The Innovative Organization:
Creating Value Through Outsourcing

Steven Tadelis

In 2004, Sears, Roebuck and Co. outsourced its suite of IT services to Computer Sciences Corporation (CSC) in a highly celebrated deal that was to last for 10 years and was expected to cost $1.6 Billion. Not a full year had passed when Sears terminated its agreement with CSC "for cause." It did not elaborate on what it claimed as the exact breach. Shortly thereafter, CSC sued for damages, complaining that a corporate restructuring left Sears with a new management team that wanted nothing to do with outsourcing (thus, claiming that the termination was one of "convenience" and not "cause.") By 2006, Sears announced that the two parties had agreed to "voluntarily mediate their disputes" out of court so as to avoid fees in litigation, as well as the risks associated with an adverse court decision.[1]

Where did things go wrong? We won't know for certain in this case, but what is known is that many companies who have tried outsourcing view it as a difficult process that does not often end as initially planned. Indeed, the failure rate for outsourcing relationships remains incredibly high.

In a recent Deloitte Consulting survey of 25 world-class organizations covering various industries, the conclusions about outsourcing were not encouraging.[2] One-quarter of the companies had brought business functions back in-house after realizing that they could do the work themselves more successfully and at lower costs. Forty-four percent of the companies surveyed reported that outsourcing didn't save any money, and nearly half identified hidden costs as the most common problem when managing outsourcing projects. Hence, though initially motivated to outsource in order to cut costs, simplify projects, and tap expertise not found in-house, many companies learned that unexpected complexity, lack of flexibility among outsource providers, and other unforeseen

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problems added costs as well as friction, ultimately translating into higher total costs than originally anticipated.

In May of 2006, *InformationWeek* surveyed 420 business technology professionals, with results that were similar to those from the Deloitte study.[3] In that survey, participants were asked to rate services provided by their outsourced vendors in a number of categories on a scale of 1 to 10. Respondents were only reasonably satisfied with their vendors' performance and generally disappointed with the cost-for-value of the service.[4] When referring to failed outcomes, forty-five percent attributed failures to poor service and lack of flexibility, and thirty-nine percent pointed to hidden costs as a serious problem, much like results from the Deloitte survey.

What are the "hidden costs" of outsourcing? Clearly, they were not anticipated by the companies who blamed failure on these costs and, as such, were not taken into account at the time of contracting. To be sure, the costs of identifying and specifying the functions in a business that can be outsourced can be expensive, especially if a company relies on the services of outside consultants to do the evaluation. The real hidden costs that most often adversely affect the bottom line, however, are in the transfer of knowledge and scope of work along with the costs of ongoing management of the outsourcing relationship.

At the heart of the problem lies a conflict of interest that is present in any outsourcing relationship. On one hand, the customer is seeking to procure a good or service at lower costs than it would incur with in-house production. On the other hand, the vendor wants to make a profit. This tension between the buyer's wish to buy at a low price and the seller's wish to sell at a high profit margin means that the relationship must be designed carefully in order to ensure a successful outcome for both customer and vendor. As a consequence, if the activity outsourced is difficult to scope, define, bound or monitor, then what the buyer may seek and what the vendor delivers are neither aligned nor easily described, leading to an imperfect contract for which neither party's expectations are adequately accounted. Furthermore, if the service requires adaptation as the relationship evolves, then the flexibility a company would have with its own workforce is no longer aligned with the vendor's expected margin for profit, thus leading to conflict.

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The decision to outsource an activity should begin with a straightforward cost-benefit analysis that quantifies all the relevant costs associated with the prospect of outsourcing a function and weighs them against the projected benefits from having that function produced outside of the company's control. Some measurable dimensions over which these costs and benefits can be assessed in order to make informed business decisions include the costs of scoping the activity, the time requirements on managing and directing the contract, and the expected evolution of the activity's function. Once such a sound business analysis is completed, an operational framework for analyzing strategic sourcing deci-

sions can be made on an informed basis, exploiting the opportunities from outsourcing and offshoring by a systematic method.

The framework proposed here argues that any activity can be viewed either by considering the *function* that it performs or by considering what *inputs* are used to create it and how these inputs need to be *managed*. As a simple illustration, consider a carpenter who needs a nail to attach two pieces of wood together. The *function* that the nail provides is best fulfilled with a nail that meets some specifications, say, two inches long, an eighth of an inch thick, a certain head-size, and some ideal hardness and strength. The carpenter can scope and define these specifications and find a vendor that will sell him such a nail. Hence, he buys the function. Alternatively, the carpenter can buy steel, other needed equipment, and hire an employee who can work to create the nail under the carpenter's supervision. Hence, he buys the inputs, and manages the production of the nail himself. Procuring the nail directly is akin to outsourcing, while producing it under his control is in-house production.

