personnel Journal*, Vol. 75, No. 6, pp.44-50.
- Leiblein, M.J., Reuer, J.J., and Dalsace F. 2002. Do make or buy decisions matter? The influence of organizational governance on technological performance. *Strategic Management Journal*, 23(9): 817-833.
- Mashayekhi, B., & Mashayekh, S. (2008). Development of accounting in Iran. *The International Journal of Accounting*, 43, 66–86
- McIvor, R. (2009). How the transaction cost and resource-based theories of the firm inform outsourcing evaluation. *Journal of Operations Management*, 27, 45-63
- Mierau A. (2007). *Strategic Importance of Knowledge Process Outsourcing*. Technical University of Kaiserslautern Germany
- Murray, J., Kotabe, M., & Wildt, A. (1995). Strategic and financial performance implications of global sourcing strategy: A contingency analysis. *Journal of International Business Studies*, 26(1), 181-202
- Norizan, A.R. (2005). *An analysis of Malaysian e-community centers in bridging the digital divide*, paper presented at the E-Malaysia Seminar, 6-7 December.
- Overby, S. (2007). ABC: An Introduction to Outsourcing. *CIO.com*.
- Pandey, et al. (2004). India's transformation to a knowledge based economy-Evolving role of Indian diaspora, *Evalueserve*, July 21. [www.evalueserve.com](http://www.evalueserve.com)
- Pandey, Vivek, Bansal, Veena (2003), *A Decision-Making Framework for IT Outsourcing using the Analytic Hierarchy Process*
- Penrose, E. T. (1959). *The Theory of the Growth of the Firm*. New York: John Wiley.

- Poppo, L., and Zenger, T. (1998). Testing alternative theories of the firm: Transaction cost, knowledge-based, and measurement explanations for make-or-buy decisions in information services. *Strategic Management Journal*, 19(9): 853-Porter, M.E. (1996), *Competitive Strategy: Techniques for analyzing Industries and Competitors*, The Free Press, New York.
- Quinn, B.J. (2000). Outsourcing innovation: The new engine of growth. *Sloan Management Review* 41 (14):13-23.
- Sachdev, R. (2006). The big business of Clinical Outsourcing, Power Jobs, *Hindustan Times*, 14 March.
- Sargeant, A. (2006). Outsourcing Relationship Literature: An Examination and Implications for Future Research, *SIGMIS-CPR '06*, April 13–15, 2006, Claremont, California, USA.
- Schniederjans, M. J., Schniederjans, A. M., & Schniederjans, D. G. (2005). *Outsourcing and Insourcing in an International Context*. London: M. E. Sharpe.
- Sen, F & Shiel, M. (2006). From Business process outsourcing to Knowledge process outsourcing: Some issues. *Human Systems Management*, Vol. 25, p145-155.
- Sengupta, S. (2005), 'Skills Gap Hurts Technology Boom in India', *New York Times*, Technology Section, October 17
- Skyrme, D. (1997). *Capitalizing on knowledge*. London: Routledge.
- Sparrow, E. 2003. *Successful IT outsourcing*. Great Britain: Springer-Verlag London Limited.
- Stiglitz, J. (1999). *Public Policy for A Knowledge Economy*. Accessed September 2012: <http://akgul.bilkent.edu.tr/BT-BE/knowledge-economy.pdf>.
- Stiglitz, Joseph. E. (1999). *Economics of the Public Sector (Third Edition)*. W.W. Norton & Company: New York
- Taylor, H. (2006), Critical risks in outsourced IT projects: the intractable and the unforeseen. *Communications of the ACM*. Vol. 49, (11), str. 75-79.
- Teng, J., Cheon, M. and Grover, V. (1995). Decisions to outsource information systems functions: Testing a strategy-theoretic-discrepancy model. *Decision Sciences*, 26,(1), 75-103.
- Thoms, Brian (2004), *Outsourcing: Inside Out and Outside in*. Stevens institute of technology, Hoboken, New Jersey.
- Tompkins, J.A. (2005) Don't Outsource the Relationship, *Industrial Engineer*, 37, 1 p.30-33
- Vining A., Globerman S., „2000. A Conceptual Framework for Understanding the Outsourcing Decision”, *European Management Journal*, 17/6, 645-654,
- Wilson, R., (2005), “An Approach to Some Noncooperative Game Situations with Special Attention to Bargaining,” in *Game-Theoretic Models of Bargaining*, New York, NY: Cambridge University Press.
- Yamane, Taro (1973). *Statistics: an introductory analysis.* New York: Harper & Row.
- Yankelovich D. (2003). *GBC presentation: Outsourcing offshore-balancing the equation (concentric solutions)*
- Yin, R. K. (2003) *Case study research: Design and methods*. Sage Publications, Inc., Thousand Oaks, London, New Dehli.
- Rodríguez Espino-, and Robaina, Padròn-V. (2006). A review of outsourcing from the resource- based view of the firm. *International Journal of Management Reviews*, 8(1), 49–70
- Chase, L. (2006) A review of understanding E-government: information systems in public administration. *Information Society*, 25 (1) pp 75–76