



The Outsourcing Revolution

Why It Makes Sense and How to Do It Right

by Michael F. Corbett Dearborn © 2004 256 pages

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Take-Aways

- The average manufacturer outsources 70% to 80% of its finished product.
- Outsourcing is no longer just about cost saving; it is a strategic tool that may power the twenty-first century global economy.
- Outsourcing can increase productivity and competitiveness 10- to 100-fold.
- For every 1,000 jobs British Airways sends to India, the airline saves \$23 million.
- Companies are beginning to devote a portion of their outsourcing savings to helping employees make job transitions.
- Leaders can no longer afford to view outsourcing as a mere business tactic; it is now essential to remaining competitive on the world stage.
- Workers now compete globally, so individuals must continually learn more to vie successfully with their peers worldwide.
- The average company only spends about 2% of the value of its outsourcing contracts to manage its relationship with the outsource provider.
- In a survey, 90% of firms cited outsourcing as crucial to their growth strategies.
- A Java programmer earns \$60,000 a year in the U.S., but \$5,000 a year in India.

Rating (10 is best)			
Overall	Applicability	Innovation	Style
8	9	8	7

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Relevance

What You Will Learn

In this Abstract, you will learn: 1) What economic forces drive the push to outsource; 2) How outsourcing is moving from a cost-saving measure to a key part of corporate strategy; 3) How to take the initial steps toward outsourcing; 4) What legal ramifications and negotiating issues to consider; and 5) How to respond to domestic concerns about exporting jobs.

Recommendation

Author Michael F. Corbett boldly stakes out the territory for his book on outsourcing. As a consultant and as an advocate of the offshore outsourcing movement, he states plainly that he wants this to become the essential guidebook for anyone considering outsourcing. Impressively, he takes great strides toward achieving just that. Clearly written and easily readable, his book refutes exaggerated concerns about job loss while providing nuts and bolts advice on getting started, picking a leader for your outsource project design team, negotiating contracts and maintaining your relationship with your outsourcing vendor. He makes a sound case for a strategic approach to outsourcing as a potential primary driver of the global economy. *getAbstract.com* finds that his comprehensive treatment of outsourcing issues makes this a must-read for anyone who seeks a better understanding of the outsourcing phenomenon, particularly executives thinking about dipping their toes into offshore waters.

Abstract

Refuting Outsourcing Myths

The first myth about outsourcing is that it's new. Actually, the term dates to the 1970s, when manufacturing companies seeking efficiency began hiring outside firms to manage less-than-essential processes. Outsourcing worked. Today many manufacturers outsource 70% to 80% of the content of their finished products. Large companies commonly outsource half of their IT operations. Organizations outsource their entire back office operations, including human resources, payroll and accounting. Companies may soon be more outsourced than "in-sourced," signifying a fundamental reorganization that will affect employees, managers, customers and executives. Consumer choices will increase, product costs will drop and workers' roles will change.

Today, outsourcing is at a crossroads. Companies no longer outsource only vertical business units. The new cross-functional approach follows a process horizontally throughout an organization — so-called business process outsourcing, or BPO. Now more companies are seeking strategic advantages based on outsource alliances. While the relentless push to operate more efficiently remains the driving force behind outsourcing, it has also become a competitive, strategic marketplace tool, allowing companies to improve response times and develop new products faster than ever. Once focused just on reducing expenses, today's outsourcing initiatives are likely to help companies do things they previously could not do.

Once technology made it feasible to outsource operations abroad, media attention made outsourcing part of the public lexicon. Intense debate ensued as jobs left domestic boundaries and headed overseas. Opponents often overlook outsourcing's benefits, such as allowing consumers to buy better products for less money. And, tens of millions of stockholders of major companies benefited as the value of outsourcing companies markedly increased.

"Outsourcing helps build better businesses, stronger economies and a more prosperous way of life. This is true not only for the developing countries like India that are the recipients of work being outsourced offshore, but also for Western countries that are doing the outsourcing."



"Managers just joining the business world need to understand how outsourcing will shape the future of the organizations they work for and will someday lead."

"Very few business tools have the power to fundamentally transform an organization — outsourcing is one of them."

"Far from being bad for businesses or their workers, outsourcing is one of the most important and powerful forces available for building successful companies, creating economic growth, and generating and enhancing jobs."

"The single most visible result of this hyper-competitive environment is rapid commoditization. Power is essentially shifting from the producers of goods and services to the consumers. A company's ability to command a higher price for the unique value it offers lasts only for a fleeting moment."

