To understand the risk exposure in offshore outsourcing, organizations should evaluate two factors - the importance of potential loss that can occur due to the risk as well as the propensity of the risk to occur while outsourcing specific functions.
Outsourcing has the potential to create significant value for business enterprise. Outsourcing is a core aspect of many organizations’ globalization strategies – in many service sectors it has become an imperative for business sustenance and competitive advantage. Over the years, many companies have capitalized on this opportunity to utilize excellent talent pools in low-cost countries, in turn reducing costs, expanding capabilities and increasing flexibility.

While the early adopters and innovators have found success through outsourcing initiatives, there are still many firms that have not realized the immense potential of offshore outsourcing. This article will demystify offshore outsourcing by offering an honest look at the inherent risks in the outsourcing business – as well ways to mitigate these risks.

Outsourcing is a complex process that requires the development of the right solution. As such, the benefits often associated with outsourcing are not realized for every firm, on every project. The actual value generated by offshore outsourcing activities depends (in part) on the firm’s knowledge of offshore supplier operations, transition process and an appreciation for globalization governance. The more knowledge a firm has, and the more successfully it leverages that knowledge, the less the inherent risks become.

Creating detailed sourcing and program management plans will require a firm to devote more time, resources, and commitment initially. As firms ascend the learning curve, the process will require progressively less investment. The institutionalization of comprehensive planning activities often means the difference between an average or sub-standard sourcing engagement and an engagement that leverages best practices and delivers maximum value.

Risk is inherent in most business decisions. The level of risk ranges from very low for common decisions that affect a small stand-alone operation to very high for extraordinary decisions that send ripples throughout the organization. New product development, capital investment, and implementation of cutting-edge technologies are among the types of decisions that rank higher on the risk scale. While these types of decisions have a higher probability of generating significant losses, they often offer potentially significant benefits as well. Outsourcing decisions are also commonly considered to be higher on the risk scale. While outsourcing can lead to lower costs, economies of scale, access to specialized resources, and new business ventures, it can also lead to increased costs, decreased service abilities, and loss of subject matter experts.

What are the risks in offshore outsourcing?

To understand the risk exposure in offshore outsourcing, organizations should evaluate two factors - the importance of potential loss that can occur due to the risk as well as the propensity of the risk to occur while outsourcing of the specific function. This evaluation is not deterministic on offshore outsourcing decision of a specific portfolio but need to be assessed and preventive control measures need to be developed to mitigate the potential risk. Typically, organizations opting for outsourcing for the first time are comfortable with low loss – low risk probability functions, while experienced outsourcing firms decide on aggressive trade-off model to realize
maximum value from outsourcing taking higher risk. As the outsourcing industry matures in any given offshore location, the complexity of the processes outsourced there intensifies, as does the complexity of the arrangements themselves. With increasingly complex processes, the firm’s risk exposure increases exponentially.

Table 1 summarizes the specific risks associated with offshore outsourcing. These risks are not mutually exclusive - they overlap throughout the project’s life cycle. The risks do vary in magnitude, as some have a potentially greater impact on the business than others, depending (in part) on the particular phase of the project’s life cycle. The management effort these risks require also varies – some projects require relatively little management oversight while others require a significant commitment from the Project Management Office (PMO).

