

Managing Risks in
Outsourcing/Offshoring Engagement –
A Value Creating Opportunity

The publication is prepared for informational purpose only. Any use of the information in this document in making business decision is sole responsibility of the business. Before using this information, you must consult a professional advisor. This document should not be treated as a professional advice.

Table of Contents

1.	Preface	ii
2.	Introduction to Risk in Outsourcing	1
3.	The Outsourcing Life Cycle	2
4.	Common Pitfalls	3
5.	Strengthening your Value extraction basket	10

Preface

Because of the intense focus on shareholder value in developed economies, Outsourcing is thriving and growing phenomena. The induction of Outsourcing arrangement as a key component of cost reduction and capability supply strategy has opened many opportunities along side bringing with it significant risks that must be recognized and managed. From the Outsourcing strategy development until the value of Outsourcing is realized, many aspects of the Outsourcing life cycle poses different types of risks. Risks of different types- endogenous or exogenous are involved at all steps of the Outsourcing life cycle. All decisions taken during the process, strategic assessments done, operationalization of the Outsourcing strategy, vendor choice and value extraction from the Outsourcing arrangement involves risks. This paper discusses some of the risks involved at each of steps in Outsourcing life cycle. We encourage you to share this paper with senior executives of your organization.

Note: Although Outsourcing and Offshoring are different terms, they may be used interchangeably in this document for understanding.

Introduction to Risk in Outsourcing

The term “Outsourcing” describes contracting a third party vendor to perform and/or manage a process or function or a business requirement to deliver to its requisite utility for the business.

Various services fall in Outsourcing basket. Some Outsourcing vendor perform back office operations, others supply materials, some serve for IT applications, IT Infrastructure Management and BPO services and others in sourcing of business functions. Outsourcing industry is broad and inclusive of many other services including ITO & BPO. Different forms of Outsourcing models based on distance from the business operations exist in the market, for example, On shoring, near shoring, Offshoring. Other models are based on dispersion of service providers, for example, Home shoring, Crowd sourcing, and Free Lancers. Some models based on Degree of ownership are: Captive, Assisted Captive, Joint Venture, Build-Operate- Transfer, Build- Operate, Build- Operate- Own and Outsource. Others are based on type of services provided: Legal Process Outsourcing, Knowledge Process Outsourcing, IT Services Outsourcing, IT Infrastructure Management and Business Processes Outsourcing.

Many organizations have relied on Outsourcing and their numbers are increasing. The scope and scale of Outsourcing along with the increasing focus on risk management by number of Outsourcing customers have generated enough insights to apply risk management principles to Outsourcing arrangements. To manage the downside possible due to risk exposure, a structured methodology is to be applied for risk management at all individual stages and their interconnections in Outsourcing life cycle.

Due to the bulk of business in Outsourcing industry is driven by Offshoring in Information Technology and Business Process Outsourcing and secondarily by Knowledge Process Outsourcing, for this paper, we restrict to Offshoring in ITO and BPO segments. And the risks depicted in this paper can be selectively and where appropriate be applied to different Outsourcing arrangements. Please note, this is not an exhaustive and comprehensive list of risks associated with Outsourcing/Offshoring life cycle.

Risk management is a structured approach of analyzing and managing the possibility of loss or injury, or an exposure to hazard. Every Outsourcing/Offshoring arrangement involves risks and rewards. As the quality of rewards expected by the customer increases so does the magnitude of risk involved. Businesses looking for rewards should not overlook the risks involved at various stages in the Outsourcing/Offshoring life cycle. These risks may affect negatively or bear positive result to the Outsourcing/Offshoring arrangement and ultimately to your customer, the choice is all yours.

The Outsourcing/Offshoring Life Cycle

In the Outsourcing/Offshoring life cycle, integrated risk management approach than applying individual solutions to the individual silos in the cycle delivers quality and long term results. The utility of Outsourcing/Offshoring methodology inculcating the outlook for risks involved adds immense value in short and long term to the Outsourcing/Offshoring arrangement. A risk focused approach should account for risk spectrum in business decisions and activities. The list of risks in this document is by no means incorporate all the risks involved in the Outsourcing/Offshoring spectrum exhaustively and comprehensively.

