

Effect of Sub-Contracting on the Profitability of Small and Medium Scale Enterprises (SMES): Empirical Evidence from Selected Enterprises in Benue State

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Abstract

This research work ascertained the effect of outsourcing core operational activities (primary and accounting activities) on the performance of Small and Medium Scale Enterprises (SMEs) in Benue state. Survey research design was adopted with Gboko, Makurdi and Otukpo Metropolis of Benue state as survey area with population of 563 SMEs gotten from the records of Benue Board of Internal Revenue Service (BIRS) and a sample of 233 SMEs was selected using Taro Yemane's formula and distributed among five categories of SMEs. Simple random sampling technique was used in selecting respondents that provides answers to the self-administered questionnaire. The data was statistically analyzed using multiple regression technique. At the end of the research, the study found that; there is a significant relationship between outsourcing of primary activities and performance of SMEs in Benue but outsourcing of accounting activities has no significant effect on performance of SMEs in Benue. This study therefore recommends among others that SMEs should embark more on outsourcing of primary activities to attain the benefits of cost savings/restructuring which results in better customer service and consequently profitability; also, outsourcing process management through follow up steps like effective communication and monitoring should be employed and taken seriously to better reap the benefits of this maintenance/growth strategy.

Key words: Sub-contracting, Core activities, Small scale enterprises.

1. Introduction

Business environment especially in today's world is severely dynamic. As rightly noted by Sev (2009:3), "rapidly changing and increasingly complex business issues are creating key shift in organizations and the manner in which they do business". In order to achieve its set goals in the presence of technological advancement, sophistication of business processes, knowledge explosion and need for constant growth, an organization looks out for strategies to enhance performance which outsourcing is an option (Anza, 2016). Outsourcing is gaining currency among managers in addressing the new dynamic business order. It entails contracting out of a business function.

According to Dominguez (2006:5), outsourcing can be defined as "the practice of hiring functional experts to handle business units that are outside of your firm's core business". It is a method of staff augmentation without adding to headcount. That is, it is the process of replacement of in-house provided activities by subcontracting it out to external agents. Consequently, the management and development of innovations in outsourced activities become the responsibility of an agent external to the firm.

Outsourcing avails organizations the opportunity to concentrate her core competencies on definable pre-eminence business area and provide a unique value for customers (Behara, Gundersen, & Capozzoli, 1995). Also worthy of note is the fact that present day outsourcing is no more limited to peripheral activities such as cleaning, catering and security. As noted by Jennings (1997:85), outsourcing also includes critical areas such as design, manufacturing, marketing, distribution, information system etc. Outsourcing can be selective outsourcing or total. While selective outsourcing may target a single time consuming task within a department, such as manufacturing a minor component that can be handled more efficiently by an outside specialist or preparing a payroll. Total outsourcing may involve dismantling entire department or divisions and transferring the employees, facilities, equipment and raw

materials for a product to an outside vendor.

In Nigeria, Sev (2009) noted some examples of companies who have outsourced their operations as Ashaka Cement Plc, which has outsourced its operations and services to Blue Circle industries of United Kingdom; Dangote Cement, Gboko (Benue) plant which acquired the expertise of Pakistani who have managerial know-how and expertise to give quality services and operations. Notable also is in the banking sector where several Nigerian Mega banking groups have outsourced their operations and services to "Experts" to enhance global competition in the international financial markets. For instance, United Bank for Africa (UBA) plc, Access Bank plc, and other universal banks in Nigeria outsourced Automated Teller Machines (ATM) to a company called inter-switch. Similarly, most banks' recruitment exercises are being outsourced to other human resource companies like Dragnet and Philips consulting. However, as noted by Sev (2009), despite the outsourcing they have been carrying out over the years, some organizations still suffer in terms of their goal achievement; some have experienced low productivity both in terms of quality and quantity, their profitability has not been stable, and their capacities are grossly underutilized.

