An Introduction to Outsourcing

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Abstract: *Outsourcing has come a long way. Initially, the practice made a well-publicized mark when U.S. manufacturers began sending their operations to developing-market countries and laying off blue collar employees back home.Multinational corporations are looking at near-shoring, offshoring and outsourcing as a means of restructuring themselves strategically in order to better compete in an increasingly global economy.*

Key Words: outsourcing, ITO, BPO, KPO, backsourcing.

Outsourcing became part of the business lexicon during the 1980s and refers to the delegation of non-core operations from internal production to an external entity specializing in the management of that operation. Outsourcing is utilizing experts from outside the entity to perform specific tasks that the entity once performed itself.

The decision to outsource is often made in the interest of lowering firm costs, redirecting or conserving energy directed at the competencies of a particular business, or to make more efficient use of labor, capital, technology and resources.

What is outsourcing?

There are as many definitions of outsourcing as there are ways to screw it up. But at its most basic, outsourcing is simply the farming out of services to a third party. With regards to information technology, outsourcing can include anything from outsourcing all management of IT to an IBM or EDS to outsourcing a very small and easily defined service, such as disaster recovery or data storage, and everything in between.

Outsourcing involves the transfer of the management and/or day-to-day execution of an entire business function to an external service provider. The client organization and the supplier enter into a contractual agreement that defines the transferred services. Under the agreement the supplier acquires the means of production in the form of a transfer of people, assets and other resources from the client. The client agrees to procure the services from the supplier for the term of the contract. Business segments typically outsourced include information technology, human resources, facilities and real estate management, and accounting. Many companies also outsource customer support and call center functions like telemarketing, customer services, market research, manufacturing and engineering.

Why outsource?

The decision to outsource is taken at a strategic level and normally requires board approval. Outsourcing is the divestiture of a business function involving the transfer of people and the sale of assets to the supplier. The process begins with the client identifying what is to be outsourced and building a business case to justify the decision. Only once a high level business case has been established for the scope of services will a search begin to choose an outsourcing partner.

The business case for outsourcing varies by situation, but reasons for outsourcing often include one or more of the following:

- lower costs (due to economies of scale or lower labor rates);
- variable capacity;
- the ability to focus on core competencies by ridding yourself of peripheral ones;
- lack of in-house resources;
- getting work done more efficiently or effectively;
- increased flexibility to meet changing business and commercial conditions;
- tighter control of budget through predictable costs;
- lower ongoing investment in internal infrastructure;
- access to innovation and thought leadership.

ITO, BPO, KPO - what's the difference?

Business process outsourcing - or BPO - is the outsourcing of a specific business process task, such as payroll. It's often divided into two categories: back office outsourcing, which includes internal business functions such as billing or purchasing, and front office outsourcing, which includes customer-related services such as marketing or tech support. Information technology outsourcing (ITO), therefore, is a subset of business process outsourcing.

While most business process outsourcing involves executing standardized processes for a company, knowledge process outsourcing - or KPO - involves processes that demand advanced research and analytical, technical and decision-making skills. Less mature than the BPO industry, sample KPO work includes pharmaceutical R&D, data mining and patent research. The KPO industry is just beginning to gain acceptance in corporate America.

IT outsourcing clearly falls under the domain of the CIO. But often CIOs will be asked to be involved - or even oversee - non-ITO business process and knowledge process outsourcing efforts. CIOs are tapped not only because they often have developed skill in outsourcing, but also because business and knowledge process work being outsourced often goes hand in hand with IT systems and support.

Why is outsourcing so hard?

There's no debate about it. Outsourcing is difficult. The failure rate of outsourcing relationships remains high. Depending on whom you ask, it can be anywhere from 40 to 70 percent. At the heart of the problem is the inherent conflict of interest in any outsourcing arrangement. The client is seeking to get better service, often at lower costs, than it would get by doing the work themselves. The vendor, however, wants to make a profit. That tension must be managed closely in order to ensure a successful outcome for both client and vendor.

Another cause of outsourcing failure is the rush to outsource in the absence of a good business case. Outsourcing is increasingly pursued by organizations as a "quick fix" cost-cutting maneuver rather than an investment designed to enhance capabilities, expand globally, increase agility and profitability, or bolster competitive advantage.

