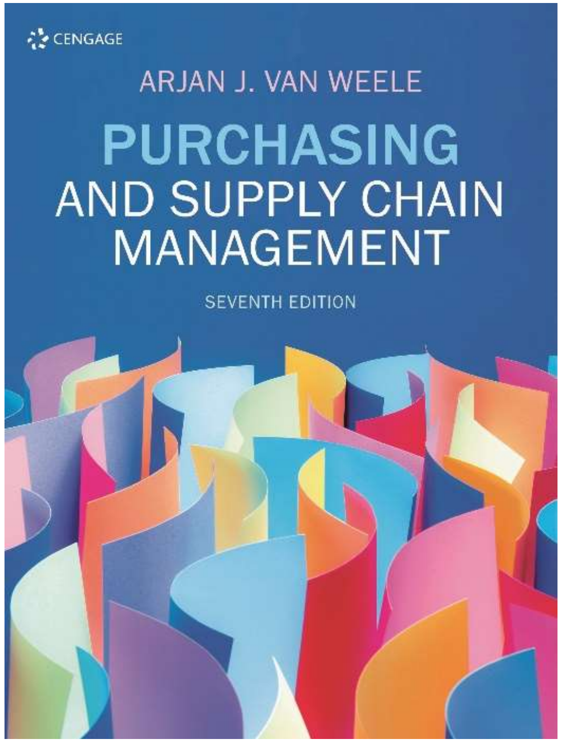


MASTER OF SCIENCE IN BUSINESS ADMINISTRATION

Procurement & Supply Chain
Prof. Corrado Cerruti

Chapter 8

Outsourcing and risk management

CENGAGE Learning

Learning objectives

- Why companies outsource part of their business processes.
- How to structure the process of outsourcing.
- The most important risks and pitfalls related to outsourcing.
- How to deal with the most important downside risks related to outsourcing.

Outsourcing as a business concept

- Outsourcing can be described as the transfer of activities that were previously conducted in-house, to a third party. The company divests itself of the resources to fulfil a particular activity to another company, to focus more effectively on its own competence.
- Outsourcing in US became a standard business practice among all companies in all industries by 2000. (Outsourcing Institute, 2000)
- The global market of outsourced services in the US increased from $45 billion in 2000 to $104 billion in 2014.

Definitions and concepts

- Characteristics of **outsourcing:**
  - In-house performed activities are transferred to an external party
  - Assets, knowledge and sometimes employees are sent to the external party
  - Extended and long term relationship
  - Buyers from both parties experience new costs and risk profiles
  - Complex transition and change

Definitions and concepts

- **Offshoring:** Offshoring relates to the commissioning of work to a provider in a low cost country. In many cases offshoring is concerned with outsourcing of (IT) services.
- **Partial outsourcing:** only a part of an integrated function is outsourced. The coordination of the function and activities still lies with the client (the buyer). Here a major problem is of course how to demarcate the responsibility between the parties involved.
- **Turnkey outsourcing:** applies when the responsibility for the execution of the entire function (or activities) lies with the external provider. This includes not only the execution of the activities, but also the coordination of these activities.

Table 8.1 Partial versus turnkey outsourcing

	Advantages	*Disadvantages*
Turnkey outsourcing	Buyer has minimal responsibility for outsourced processes	The buyer has limited influence on the determination of the price and little insight in cost structure of provider
	Buyer doesn't need to have experience with similar projects	The buyer has limited influence on the staff, technology and materials used and their quality
	The project generally goes smoothly for the buyer	Large dependence of buyer on provider resulting in high commercial, technical and performance risks
Partial outsourcing	The buyer has more influence on prices, rates and costs	The buyer is required to have knowledge of the separate parts of the outsourced function/ activities
	The buyer has more influence on the staff, technology and materials used and their quality	The buyer is required to have the organizational capacities to co-ordinate and integrate the outsourced function/activities
	Specific advantages can result in cost reductions	Communication and co-ordination problems between parties involved can be a cause of delay and disappointment

Rationales for outsourcing

FIGURE 8.1 The outsourcing matrix

Source: adapted from Savelkoul (2008)