More than 90% of companies say that outsourcing is an important part of their growth strategy. Management expert Peter Drucker calls outsourcing America's fastest-growing industry, involving such companies as ARAMARK Corporation, Electronic Data Systems Corporation (EDS), General Electric (GE), International Business Machines Corporation (IBM), United Parcel Service of America, Inc. (UPS), Xerox and others. Many U.S. firms provide outsourcing services. Outsourcing is one of the very few business techniques that can transform a firm fundamentally and increase its competitiveness exponentially.

Reliable Sources

Outsourcing begins with an understanding of your business's core identity. If you understand your unique competitive advantage, you're positioned to consider what work you're doing that others could perform better. Essential areas of an organization are called core competencies. Microsoft Corporation's core competencies, for example, are product design, product development and marketing. To the extent that Microsoft avoids spending resources on non-core competencies, it probably operates more efficiently.

According to survey results from the 2004 Outsourcing World Summit, a trade show, only 3% of companies outsource to achieve innovation. An equal percentage outsources to conserve capital for other investments or to improve product quality. About 4% believe outsourcing will increase revenues. About 9% outsource to obtain skills they can't find or can't afford. Some 12% of firms outsource to obtain the benefits of a variable cost structure. Another 17% say outsourcing helps them improve their organization's focus. And fully 49%, or almost half, say cost reduction is the primary benefit. How significant are the savings? In 1988, General Motors Corporation had 3,290 employees in various departments handling payables, payroll and accounts receivable. GM reengineered its accounting processes without outsourcing and reduced the number of people doing that work to 560, slashing costs in this area 60%. When it outsourced those activities in 1998, it reduced costs another 20%.

Impediments to Outsourcing

Of course, outsourcing faces several obstacles. Commonly heard objections include:

- Reluctance to lose control and flexibility When you outsource, you rely on a contractual relationship with a service provider. Some executives would rather manage contracts than internal processes. Fretting over flexibility fails to consider that outsourcing can actually increase management's control over certain operations.
- A given function is too critical to outsource Crucial functions, such as payroll, are outsourced all the time. In fact, an argument can be made for outsourcing pivotal functions to specialists who can perform them more effectively.
- <u>Anticipated negative reaction by customers</u> Customers may get nervous, until they see the enhanced service levels that outsourcing makes possible. The involvement of a third party is a secondary consideration.
- <u>Employee resistance</u> Outsourcing often involves breaking down organizational structures to enhance efficiency, which changes job roles. When employees resist, companies should respond with proper communication and training.

The Arithmetic of Offshoring

If you wonder why companies send operations thousands of miles away, do the math. An architect earns \$3,000 a month in the U.S. but \$250 a month in the Philippines. A Java programmer earns \$60,000 a year in the U.S. and makes \$5,000 annually in India. U.S.



"At the same time, the pressure on businesses for improved performance is unrelenting. Growth and profitability are expected."

"No organization can stay competitive in today's rapidly changing global economy by relying solely on its own resources. Outsourcing is a necessary response to today's hyper-competitive environment."

"Traditionally, organizations have seen only one source of competitive advantage: their internal operations. However, outsourcing opens up brand new sources of competitive advantage."

"Leaders can no longer afford to approach outsourcing as a tactical response to specific change initiatives. To stay competitive, they need to make it an integral part of how they think about and run their operations."

aerospace engineers earn \$6,000 a month; the same workers in Russia take home \$650. Net savings on operations are generally somewhere in the 20% to 40% range. British Airways calculates that it saves \$23 million a year for every 1,000 jobs it relocates to India.

Despite the savings, quality does not suffer. Actually, a quest for greater quality is a primary reason companies move functions offshore. Call centers show how offshore outsourcing can improve quality, in part because Indians highly esteem call center jobs, while Westerners hold them in low regard. Most Indian call center operators have college degrees. Thus, all offshoring is not cost-driven. Instead it rests upon "strategic sourcing," that is, establishing partnerships to enhance capabilities as well as profits. India is clearly most U.S. companies' preferred outsourcing destination, due to its low wages and English-speaking populace. Some studies say it enjoys as much as 70% of the market share. The Philippines, with excellent language skills and infrastructure but with fewer skilled workers, places second. Other outsourcing destinations include Ireland, Central and South America, Russia, Canada, China, Malaysia and Eastern Europe.

