The Changing Techniques of Outsourcing

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Abstract

Technological advances combined with increased globalization and competitive pressures have forced many firms to consider alternatives that will reduce organizational cost, and at the same time create and/or maintain their competitive advantage in the global market. Increasingly, many firms are considering the phenomenon of outsourcing as a solution to their IT needs and problems. This report identifies the key elements that should be considered while managing an outsourcing relationship with a 'foreign' vendor. The recent changes in the world economic & security scenario has made significant changes in this industry.

What is outsourcing?

Outsourcing is the hiring of outside professional services to meet the needs of an organization in areas as diverse as human resources, taxes, inventory management etc. It means using external agencies to create process, manage and maintain information systems and to provide the company with a wide range of information related services such as data processing, global networking, gathering business intelligence etc.

In outsourcing, the buyer does not instruct the supplier how to perform its task but, instead, focuses on communicating what results it wants to buy; it leaves the process of accomplishing those results to the supplier.

However quite often organization outsource only basic data processing operation, general business functions, and systems that are not in their direct line of business. Rarely do companies outsource their STRATEGIC SYSTEMS.

Contracting vs. Outsourcing

Contracting is when a company (buyer) purchases goods or services from another company (supplier or vendor). In this situation, the buyer owns and controls the process. In other words, the buyer tells the supplier exactly what it wants and how it wants the supplier to perform those services. The supplier cannot vary from the buyer's instructions in any way. The buyer can replace the supplier quite easily by breaking the contract.

Outsourcing: In outsourcing the buyer turns over the control (ownership) of the process to the supplier. The buyer tells the supplier what results it wants the supplier to achieve, but the supplier decides how to accomplish those results. If the buyer were to dictate to the supplier how to do the job (as happens in contracting), the buyer would be destroying an important aspect that makes outsourcing work – the value that is created by using the supplier's expertise and economies of scale and this eliminates accountability on part of supplier.

Why outsource?

To survive in today's competitive markets, companies must focus on core competencies and adopt outsourcing as the strategic solution to improve quality of service and reduce costs of important, non-core processes.

Organizations outsource for reasons that can be classified into four broad categories.

1.Strategic Focus

An organization may outsource so that it can better focus on its primary line of business and channel its limited resources to meet its strategic goals and achieve its mission.

For example in 1989 KODAK outsourced its data centers to IBM, its communication system to DEC and its microcomputer-based network to Business Land. It was an indication that it was doing so because these functions were not in its direct line of business.

2.Economic Reasons

Since most outsourcing agreements are fixed price contracts this eliminates the escalating costs that are often associated with system design and

development. When outsourcing contracts are carefully designed, it can decrease the overall cost of IS operations due to elimination of hidden costs & no long term liabilities.

3.Market Forces

If an outside vendor can provide a support function more efficiently, outsourcing that function can reduce operating costs and give the company a competitive advantage.The company saves in terms of training & equipment for the latest technologies. The cheaper labour from other countries is also the driving force.

4.Technical Consideration

Technical Consideration such as alack of qualified technical personnel may make outsourcing and attractive alternative. Companies on the leading edge of technology often face a shortage of skilled personnel.

One of the primary concerns that manager face when it comes to outsourcing is legacy system , which are large systems (usually on mainframes) that handle company's payroll, inventory management and so on. There are three primary outsourcing options with regard to legacy systems.

1. Outsource the maintenance of legacy systems and use in-house staff to build new systems.
2. Outsource the development of new systems and keep in-house staff to run and maintain legacy system.
3. Use insourcing for both legacy systems and new systems.

Insourcing involves treating the IS departments as a business within the business and training the system development staff to meet present and future development needs. This may prove beneficial to the organization as this trained staff can be used for outsourcing.

How outsourcing transactions are priced

The structure of the pricing for the outsourcing contract can be one of the following:

(1) **Cost Plus**. This approach pays the supplier for its actual costs, plus a predetermined profit percentage.

(2) **Unit Pricing**. This is a set rate determined by the supplier for a particular level of service, and the client pays based on its usage.

(3) **Fixed Price.** Some buyers think this is the best approach, because they know exactly what the supplier's price will be, even in the future. But the problem with this approach is that if the buyer does not adequately define the scope of the process and design effective metrics before signing the contract, too often the result will be that the supplier claims a particular service or service level is beyond the scope of the contract and then charges a premium for it.