Generally speaking, risks increase as the boundaries between client and vendor responsibilities blur and the scope of responsibilities expands. Whatever the type of outsourcing, the relationship will succeed only if both the vendor and the client achieve expected benefits..

How is outsourcing priced?

There are various ways to structure pricing within an outsourcing contract, including:

Unit pricing: The vendor determines a set rate for a particular level of service, and the client pays based on its usage of that service. For instance, if you're outsourcing desktop maintenance, the customer might pay a fixed amount per number of desktop users supported.

Fixed pricing: The customer pays a flat rate for services no matter what. Paying a fixed priced for outsourced services always looks good to customers at first because costs are predictable. And sometimes it works out well. But when market pricing goes down over time (as it often does), a fixed price stays fixed. And suddenly it doesn't look so good. Fixed pricing is also hard on the vendor, who has to meet service levels at a certain price no matter how many resources those services end up requiring.

Variable pricing: This means that the customer pays a fixed price at the low end of a supplier's provided service, but allows for some variance in pricing based on providing higher levels of services.

Cost-plus: The contract is written so that the client pays the supplier for its actual costs, plus a predetermined percentage for profit. Such a pricing plan does not allow for flexibility as business objectives or technologies change, and it provides little incentive for a supplier to perform effectively.

Performance-based pricing: At the opposite end of the spectrum from cost-plus pricing, a buyer provides financial incentives that encourage the supplier to perform optimally. Conversely, this type of pricing plan requires suppliers to pay a penalty for unsatisfactory service levels. This can be tricky to pull off successfully, but is becoming more popular among outsourcing customers, dissatisfied with performance in their previous forays into outsourcing.

Risk/reward sharing: With this kind of arrangement, the customer and vendor each have some skin in the game. Here, buyer and supplier each have an amount of money at risk, and each stands to gain a percentage of the profits if the supplier's performance is optimum and meets the buyer's objectives. The buyer will select a supplier using a pricing model that best fits the business objectives the buyer is trying to accomplish by outsourcing.

What about bundling?

Bundling services means paying an IT services provider one price that has more than one IT service or product lumped together. It's usually not a good idea. If you agree to the bundling of certain service levels into the price of a product, for example, you must buy that service every time you buy the product - whether you need it or not. Bundling also makes it difficult to understand what you're paying for individual products or services and to benchmark that against market pricing. Itemizing products and services keeps the vendor more accountable and enables the buyer to be able to charge back the usage fees to its various user departments.

What is an SLA?

A service level agreement (SLA) is a contract between an IT services provider and a customer that specifies, usually in measurable terms, what services the vendor will furnish. Service levels are determined at the beginning of any outsourcing relationship and are used to measure and monitor a supplier's performance.

Often, a customer can charge an outsourcer vendor a penalty fee if certain SLAs are not met. Used judiciously, that's an effective way to keep a vendor on the straight and narrow. But no CIO wants to be in the business of penalty charging and collecting. Bad service from an outsourcing vendor, even at a deep discount, is still bad service, and can lead to greater problems. It's best to expend that energy on finding out why the SLAs are being missed in the first place and working to remedy the situation.

What is the best length for an outsourcing contract?

What's the best length for a skirt? While the outsourcing industry is not quite as fickle as fashion, the prevailing wisdom about the best length for an outsourcing contract has changed over the years. When outsourcing first emerged as a viable option for providing IT services and support, long contracts - as many as 10 years in length - were the norm. As some of those initial deals lost their shine, clients and vendors began to look at contracts of shorter duration.

So what is the best length for an outsourcing contract? As with most other questions about outsourcing, the answer really depends on what's being outsourced and why. A transformational outsourcing deal will require more time to reap benefits for both client and vendor and therefore must be structured as a longer-term contract. But when outsourcing desktop maintenance or data center support, a shorter relationship may work better. Generally speaking, overly long contracts (more than seven years) are frowned upon unless there is a great deal of flexibility built into the contract.

Should I outsource everything to one vendor? Or should I use a best-of-breed approach?