Facts do not support the predictions that outsourcing will cause economic doom. Indeed, as offshore outsourcing increased from 1970 to 2002, the U.S. economy boomed. Its service jobs increased from 47 million to 107 million, and per capita income rose from \$12,543 to \$22,851. This does not change the harsh reality that many workers have lost and are losing jobs to overseas outsourcing. Companies are addressing this concern. IBM has set aside \$25 million for retraining and transition services for former employees. Just as no company can assume the public will always demand its product, employees cannot assume they will command the same salaries tomorrow that they command today.

Managing the Relationship

Companies typically spend about 2% of the value of their outsourcing contract to manage the vendor relationship. Effective management of vendors is based on these 10 principles:

- 1. <u>Maintain strategic responsibility</u> Operational issues must be handled at various levels, but do not delegate the alignment of your firm's interests with its vendor/ supplier. Making sure that the relationship works is a job for a top executive.
- 2. <u>Create multiple organizational links</u> Promote them at every level of the company.
- 3. Hold regular meetings Get together periodically to iron out any issues.
- 4. Employ technology Use the Internet, e-mail and such tools in management.
- 5. <u>Define escalation processes</u> Everyone should know the processes to be followed when issues need to be elevated to higher levels.
- 6. <u>Use a scorecard</u> Define and apply metrics that will gauge success.
- 7. Apply carrots and sticks Motivate employees with fair incentives and penalties.
- 8. <u>Reward your vendor's employees</u> Without becoming a co-employer, find ways to motivate and recognize the employees of your outsourcing partner.
- 9. Define the change process How will both firms address the need for change?
- 10. <u>Honor the relationship</u> Carefully manage, respect and nurture the outsourcing relationship. It is a strategic asset for your company.

The Future of Outsourcing

Change, including change in employment, has become a constant. These changes await:

• Expect more competition — Whatever you do, you will be competing with well-trained professionals who earn a fraction of your salary. Today those workers live



"Optimizing the effect of business process outsourcing requires a consistent management process where potential opportunities are prioritized in terms of impact, benefit, and risk."

"We have learned to embrace the changes that information technology has thrust upon us"

- in India, the Philippines, China or Eastern Europe. Soon Afghanistan, Thailand and Vietnam will step up to the plate. To stay ahead, advance your knowledge constantly.
- Everyone will be self-employed Even if you work for a firm, you are essentially self-employed. And self-employed people know they only get work if they address the needs of the companies that hire them. Self-employed workers take responsibility for their own training, realizing that their knowledge and expertise define their value.
- Outsourcing will change the role of managers and executives Increasingly, they
 will shift away from functional or operational expertise and toward the integration
 skills that top managers have always needed. Mike Useem of the University of Pennsylvania's Wharton School terms this "lateral leadership" and says lateral leaders need
 four essential capabilities. They must be able to think strategically, to make deals, to
 govern partnerships (such as outsourcing agreements) and to manage change. Companies will pay a premium for mid-level and senior managers with those abilities.
- <u>Project/process leadership</u> More outsourcing means a greater focus on project and process leadership. Businesses increasingly create teams to attack specific tasks and achieve specific results. A team comes together to find a solution and then disbands. Project leadership requires a different set of skills and a knack for blending team members' competing interests. Everyone must stay focused on the task at hand.
- Global leadership Gone are the days when leadership primarily meant managing the people stationed in the headquarters in Little Rock or Newark. As outsourcing goes global, managers and executives at every level must work with those from different cultures and countries. Global experience will be vital to a manager's career.
 - Transformed organizations Like prisms, companies will unite external resources and focus them into a laser-sharp result that meets consumers' needs. Certain business units will be affected more than others. Departments that innovate, for instance, will see a great deal of activity go offshore. The pharmaceutical industry will outsource the discovery of new drugs, for example. Technology firms such as Dell, Cisco and Intel already have turned outsourcing from a supply chain mechanism into an innovation chain, delivering not new hardware, but new ways of doing business. Because innovation is based on knowledge whether information about employees, customers or operational systems managing knowledge will be more important than ever. The challenge is to facilitate and encourage the sharing of knowledge across business structures and units. Risk management will also see profound change. Outsourcing makes organizations more interdependent, so risks that affect an outsourcing partner now also affect the domestic firm. Thus, U.S. firms must hold their foreign partners accountable for compliance with standards and regulations.

About The Author

<u>Michael F. Corbett</u> is president and CEO of Michael F. Corbett & Associates, Ltd., which provides outsourcing consulting, research and training. The firm produces The Outsourcing World Summit, an industry trade show. Corbett has testified before Congress, written for *Fortune* magazine and appeared as an analyst on several news programs.