Various companies associate or have experienced risks at individual stages of Outsourcing life cycle. Such risks if properly planned ahead would help outsourcers to extract optimum value from the Outsourcing engagement. A premeditated outlook and approach for risk identification and definition early in Outsourcing life cycle would allow the integration of risk assessment and mitigation.

Outsourcing Life Cycle:

1. **Outsourcing Decision:** Involves all the decision sequences from strategic integration of Outsourcing as a value creator to value appreciation from business case presentation.
2. **Vendor Selection:** Involves screening vendors according to the criteria selected in strategic integration and other pertinent business needs. Identification and selection of best value vendor from various Outsourcing vendor options in the market. Some of the research factors are: legal analysis, country, cost, skill and other Outsourcing advantages' trend analysis.
3. **Contracting/Signing On:** RF'X' evaluation, management and appropriateness with respect to contents and business needs. Negotiation on terms which capture needs and expectations of both the parties. Compliance agreement and addressal of risks identified in previous stages. SLA & price negotiation and ensuring transparency and accountability.
4. **Transition, Delivery and Post Transition Management:** Establishing detailed budgets and management force from the pilot phase of Outsourcing to post transition management and governance. Managing the pilot, Knowledge Transfer, migration, monitoring performance and SLA's.
5. **Termination & Exit Management:** Although contracts are designed to minimize disputes, in times of reaching a "no chance" situation of continuation, organizations need to have an exit management or termination strategy.

Our understanding is many Outsourcing decision are taken based on the "alternate supply analysis", and project management concepts are applied thereafter to transfer the Outsourcing candidate to the vendor's operations. What organizations need to do is to

analyze the real costs incurred along with risks involved and ensuing gains to maneuver the engagement to maximum benefits. Companies need to focus on is the risk considered Outsourcing methodology while considering an Outsourcing engagement.

Common Pitfalls

1) **Outsourcing Decision:** Outsourcing is not only for cost reduction; many organizations are appreciating other factors like labor arbitrage, cost restructuring opportunities, quality improvements in their strategic meetings. Acceptance of Outsourcing as a lever for growth of the company, involves deeper understanding and right evaluation of the related strategic and organizational attributes. What should a company think about and know of for selecting Outsourcing as the right option for its growth. Companies perform an alternate supply analysis, cost benefit analysis, to be expressed in business case form, and may look at its readiness level for Outsourcing, but is that it? Outsourcing decision calls for better in depth analysis. Some of the first level risks are:

- **Strategic Integration:** Outsourcing should integrate with the larger corporate strategy of organization to reap its benefits in medium and long term. Organizations may end up taking an asymmetrically considered decision of valuing the cost savings more than related strategic risks. Thereby ending up risking the long terms benefits and encroaching furtively on short terms gains. Clearly set strategic integration along with supplementing goals and objectives supported by strategic value creation takes an Outsourcing engagement a long way. This is the foundation on which any Outsourcing engagement has to stand strong. If the foundation itself is not clear and is pregnable, Outsourcing arrangement falls straight on the face.
- **Emotions & Power Loss:** As normal, top management who has brought up the organization as their baby, and other senior officials in the process may have developed emotional attachments for the business functions or processes. Such emotional issues and fear of loss of power acts as strong luggage in addressing the foundational decisions and may obscure the unbiased analysis of Outsourcing as a solution. Such issues if not discerned and removed at the beginning leads to a biased version of discussions on Outsourcing.
- **Core Competency:** With the unclear definition of core competency and the complexity of new age business processes, it some times becomes unclear for the outsourcer to clearly define which functions or processes are core to the business and which are not. Business clarity and strategic analysis provides critical insights in the right direction to distinguish the core from the context. If inappropriate processes or functions are chosen for Outsourcing, it may compromise the long term competitive ability of the company.