(4) **Variable Pricing**. This plan involves use of a fixed price at the low end of the supplier's service, with variances based on higher service levels.

(5) **Incentive-based (or performance-based) pricing**. Here, the buyer provides incentives to encourage the supplier to perform at peak level by offering a bonus reward if the supplier performs well. This same plan works in ensuring that the supplier must pay a penalty if it does not perform to at least the "satisfactory" service level designated in the agreement.

(6) **Risk/Reward sharing.** Here, the buyer and supplier each have an amount of money at risk and each stand to gain a percentage of the profits if the supplier's performance is optimum and achieves the buyer's objectives.

Outsourcing suppliers acts like as insurance companies

To understand how outsourcing suppliers acts as insurance companies we will have to understand the three types of capital risks.

The first is asset risk. These are long-lived physical assets that produce a stream of income. Companies have to invest to acquire these assets. Rapid technological change can render them obsolete. Companies are at risk loosing their physical assets after every project.

The second capital risk involves a company's human capital. Companies hire people with skill sets they need. Then they train them. Like

physical assets, their knowledge becomes capital that can become obsolete as technology or business needs change, and people can leave the firm, taking their knowledge with them. Companies are at risk loosing their human capital after every project.

The third capital risk involves knowledge capital. Knowledge capital is the information the organization uses to make good business decisions. "Knowledge capital is not inherent in one person. It's a group phenomenon," Knowledge capital becomes obsolete when economic conditions change or key people leave & the knowledge becomes obsolete. So companies are at risk loosing the knowledge capital after every project.

Scale Mitigates Risk

The larger outsourcing vendors have tremendous scale. Their scale mitigates the human capital risk by fitting people into a much larger puzzle than exists in the buyer's company. The vendor has many ongoing projects and can reassign people depending upon the need. Because their customers operate in a wide variety of industries, they may not feel the sting of economic ups and downs as sharply as their individual buyers do. This wide range allows a vendor to diversify risks that a normal organization can't

The same applies to technology assets. The vendor's bigger picture helps it deal with obsolescence in a more effective way. Outsourcing vendors have more options and greater flexibility. For example, they may have preferred relationships with equipment manufacturers which entitle them to better prices than an individual company could negotiate on its own and preferred relationships with equipment resellers.

Outsourcing Vendors Can Afford the Gurus

Some outsourcing vendors specialize in a small but important area of expertise. These suppliers can hire experts a buyer could never afford. They can spend the big bucks because they spread the cost of this high priced knowledge over many buyers. Their knowledge and expertise mitigate some of the risk of working with new technologies, markets or products.

Knowledge capital, however, is risky for any company to outsource. This is the knowledge that differentiates your company from every other company. However, companies may discover they are lacking in knowledge capital. One of the ways to gain it is through partnerships and alliances with companies that have complimentary but different knowledge capital. By sharing complementary knowledge capital with each other, both parties can perform in ways they could never do alone.

Thus it can be said that *Buyers who outsource shift much of these risks to the vendor. "It's like buying insurance," In this analogy, the outsourcing vendor is akin to the insurance company.*

How the September 11 Attacks Changed Offshore Outsourcing

American companies have enjoyed significant advantages outsourcing to companies located beyond their borders. Offshore outsourcing provides a powerful labor arbitrage; U.S. firms can receive made-in-the-U.S. quality at remarkably lower prices because of the wage scale differential in other lands. Labor savings can be as much as 60 percent. And, time zone differences mean someone is always on the job.

But this formula works only when the offshore partner operates in a secure political environment that remains friendly to America. The events of September 11 taught Americans there are some who do not cherish our way of doing business. Here's how the terrorist attacks have impacted offshore outsourcing.

The New Importance of Risk Management

Risk management has risen to the fore. Now, companies want to have multiple suppliers if they are using labor arbitrage Having more than one provider in different corners of the globe reduces the risk. After doing a serious risk assessment since the attacks, most of the organizations have

decided to diversify and have their work performed in more than one area of the world. Risk involved will be now less on one location or one area , making it possible to undo the damage done in one part or one area of business.