SMEs performance here is seen as the output of the organization measured in terms of profitability. Profitability is measured in terms of Cost savings, Focus on core business (thus increasing efficiency), Reduction in money spent on fixed assets (cost restructuring), Reduction in tax paid (tax benefit) and Increase turnover (Sales) (Kotabe et al., 1998). The case of SMEs has being so peculiar here. Their outsourcing is in addition to the backup/supporting activities, more of their core areas which are before now being retained in-house. This research shall therefore delve in the specific outsourcing strategies embarked upon by these SMEs; why their choice and the effect of various strategies on organizational performance of these SMEs in Makurdi metropolis, Benue state.

This research work explores outsourcing activities among SMEs in Gboko, Makurdi and Otukpo metropolis of Benue State, Nigeria with

emphasis on organizational operations for the recent past five years (2011 to 2015). Small and Medium Scale enterprises here are defined in line with the definition of SMEs by the National Council of Industries in Onugu (2005) as any enterprise whose total worth including working capital but excluding value of land is more than ten (10) million naira but less than one hundred million naira (N300, 000,000.00); a workforce between eleven (11) and seventy (200) full-time staff and/or with a turnover of not more than twenty million naira (N20, 000,000) in a year.

Research Objectives

The main objective of this study is to ascertain the impact of SMEs outsourcing of core activities on their performance in Benue state. The specifically objectives are to:

1. Assess the impact of Outsourcing Primary Activities on the profitability of SMEs in Benue state.
2. Ascertain the impact of Outsourcing Accounting Activities on the profitability of SMEs in Benue state.

Research Hypotheses

The primary intent of the study is to examine the conjectural statement that outsourcing core activities as an independent variable has an effect on performance variable depicted by

profitability. Specifically the hypotheses are:

- H₀₁:** Outsourcing Primary Activities has no significant impact on the profitability of SMEs in Benue state.
- H₀₂:** Outsourcing Accounting Activities has no significant impact on the profitability of SMEs in Benue state.

2.0 Review of related Literature
Conceptual Framework

Outsourcing Activities

Outsourcing activities have been classified by different scholars in different ways. For the purpose of this research, the classification by Gilley and Rasheed (2000) is reviewed.

According to Gilley and Rasheed (2000), outsourcing activities can be grouped into four strategies housing related activities commonly outsourced. These four strategies are:

1. Outsourcing of back office activities
2. Outsourcing of primary activities
3. Outsourcing of accounting activities
4. Outsourcing of support activities

Isaksson and Lantz (2015) based on the classification by Gilley and Rasheed (2000) fit in sixteen (16) sub activities commonly outsourced in the strategies base on their characteristics. An improved version of these activities is here presented for this research.

The classification is shown in a diagram below.

