



Starting with risk in mind

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Before we get too joyous with the festivities descending upon us, I thought it important to remind ourselves of what sourcing governance must be all about – managing risk.

When I hear folk talking about the massive rewards that are on offer from outsourcing and offshoring, how they will transform organisation and even the state of finances for some countries, I cannot help reminding myself of the much derided banker, whose motto has always been “the risk-reward” trade-off - the more rewards you expect to achieve, the more risks you must bear, and vice versa.

Given outsourcing and offshoring can deliver over 50% savings, transform organisations and make those dinosaurs into nimble eagles, we must accept, based on our banking colleagues equation, that associated with those rewards, must lay massive risks. Well, not surprisingly, studies have found that the success rate (achieving what you set out to achieve) of IT outsourcing is only around 50% (not to different from JVs).

Other estimates show that outsourcing clients spend as much as 15% of their IT budget on litigation in the case of IT Outsourcing. Outsourcing large scale IT in the public sector has until now, been disastrous (one hopes we don't waste many more millions of what we don't have, doing the same again). Even the SME trying to outsource small scale IT to an offshore vendor in India, will tell you, it isn't easy, and it certainly is not risk free.

The decision to outsource should not only be based on the promised land of lower cost, flexibility, accountability.....(rewards), but also the possible risks embedded in such a decision.

All too often, many organisations set up project teams to start thinking through and implementing outsourcing programmes; teams who may have little experience, little detailed know-how and really very little understanding of the risks that are inherent in the decisions they are about to engage in. Many of the people within these teams, come from procurement backgrounds, and concentrate on those limited sets of risks which they are familiar with. Most use ad-hoc processes and systems to muddle their way through.

Actually, this is one of highest risks – not consulting all stakeholders, leaving the decision in the hands of the few and not actually having a process of good decision making!

Unfortunately, risks in outsourcing are bountiful – and must be at the heart of the outsourcing decision making process and subsequent implementation. Some of the more obvious ones include:

Strategic risks

- Not achieving the originally planned benefits - the less experienced both parties are, the higher the risks. Clients sometimes have unrealistic expectations about what can realistically be achieved by outsourcing. When an outsourcing relationship is started, with cost reduction as the main objective - organisations tend to forget the search, contracting, transition costs, or indeed the cost of managing the service provider – i.e. a very optimistic business case;
- The loss of core activities and competencies - excessive outsourcing can lead to considerable reduction of overhead so that the host organisation becomes a fraction of its former self, something termed the “hollow corporation”;
- Lost opportunity - selling a strategic resource may cost a company dearly in the long-run;
- Loss of skills and corporate memory - by contracting out goods and services traditionally



produced in-house, the organisation loses skills, competences and collective knowledge, as both a producer and client of those services;

- Loss of strategic business flexibility and innovation capacity - the functionality provided by the vendor is available to all customers simultaneously, thus there remains no real first mover advantages. During the term of the contract, client firms' business environment could also change dramatically - so poorly designed outsourcing contracts may well lead to future strategic inflexibility.

Operational risks

- Dependency on the supplier - often finds its roots in: poor contracting, outsourcing into limited supply markets and high asset specificity;
- Cost increases - hidden costs emerge if managers incorrectly assume the depth and extent of activities included within the outsourcing contract - the pursued cost efficiency of outsourcing is certainly not always achieved;
- Transition and switching costs - outsourcing requires a redefinition of organisational boundaries, which in turn induces possible further restructuring and dislocation of resources and induces a variety of costs in the process;
- Reversibility and Customer lock-in - once a process has been handed over to an outsider, it is extremely difficult and costly to bring it back in-house. The extent of this risk is driven by two factors: (1) Level of standardisation and complexity of the process and (2) the level of market maturity. The more customer specific a process, the greater the difficulties associated with switching to another service provider;
- Diminished quality of service - reduction of quality may result from several factors: the interdependence between an outsourced activity and processes which remained in house, the lack of experience and expertise of the service provider with the outsourced activity, as well as the normal operational factors which can impact quality;
- Loss of management control - loss of control over suppliers can occur when firms do not closely monitor suppliers and where suppliers assume leadership in their relationship;
- Technology change - provider owned outsourcing services are less likely to tap opportunities presented by competitive providers;
- Suffering interruptions to supply, especially during transition.

Commercial risks

- Security breaches – especially within BPO where there is risk to data privacy. There is also the possibility of risks from knowledge diffusion – such as confidentiality leaks and loss of intellectual property rights by the vendor;
- Contract costs - the time required to create and manage the contract may make outsourcing actually more expensive;
- The loss of intellectual property rights;
- Compliance risk - the risk to earnings or capital that arises from violations of laws or regulations or non conformance with internal policies or ethical standards.



Human Resource / Communication risks

- Loss of internal coherence - external sourcing of certain activities will hamper the internal coherence of the company. Employees' morale, trust and productivity can be damaged due to job security issues related to outsourcing;
- Staff degradation - reduction in employee morale may encourage the most talented and marketable staff to seek opportunities elsewhere;
- Communication mismatches - what initially seems to be clear and unquestionable to one side might result in disputes and litigation due to contrary interpretation by the other partner. This can be especially true for offshore outsourcing;
- Public image - large employee lay-offs are not beneficial to a corporate image.

Strategic risks to some extent form the greatest challenge as they require a combination of strong yet flexible formal contracts, better knowledge management and the development of trust and commitment which aid in developing complementary competences and achievement of the benefits being sought from the outsourcing initiative.

The HR and communications risks tend to get overlooked, as it traditionally requires considerable effort consulting with stakeholders and getting their buy-in.

Needless to say, a rational decision to outsource, a robust business case, and the identification of all risks are prerequisites to effective risk management.

When organisations outsource to offshore destinations, additional risks are introduced, which may include: Culture, Language, Time-zone differences, Institutional differences, such as quality of infrastructure, security, political conditions, socio-economic conditions etc within the offshore country.

These are just some of the many risks - however what is equally, if not more important, is how, who and by what means these risks are managed!!

Sourcing governance must start with a holistic, organisation-wide embracement of outsourcing, examining the good, the bad and the ugly of outsourcing...

Merry Christmas!

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