



*Global Business*

## **Seven Myths About Outsourcing**

**No. 1: 'We can have it all'**

**By PHANISH PURANAM AND KANNAN SRIKANTH**

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In recent years, there's been a seemingly endless boom in offshore outsourcing. But companies that think handing off an operation to an overseas provider is easy can get a rude awakening.

The transition often proves to be much more costly and complicated than expected. And companies often find that their high hopes about cost savings and greater efficiency don't pan out.

### **THE JOURNAL REPORT**

To get a better understanding of the problems and solutions, we conducted a survey of senior executives at 62 of the 100 largest financial-services firms in the U.S. and Europe. Arguably, this industry is the deepest repository of leading-edge practices in outsourcing and offshoring. We also conducted approximately 100 interviews with outsourcing clients and vendors from financial services as well as other sectors such as pharmaceuticals and the media.

We found seven common myths that vendors and clients cling to about offshore outsourcing -- false assumptions about how the process should work. They range from unrealistic expectations to poor ideas about how to structure contracts to mistaken views of risk. These ideas can prove deadly to the success of outsourcing projects and even to an organization's overall services-sourcing strategy.

Here's a look at those destructive myths, and how to overcome them.

#### **1. We Can Have It All**

##### **WALL STREET JOURNAL VIDEO**

[Phanish Puranam, a London Business School](#) assistant professor and a scholar at the Advanced Institute of Management in London, discusses what it takes to outsource effectively.

In our survey, the executives told us their top criteria for judging the success of an outsourcing project were efficiency, or cost reductions; effectiveness, or improvement in service; and flexibility, or the ability to increase and decrease production rapidly.

Each in itself is a perfectly valid objective. The problem is that many clients expect -- and, indeed, many vendors promise -- all three in the same outsourcing project. The fact is, achieving one objective means making a trade-off in another area.

Let's say a company wants to boost effectiveness by adding more features to its outsourced products or services. Even under the most efficient conditions, costs will increase. For instance, a company with an outsourced call center might set a new goal for effectiveness -- answering 99% of calls within a minute rather than 95%. In most cases, that means the call center must have more employees on hand, especially at peak periods.

There's also a very prosaic reason why mixed motives are dangerous: If people inside the client company have different expectations about the outsourcing project, it's in political trouble before it begins. It is important to prioritize outsourcing objectives and communicate them widely within the organization.

## **2. Outsourcing Services is Like Buying Commodities**

Many companies think outsourcing is a "frictionless market," with no transaction costs or other restraints. A senior operations manager at one of Europe's largest financial-services companies told us, "You'll be surprised at how many of our people thought that outsourcing back-office operations is fundamentally like procuring stationery!"

On the contrary, outsourcing carries significant transaction costs, starting with finding a vendor and negotiating a contract. Then there's the expense of moving the operation from one location to another and subsequently keeping it in sync with the rest of the company.

An offshoring manager from a large financial-services company said, "We still have a significant number of key people on our outsourcing partner's sites in India, but we are very reluctant to bring them home, as we still lack confidence in our partner's ability to deliver if they are not there. This was not envisioned at the start and has caused numerous issues and unexpected costs -- when we went into the deal to reduce cost."

## **3. We Need an Ironclad Contract**

Outsourcing is not a one-time transaction, but an exchange that evolves over time, as competitive conditions and technology change. So, many executives try to write complex contracts that protect them in a host of possible circumstances.

But that's usually a waste of time, as many of our respondents discovered. It is impossible to take all contingencies into account. Instead, companies should write a contract that ensures that all parties understand their roles and responsibilities, and then put in place a process for negotiating changes.

The risks of writing an overly complex contract are significant. In some cases, we learned that a protracted and contentious contract-negotiation process can sour relations between vendor and client even before the beginning of the outsourcing project.

Moreover, sometimes deals are so inflexible that customers must sign a fresh contract to handle any unexpected changes, such as new industry regulations or a change in business strategy. The "simple" act of negotiating and writing a contract also brings high legal fees,

and it may lead to productivity losses, as middle managers hold up a job until a new agreement is in place.

