

# Outsourcing Decisions & Models - Some Practical Considerations for Large Organizations

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## Abstract

*Outsourcing has recently spurred broad discussions due to the relatively high failure rate of outsourced activities. To analyze how organizations can increase their success rate of outsourcing activities, the authors take a two-prong approach to the outsourcing decision and execution process, covering the “why” and “how to” outsource.*

*To determine the optimal setup, the authors introduce six outsourcing dimensions, which trigger the decision process and the subsequent procurement and execution processes. Strategic and operational considerations as well as risk implications are further elaborated.*

## 1. Introduction

Outsourcing has affected all major Western economies and impacted both operations and project execution of virtually all major corporations and government entities. The massive outsourcing trend, which despite earlier examples started in 1989 with Kodak's 10-year, \$250 million data center outsourcing

deal [1] and gained further momentum in the new millennium, recently spurred increased discussions around commercial, economic and political implications but also left many organizations puzzled on how to achieve a higher success rate through better selection, setup and management of outsourcing ventures.

Large organizations, both corporate and governmental, have been reviewing their value chains and embarked on outsourcing ventures in order to achieve increased focus on core activities, cost savings and improved service levels. Intuitively, the pursuit of such objectives appears to be beneficial to any organization, but it can be fraught with danger if it is not planned, executed and managed carefully and if does not take a long-term strategic view, weighing both opportunities and risks over time. Outsourcing in the public sector has been a subject of political controversy for a long time; due to issues of regional or domestic loss of employment, privacy and national security concerns as well as the never-ending debate on the “appropriate” degree of services to be provided by government, rooted in the economic beliefs of the political players. In the analysis of outsourcing government activities such factors have to be added to the decision criteria.

The outsourcing of projects naturally requires project management capabilities; whilst outsourcing of operational activities often involves a portfolio of cascading projects to deliver the outsourcing model. Some of these projects are directly related to the outsourcing act, such as shifting an operation or process from being internal to external delivery. Others are indirect, such as the development of an effective oversight or governance capacity for managing an outsourced venture or may include change management activities that are nested inside or surround the actual outsourcing project.

This paper discusses the dimensions of potential outsourcing scenarios, process and parameters for outsourcing decisions, risk implications of selected scenarios and the impact on procurement choices.

## 2. Establishing the business case for outsourcing ventures

In recent surveys, CIO Magazine [2] and Deloitte Consulting [3] analyzed reasons why large organizations outsource activities. In both studies about two thirds of the respondents named cost savings as the primary driver for their move towards outsourcing. However, as Deloitte's recent survey points out, 38% of the respondents which engaged in outsourcing ventures to save cost, experienced unexpected additional costs and did not meet their cost savings objective. Many outsourcing ventures did not deliver on other promises: the desired increased focus on core business was not achieved, critical processes were mislabeled as non-strategic and had to be re-insourced, vendor risks had been underestimated and better access to quality resources often overestimated.

While this by no means suggests that outsourcing is an unsuccessful model, a solid business case is essential to the success of outsourcing activities. Such a business case should state the expected quantitative and qualitative benefits both from a tactical and strategic perspective, identify and estimate all related risks and establish suitable metrics to measure the value-add of the outsourcing venture on an ongoing basis. A comprehensive business case should include all direct costs for the services being provided as well as the indirect costs associated with managing the supplier-customer relationships.

Lastly, outsourcing should not be the strategic objective, but an option to achieve a strategic objective defined by management.