This caricature example illustrates a distinction that will prove useful and is very general as it applies to activities that are either core or context. Namely, a company has to decide between buying the function, or output, versus buying and managing the inputs, the latter including capital and labor. Hence, the celebrated "make-or-buy" question can be thought of as a "buy-or-buy" question, where the refined question is what to buy, function or inputs, and how to manage the deal. This distinction between function versus input procurement helps to evaluate contractual incentives having a potential for affecting conflicts of interest between a company and its sourcing vendor.

The relative advantage of outsourcing as compared to in-house production is cost-savings associated with the procurement of well-defined functions and enforcing adequate delivery by the outsource vendor using a well-defined contract. This means that both the complexity of the function and the need to adapt the function over time will put a strain on the ability of a company to outsource an activity. Thus, the framework offers an operational method for evaluating the hidden costs by which so many companies have fallen prey to disappointment. The framework further provides a method for evaluating the costs and projecting the benefits of employing external markets to procure needed goods and services.

Procurement decision processes apply overwhelmingly to for-profit companies. That said, nonprofit organizations and governmental agencies may benefit from well-reasoned analysis as well. By procuring activities more efficiently, for-profit firms will make more profits, nonprofit firms can relocate scarce money to enhance their core mission, and governmental agencies can stretch tax dollars to cover more ground or even reduce the tax burden.

FIGURE 1. The Two Dimensions of Organizational Sourcing Design

	Local	Abroad
Do It Yourself	Locally Integrated	Multi-National
Outsource	Local Outsource	Offshore

The Sourcing Problem

Outsourcing and Offshoring

Few business trends have received as much public attention in recent years as outsourcing, yet the term is often used in different yet related ways. For these discussions outsourcing is the transfer of a business activity or function to an external contractor (or vendor) who takes control of the activity's inputs, and then performs that function off the company's balance sheet, and sells the activity's function back to the company.

Offshoring is where a company outsources a business activity to a contractor in a foreign country. Offshoring may be a function of many decisions such as foreign labor costs, global strategy, and even regulatory constraints (e.g., it may be that production is outsourced to a foreign country to get around domestic food and drug laws.) As such, the consideration of which activities to contract for and where an activity should be produced can be considered as two separate dimensions of organizational design (as depicted in Figure 1).

If a company decides to produce the good or service internally, then it is "integrated" because the activity is integrated within the boundaries of the company. That can be accomplished locally within the limits of its national environment or, in the case of multinational companies, across borders. The latter instance, however, is not considered offshoring because of common corporate ownership and control. It is when a company's activity is relocated to a vendor that has no corporate affiliation with the company that the activity is considered outsourced or, where contracted to a vendor abroad, offshored.

The choice of where to outsource to is considered by many to be closely related to the question of whether to outsource. Among the many considerations for outsourcing and one of the primary reasons to outsource is cost savings. For many activities, the cost of human resources is the largest component. If a company learns that the cost of labor in India or Pakistan is a fraction of the costs currently incurred by the use of local labor, then the information about

labor costs in different international markets will affect the decision of whether or not to outsource that activity—assuming all skills are of potentially equal quality.

That being said, whether to outsource an activity should be considered as separate and distinct from the decision of where to do it. On that premise, it is critical to determine those business activities that are good candidates for outsourcing. A key to that determination is informed by the characteristics of a particular activity and how that activity relates to other functions in the company. In contrast, the question of where to outsource will be answered by market conditions (such as labor costs) and by the extra management time needed to maintain relationships that span both geographic and cultural distances.

Backsourcing

A relatively new term, along with outsourcing and offshoring, is backsourcing, which refers to the action of bringing an outsourced service or good back in-house. This is often done when an outsourcing arrangement proves not to work as anticipated, which typically happens for one of two reasons. First, it may be that the decision to outsource was a mistake in the first place (for one of the reasons described below), and it makes no sense to continue the relationship and further waste good money after bad investment decisions. A second reason is because it made sense in the first place, but the business environment changed and the reasons for outsourcing are no longer present.

It is important to recognize that backsourcing is always an option, and the savvy business leader will regularly evaluate current business sourcing practices and compare them against the alternatives. However, it requires another cost-benefit analysis over time, weighing the benefits of backsourcing against the challenges of unwinding an outsourcing agreement, appeasing dissatisfied customers, and reproducing the infrastructure to support the function back in-house. In the alterative, there may be an opportunity to renegotiate and reorganize outsourcing contracts and relationships instead of trying to backsource, but that depends on how leveraged a company is to renegotiate terms after outsourcing has been undertaken and infrastructure shifted.