Several years ago, the megadeal - multi-billion-dollar IT services contracts awarded to one vendor - hit an all-time high, and the IBMs and EDSs of the world couldn't have been happier. But this wholesale outsourcing approach proved difficult to manage for many companies. Today, although the megadeal is not dead, the trend has turned toward the multi-vendor approach, incorporating the services of several best-of-breed vendors to meet IT demands. And the major IT services players say they're able to accommodate this change. The highest-profile example of this brand of outsourcing is GM. After years of outsourcing much of its IT to EDS, GM is pursuing what it calls the "third wave" of outsourcing, bringing together a cadre of competing outsourcers to work together.

How do I decide what vendor or vendors to work with?

Selecting a service provider is a difficult decision. But start by realizing that no one outsourcer is going to be an exact fit for your needs. Trade-offs will be necessary.

To make an informed decision, you need to articulate what you want to gain from the outsourcing relationship and extract from that your most important criteria for a service provider. It's important to figure this out before soliciting any outsourcers who will undoubtedly come in with their own ideas of what's best for your organization, based largely on their own capabilities and strengths.

Some examples of the questions you'll need to consider include:

- What's more important to you: the total amount of savings an outsourcer can provide you or how quickly they can cut your costs?
- Do you want broad capabilities or expertise in a specific area?
- Do you want low, fixed costs or more variable price options?

Once you define and prioritize your needs, you'll be better able to decide what trade-offs are worth making.

Can I get outside help with this decision?

Many organizations bring in an outside sourcing consultant or adviser to help them figure out what their requirements are and what priority to give them. While third-party expertise can certainly help, it's important to research the adviser well. Some consultants may have a vested interested in getting you to pursue outsourcing rather than helping you figure out if outsourcing is a good option or not and then helping you figure out your requirements and priorities. A good adviser can help an inexperienced buyer through the vendor-selection process, aiding them in steps like conducting due diligence, choosing providers to participate in the RFP process, creating a model or scoring system for evaluating responses, and making the final decision.

Help can also be found within your own organization, from within IT and from the business. These people can help you figure out what your requirements should be. There is often a reluctance to do this because any hint of an impending outsourcing decision can send shivers throughout IT and the larger organization. But anecdotal evidence suggests that bringing people into the decision-making process earlier rather than later makes for better choices and also creates an openness around the process that goes a long way toward allaying fears.

The advice given above for selecting a provider holds true for negotiating terms with the outsourcer you ultimately select. A third-party services provider has one thing in mind when entering negotiations: making the most money while assuming the least amount of risk. Clearly understanding what you want to get out of the relationship and keeping that the focus of negotiations is the job of the buyer. Balancing the risks and benefits for both parties is the goal of the negotiation process, which can get emotional and even contentious. But smart buyers will take the lead in negotiations, prioritizing issues that are important to them, rather than being led around by the outsourcer.

Creating a timeline and completion date for negotiations will help to rein in the negotiation process. Without one, such discussions could go on forever. But if a particular issue needs more time, don't be a slave to the date. Take a little extra time to work it out.

Finally, don't make any steps toward transitioning the work to the outsourcer while in negotiations. An outsourcing contract is never a done deal until you sign on the dotted line, and if you make steps toward moving the work to the outsourcer, you will be handing over more power over the negotiating process to the provider.

What are the "hidden costs" of outsourcing?

The total amount of an outsourcing contract does not accurately represent the amount of money and other resources a company will spend when it sends IT services out to a third party. Depending on what is outsourced and to whom, studies show that an organization will end up spending 10 percent above that figure to set up the deal and manage it over the long haul. That figure goes up exponentially - anywhere from 15 to 65 percent - when the work is sent offshore and the costs of travel and difficulties of aligning different cultures are added to the mix.

Among the most significant additional expenses associated with outsourcing are: the cost of benchmarking and analysis to determine if outsourcing is the right choice, the cost of investigating and selecting a vendor, the cost of transitioning work and knowledge to the outsourcer, the costs devolving from possible layoffs and their associated HR issues, and ongoing staffing and management of the outsourcing relationship. It's important to consider these hidden costs when making a business case for outsourcing.

What do I need to know about the transition period?

Vantage Partners calls the transition period - during which a new provider's delivery team is getting up to speed on the buyer's business, existing capabilities and processes, expectations and organizational culture - the "the valley of despair." During this period, the new team is trying to integrate transferred employees and assets, begin the process of driving out costs and inefficiencies, while still keeping the lights on. Throughout this period, which can range from several months to a couple of years, productivity very often takes a nosedive.