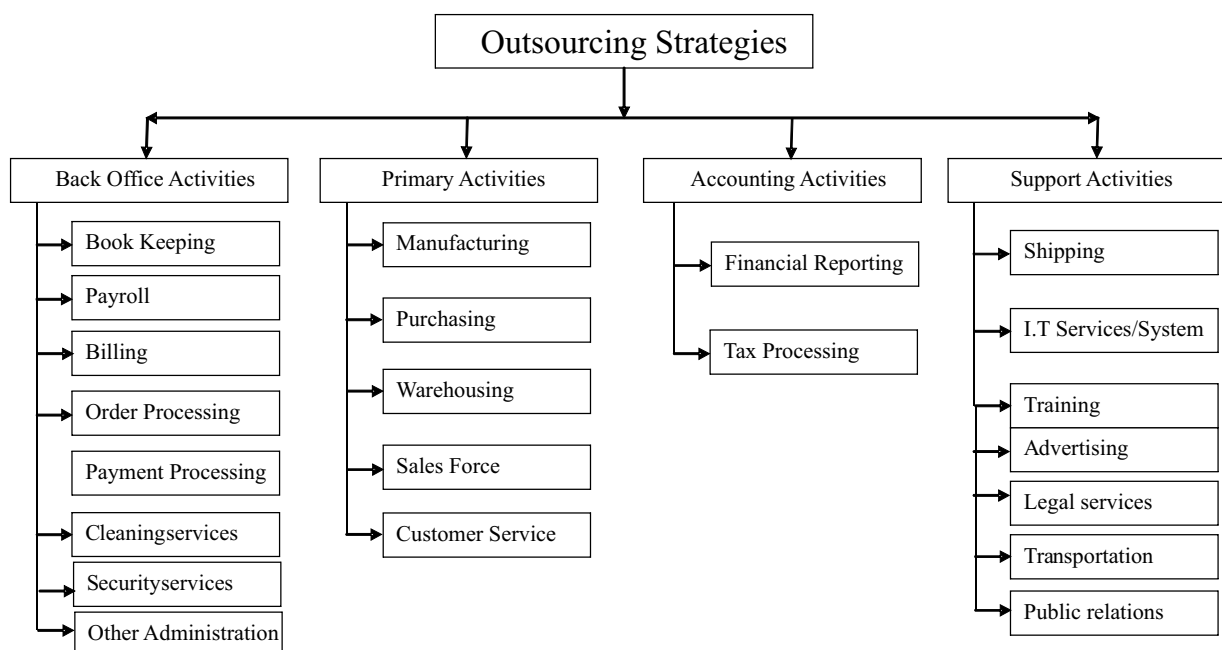


Figure 1 Classification of Outsourcing strategy according to Gilley and Rasheed (2000)

Source: Base on the classification of outsourcing strategies by Gilley and Rasheed (2000);Isaksson and Lantz (2015).

From figure 1 above, the items which constitute the typical back office activities are shown as bookkeeping, payroll, billing, order processing, payment processing, cleaning services, security services and other administrative activities. Those activities which are directly related to the primary operations are manufacturing, purchases, warehousing, Sales force and customer service. Also, activities which are typically performed by outside accountants are grouped under accounting activities and they include those of financial reporting, tax processing. The last classification is that of support activities. They include shipping, IT services/system, training, advertising, legal services, transport services, public relations. This classification by Gilley and Rasheed (2000) is therefore adopted and adjusted to house specific core activities outsourced by SMEs in Nigeria as

below:

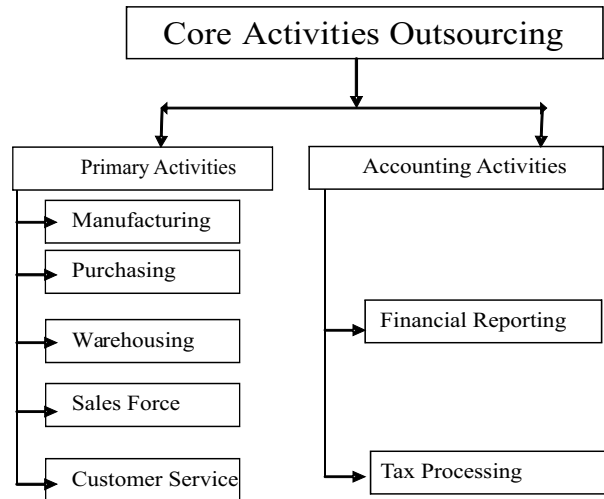


Figure 2 **Classification of SMEs' Outsourcing of core activities**

Source: Base on the classification of outsourcing strategies by Gilley and Rasheed (2000);Isaksson and Lantz (2015).

The choice of this classification is due to its explicit nature. It points out clearly, the activities which are being outsourced and also, succinctly classified base on its peculiarities. A pilot survey also shows clearly the fact that, these activities are usually outsourced by Nigerian SMEs at various extents.