In 2002, JPMorgan Chase outsourced its information technology (IT) function to IBM under a $5 billion contract, the largest outsourcing deal on record at that time. The deal was touted as a sign of the future for IT operations. All parties to the agreement celebrated it as "a 'ground-breaking' partnership that would cut costs, increase innovation, and benefit its IT workers."[5] However, less than two years later, JPMorgan Chase completed a merger with Bank One, a company that a few years earlier had cancelled another celebrated outsourcing deal with IBM and AT&T. At the end of 2004, the merged company announced its backsourcing decision.

Clearly, JPMorgan Chase incurred tremendous costs over each stage of transitioning from one sourcing method to another and back. The company had to reorganize twice and employee morale was shaken on both occasions. These are measures that executives must weigh, specifically whether the costs of back-

sourcing will be outweighed by the benefits. If an outsource arrangement was a bad idea from the start, or if evolution of environmental changes make the deal undesirable and difficult to modify, then management should only focus on the net benefits of how to move forward, which may require backsourcing.

Consider the case of Diebold, a services company providing integrated technology solutions that enable their customers to maximize their own self-service capabilities. The company is well known for its Automatic Teller Machines (ATMs), as well as for electronic voting machines and security systems. In 2002, Diebold hired Deloitte to perform various IT-related services over a 7-year period, including deployment and implementation of their Oracle Enterprise Resource Planning (ERP) system. In 2006, not long after Deloitte released its study outlining the problems with outsourcing, Diebold decided to backsource the implementation and support of the Oracle ERP system as well as some other IT functions. Diebold's decision to end the contract with Deloitte three years earlier than planned was estimated at $7 million dollars—or 7 cents a share.[6]

Diebold's reasoning for backsourcing was to bring back direct control of its IT operations for flexibility and to speed up the implementation of the ERP project. It sought to reap overall benefits from a company-wide information system. CEO Thomas Swidarski was quoted saying that "this strategic decision is critical to achieving the operational improvement targets we have set." Despite the large termination fee and all the already sunk costs of the initial outsourcing decision, Diebold concluded that backsourcing was the right move since it brought back the control and flexibility that was needed to enjoy the full benefits that could not have been achieved under the contract with Deloitte.

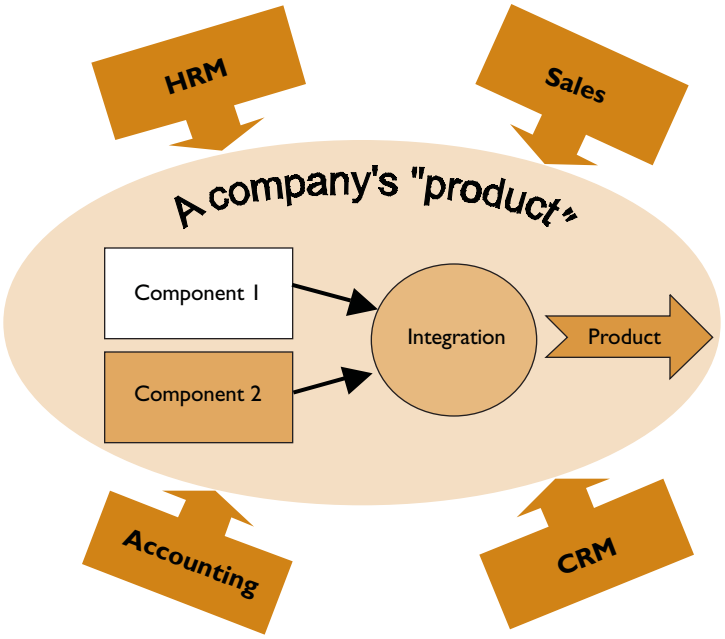
It is interesting to note that on September 6, 2007, Diebold released a press statement announcing the launch of a new Outsourcing Assessment Center. The center is an interactive tool that allows financial institutions to evaluate its current ATM channel against industry standards, which in turn is hoped to inform how outsourcing can positively impact the bottom line in companies. Given its history, Diebold is in a better position than others to shed light on this important issue. Time will tell if Diebold will successfully educate its clients.

Innovative Sourcing: A Framework

The Company: Core and Context

To create value or increase shareholder wealth, a company must have a product or service that is core to the business. In support, there are systems and infrastructure set up to supplement the company's value proposition, its product line, or core business activity. These support systems may include human resource management (HRM), customer relationship management (CRM), sales, accounting, and general and administrative as well as other functions or services. Thus, it is possible to think of a company as depicted in Figure 2.