## 3. Determining the optimal outsourcing setup

### 3.1 Outsourcing Dimensions

Currently many variations of outsourcing can be observed. The authors suggest the following classification of outsourcing variations, based on six dimensions:

#### I. Activity Dimension

- Projects
- Programs
- Portfolios containing projects or programs
- Operations or business processes

#### II. Geographic Dimension

- Local/ Regional/National (on-shore)
- International/Global activities (near-shore or offshore)

#### III. Legal Entity Dimension

- Within one legal entity
- In a different legal entity, but within a corporation
- Outside the corporation

#### IV. Distribution Dimension

- All activities are performed within the organization (collocated execution);
- Activities are distributed across multiple locations and partially executed in-house and outside (out-tasking)
- All activities are performed outside the organization (full outsourcing)

#### V. Engagement-Temporal Dimension

- Hands-off divesture
- Experimental – spin off
- Experimental – growing partnerships to divest
- Experimental – growing partnerships to potentially absorb

#### VI. Mobilization-Demobilization Dimension

- Simple (no re-entry expected)
- Moderate (re-entry possible)
- Intense (re-entry probable)

The Activity Dimension describes what organizational activity is to be outsourced and distinguishes between short- and long-term endeavors like projects and programs on one hand and open-ended activities like the permanent execution of

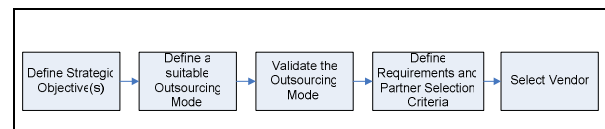
processes on the other hand. The Geographic Dimension relates to the locations included in an outsourcing scenario, and captures the geographic distance of the outsourcing partner. Furthermore, the Legal Entity Dimension defines the legal relationship of the partners of an outsourcing agreement, which can reside either within (shared services model) or outside a corporation. Finally, the Distribution Dimension captures to what degree an activity is outsourced, which for a defined activity can range between collocation (0%) and full outsourcing (100%). The Engagement-Temporal Dimension classifies the partnering approach from the kick-off of an outsourcing relationship and will mainly impact procurement considerations for the outsourcing contract. Some of the successful outsourcing partnerships have moved through some experimental stages to a more hands-off model. Lastly, the Mobilization-Demobilization Dimension captures the impact of outsourcing an activity and may imply significant efforts, depending on the implied re-entry option: a full divesture with no plans for taking back on the outsourced activity in the foreseeable future (simple), demobilization of resources with possible re-entry (moderate) or probable re-entry (intense), which requires legacy capacity to do so.

The six dimensions allow numerous strategic or tactical permutations of outsourcing scenarios. As an example for the mix of these dimensions, an organization could decide to outsource a project component, such as the generic code development for a defined component of a software product, to a 3rd party in an offshore location with little need for developing any long term relationships or embedded learning product enhancement nor any need for complicated re-deployment or redundancy of existing staff. Such an out-tasking scenario may yield certain benefits, although there is much literature to refute this as an activity that saves money and delivers unless there is an ongoing relationship with the supplier. It would be particularly suitable for a one-time, short-term outsourcing need for a clearly defined, and potentially rather commoditized service, which requires specialist skills or could be provided by a third party at substantially lower cost, in a shorter period of time, or/and in higher quality. The risk of this out-tasking strategy is lower than a full outsourcing scenario, due to lower switching costs associated with mobilization and demobilization of key resources and the likely wide availability of qualified resources in the market place to provide such (commoditized) services. Out-tasking, as described in the above example, requires that a certain level of trust is established between the two organizations, but the level of relationship

management and ongoing support is considerably less than with the outsourcing of an operation or process. The customer may procure additional services from the same provider or within the market place due to the commoditized nature of the underlying delivery models. Risks relating to the retention of intellectual property and the build-up of a potential competitor are limited, as the conscious decision is made to only out-task a part of the development effort and to focus on commoditized activities. Outsourcing the development of further software components to other partners may increase the leverage while maintaining ownership of the overall design and architecture and securing the intellectual property of the overall product.

### 3.2 Strategy-driven Outsourcing Decision and Implementation Model

The authors suggest that outsourcing decisions should be a truly strategy-driven process, which could be executed as follows:



**Figure 1: Outsourcing Decision Process**

(i) Define Strategic Objectives: The authors believe that the clear definition of the objective and target variables, which will be used to measure the success of the taken action, is most critical for the success of an outsourcing venture. The relevance of this first step is often underestimated and will be further elaborated in this section.

(ii) Define a suitable Outsourcing Model: Based on strategic objectives, the six dimensions can be used for defining a suitable outsourcing model. Metrics defined in the prior step will help estimate the business benefits and set target values.