Key Links in Outsourcing Process and Implementation in the Small and Medium Enterprises

According to Li and Zhau (2009), the entire process that the small and medium enterprises usually implement outsourcing can divide into three phases - outsourcing decision-making,

outsourcing implementation and contract closing. The phase of outsourcing implementation includes outsourcing service companies choosing, outsourcing contract negotiating and signing and outsourcing service process inspecting and evaluating. The outsourcing process involves five links; outsourcing decision-making and planning link, outsourcing service providers choosing link, outsourcing contract negotiating and signing link, outsourcing service process inspecting and evaluating link and choice exiting link. They are shown in figure 3 below:

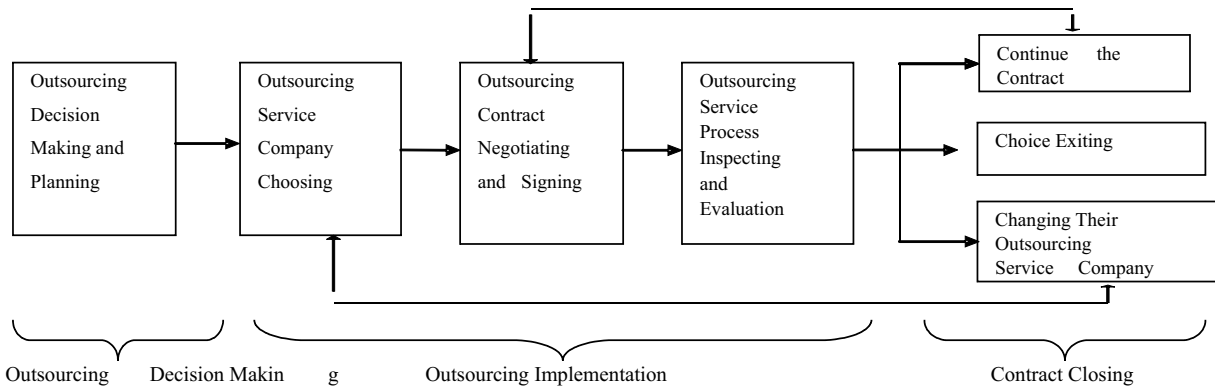


Figure 3 **Key Links in Outsourcing Process and Implementation in the Small and Medium Enterprises**

Source: Adopted from Li, K & Zhau, J, (2009). *The Outsourcing Strategy of Human Resources Management in Chinese Small and Medium Enterprises under the Economic Crisis.*

www.seiofbluemountain.com/en/search/detail.php?id=4348/ retrieved on 19th July, 2015 by 5:00 pm

Link 1: Outsourcing decision-making and planning link. The main work in this phase includes analyzing carefully in the actual demands, the environments and both inside and outside conditions, defining the outsourcing aim to make the human resource management outsourcing activities tally with the integral developing strategy, and confirming the content of human resource management outsourcing.

Link 2: Outsourcing service providers choosing link. The main work in this phase is to choose the most suitable outsourcing service companies by identifying and evaluating.

Link 3: Outsourcing contract negotiating and signing link. In the link, it will restrict both actions with the contract. Commonly the contract should identify both rights, duties, service area, price, payment, time limit and default terms.

Link 4: Outsourcing service process inspecting and evaluating link. The main work is to effectively supervise, control and motivate the outsourcing service providers based on the outsourcing plan and contract, so that their work will move toward the fixed aim, and objectively detect their work and estimate their performances.

Link 5: Choice exiting link. The enterprises will decide the next choice according to different evaluation results and their own grade of satisfaction. If they are satisfied, they'll continue their contract and even enlarge the cooperation scope. But if they are not satisfied at all, or they find their enterprise is not fit for outsourcing through this practice, they'll decide to exit. If it's because of the company' bad service, they can considering changing their outsourcing service providers, and return to link 2.

Theoretical Framework

According to Prahalad and Hamel (1990); Penrose, (1959); Richardson, (1972); Williamson, (1985), there are two theories most often referred to in relation to outsourcing. These are the **Core Competencies Theory** (Resource-Based Theory) and Transaction Costs Theory. This research however will be based on the Transaction Costs Theory.