FIGURE 2. An Abstraction of a "Company"



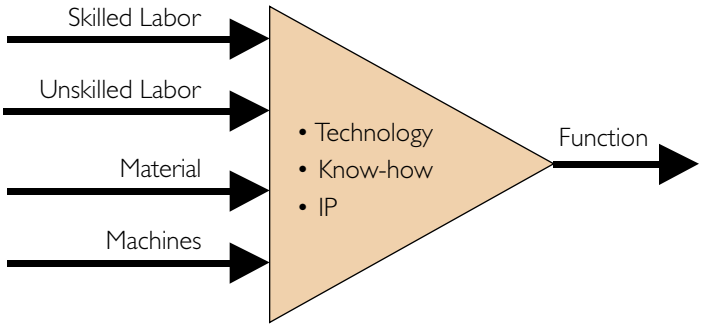
Consider the Diebold example within the framework outlined above but focusing only on the ATM business as the core "product" that generates Diebold's profits. It goes without saying that the ATMs themselves are complex products that are built from smaller components. In relation to Figure 2, and by way of illustration, imagine that Diebold has only two components that make up the ATMs: the computer behind the ATM machine and the electromechanical systems that read cards and print receipts. Then there is HRM, CRM, accounting, and sales, all of which support the core business of ATMs.

Based upon this depiction, then, when it comes to whether or not Diebold should outsource an activity, it must consider several potential candidate activities. Arguably, something must remain core to the business, which in this case is best thought of as the intellectual property, as well as the knowledge and skill of integrating the components into a final high-quality product. This is the source of the company's value-generating proposition in a typical business model. As a consequence, one can argue, all the other activities are candidates for outsourcing, starting with the two components that make up the ATMs and ending with any one of the supporting functions.

Components: Functions and Inputs

Although it seems that many outsourcing deals involve IT and other support systems, it is useful to focus the analysis on whether or not the company

FIGURE 3. The Production of a Component



would benefit from outsourcing one of the two components. The analysis will qualify equally well for support activities.

Turning to a single component, one can look deeper into the organization of production. The function of each component is itself produced with a combination of inputs, such as labor (both skilled and unskilled), material, and the use of capital equipment. These are the inputs that together—through technology, know-how, and possibly intellectual property (including intangible assets in the form of patents and trade secrets)—are used to create the component and the resulting function that it provides. Thus, the technology of producing the component is described in Figure 3. As it is often called the "make-or-buy" problem, it is now possible to refocus the outsourcing problem by recognizing that it is really a problem of what can be bought and what needs to be managed for optimizing a company's value proposition and profits.

Imagine that a component (or support service) is procured from the market. As a result, production is outsourced to a vendor who produces the described function by procuring and managing the inputs that together make up the function. If, instead, the company chooses to keep the production of the component (or support service) inside the company, then it is effectively procuring the inputs that make up the function—and it is itself managing these inputs to acquire the desired function. Dissecting the problem into these two modes of procurement will clearly illustrate the costs and benefits of each of these two modes of procurement.

Comparative Analysis of Sourcing Methods

Outsourcing has been described as the procurement of a necessary function from an outside vendor who manages production. In-house production has been described as procuring and managing the inputs directly to produce the desired function. In both cases, however, the company engaged in a transaction that was intended to provide a needed function. Identifying the costs and bene-

fits of the two different procurement methods of the same transaction requires analysis. Indeed, this is the central tenet of "transaction cost economics" as outlined by Oliver Williamson: identify the transaction, which in this case is the procurement of the component (or support service), and then identify the costs and benefits of procuring it using different methods of procurement.[7]

In addition to identifying the transaction, one must also identify certain characteristics of the transaction that would determine which mode of procurement will offer the greatest benefit. Once the company can identify and quantify characteristics of their activities, each type of transaction will have a well-determined best-practice method for informing procurement decisions.

Outsourcing: Buying the Function

Beginning with outsourcing, the most common quoted reason for outsourcing activities is cost savings. This is a consequence of using the competitive market. If there are many potential vendors, then by describing the function (or "what" has to be done), vendors who have superior production methods or lower production costs will be able to pass on their cost advantage to the company through an outsourcing arrangement. This is the outsource provider's value proposition.

In order to identify the most productive vendors, the starting point must be the ability to identify what function is being performed by the activity that is to be outsourced. Outsourcing offers the opportunity to allocate the activity to its most productive vendor, but this option becomes more costly the harder it is to specify and verify functional performance. Hence, gaining production efficiency is tied to the company's ability to describe the function in detail to a potential vendor in order to receive a meaningful and responsive bid, articulating clear metrics for performance. Defining clear metrics for the function makes it a commodity that may then be properly bid and then memorialized in a well-defined contract outlining the expectations of each of the contracting parties.

Building on this observation, it is easy to see that if it is indeed possible to specify, describe, and verify performance of the desired function, then it is easy to let the market mechanism work through the use of competitive bidding. Namely, once the company sees that the function is very well defined, and that it is easy to specify it in a contract, then the next step of writing a comprehensive request for proposal (RFP) and choosing the lowest bidder is easy. Problems arise, however, when one of two conditions is present: when the description of the function is insufficient; or when the ability to measure performance is not as simple as originally anticipated.