Memo 8.1 top ten reasons to outsource

1. Improve company focus
2. Gain access to world class capabilities
3. Get access to resources that are not available internally
4. Accelerate reengineering benefits
5. Improve customer satisfaction
6. Increase flexibility
7. Sharing risks

1. Reduce control costs and operating costs
2. Free up internal resources
3. Receive an important cash infusion
4. Improve performance
5. Ability to manage functions that are out of control

All these reasons underlie one overall objective: to improve the overall performance of the outsourcing firm

Advantages and disadvantages of outsourcing

TABLE 8.3 Advantages and disadvantages of outsourcing

Advantages	*Disadvantages*
Freeing up of cash: investments can be concentrated on core activities	Increased dependence on suppliers
Optimal usage of knowledge, equipment and experience of third party	Continuous follow-up and monitoring of the supplier relationship is necessary
Increased flexibility: fluctuations in the workload can more easily be absorbed	Risks of communication and organizational problems during the transfer of activities to a third party
Outsourcing leads to easier and more focused primary processes in the organization	Risk of leakage of confidential information
Input through an independent party's point of view which reduces the risks of introvert short-sightedness in the organization	Depending on balance of power between parties: inability to execute contractual performance incentives and penalties
	Risk of losing essential strategic knowledge

Success of outsourcing

- (Delen et al,. 2016) Recent research on IT outsourcing found that around 40 per cent of such projects fail.
- (Deloitte, 2014) reported that 49 per cent of companies who had outsourced part of their business processes complained about the reactive attitude of their outsourcing partners.
- (Deloitte, 2014) reported that 48 percent of these companies (who had outsourced part of their business processes) complained about the poor service quality that they gained from these partners.

The outsourcing process

- Three phases:
  - Strategic phase (why, what, who?)
  - Transition phase (how?)
  - Operational phase (how to control?)