The problem is, this is also the time when executives on the client side are looking most avidly for the deal's promised gains; business unit heads and line managers are wondering why IT service levels aren't improving, and IT workers are wondering what their place is in this new mixed-source environment.

IT leaders looking to the outsourcing contract for help on how to deal with the awkward transition period will be disappointed. The best advice is to anticipate that the transition period will be trying and attempt to manage the business side's expectations and set up management plans and governance tools to get the organization over the hump.

How important is ongoing relationship management to outsourcing success?

The success or failure of an outsourcing deal is unknown on the day the contract is inked. Getting the contract right is necessary, but not sufficient for a good outcome. One study found that customers said at least 15 percent of their total outsourcing contract value is at stake when it comes to getting vendor management right. A highly collaborative relationship based on effective contract management and trust can add value to an outsourcing relationship. An acrimonious relationship, however, can detract significantly from the value of the arrangement, the positives degraded by the greater need for monitoring and auditing. In that environment, conflicts frequently escalate and projects don't get done.

What if outsourcing doesn't work out? Can I just bring the work back in?

Backsourcing (bringing an outsourced service back in-house) when an outsourcing arrangement is not working - either because there was no good business case for it in the first place or because the business environment changed - is always an option. However, it is not easy to extricate yourself from an outsourcing relationship, and for that reason many clients dissatisfied with outsourcing results renegotiate and reorganize their contracts and relationships rather than attempt to return to the pre-outsourced state. In a recent study, outsourcing consultancy TPI found an "unprecedented" concentration of contract restructuring in 2005, with a significant number of mega-deals being reworked.

7 Tips for Secure Outsourcing

Burton Group Analyst Diana Kelley offers a handful of critical tips to secure your data when working with an outside vendor.

1. Know what you're outsourcing. Assess internal controls and policies and decide what level of risk management needs to be extended to the outsourced process (more, less, equal and so on). Remember that most accountability and almost all reputational risk cannot be outsourced.

2. Understand risks and dependencies. Learn about regulations and compliance controls of the country, financial stability, geographic risks (flood zone, power grid stability) and legal recourse options.

3. Assess outsourcer's risk management level. Review outsourcer's policies and procedures as well as any key audit findings.

4. Ask about training and background checks of personnel. Assess experience level of employees. Look for checks of any past criminal behavior.

5. Ensure data is protected appropriately. Review access control policies and technologies to ensure only authorized access to

data and systems, review physical and virtual separation controls, restrict outsourcing by outsourcing, review data lifecycle management processes and encryption procedures (creation, storage, destruction).

6. Request transparency for monitoring and controlling data and services housed at outsourcing vendor. Here's some to consider: Daily or weekly reporting and audit log reviews, remote admin rights to monitor log files.

7. Create clear and explicit service-level agreements (SLAs) and have legal review them. Reserve "right to audit" (physical/logical) clauses, escalation path and altering process, quantify remuneration for data loss or service down time.

Success and Failure in Outsourcing

In a strategic partnership, vendors provide an integrated set of operational services. For example, a single IT outsourcing deal might encompass mainframe operations, WAN and LAN management, telephony and help desk services - some of which are commodity services. By integrating its service offerings, the vendor adds value beyond the value of the individual services.

In a strategic partnership, the client expects to be able to focus on core competencies after handing off major operational responsibilities to the vendor. Clients also usually expect to realize cost savings and have access to variable capacity. To meet these expectations, vendors rely on economies of scale and scope, shared resources and best practices. Despite the potential for mutual benefit, these deals are risky. Only 50 percent of strategic partnerships in our study were successful.

Metrics are part of the problem. While vendors expect to earn a margin on the integrated set of services, client assessments of their partners often rely on a set of service-level agreements for the individual services. We believe the value of a strategic partnership is better assessed by its impact on the client's bottom line.

Strategic partnerships work best when they are treated by both client and vendor as long-term interdependencies with shared risk. Clients need vendors to adapt their offerings and processes to changing business conditions; vendors need clients to adapt their expectations and behaviors to permit appropriate process innovations and service changes. Successful strategic partnerships often apply a first-choice provider principle, meaning that the strategic partner is favored when new activities are to be outsourced. This reduces search costs for the client and sales costs for the vendor.

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