Basic tenets of negotiation and contracting would teach that where the description of the function is vague, a sophisticated vendor may identify gaps in the RFP that offer some wiggle room in the competitive bidding process. Perhaps a vendor might anticipate that the company will have to request changes after the contract is signed. At that later stage, the competitive market no longer exists since the company is locked-in with the vendor, who now has more leverage and can charge inflated prices for small modifications to the contract. Thus,

the use of the market mechanism comes at a potential cost that can be called opportunistic bidding: bidders who anticipate gaps in the contract that they can later benefit from will have a competitive advantage that they will price into their bid. After the contract is signed and set into motion, these vendors will collect large additional payments with fat margins when the change orders come in from the purchasing company.

Similarly, when the ability to measure performance is not straightforward, then a potential conflict is in the making between the company and the vendor. The vendor has the incentive to cut its own costs, and with vague metrics in place, there may be ways to cut costs at the expense of quality while staying within the acceptable limits of the contract.

That these potential problems arise from vague contracts implies the following: If an RFP is air tight, then competitive bidding for the outsource function will efficiently leverage the market mechanism. If instead the contract has unforeseen (or perhaps even latent) gaps, then sophisticated bidders may take advantage and price more competitively realizing increases after post-agreement lock-in occurs. Moreover, if it is costly to modify contractual obligations, implementing tighter metrics for performance, and if the vendor can save on costs by cutting back on these performance dimensions, then market mechanisms protecting the purchaser will fail.

Hence, effective use of market mechanisms for increasing productive efficiency is tightly linked to the company's ability to carefully define what it wants to buy over the life of the contract. Many outsourcing contracts—in particular, IT outsourcing contracts—require an initial investment by the vendor bidding for the job. In addition, there may be significant up-front costs for the company itself to ensure the smooth transfer of knowledge and intangibles. Consequently, IT outsourcing contracts are often long-term contracts that last five to ten years in most cases, and it is not viable to reconsider the relationship in any meaningful way without departing from the original terms in the contract.

As a result of long-term contracts, it is not enough that the company knows what it wants before specifying the RFP, nor is it enough that it can monitor and measure performance according to the contract specifications. Above and beyond these two benchmarks, the company has to be able to predict its needs over the lifespan of the contract. If the company cannot predict its needs well enough, then it is very likely that the contract will not meet future requirements; and, as a result, the company will have to renegotiate the contract to implement changes. In other words, there will be a need for flexibility to be built into the terms of any contract for market efficiencies to be realized.

This need for adaptation and flexibility is a central focus of transaction cost economics.[8] Outsourcing contracts may be considered incomplete for failure to anticipate and specify future needs of the business and describe some circumstances for which flexibility will be required. Realistically, every contract is incomplete, but some are more incomplete than others. If the activity is routine so that changes and adaptations will not be required (e.g., a simple component that is clearly specified and necessary regardless of other developments, or a very

routine IT task whose purpose is unlikely to change), then this problem is unlikely to arise. As a result, the outsourcing relationship will most likely be smooth and expectations will most likely be met. In contrast, for complex activities, it is very likely that adaptations and changes will be needed; and when this happens, conflicts between company and vendor arise. In a nutshell, outsourcing arrangements will perform well if contract terms and specifications are expected to last over the course of the contract. If contractual incompleteness is anticipated and the need for flexibility can be foreseen, then problems are more likely to occur with outsourced contracts. In other words, "you get what you pay for."[9]

A primary reason for outsourcing is not merely cost savings for core or context activities, but also the ability to focus on core activities. Outsourcing peripheral activities such as IT allows companies to concentrate on core strategic goals that generate the company's revenues and, in the case of public companies, increase shareholder wealth. Activities linked to the core business will often share some synergies with core activities and, as such, will not be candidates for outsourcing. Some activities may be dependent on valuable IP, including intangible assets and trade secrets, the loss over control of which would make outsourcing strategically dangerous. Thus, it is key to focus on core activities and core knowledge and differentiate that from peripheral non-core activities. This affords management more time to focus on optimizing business success, reducing distractions. That said, the analysis above applies to those peripheral activities a company may want to outsource—those that are easy to define and that are not expected to change much over the duration of the outsourcing arrangement.

Figure 4 offers a concentrated summary of the main pros and cons of outsourcing an activity.