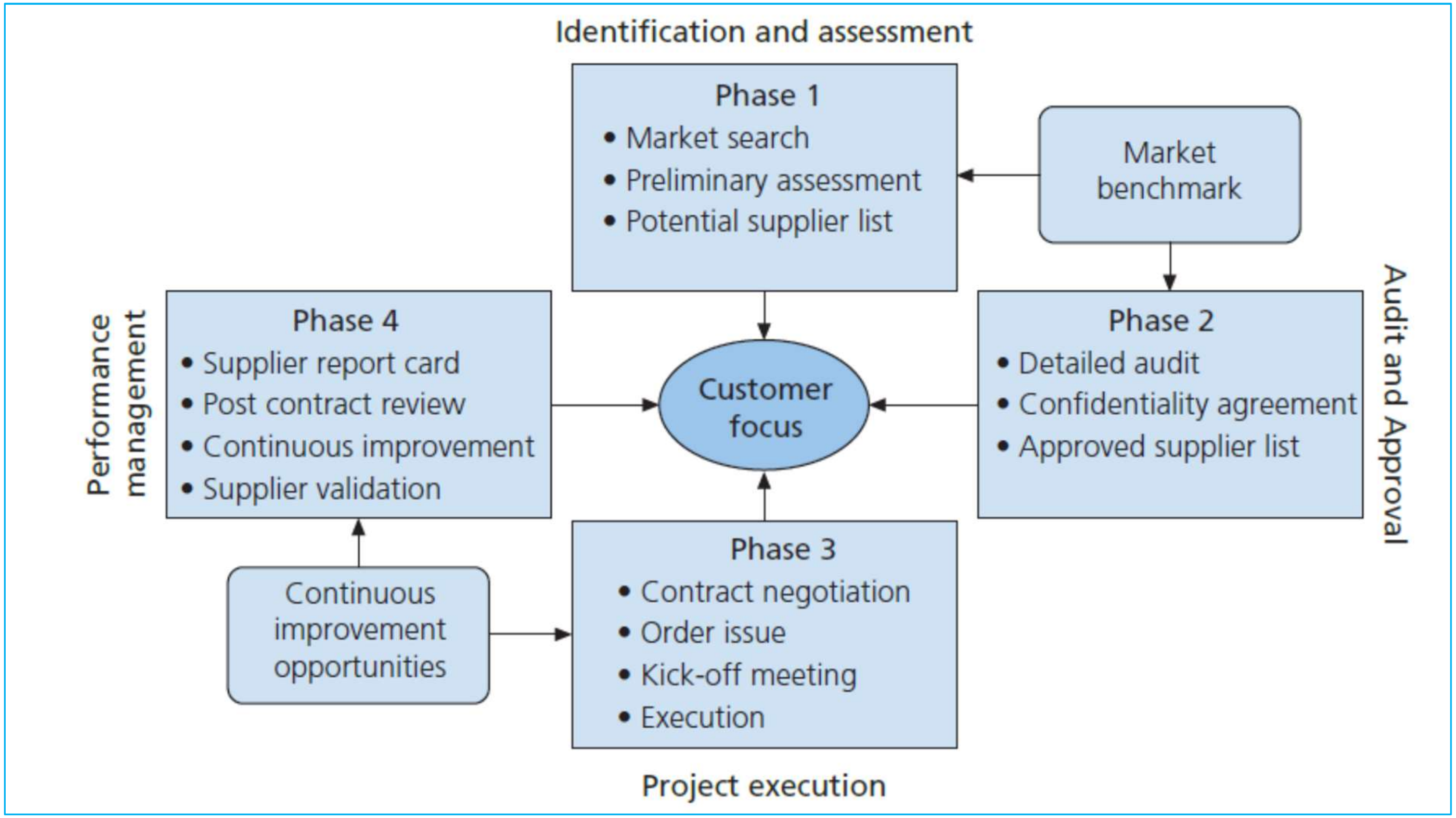
FIGURE 8.2 The outsourcing process

Source: adapted from Momme and Hvolby (2002, p. 71)

Strategic phase

1. Motives for outsourcing
   - Focus on core competences
   - Focus on cost efficiency/ effectiveness
   - Focus on service
2. Which activities or functions are outsourced
   - Transaction cost approach
   - Core competence approach
3. Qualifications of the supplier
   - Technical and managerial qualities to achieve demanded level of performance

Figure 8.3 Four-phase strategic outsourcing model



Source: Momme and Hvolby (2002, p. 191) Reproduced with permission.

Transition phase

- Contract negotiation
  - Contract forms a legal basis for relationship
  - Contracts depends on characteristics of outsourced activity
  - The contract type has a great impact on the success of the joint operation
- Project execution and transfer
  - Outsourcing transition can be very complex
  - The transfer should be conducted using project management principles
  - Test phase before going 'live'

Transition phase

- The type of contract is just one of many issues to be discussed. Other ‘ingredients’ in an outsourcing agreement are:
  - The scope of the service
  - Terms of agreement
  - Rates, fees, incentives
  - Termination plan
  - Conflict resolution
  - Communication
  - Management and control
  - Other (warranty, confidentiality etc.)

Operational phase

Table 8.3 Core values and supporting factors of an outsourcing relationship

Core Values	Supporting Factors
Shared goals and objectives	Developing a personal relationship
Mutual dependence	Having professional respect
Open lines for communication	Investment of effort by top management
Concern for the other's profitability	Commitment to continuous improvement
Mutual commitment to customer satisfaction	
Trust	

