Getting offshoring right (Aron & Singh, 2005)

Concerning offshoring; companies benefit only when they pick the right processes, calculate both the operational and structural risks, and match organizational forms to needs.

Last five years (beginning of the millennium): companies in North America and Europe have experimented with the strategy of offshoring/outsourcing, hoping to reduce costs, become more efficient and gain a little strategic advantage. According to several studies, half the organizations that shifted processes offshore failed to generate the financial benefits they expected to. Many also faced resistance from employees as well as consumer dissatisfaction.

Most companies believe it’s easy to offshore business processes – therefore they don’t make decisions about offshoring systematically enough.

**Three fundamental mistakes, according to the authors**

1. Focusing efforts on choosing countries, cities, and vendors, as well as on negotiating prices. Don’t evaluate which processes to offshore.

Challenging to differentiate between core, critical and commodity processes (the last category is best suited for outsourcing)

1. Most organizations don’t take into account all the risks that accompany offshoring
2. Most companies don’t realize that outsourcing is no longer an all-or-nothing choice – that they have a continuum of options.

Outsourcing to external providers vs. executing processes in-house.

Alternatives in between: buy services from local providers, joint ventures, captive centers overseas. In addition to not considering all alternatives, most businesses analyze processes to narrowly, looking only at the direct costs and failing to examine interdependencies that might tip the cost/benefit-analysis in favor of keeping services in-house. The authors’ research shows that both location and organizational form decide the fate of offshoring strategies.

*Task of article: outline tools to help companies choose the right processes to offshore, discussing the associated risks. Describe a new kind of organizational structure and show how companies can use it to benefit from offshoring.*

## Rank processes by value

Should figure out how each process helps the company to create value for customers and to capture some of that value.

Questions to ask:

* How crucial is each process (or sub-process) compared with others in creating value for my company’s customers? Answer will differ from business and often by industry.
* In relative terms, to what degree does each process enable my company to capture some of the value that it has created for customers?

Executives may feel that one of the two dimensions is more important in the industry or for their company. In that case, they must calculate the total rankings after assigning greater weight to the more important aspect. By ranking all the processes, executives can create a value hierarchy. The higher a process’ rank in the hierarchy, the more crucial it is to the company’s strategy, and the less the organization should think about moving it offshore or outsourcing it.

Value hierarchy; serves several purposes:

* Standard basis for comparing processes
* Allows managers to think systematically about the importance of the process

## Identify and manage risk

Operational risk:

service providers won’t be able to execute business processes as well as their employees perform them in-house (in the short term). Until service providers move up the learning curve, they will make more errors and execute tasks more slowly than companies’ employees do. Often results in lower customer satisfaction.

Twin causes to operational risk:

* an organization’s ability to codify work

By documenting the work done, that is, by describing responses to situations explicitly, covering all scenarios, people anywhere could perform this work, thus, the operational risk would decrease. E.g. banking services 🡪 consistent procedures entails that the same services could be performed anywhere.

However, if a service provider’s employees require a great deal of domain experience – information about the client’s customers, a deep understanding of how its product and geographic markets function, and knowledge that the client’s managers carry – to execute processes, they are unlikely to get those processes right for a long time.

* Company’s use of metrics to measure the quality of processes

Many businesses haven’t developed effective metrics, or they formulate them for the first time when they outsource processes. Both increase operational risk because, when such companies offshore or outsource processes, they have no way of knowing if providers have executed those processes better or worse than themselves. Businesses would do better to create metrics, measure the quality of processes for a while, and improve their quality in-house before deciding to offshore or outsource them.

Only firms that set tolerance limits for errors, draw up completion times and productivity norms, and continuously measure employees’ performance are able to move processes offshore.

When companies look at the extent to which they codify work and use metrics to measure process quality, they will see that their processes fall into four distinct categories:

**Transparent process:** Companies have metrics to measure the quality of processes, and they can codify the work. Operational risk of offshoring/outsourcing: very low

**Codifiable processes:** Companies have some ability to measure the quality of execution and can codify most of the work. Still, only people who have formally mastered a body of knowledge, such as accountants and lawyers, can execute these tasks. Difficult to manage the quality of work in real time. If firms can measure the quality of the end result, the risk of offshoring or outsourcing the processes becomes manageable. However, if measuring results is difficult, the risk of offshoring is very high.