- **Model Selection:** With focus on Offshoring to countries like India, China, Thailand, and other countries taking a fore in Outsourcing industry, evaluating the right model for Outsourcing forms one of the gravest of issues an organization may overlook. It might be that near shoring is a better option to organizations for their functions or processes than Offshoring. Organizations must consider “internal supply or alternate supply” analysis or reengineering options, functions/processes’ customers reactions, control required over the outsourced candidate and other ownership issues apriori. If different models for Outsourcing are not evaluated it might acerbate the future optimum value realization from the Outsourcing initiative.
 - **Strategic Assessment:** Every Outsourcing initiative is focused on maximizing value. Once the right model’s value is been agreed upon, assessments for Organizational Readiness for offshoring, structural due diligence and offshorability analysis of the functions/processes and other requisite value revealing analysis is to be done. If right value capturing parameters, prerequisites are not used, optimal value may be a distant dream and not be realized. And under such circumstances related risks would spring their heads leading to long term costs. And while preparing a business case all related costs including the services hired for the Outsourcing initiative, project management costs, legal costs directly attributable to project and the management and governance costs post transition should be included in business case presentation.
 - **Risk Map:** A premeditated risk mapping at this stage of any possibilities in future stages would take the Outsourcing engagement to the next level. This activity of risk identification and mapping helps the decision makers to evaluate risk areas appropriately and incorporate the same in the next stages of the Outsourcing life cycle. If the high level risks are not extensively and comprehensively understood, the Outsourcing engagement will shower frequent intermittent problems due to negative side of the risks which were not considered leading to extra costs to be borne by the outsourcer. One of the risks to include at this level is a development of initial cooperation outlook. What exactly does the Outsourcing company is expecting? What are those areas where outsourcer cannot negotiate on? And what are those it may? Companies many a times choose to understand what the vendor has to offer and evaluate it against their specific needs or may involve the seller team to customize their solution to its requirement. A Initial draft would be beneficial to the company to have a pre-designed co-operation items list and its respective value, with which it becomes easy to evaluate the risks involved and manage the whole show. A Clear high level expectations or an idea on the same would allow the organization to focus on what it wants and bargain for better value than accept what the outsourcer has to offer.
- 2) **Vendor Selection:** No matter how diligently a company assesses the vendor, it fails on knowing everything about the vendor. Services, which the vendors provide are intangible

in nature therefore difficult to measure. Alongside the fragmentation of the vendor landscape, allow more complexity for vendor evaluation. Until all the relevant parameters for the Outsourcing engagement are identified, it is difficult to select the right vendors. Companies should have a holistic due diligence, prior to engaging a vendor. Some of the O/O risks at this stage are:

- **Resource Usage:** Vendors past history on the resource usage provides critical insights on their resource management tactics. Delays in recruitment or an excessive effort on sourcing the right candidates can eat into valuable delivery time and other financial resources. Its well known a fact, as how difficult is it to replace the lost time, if the vendor has fallen short of project requirements and therefore customer expectations.
- **Vendor Subcontracting:** In a complex and large scale project, it is quite common to have multiple vendors involved who are serving individual service silos. It is preferable to have the direct vendor serve the silo assigned than subcontract to another third party or several independent vendors. This affects the outsourcer's management control much more than the financial margins the vendors make from the outsourcer. The assigned vendor may not be able to act immediately and also fall short on immediate execution of the change requests made by the outsourcer. Such delay due to unaccounted risk in vendor evaluation is critical and will affect the performance directly. At what price the outsourcer accepts the shrinkage in performance? Only the outsourcer party knows.
- **Bid Strategy:** While reviewing vendors, low cost bidders are spontaneously screened for evaluation. But beware from falling in the trap of low cost bidders. Some have legitimate market penetration strategy and some others may under- scope the service and amount of effort needed. And in latter case it is common to find a strong change management program further down the road and every time new requirements show up, it drills deep into the outsourcer's pockets. And on a long run, the low cost bidder may turn to be the highest money grosser from you. It is better to be late than sorry. Taking time in evaluating technicalities and factors effecting the solution drives a long term cost savings better than short term L+2 approach.
- **Supplier's Financial Viability:** Even after transferring the risk to the supplier, the accountability of the process remains with the outsourcer. It is important for the outsourcer to have a capital necessary for the research and development and other accessory activities. Supplier's financial risk analysis knowing who their customers are, its revenue dependency, and susceptibility for a major financial loss is to be evaluated well beforehand. The financial viability of the supplier is univocally, one among the top criteria for evaluation. What stability in services would the financially lame organization offer to outsourcers? Vendor's financial risk mapping, yes, is an undeniable criteria featuring in top list of vendor evaluation.