FIGURE 4. The Pros and Cons of Outsourcing

Pros	Cons
Productive Efficiency: "What" not "How"	Describing and enforcing performance is costly
Spell out outcomes and define milestones	Changes require costly adaptations
Use market mechanism (RFPs)	Expose yourself to Opportunistic bidding
Focus on core business and increase efficiency	Lose expertise that may be valuable for future

In-House Sourcing: Managing the Inputs

The conclusions following from the first three pros and cons regarding the benefits of outsourcing as described in Figure 4 have immediate implications regarding the cost-benefit analysis business executives must undertake for determining which functions should remain in-house and which should go to outside providers. In sum, for complicated activities that cannot be carefully specified in advance or for which a need for flexibility is necessary but cannot adequately be anticipated or described in a contract, outsourcing will imply additional costs from renegotia-

tion and adaptation of the original contract. Furthermore, flexibility is always compromised by contract rigidity. As a result, such activities should remain in-house. If, however, activities or functions are clearly non-core and well-described, then such functions are ripe for outsourcing. In other words, the same things that make outsourcing good, make in-house provision wasteful; and the same things that make outsourcing bad mean that in-house management and oversight will be more cost-effective.

The focus on procuring the inputs versus procuring the desired function of an activity is important. Imagine that there are impediments to the ability to use the market mechanism, perhaps because the function is not easily contracted for, or maybe there is anticipated need for adaptation that cannot be carefully specified. In such a case, the only way to guarantee that the function will be delivered according to the company's need, and will respond for change as needed, is to procure the activity's inputs and to manage them according to future requirements. Typical outsourcing considerations fail to include "how" an activity is optimally managed. That is the benefit of in-house provision.

As with outsourcing, in-house production has obvious implications regarding core functions, including a focus on core activities, the ability to build and retain reusable knowledge, and the ability to protect precious IP. If there is a strategic risk to outsourcing a core-related activity, or even a peripheral activity that may require the transfer of important company-specific knowledge, then the company risks losing important expertise and perhaps its competitive advantage by virtue of losing control over knowledge that may be most beneficially retained in-house (see Figure 5).

In a recent study by MIT's Center for Information Systems Research,[10] 90 outsourcing deals in 84 companies were studied and classified into three categories. The first, "transactional outsourcing deals," involved discrete processes that have well-defined business rules. These deals were successful 90 percent of the time. The second, "co-sourcing alliances," involved both the company and the vendor jointly managing the projects (usually application development or maintenance work that goes offshore). These, which are less suited for outsourcing given their more complex nature, were successful only 63 percent of the time. The third category, "strategic partnerships," involved a single vendor who took responsibility for a big bundle of IT services, many of which were hard to specify contractually. Not surprisingly, these worked only half the time. Why then did these deals come to fruition? The reason is, most

FIGURE 5. The Pros and Cons of In-House Sourcing

Pros	Cons
No need for externally enforced contracts	Can't use the market mechanism
Flexible process: "own" the process itself	Internal production lacks cost incentives
Keep broad set of Expertise and IP	Have more clutter and less focus

likely, because the costs and benefits of outsourcing were not adequately quantified.

In summary, the key to making an outsourcing decision rests on the contractibility, or lack thereof, of the activity and how important the knowledge associated with it is to maintain superiority in core business activities. First and foremost, if the activity is difficult to describe and circumscribe by contract, either because of its complexity and vagueness, or because of constant evolving needs, then the activity is not a good candidate for outsourcing. Second, if the transfer of the activity will require the transfer of strategic knowledge or IP, and possibly cause the company to lose certain knowledge-based expertise and control over intangible assets, then outsourcing poses too great a risk of losing an important strategic advantage.