Transaction Cost Theory

This theory holds an assumption that business outsourcing is implemented in order to lower the transaction costs. Transaction Cost Analysis (TCA) is another widely used outsourcing based theoretical perspective especially in supply chain management (Busi and McIvor, 2008). The approach seeks to identify the environmental

factors that together with a set of related human factors explain how companies can organize transactions to reduce the costs associated with these transactions. TCA postulates that managers suffer from bounded rationality, whereas other stakeholders may opportunistically act if given the chance. Small and medium scale enterprises are always out to minimize their cost of operation. They therefore subcontract some of their jobs which can be done more efficiently by outside vendors. This also paves way for them to enhance their customer service which leads to customer satisfaction.

This theory asserts that, an organization may outsource even when it has the wherewithal to execute the activity itself if and only if the sum cost carrying out the activity by an outside vendor including contract processing cost is lower than the cost of carrying out the activity in house. This theory is quite relevant in explaining the outsourcing of primary activities which are seen as being part of the organizations primary (core) operation as capture their mission statement.

This research is based on the *transaction cost* theory which emphasizes minimization of cost either through concentrating on their core competences and subcontracting other non-core areas of operation or subcontracting even their primary activities to others that can perform them less costly thereby earning some returns which is in form of the difference between the value of the contract and the cost of its execution. Cost here entails both; the amount paid the outsourced and the processing/ operational fee. The choice of this theory is due to the fact that, the focus of every manager is achievement of objectives at a lesser cost. When one achieves a goal, the first question that comes to mind is how? How much was spent in realizing the goal? Is there any better way of doing it thereby incurring less cost? Outsourcing here is looked at as a make or buy decision where the decision maker looks at the cost of carrying out an activity and outsourcing it and goes for the more efficient one. This leads to achievement of customers' needs thereby attaining customer satisfaction at a lesser cost.

Empirical Review

Previous research findings have proved contradictory results on the effect of outsourcing strategy on performance. While some presented a **positive effect**, others found negative or no relationship between outsourcing and performance. These researches are presented in table 1 below:

Table 1: A Summary of the Empirical Studies on Effect of Outsourcing Strategies on Organizational Performance.

Author(s)	Research questions/objective	Methodology/ Data analysis	Sample/ data collection	Findings
Isaksson & Lantz (2015)	To explore outsourcing strategies among small manufacturing firms, and to test how these strategies can be linked to financial performance	Multiple regression	The study is based on questionnaire and financial data collected through a stratified sample of 700 small (<50 employees) manufacturing firms in Sweden (with a response rate of 56 percent or 400 firms)	Multiple regressions did not reveal any significant relationship between the strategies (Back office activities, Primary activities, Accounting activities, and Support activities) and financial performance
Yeboah (2013)	To examine the relationship between outsourcing and organizational performance in the services sector	SPSS was used to correlate the variables	The population of the study is made up of 50 firms operating in the banking and insurance sectors of the economy of Ghana.	There is no statistically significant correlation between outsourcing and organizational productivity, There is statistically significant correlation between outsourcing and quality, There is statistically significant correlation between outsourcing and competitive advantage
Akewushola, and Elegbede (2013)	To examine the axiomatic relationship between outsourcing strategy and organizational performance in Nigeria manufacturing sector	Data obtained were analyzed using Regression analysis.	The study adopted a stratified sampling technique to arrive at 120 sample elements for the study. Some of the top and middle level managers of Cadbury Nigeria Plc and Nestle Foods Plc responded to the questionnaire administered and were interviewed to further elicit information on the key variables.	Firms that outsource experience reduced average cost, increased sales turnover and profitability, enhance expertise, improve service quality, reduce staff strength, streamline the production process, reduced administrative burden and save time for core activities.
Nazeri, Gholami & Rashidi (2012)	To examine the propensity to outsourcing and its impacts on operational objectives including cost	Feedbacks are analyzed using SPSS and Minitab software based on deductive and descriptive	Questionnaires are distributed among the board of directors, quality managers, operational administrators, and lower managers.	The results of the survey indicated that outsourcing could lead to reduced cost, improve quality, increase flexibility, better financial and non-financial performance and services

Source: Empirical reviews, 2015.