3) **Contracting/Signing on:** After key risk areas and areas of contract importance are identified, deal making sounds like an easy process. RFP's may be a rosy picture to the contracting firm to sign on. Organizations should maintain restraint at the stage which best suits to extract value from the whole Outsourcing engagement. The contracting phase offers the first legal platform involving the endorsement of negotiated expectations and delivery. The significance of value which the signing on/contracting phase offers is immense in settling at the right deal for the outsourcer and extract best value from the available information along with support from the risks and contract outline prepared in previous stages. This phase allows the outsourcer to manage and transfer appropriate risks and increase the over all value accrued from Outsourcing engagement. Discussed below are some of the relevant risks:

- **Price Range:** Focus of any negotiation from the outsourcer's perspective is to squeeze the best value for the least price. Inaccurate estimation of effort, time, scope and dollars involved by the vendor, leads to inaccurate pricing. A critical insight in estimation and clear value appreciation avoids outsourcers from paying huge sums for their Outsourcing engagement. Experienced personnel from the outsourcer's team should be involved in such estimation exercise from outsourcer's perspective to have a clear and unbiased estimation.
- **Service Level Agreement:** Institutions entering into Outsourcing arrangements should have signed contracts, detailed the service-level agreements and other contract ingredients. Inadequate contractual arrangements may leave a company heavily exposed to risks, should any problems arise in the relationship with the third party. While it is important that there be comprehensive contractual agreements in place, it is equally important that institutions do not overlook the risks involved. These clauses protect institutions from the reputational impact of major failures. Outsourcing also exposes institutions to legal-liability risk if confidential customer information is not adequately secured and used. Handling of such information should also be included in the contract.
- **Negotiations:** If outsourcer's focus on extracting best value at least price starts on the negotiating table without preparation, it will drive profits in the vendor's pockets. An organization should never take this risk. A well thought after negotiation strategy, gate keeper conditions, heads and level of different terms involved in statement of work, negotiation dimensions, integration of vendor and outsourcer's expectations and in depth vendor research are some of the items which will add up to the ammunition of the outsourcer. As strong is the ammunition, so better will be the bargaining power. Unprepared or incomplete negotiation items will tilt the bargaining power and benefits on vendor's side.

4) **Transition, Delivery and Post Transition Management:** A smooth transition leading to delivery in completeness and agreement with SLA will communicate a successful

Outsourcing value. The Outsourcing transition phase may also fail if schedules and budgets are not achieved because of insufficient planning and/or resources. An Outsourcing project must be run with the same discipline and planning as a large-scale systems implementation. Outsourcing being a replacement arrangement, still the outsourced functions has a direct bearing on the company's ability to meet its commitments to customers and shareholders. As important is the post transition management, for the continuance of the service, so is a robust governance framework providing a strong support to quality service. Transitioning of services is one aspect of the Outsourcing arrangement which can give rise to complex risk allocation considerations between the customer and service provider. As the hand-over of responsibility for service provision happens in a phased manner, if not executed well may lead to disaster. To manage the show well, couple of risks are discussed below:

- **Inaccurate planning:** Cost over runs, compliance issues, quality management, incomplete knowledge transfer leads to bad delivery in service. Unforeseen major and minor changes in the service scope or inaccurate planning for change control or escalations management guidelines defeats the purpose. In transition process, from the pilot to the post transition management, Outsourcing project runs into many problems due to inaccurate planning. Proper planning and administration with appropriate risk management leads to a phenomenal success in delivery, which every business is expecting.
- **Shrivingling:** represents deliberate under-performance on a task that is difficult to measure, while still claiming full payment as if the task had been fully accomplished and had been completed in accordance with agreed upon standards of performance. Shrinking may be seen in the terms where SLA's are not properly and completely defined or in cases where the SLA does not incorporate all the necessary clauses for "desired" performance. Such situations will leave the outsourcers either in quandary or direct for change management thereby increasing the project costs.
- **Intellectual Property:** Theft and subsequent misuse of information or training or expertise, given in trust for the accomplishment of a specific purpose, used for the gain of the recipient of the information and to the detriment of the giver. Such risks due to misuse of intellectual property arise anytime when the outsourcer is releasing specific information or intellectual property to the vendor. Once the information or expertise is transferred, it is impossible to reclaim it. This information may be used by the vendors in accessing critical data, selling to or for targeting outsourcer's competitors. Such risks have a potential of huge loss for the outsourcer. Appropriate control measures need to be taken while releasing or making the vendor a party in accessing the information.
- **Renegotiation because of outsourcer's strategic vulnerabilities:** is a situation where vendors become powerful and can exploit the strategic vulnerability of the outsourcer. For example, vendors have a bargaining power, when mission critical Outsourcing candidates are served by only one vendor or certain strategic actions by

the outsourcer will not allow it to repeal or relax the arrangement. Such repricing occurs because of the increase in strategic vulnerability, being unanticipated, is not adequately protected by terms of the contract, allowing the stronger party to make plausible threats if the new payment structure is not accepted. The commitment levels of both the parties should be equal, and if the dependency of the outsourcer is higher on the vendor then the vendors may drive for repricing of the contracts.

- **Supplier base dependency:** In markets where outsourcer has few alternative choices of service supply and a vendor has a large number of alternative customers then the outsourcer has a high degree of vulnerability and the vendor can indeed engage in opportunistic pricing. Small numbers bargaining situations can be created even when there are alternative vendors, if the switching cost for the outsourcer is higher than the value created. Such restrictions and lock-ins without positive mutual interests from both sides creates uneasiness in the whole Outsourcing process.

5) **Termination & Exit Management:** Termination is one stage which if reached to would be non-beneficial to one of the parties. Although counter intuitive to contract execution, exit procedures for transitioning of services back to the customer, or its third party nominee, following a termination or expiry of the Outsourcing arrangement, need to be documented at the outset. The ultimate sanction against the service provider under situations of under performance against inadequate service levels or descriptions. Contract termination can be due to insolvency, financial reasons of both vendor/outsourcer. Among the common terms which should be included for termination and exit management, couple of them are discussed below:

- **Transfer Plan:** A clearly laid out transfer plan with appropriate timelines of service retrenchment or transfer to the third party assigned by the vendor allows smooth transition in full sense. Providers need to plan appropriate timelines for implementing the exit strategies. Otherwise the whole service solution transfer will not be managed well to be taken care of later.
- **Exit Strategy:** Inclusion of various terms in exit strategy is critical for ensconcing the exit strategy for the specific Outsourcing arrangement at hand. It should contain post exit assistance, staff transfer, ownership of data; no poaching agreement of key personnel, among other relevant points should be included in exit strategy. It should comprehensively also include the obvious and obscure risks involved to reach a “back transfer” or “as it is now” state of the Outsourcing candidate.
- **Information Dissemination:** A critical factor while considering the termination or exiting an outsourcing contract is the information dissemination and management support by the vendor. To maintain similar service levels and quality of the service, operational best practices and other detailed information related to the outsourced

candidates would reduce the relearning and understanding time to manage the service at the same levels as previously. Such considerations are critical for the outsourcer to take into account while penning down the exit or termination strategy.

Strengthening your Value extraction basket

Accoutered with risk considered outlook included in Outsourcing/Offshoring life cycle would take your Outsourcing engagement to next level delivering greater benefits. Step by step focus and systematic building of risk mitigation strategies in downstream stages of O/O life cycle would increase the outsourcing value. Efforts driven towards value driving and downside risk management interventions will lead to a successful value creation in a collaborative Outsourcing arrangement.

06/08

Protomind Consulting

About Protomind Consulting:

Protomind Consulting is a strategy and management consulting firm. We provide strategy and management consulting and outsourcing advisory services. For more information you may contact: contact@protomindconsulting.com or browse www.protomindconsulting.com