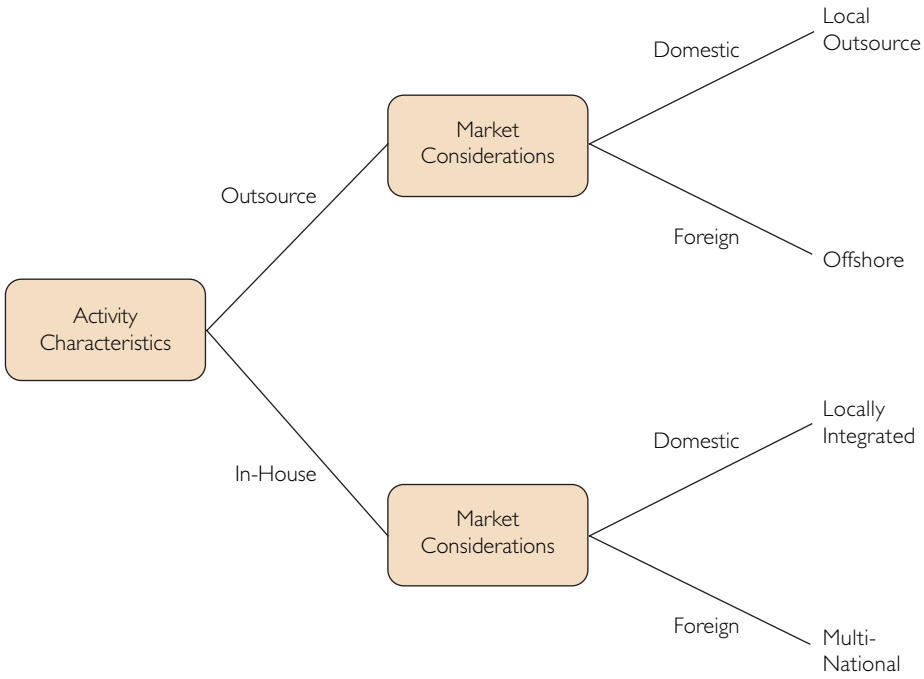
Offshoring: The Many Distances

The sourcing framework offered above does not take into account the dimension of location, be it for a multinational in-house provider with a plant overseas or for offshoring local activities outside borders to third-party providers. Instead, the framework argues that the characteristics of the activity will determine whether or not it is a good candidate for outsourcing. Who is best qualified to take on the outsourcing deal will depend on relative cost advantages and the ease or difficulty of managing the relationship, which are market considerations. One can think about these decisions (of whether to outsource versus where to have the activity produced) along the lines of a decision tree, as depicted in Figure 6.

With the analysis above, an informed business leader is equipped with the ability to address this question. If the outsourcing choice is an easy one because the activity is easy to contract for, then one great way to save on costs is to open the door to bids from foreign businesses in low labor cost areas, and even to actively solicit such bids. That said, there are several key issues that might cause another source for "hidden costs" that are unrelated to those discussed earlier. The following are the most common:

- **Geographical Distance**—Two of the most common costs incurred by a company that chooses to outsource an activity are the cost of transitioning work and knowledge to the vendor and the ongoing cost of staffing and managing the outsourcing relationship. It is hard not to notice that Asia is quite a ways from the U.S., and that travel costs can add up quickly. When these are not fully considered, the transition period from in-house to offshored activity may become very expensive. This is the time during which many face-to-face interactions are needed, and if the cost of travel is not priced into the cost-benefit analysis, then what may seem as a good deal will quickly erode by otherwise ignored costs.
- **Language and Cultural Distance**—The basis of the analysis offered earlier lies squarely in the realm of cost-benefit analysis, with a careful consideration of the economic costs and benefits from sourcing choices as they relate to the characteristics of the activity in question. Though it is

FIGURE 6. The Decision of How and From Where to Procure an Activity



possible to quantify the travel costs resulting from long-distance offshoring, it is much harder to quantify the costs of "cultural distance," namely, the cost from misaligned cultures and language barriers. The problem is that these costs are often underestimated, if taken into account at all. As a result, a company should evaluate substantive production cost savings prior to accepting the uncertainty of cultural and language barriers. This of course applies as well to locating plants abroad, even when these are under the control of the parent company back home. These problems are further intensified when the activity is complex and adaptation may be needed.

- **Regulatory and Policy Distance**—Another important difference between local versus offshore business relationships is that government policy and regulation will be different, implying sometimes that the business game has different rules. Sometimes these can be beneficial, for example, if the foreign government offers incentives for doing business within their boundaries. It is important to understand the foreign policy landscape before diving into a business relationship so as to prevent hidden costs that emerge due to these policy differences.
- **Legal Distance**—It is well known that a contract is not worth the paper it is written on if the terms cannot be enforced. As such, it is essential that

a company fully understand the rules and practice of the legal system in the jurisdiction of practice or under foreign laws specified in the contract. We often take the legal system in the U.S. for granted, not recognizing that enforcement is strong and interpretations are based on a long history of cases that are well understood. However, the level of enforcement for contractual clauses and IP protection can differ significantly across borders in other countries, and not taking this into account can lead to devastating consequences. Moreover, disputes handled or settled in foreign jurisdictions provide local vendors a home-court advantage. In China, for example, taking IP (such as copyrighted material) and selling it in a manner that would be considered infringement in the U.S. is not even governed by the laws in China.

Of course, these four points should also influence the decision of whether to employ a foreign plant that is part of the company. This offers a way to benefit from low labor costs without having to rely on outsourcing contracts, and it leaves many levers of control in the hands of he company. Still, the great distance from the company's base of operations will result in costs that need to be taken into account, and such decisions should be evaluated carefully in advance.

Tips for Success

Outsourcing is broadly applicable across industries, be that of an automobile manufacturer that needs to procure a braking system, an accounting firm that needs to procure information technology services, or a city hall that needs to provide garbage collection and disposal services for its residents.

Realizing that every activity (or transaction) serves a function is the first step towards effective procurement. Realizing that the ease of contracting for the delivery of the function will affect the effectiveness of outsourcing is the second step needed to identify activities that are good candidates for outsourcing. The key driver is determining how difficult it is to develop terms in a contract that adequately cover the function—activities required to fulfill the function over time. The more difficult to prescribe, then the less likely outsourcing will be the right choice.