3.0 Methodology

The specification of relevant procedures for collecting and analysing information (data) which would help solve the research problem at hand is quite pertinent for a research (Agburu, 2007). For the purpose of this study, survey research design and secondary data was adopted. Thus, data was collected through the use of questionnaire (which entails going to the field to source for responses from experts and other respondents). Also, a secondary data source was used which contains the relevant data about outsourcing strategies and also, profitability of some selected SMEs.

The population of SMEs within Gboko, Makurdi and Otukpo metropolis is Five hundred and sixty three (563) based on the records for year 2014 gotten from Benue state Board of Internal Revenue Service (BIRS). For the purpose of primary source data, a sample of 233 SMEs was selected from the population of 563 using Taro Yemane's formula for sample determination as follows:

$$n = N/1 + N(e)^2$$

Where: n = sample size; N = population size; e = level of significance; 1 and 2 are constants.

$$n = 563/1 + 563(0.05)^2$$

$$n = 563/1 + 1.4075$$

$$n = 233$$

The sample size as calculated above is 233 SMEs and is shared among the three selected towns under study using Bourley's 1994 population allocation formula in Nzeribe and Ilogu (1999, p.201) as stated below:

$$nS = \frac{n(NS)}{N}$$

Where: nS = sample size per town; n = total sample size; NS = Total number of SMEs in the area of study; N = Total population size. This results in the sampling of 69 SMEs in Gboko, 105 from Makurdi and 59 from Otukpo metropolis.

A simple random sampling technique was employed in selecting the sample of 233 SMES. A questionnaire was administered on every SMEs sampled whereby either the owner, manager (or a top officer) responded to it. This was done through personal delivery.

To ensure validity of the measuring instruments in this research, a carefully drafted and wide-ranging questionnaire aimed at eliciting right responses was constructed and piloted in order to

detect any ambiguities or inherent problems. While some questions were open-ended most were with a response scale of 1 to 5. The questionnaire is designed to capture detailed profile of the respondents in addition to what they consider as their outsourcing of core activities and its effect on their performance.

Expert opinions on the subject were sought to confirm the extent to which the question has face and content validity. To ensure reliability, this research used Cronbach alpha coefficient to test reliability. *Cronbach's coefficient alpha* is one of the most widely-used indices of internal consistency. The Cronbach's coefficient alpha ranges from 0 to 1. A scale is considered to have good reliability if it has an alpha value greater than 0.60 (Zickmund, 2010). The Cronbach's alpha results were 0.721 for primary activities, 0.701 for accounting activities, 0.843 for organizational performance while the overall alpha coefficient is 0.922.

Hypotheses were tested using multiple regression analysis. The output shows the t-statistic and p-values for the coefficients which results in either rejecting or accepting the hypotheses at a specified level of significance. The null hypothesis is rejected where the p-value is less than the critical value (0.05). Also, the output shows the coefficient of determination (r^2), which measures the proportion of the dependent variable that is explained by the regression model. The range for the coefficient of determination varies between 0 and 1; that is 0 r^2 1. As r^2 approaches 1, the more the independent variable explains the variation in the dependent variables. Statistical Package for Social Sciences (SPSS v20.0) computer program was used to enhance the robustness of the results.

4.0 Result and Discussions

A total of 233 questionnaires, each containing 15 questions were designed and issued out to respondents who are owners/managers of SMEs. At the end of the questionnaire process which took place from 16th March, 2016 to 15th May, 2016, only 218 representing 93.5% of questionnaires were dully filled devoid of errors and returned to the researcher and so, the presentation and analysis of questionnaire responses was based on these 218 copies dully returned.

Table 2 Effect of outsourcing strategies on SMEs profitability (based on questionnaire responses)

Model	B	Std. Error	T	p-value
Outsourcing of Primary Activities	.247	.060	4.133	.019
Outsourcing of Accounting Activities	.018	.060	.295	.768

Source: Fieldwork, (2016) SPSSv20

From table 2 above, shows the results of multiple regression analysis with profitability as dependent variable and the outsourcing strategies as explanatory variables. From the regression result, $F(4, 218) = 102.032$ at a 0.00 level of significance while $R^2 = 0.596$. It points that the regression model explains up to 59.6% of the dependent variable.