Outsourcing In India

Political stability is now a key question for offshore suppliers. The companies are uncomfortable with what's happening in Asia. They want to know what happens if India gets involved in a conflict. They want to be reassured nothing will go wrong with their business if they outsource. The companies are factoring in the new risks that have been introduced since the terrorist attacks. Though India is politically aligned with America in this case but it's close proximity to central Asia and the warning by the jehad leader osama bin laden on India is causes of worry

The U.S. economy was in a free fall before the attacks and has gotten worse since. That has made it hard to ignore India's enticing labor arbitrage argument. Fully loaded labor costs including technology are up to 60 percent cheaper than in the U.S and the fact that Indians are native English speakers put the Indians on a hot seat.

The attacks have, however, had some deleterious effects on outsourcing partners in India. There are problems with international travel especially to countries with large Muslim populations like India. Also, the U.S. Immigration department has tightened up entry restrictions, which has delayed visas and increased denials. This has hurt body shops in the U.S. staffed by Indians.

The Changing Face of the Outsourcing Marketplace

In 2001 outsourcing became the solution for many companies both for buyers and suppliers. On the ***supplier side***, vendors looked at outsourcing as a formula for financial stability through increased revenue, long-term customers and sustained profitability.

There was a renewed focus on outsourcing on the ***buyer side***, too. Employers facing the tough issue of downsizing realized they needed a scalable solution that could easily shrink or grow with their needs. ***Cost saving tended to be the initiating motivation for buyers considering outsourcing in 2001***.

But in future, there will be two dominating trends.

Trend No. 1: The Need to Differentiate IT suppliers are coming under pressure to differentiate themselves in a saturated marketplace. Today it seems almost everyone wants to become an IT outsourcing supplier and the competition for business is fierce.

Suppliers will be able to differentiate themselves by:

1.Specializing in different forms of business process outsourcing (BPO).

2.Gaining deep vertical market knowledge.

3.Developing technological innovation that creates real competitive advantage for buyers.

Trend No. 2: Shift of Focus from Cost Savings to Value Creation

In last year's tough economy, cost savings rose to the top of the list of reasons why companies decided to outsource. This year cost savings will remain important. But value creation will become a significant catalyst for outsourcing.

This year the company's top executives will drive the search for enterprise sourcing strategies. They will search for an outsourcing supplier who they view as a strategic business partner. Together they will develop a solution that provides a true competitive advantage for the buyer.

Finally, there will be alternative methods for deal construction. This year buyers will embrace concepts like Everest's Total Value Equation[s] (TVE) that allows them to transform the entire Organization, not just individual business processes. TVE[SM] is designed to allow organizations to make decisions that cover the range from cost savings to true value creation for the business.

Why is outsourcing sometimes not successful?

Outsourcing is based upon fundamental principles and, if those are applied at the outset of a relationship, the parties will most likely have an effective, successful relationship. If the parties enter into an agreement that is not based on those principles, the result will be an unsatisfactory relationship and, probably, an early termination of the contract.

The first of these basic principles is for the buyer to determine the scope of services and the metrics, for the performance levels, it wants from the supplier. This is the only way a buyer can achieve a comfort level with turning over its process to the supplier and ensuring that it gets what it pays for. This is the only way to ensure accountability from the supplier. It must be done up-front, before the contract is signed.

A certain cause for failure in an outsourcing relationship is for the buyer to let the supplier dictate what the services and performance levels will be.

Another sure cause for failure is for the buyer not to completely describe the scope and boundaries of every component of the service. This can lead to a supplier providing something that was not agreed upon and then charging a premium for it or the supplier not providing something the buyer assumed it would be getting for the price it is paying

Conclusion

Thus from the various details we see that outsourcing is an efficient methodology for utilizing the resources of an organization properly. It helps in cost saving and utilizing the expertise of suppliers. The primary advantage of outsourcing is that burden of developing and delivering high quality information systems is on the outsourcing vendors and not on the organization. Outsourcing can reduce the cost of IS functions and services, decreases overhead and reduces problems associated with technological obsolescence. But outsourcing also has some disadvantages it often results in job losses. Employees may also view outsourcing as a vote against their technical skills or as a sign that troubled times are ahead for the company, prompting key IS personnel to quit the company. Finally outsourcing to the wrong vendor may result in loss of control over the quality and reliability of the IS function.

Therefore, a company must carefully analyze and balance the pros and cons of outsourcing and take into account not only it's information needs but also the organizational culture, the managerial style, and the strengths and weaknesses of its IS personnel.

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