To conclude, here are several "tips for success" to assist a company's executives in making informed outsourcing decisions, optimally leveraging use of the global market economy to a company's advantage:

- **Reasons**—Good reasons for outsourcing are looking for cost-effective deals, reducing distractions for non-core activities thus increasing core-activity focus, and keeping fluctuating capacity outside the company. A bad reason to outsource is to move a problematic activity outside the company. You can't outsource your problems, and by trying, you will make them worse.
- **Timing**—Analysis of the company's direction over time provides a basis to distinguish core from contextual activities. Using outsourcing to drive

the innovation of the company's procurement structure means that it is important to recognize the need to outsource early ahead of the competition. It is equally important not to outsource too early by blindly following the competition without conducting an independent analysis. Today's core function could be tomorrow's auxiliary function. Hence, foresight in planning whether a core function could potentially be outsourced, or an auxiliary one should not, is very important.

- **Contract**—Having a well-defined contract is paramount. Clearly define expectations, responsibilities, and activities on both sides up front, and make sure to have good evaluation systems to measure outcomes. Define the process through which changes in scope will be negotiated and approved within fair and reasonable financial boundaries; and, to the extent possible, set expectations for contract renegotiation and exit options. Considering termination for convenience (with fair financial terms to compensate a vendor for infrastructure and other investment directly attributable to conducting work for the company) may be beneficial.
- **Accountability**—Ensure that every contractible action has an accountable entity, and define the relationship clearly—who's responsible for what, and what gets done cooperatively. When possible, build penalty and performance clauses into contracts, and share both risk and rewards to provide ample and aligned incentives to do the job effectively and efficiently. That, along with escalations and paths to resolution, will assist in keeping expectations aligned over the life of the relationship.
- **Life Cycle**—Be mindful of the project's life cycle. If up-front transition costs are very high, a longer contract is needed to benefit from reduced long-run costs. However, longer-term contracts are more likely to require changes and adaptation, which often increase costs dramatically. It is therefore necessary to fine-tune the scope and the length of the contract to maintain balance between the contract length and the potential needs for flexibility.
- **Selection**—If you know what you want, and have a solid contract in hand, using the market mechanism (competitive or invited bidders) will be best. Use a network of other companies who have experience in outsourcing similar activities to help identify qualified vendors.

Finally, sourcing can prove to be a valuable tool in the arsenal of innovative business leaders who wish to create value and, in the case of public companies, increase shareholder wealth. It is important to acknowledge, however, that the bottom line will be compromised if the so-called hidden costs of outsourcing are not uncovered and quantified, and the need for flexibility is not adequately considered and accounted for in advance. Following the framework and guidelines prescribed here will result in better business decisions for strategic sourcing.

Notes

1. See Paul McDougall, "In Depth: When Outsourcing Goes Bad," *InformationWeek*, June 19, 2006, <www.informationweek.com/story/showArticle.jhtml?articleID=189500043>.
2. See Deloitte Consulting, "Calling a Change in the Outsourcing Market," April 2005, <www.deloitte.com/dtt/cda/doc/content/us_outsourcing_callingachange.pdf>.
3. See Paul McDougall, "Customers Rate Their Outsourcers," *InformationWeek*, June 19, 2006, <www.informationweek.com/story/showArticle.jhtml?articleID=189500059>.
4. See Paul McDougall, "In Depth: When Outsourcing Goes Bad," by *InformationWeek*, June 19, 2006, <www.informationweek.com/story/showArticle.jhtml?articleID=189500043>.
5. See Stephanie Overby, "Backsourcing Pain," *CIO*, October 11, 2005, <www.cio.com.au/index.php?id=17961209118eid=-154>.
6. See W. David Gardner, "Diebold Outsourcing Reversal Shows Industry In Transition," *InformationWeek*, May 22, 2006, <www.informationweek.com/news/showArticle.jhtml?articleID=188100862>.
7. Oliver E. Williamson, *The Economic Institutions of Capitalism* (New York, NY: Free Press, 1985).
8. Oliver E. Williamson, *Markets and Hierarchies*, (New York, NY: Free Press, 1975); Patrick P. Bajari and Steven Tadelis "Incentives Versus Transaction Costs: A Theory of Procurement Contracts," *RAND Journal of Economics*, 32/3 (Autumn 2001): 387-407.
9. Stephen Kerr, "On the Folly of Rewarding A, While Hoping for B," *The Academy of Management Journal*, 18/4 (December 1975): 769-783.
10. Jeanne W. Ross and Cynthia M. Beath, "Sustainable Value from Outsourcing: Finding the Sweet Spot," MIT-CISR Working Paper Series, Vol. V, No. 1A, March 2005.