Test of Hypothesis

S/N	Model	T	p-value	Decision
1	Outsourcing of Primary Activities	4.133	.019	Rejected
2	Outsourcing of Accounting Activities	.295	.768	Accepted

Source: Fieldwork, (2016) SPSSv20

From the test of hypotheses above, the acceptance/rejection decision is taken base on the decision rule that states that, the null hypothesis will be rejected if the p-value (Sig.) is less than the critical value (0.05).

Discussion of Findings

The findings show a very strong positive effect of outsourcing primary activities on SMEs financial performance. Base on the regression result ($p = 0.000$) which fully supports the alternate view, the alternative hypothesis was accepted which says that there is a significant relationship between outsourcing of primary activities and performance of SMEs in Benue state. The findings reveal that, there is a positive effect of outsourcing primary activities such as manufacturing, purchases, warehousing, sales force, and customer service, others on the profitability of SMEs.

This finding supports the view by Crane (1999), Sinderman (1995), Casale (1996), Lau and Hurley (1997), Kotabe et al. (1998), Frayer et al. (2000), Gupta and Zeheuder (1994), Greer et al. (1999), others that outsourcing activities leads to profitability through cost savings, focus on advantaged areas of operation, cost restructuring, tax benefits and increase turnover. This finding however, opposes the finding by Isaksson and Lantz (2015) which asserts that outsourcing

strategies has no significant effect on financial performance of SMEs as shown by their research in Sweden. Also, the finding opposes the thinking of proponents of core competency theory which stresses that the primary activities which fall within the core area of operation of organizations should be retained in house and so carried out by the organization itself. Rather, it supports the transaction cost theory which emphasizes more on the cost of operation and so states that, organizations should contract or subcontract their operations if such can be done cheaper and or better by an outside vendor (Yalokwu, 2006).

For the second hypothesis, the result of regression analysis is greater than the critical value of 0.05 ($p = 0.768$), so, the null hypothesis was accepted which supports the assertion that, Outsourcing Accounting Activities has no significant effect on the profitability of Small and medium scale enterprises in Benue state. The respondents' views show clearly the fact that most SMEs do not outsource their accounting activities. They do carry out their recording and reporting internally. A fact still stands that, most SMEs do not have an established record keeping habit. This has being identified over the years as one of the major weaknesses of SMEs business operations (Onugu, 2005). The result here too may not be unconnected with the fact that SMEs

do not appreciate the importance of record keeping.

5.0 Conclusion

Based on our findings, this research concludes that, Nigerian SMEs' profitability over the years can be attributed to their outsourcing activities such as primary activities (manufacturing, purchases, warehousing, sales force, customer service, others) and accounting activities (such as financial reporting, tax processing, others). Also, most SMEs outsource more of their primary activities than others which are backup, or supporting in nature. This act is unlike the large organizations which outsource more of their non-core activities. However, not every SME outsource. Also, some which outsource have not been managing it effectively.

Recommendations

This research therefore recommends that;

- i. SMEs should embrace outsourcing as a strategic tool towards realizing financial benefits like cost savings and cost restructuring.
- ii. SMEs' outsourcing hardly follows the established process captured in outsourcing literatures as such its management should be taken seriously to better reap the benefits of the strategy. This can be achieved through effective communication and monitoring.
- iii. Owing to the unqualified imperativeness of accounting function in today's business world, SMEs should take this function with all seriousness and thus outsource it to competent vendors who can carry out this function better or at a cheaper rate than putting accountants on their payrolls.

Contribution to Knowledge

This research is an addition to the literature on Small and medium Scale Enterprises outsourcing strategies and their resultant operations in Nigeria in general and Benue to be precise. The study's novelty is embedded on the depth of the theoretical and empirical contribution thereby establishing and justifying the variables used in measuring subcontracting of primary activities and SMEs profitability are valid in research area.

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