**Opaque processes:** Companies can codify the work, but cannot measure quality of process outputs. When firms underwrite insurance policies, for instance, it’s difficult for them to measure how well their employees have executed the task since the events that policy buyers are protecting themselves from may never occur. Although the risks of offshoring these processes are moderate, companies have to inspect samples to ensure that the output meets their quality standards. Often cumbersome and expensive. If companies specify how the outsourcers’s agents should do their work and offer them performance-based rewards and penalties, they can lower the risk of offshoring these processes.

**Noncodifiable processes:** cannot easily codify work because variation in business events and employees’ responses are too great to permit standard responses. Companies may be able to evaluate the quality of execution, even though a challenging task. For instance, if employees don’t fulfill orders correctly, customers will cancel those orders or return products. These processes are prone to a high degree of operational risk. If organizations do outsource them, they should closely supervise the service provider’s agents.

### Structural risk:

Common assumption: companies assume vendors will always act in ways that maximize both groups’ interests. Vendors will act opportunistic.

Vendors can stop investing in training or employ people who aren’t as qualified as the agents they presented during negotiations.

Service providers sometimes put in less effort than they initially agreed to.

When companies supervise providers’ work, structural risk falls. In fact most successful outsourcers monitor their agents as they’re working, and the best service providers encourage this practice. Structural risk also falls when companies have metrics to gauge the quality of providers’ work.

Companies face another kind of structural risk when service providers alter the terms of contracts after clients have turned over processes to them, caused by as outsourcing contracts mature, the power shifts in the relationship from the buyers to the sellers.

When firms outsource processes that require the transfer of a large amount of tacit knowledge, they have to invest time and effort in training provider’s employees. Second, some processes take a long time to stabilize when companies offshore them. In both cases, the cost of switching from existing providers is very high. That accentuates the risk that over time, vendors will dictate terms to buyers.

When a firm negotiates a contract with a provider, it should specify a period after the contract’s expiry during which the provider must continue to offer the service at a certain price.

Should also split business between two providers, can transfer volumes between the two. Having a second provider may also lower costs, since the junior provider will bid low for contracts in exchange for greater volumes, putting pressure on senior provider.

Companies face the risk that rivals may steal their intellectual property and proprietary processes if they transfer processes offshore, especially to emerging markets.

## Choose the right organizational form

Companies should match organizational structures to needs by considering both the structural and operational risks of offshoring processes. In general, they can use location – onshore, nearshore, or offshore – to combat operational risk, and organizational structures – such as captive centers and joint ventures – to respond to structural risk. When both the operational and structural risks of offshoring processes are low, companies can outsource them to overseas service providers.

Companies should transfer processes that possess high levels of operational risk to nearby countries rather than to distant overseas locations.

When the operational risk is very high, setting up captive centers locally is often the best solution.

Outsourcing is less attractive in the case of processes with moderate or high structural risk; here, other forms of governance, such as joint ventures and captive centers, become better options.

In the case of processes that have very high levels of structural risks, outsourcing isn’t feasible. Companies must set up captive centers to execute those processes.

When both structural and operational risks are very high, offshoring and outsourcing are out of the question. Companies must execute those processes onshore and in-house.

*Extended organization –* hybrid organizational form. Companies specify the quality of services they want and work closely alongside providers to get that quality. They manage providers carefully, monitor the agent’s work to ensure that things are done properly.

The authors studies suggest that the extended organization is the most effective way to manage offshoring. Two year study: compared how a captive center, provider, and an extended organization executed several moderately complex processes in the financial service sector.

**Results:** While the captive center produced the highest quality throughout the period of study, the extended organization showed the greatest improvement and, over time, produced almost the same quality as the captive center.

The extended organization delivered that level of quality cheaper. For more complex processes: same results.

**Final comments:**

Offshoring initiatives that have cost savings as the objective, their study show, don’t allow companies to capture greater revenues from the market. Such companies don’t commit themselves to the organizational changes that are necessary for offshoring to help them, say, customize products or services, lock in buyers, compress new product-development cycles, or enhance profit margins.

When corporations begin with the desire to create strategic advantage through offshoring, they commit themselves to transferring complex processes relatively early. Companies would do well to remember that the manner in which they start their offshoring initiatives often determines how they will end.