Sometimes contracts are so long and convoluted that nobody involved has the time or patience to read or understand them. Managers end up working off rules of thumb, making the contract provisions irrelevant.

Rory Graham, a partner in the technology and outsourcing practice of global law firm Morgan Lewis, related a revealing anecdote. A large U.K. government department that outsourced information-technology services thought it wasn't getting the best out of its contract. So it engaged Mr. Graham, who was then at another firm, to study the contract and other documentation to identify possible noncompliance or breach of contract that it could use as leverage in renegotiating the deal.

Mr. Graham walked into a meeting and was confronted with a document that was 1,200 pages long. Aghast, he asked why it was so long.

"So we can control the vendor," was the response.

"Well, clearly, that isn't happening now or I wouldn't be here," he countered.

#### **4. Contracts Don't Matter**

On the other hand, sometimes companies try to rush into an outsourcing deal without a contract. They draft a memorandum of understanding or letter of intent -- informal documents that set out grand visions of the client-vendor relationship rather than focus on nitty-gritty details, as a contract does.

These documents are useful in setting the joint vision of the relationship, but they are not substitutes for contracts. Since they are usually vague on critical operational details, they may be hard to enforce in court, lead to different interpretations by different managers and ultimately undermine trust in the client-vendor relationship.

Moreover, negotiating these agreements sometimes isn't as easy as it looks. In some lawyers' experience, managers negotiate and agonize over a memorandum of understanding for such a long time that they could have negotiated a contract instead. For instance, a large U.K.-based insurance company negotiated an outsourcing memorandum for over 40 days. It was in place for less than a month before the contract negotiations kicked in and changed the terms of the deal.

Another version of this myth holds that companies don't need a contract because the deal with the service provider is much more than a simple procurement relationship. The client would rather regard the vendor as a partner, or another division of the company.

This is a good goal for the relationship -- but not something that can be assumed on day one, since the client and the service provider will not always have identical interests and

aspirations. For example, the vendor might want to bid for a contract with the client's competitor, but the client might object to the deal, fearing its trade secrets might be disclosed.

A contract can help head off those tensions. The process of negotiating a contract will enable the client and vendor to understand the risks, rewards and interests for both sides. That, in turn, will make it clear what should be on and off the table in the relationship.

Controlling Hidden Costs		
Some of the drivers of hidden costs in outsourcing or offshoring business processes, and what you can do to prevent or minimize them		
COSTS	QUESTIONS TO ASK BEFORE OUTSOURCING/OFFSHORING	RECOMMENDED ACTIONS
<b>Contracting</b>	<ul style="list-style-type: none"> <li>■ Is it difficult to measure the performance of the process?</li> <li>■ Are company-specific skills necessary to adequately perform this function?</li> <li>■ Is the function so specialized that only one or two vendors can perform it with the necessary competence?</li> </ul>	<p><b>CONDUCT</b> careful due diligence on vendors.</p> <p><b>PREPARE</b> for continuing monitoring and contract-management efforts.</p> <p><b>CONSIDER</b> setting up a "captive" (i.e., owned) unit if offshoring.</p>
<b>Transition</b>	<ul style="list-style-type: none"> <li>■ Are existing work manuals and operating procedures out of date?</li> <li>■ Is the performance of the process affected to a great extent when there is employee turnover?</li> <li>■ Does it take a long time to train employees to execute the process effectively?</li> </ul>	<p><b>PREPARE</b> to invest in codifying knowledge underlying business processes.</p> <p><b>MOTIVATE</b> employees who currently deliver the process to share knowledge with those who will take it on (e.g., through exit bonuses).</p> <p><b>DON'T AUTHORIZE</b> transition to vendor/offshore unit until you're sure knowledge capture and transfer is complete.</p>
<b>Interaction</b>	<ul style="list-style-type: none"> <li>■ Do personnel executing this process have to be in constant touch with personnel executing other linked processes?</li> <li>■ Will changes to this process lead to many changes in several of the linked processes?</li> <li>■ Is performing this process time-sensitive to performing other related processes?</li> </ul>	<p><b>PREPARE</b> to invest in re-engineering the process to make interactions with other processes as structured as possible.</p> <p><b>BUILD</b> formal communication channels between client and vendor organizations to smooth coordination; use appropriate IT.</p> <p><b>ENCOURAGE</b> periodic face-to-face meetings to foster informal communication, develop relationships and build common understanding about how the processes are linked.</p>