(iii) Validate the Outsourcing Model: This validation step may include a number of stakeholders, which will be involved in the outsourcing projects within the organization. It will further solidify the benefits and risks and could take into consideration benchmarking data for similar ventures within our outside the organization.

(iv) Define Requirements and Partner Selection Criteria: As a result of the prior steps, parameters for a proposal request can be identified as well as vendor selection criteria.

(v) Select Vendor: Based on Step (iv), a vendor selection can be performed and negotiations will be initiated.

Quinn and Hilmer [4] emphasize the idea of outsourcing being focused on the strategic end of the make-or-buy decision. As they point out, the outsourcing decision should be based upon the strategic goals of an organization and the underlying view of the purpose of that organization. Numerous authors have supported the 'resource-based view' where a company's competitiveness essentially depends on their portfolio of resources [5]. The traditional resource-based view has been extended to include intangible assets such as knowledge assets [6], [7] including the tacit knowledge of the employees, processes and technology. Others, have stressed the strategic aspect of a clear focus on core competences [8]. Finally, the dynamic interaction of markets, available resources, and an organization's ability to adapt and be flexible has led to a dynamic capabilities view of the firm [9], [10], [11]. Thus, the decision whether to use internal or external resources for executing an activity is strategic in nature and not merely a price-driven make-or-buy decision. Outsourcing of services is not merely a purchase-and-receive transaction, as long as services are typically not standardized to the extent where they are purchased and delivered like a commodity.

To successfully outsource activities, executive management needs to define the underlying drivers for such an action. To the extent that management can qualify and quantify the strategic objectives associated with the outsourcing activity, it should be possible to establish a solid business case and execute upon it. Such strategic objectives could be articulated as follows:

- Focus on core business (metric: volume and support cost for activities, which are neither considered core competencies or directly responsible for the organization's competitive advantage.
- Leverage of external subject matter expertise, e.g. for non-core product components or one-time development or integration efforts (metric: in-house development staff hired or retained for non-core development).
- Reduction of labor-intensive processes and increase of cutting-edge, customer-centric activities in locations which exhibit high labor cost.
- Understanding of the exit criteria for outsourced activities which will lead to a relocation of outsourced activities back to the parent organization or reassignment.

However, when considering the outsourcing of services, a series of additional risks should be taken into account. For example, successful outsourcing

requires that the organization ensures that not only the deliverables meet the specifications, but also the relationships and contractual requirements are to be measured and maintained [12], which constitutes additional efforts and costs on both sides. The outsourcing contract needs to define a reporting and control mechanism with agreed upon metrics and audit capabilities such that delivery risk can be managed by the customer. Outsourcing activities often lead to a shift of primary skills sets from the customer organization to the supplier, which may reduce an organization's ability to manage the delivery from requirements definition to execution. For example, the outsourcing of a manufacturing activity will impact the resident skill set for production engineering; the outsourcing of engineering capabilities may diminish the organization's ability to develop new products. The outsourcing of a complete process is likely to impact the detail understanding of the process and hence the ability to manage, monitor and audit process compliance with the intended purpose etc. This risk of losing relevant skill sets requires mitigation and will lead to cost, which will impact the business case and most likely, the procurement scenario.

Outsourcing often sees a defined set of skills transitioned from the existing organization to an external party. Although this can be managed within the transition process, consideration must also be given to the management of the transition from a staffing perspective. For outsourcing ventures pursued by government entities, their staff has typically been in specific roles for a considerable amount of time and the migration to a commercial operating environment can be a significant challenge. Staff benefits, expectations and organizational culture would need to be considered as part of the integration activities and add to the migration cost, while regulations, such as union agreements and government contracts and employment law can impact the process considerably.