Risk assessment

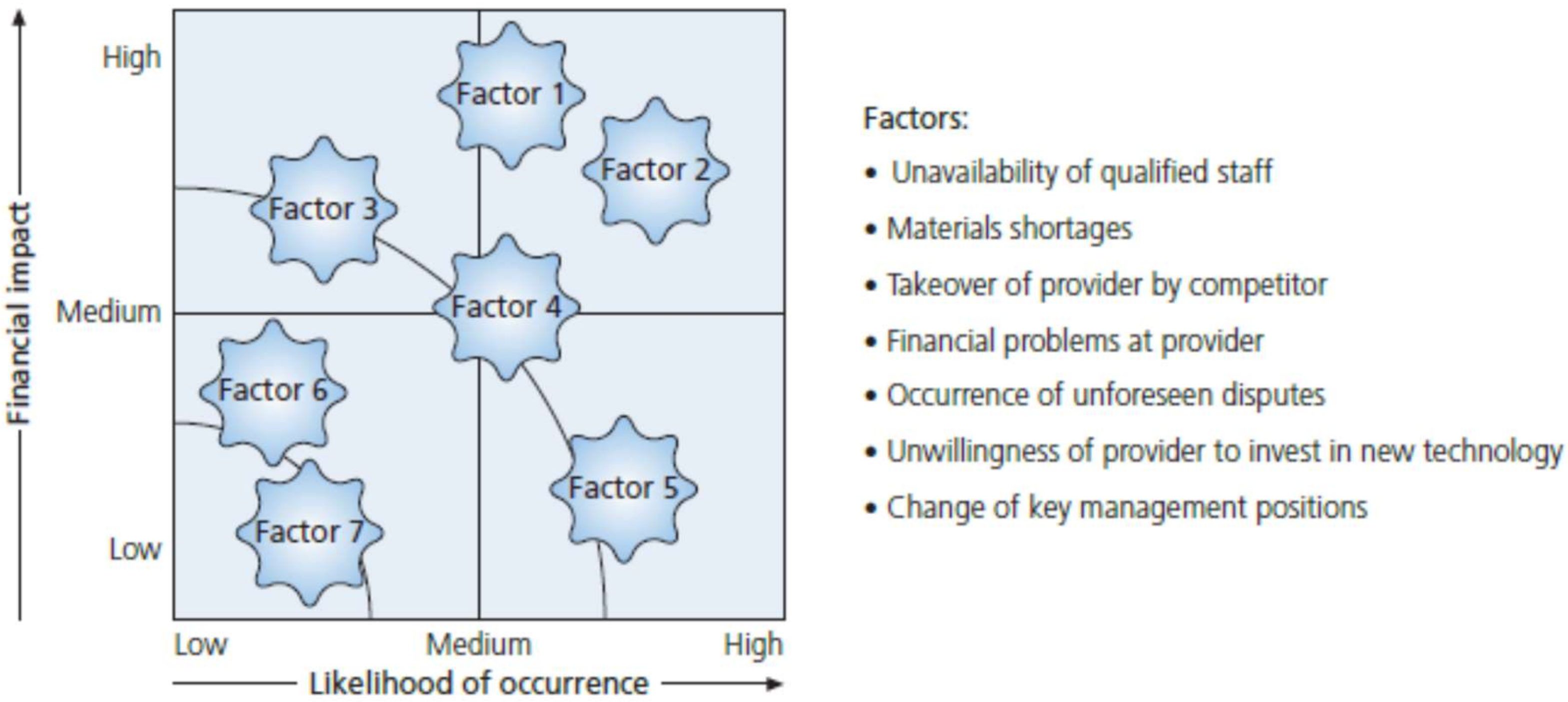
- In cases where trust and interpersonal relationships are not present, parties try to arrange for dealing with these risks and uncertainties by detailed outsourcing contracts.

- These contracts are associated with the following kinds of risks:
  - **Technical risks:** related to the extent to which the supplier is able to provide the desired functionality and performance.
  - **Commercial risk:** related to the uncertainty with regard to the price we will pay and the costs that we will incur when having outsourced our activities to the supplier.
  - **Contractual risks:** e.g. does the contract in sufficient detail describe the performance that is expected from the supplier?
  - **Performance risks:** related to the chance that the supplier is not capable of doing the job he was hired for.

- Trust and partnership are more important to solve the problem.

Risk assessment matrix

Figure 8.4 Risk assessment matrix: systematic analysis of risk factors



Risks are assessed on two criteria:
(1) the negative impact on the company's financial performance or operations and (2) the likelihood with which the risk factor probably would occur.

Critical success factors of outsourcing

- Understanding company goals and objectives
- A strategic vision and plan
- Selecting the right vendor
- A properly structured contract
- Open communication with the individual groups involved
- Ongoing management of the relationship
- Senior executive support and involvement
- Careful attention to personnel issues
- The way the company is strategically positioned vis-à-vis its supplier. Can it still exert some control over its supplier, or not?

Summary

- Outsourcing has become popular as a business strategy in many industries around the world.
- Most companies start outsourcing to benefit from cost advantages and to create more focus.
- The new strategy involves the decision to move an activity, that was conducted in house, to an outside provider.
- **Offshoring** is similar to outsourcing; it usually relates to services and is located in a low-cost country.
- The outsourcing strategy should be in line with the overall corporate strategy.
- As a result of outsourcing, the traditional balance of power between the outsourcing company and its provider changes.