Source: Phanish Puranam and Kannan Srikanth

## 5. Vendors Are Insurance Companies

The sharing of risk between clients and vendors is one of the most contentious issues in outsourcing, leading to acrimonious negotiations and poor relationships. There is a very common -- and reasonable -- perception that vendors should bear greater liability for failure than regular, in-house employees who do a job. However, client executives shouldn't take an exaggerated view of risk or believe that they can outsource risk entirely.

The client can specify standards that the vendor must meet, and penalties for falling short. However, it is unrealistic for the client to ask the vendor to take on unlimited liabilities or unlimited indemnities for failure.

Let's say an auto maker outsources the manufacture of its seat-belt system. It remains the auto maker's responsibility to ensure that the seat belts meet quality standards before selling the final product -- an automobile -- to customers. Outsourcing doesn't make the auto maker less responsible for the ultimate quality of its product.

For instance, [Ford Motor](#) Co. faced numerous lawsuits arising from the defects found in Firestone tires used in Ford vehicles. Similarly, when pharmaceutical companies outsource clinical research, the responsibility for the integrity of the research still rests with the pharmaceutical companies.

Rather than spending inordinate time negotiating unrealistic contractual clauses in case of failure, clients and vendors should concentrate on understanding the process as it operates. They should identify acceptable rates of error based on real data, and -- jointly -- invest in understanding and eliminating the problems.

## **6. It's Not Our Headache Anymore**

Similarly, sometimes companies think once they outsource a process they can wash their hands of it. "The biggest obstacle to a satisfactory partnership is that one party sees itself as relieved of all responsibility and abdicates control to the other," in the words of one senior executive from a client firm. Outsourcing does not mean that the process is not your headache anymore -- though it is (one would hope) less of a headache!

Sean Egan, former head of offshoring for [Aviva](#) PLC, the U.K.'s largest insurance firm, holds that the key to Aviva's success in its offshoring efforts in India has been the high level of engagement of his senior management team. The team visits offshore locations two or three times a year, and when there they make a habit of giving informal talks to employees, in order to build a greater sense of identification with Aviva. The senior managers also work with offshore managers on process-improvement plans. And the senior managers ensure that the offshore managers are treated as part of their extended team, and conduct joint management-development and training activities.

Such efforts are "what makes this a partnership, and a very successful one at that," says P.V. Kannan, the CEO of 24/7 Customer Inc., one of Aviva's offshore partners.

Besides building a partnership, there are other strategic reasons why clients can't afford to "fire and forget." When outsourcing an operation, the client firm should retain the knowledge underlying the process and how it fits with the overall organization. If the client firm simply abandons the process to the vendor, it can compromise its ability to produce future innovations.

For example, auto makers still carry out R&D in parts they stopped making 10 years ago, and often collaborate with parts suppliers in these efforts. This allows the auto makers to keep up with changing market trends and technology; it also allows them to figure out how to integrate those new technologies into their existing processes.

Another problem with losing all knowledge related to a process is that the vendor holds all the cards and could easily take advantage of the client. It also puts the client in a difficult position if it wants to end the relationship. The client may no longer have the competence to evaluate other vendors, negotiate suitable contracts or even lay out how the job should be done.

## **7. Our First Failure Should Be Our Last Attempt**

Very few companies report great success with their very first outsourcing project. But that doesn't mean they should give up. There is evidence of significant learning on the part of both the client and the vendor in such relationships.

With time, partners learn to communicate better, leading to more efficient coordination and fewer mistakes. Clients and vendors learn about each other's needs and are able to negotiate better contracts focusing on value creation. Our survey indicates that companies with greater experience have greater success implementing more-complicated models and face fewer problems in their outsourced and offshored activities.

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