#### 4. Procurement Considerations

The procurement process for outsourced services needs to take into account the complete lifecycle of the engagement. A number of large organizations often experienced euphoric expectations at the inception of outsourcing agreements without fully understanding and managing the risks within this new approach to business. Organizations have to consider outsourcing agreements – as any venture – as a temporary endeavor that, whether long-term or short-term follows a lifecycle, including contractual agreements and managerial contingency plans for the event of contract termination. As a part of such contingency plans, an

organization, which has completely outsourced an activity, will need to understand how it would proceed to provide that function either internally or through an alternative party if the contract was terminated. Any termination clauses should assure the least possible disruption of the activity, protection of the intellectual capital required to continue the activity and the re-transfer (or in case of software and data assets the deletion) of proprietary assets, which were provided to the outsourcer under the agreement. A number of companies experienced difficulties in enforcing intellectual property rights in offshore markets. A potential risk management strategy – besides the decisive pursuit of legal options – may include the aggressive hiring of key players of a former outsourcing partner and the protection from IP theft through selective out-tasking of only some, commoditized components. Although it is not possible to include a re-allocation of key staff in case of a termination of outsourcing agreements, there is a need to define the intellectual property that would be provided in the event of any dissolution of the service delivered. In this context, intellectual property should include any hardware, software, customized processes and procedures that have been specifically funded by the customer and integrated in to the operations of the services. It should not include any intellectual property that is used for other customers or would be commercially sensitive to the supplier. This definition, especially when considering the transfer of tangible assets needs to be contractually defined prior to the delivery of services with great care; if not, the customer can be held to the mercy of the supplying body, especially when considering mission critical services or functions that support the core business of the customer.

Within this framework, the cost of maintaining a skeleton staff that is able to maintain the customer's intellectual property and ensure that the services being delivered are appropriate and fit for purpose is a procurement expense that is often overlooked. Adding to the level of complexity of this procurement lifecycle is the need to manage both the delivery of services and the relationships within and external to the outsourced service provider.

For an operation, an outsourcing contract defines the services being delivered, functional and non-functional requirements covered as part of the service level agreement, related cost and other terms and conditions. However, the delivery of core services is not the only services that are required by the customer. The procurement lifecycle within the outsourced contract needs to include facilities for delivery of additional projects and functions that maybe required

by the customer, as requirements change over time. Therefore, the customer organization needs to understand its direct relationship within the service provider and how to engage when additional work is required. The internal customer management team needs to manage internal relationships so that service delivery is consistent and that shadow services are not provided by other, non-authorized external parties. This provides an additional burden on the customer account team but also provides them with an understanding of all the functions delivered within their organization, and a process that allows the customer to manage costs.

Governmental organizations however, may not have the size required to successfully obtain economies of scale by outsourcing service functions. Within the Australian market place for example, the federal government attempted to overcome this limitation by clustering smaller government bodies to provide a larger “carrot” for the outsourced providers. Although this was conceptually a good idea, it did not take into account the differing requirements of the previously independent government departments. As one of the drivers was cost reduction, this in turn led to lower service levels delivered to a number of the agencies and drastically decreased customer satisfaction. In addition, the ongoing management of the relationship and delivery of services required that both the outsourced service provider and the clustered agency worked as partners to meet all parties' needs and expectations. From a procurement lifecycle perspective, this is a complex task due to the differing requirements for each party.

## 5. Conclusion

Outsourcing requires a diligent decision and execution process, which should be driven by solid business objectives and the strategy to implement it. In that sense, outsourcing is not the objective but the means to delivery.

The authors conclude that based on the definition of strategic objectives a decision process should be applied, which helps assure that a suitable outsourcing model is applied. Such a scenario can be driven by the six outsourcing dimensions described in this paper. From here on, outsourcing requirements can be defined and a suitable partner will be sought.

The selection of a suitable outsourcing model will have direct implications on procurement scenarios for the outsourcing partnership. Further research could map optimal procurement scenarios, terms and conditions to the particular outsourcing scenarios based on the six dimensions.

Lastly, the execution of outsourcing agreements should include the continuous monitoring of previously agreed success metrics, with potential exit scenarios in place for the point in time, where either objectives have been achieved and deliverables completed, or turned out to be unachievable which would require an early termination or change to the outsourcing setup.

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