Table 1: Specific Risks and Risk Manifestations

<table>
<thead>
<tr>
<th>Risks</th>
<th>Risk manifestation</th>
<th>Description</th>
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</table>
| Financial Risks        | Unrealized cost-savings expectations             | • The decision to outsource typically stems from the need to reduce operational costs by utilizing resources in low-cost countries. Organizations often expect cost savings proportionate to the wage differential. However, several other hidden-cost components are inherent in offshore outsourcing, and these costs can drastically impact a firm’s savings potential.  
  • Unrealized cost-savings expectations is one of the most critical risk elements associated with offshore outsourcing, yet it is often overlooked by organizations. |
| Business Risks         | Intellectual property theft                      | • As the complexity of processes outsourced to offshore locations increases, the associated potential of intellectual property (IP) theft increases.  
  • IP laws in several key offshore locations include only select safeguards – increasing the firm’s vulnerability.  
  • Service providers’ data security practices, if not as tight as the outsourcing firm’s – can leave the system open to misuse, sabotage, and theft. |
|                        | Transition and governance breakdowns            | • The successful transition of knowledge, processes and methodologies is critical to the success of an outsourcing engagement. Thus the service provider’s ability to assimilate is a key risk element.  
  • Diligent process-driven program management and a reliable program governance framework are crucial to ensuring the success of the outsourcing initiative. |
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<tr>
<th>Vendor delivery failure</th>
<th>• One of the greatest challenges firms face while outsourcing operations is understanding the strengths and weaknesses, domain skills, process expertise, employee capabilities, delivery ability and experience and strategic vision of their offshore vendors. The farther away the vendor is, the more critical this risk manifestation becomes.</th>
</tr>
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<tbody>
<tr>
<td>Internal change management resistance</td>
<td>• Resistance to change among employees impacted and/or displaced by a firm’s offshore outsourcing decision creates a major risk for the organization. Resistance, most present during the critical transition phase has the potential to derail the entire strategic initiative.</td>
</tr>
<tr>
<td><strong>Contractual Risks</strong></td>
<td><strong>Scope creep</strong></td>
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<td></td>
<td><strong>High rates of attrition</strong></td>
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<td></td>
<td><strong>Lower-than-expected delivery quality</strong></td>
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<tr>
<td><strong>Other Risks</strong></td>
<td><strong>Cultural differences</strong></td>
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<tr>
<td></td>
<td><strong>Geo-political instability</strong></td>
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</table>
What are the critical factors that create risks in offshore outsourcing?

There are several reasons why organizations face some or all of the risks outlined in Table 1. The key causes of risk include sub-optimal strategizing, assessing and transition / program planning. These causes of risk are detailed more fully below.

- **Minimal Offshore Planning:** Business necessity can cause a company to hastily proceed with outsourcing plans before having developed a sound strategy. A firm’s outsourcing strategy must be carefully developed before any action is taken, as it is the most effective way to minimize risk.
  
  o To develop a sound offshoring strategy, a firm must determine its optimal onshore/offshore operations mix and timeline for transition. Without carefully engineering a complete offshoring plan to include understanding internal capabilities, current costs, and resources – the firm will be unable to take advantage of the potential benefits and maximize cost reduction from the outsourcing initiative.
  
  o Without adequate planning, an organization may offshore functions that would be better performed onshore and not offshore functions that would be better performed offshore. Having made sub-optimal operations decisions, the firm would find little opportunity to maximize its returns.
  
  o A firm must carefully set its savings and timing goals, taking care not to develop irrational expectations.
  
  o Ensuring buy-in and communication across key areas of the organization greatly increases the probability that the offshore engagement will succeed.

- **Limiting Scope of Geographic Areas:** A country’s labor skills and capabilities are largely based on that country’s culture, infrastructure, economy, business environment, and government.
  
  o A firm must carefully choose its sourcing destinations – based on the country-specific factors that influence the country’s labor resources and on the company-specific factors that influence the firm’s labor needs.
  
  o Given its unique needs, the firm must decide which country’s specific labor supply offers the best fit. This tying back of supplier capabilities to the client’s unique requirements requires extensive knowledge of each leading and emerging country’s particularities.
  
  o Since specific country attributes influence many supplier capabilities, not selecting the optimal destinations increases a firm’s chance of incurring delays and additional costs due to legal, cultural, and infrastructure issues.

- **Non-comprehensive Request For Proposal:** Many Requests for Proposals (RFPs) focus solely on business and technology requirements, ignoring offshore-specific productivity and service-level metrics. Ignoring these important aspects of the vendor’s service abilities is almost always a mistake.
  
  o A robust, detailed RFP is the framework for all future engagement activities.
o Incomplete RFPs can generate misaligned expectations, increased costs, and failed projects.

o Sufficient performance-based detail must be included in the RFP, so that deep visibility is given to what suppliers commit to deliver.

- **Non-optimized Time Acceleration:** Without properly planned and competent sourcing management, transition preparation, and engagement schedule, a firm could forfeit a significant amount of the initiative’s potential value.

  o Understanding an organization’s internal capabilities is critical to the creation of an optimized, company-specific timing and transition plan.

  o Moving too quickly can cause internal chaos and disrupt mission-critical operations. Moving too slowly prevents value optimization.

- **Inadequate Supplier Knowledge:** It is often difficult for firms to diligently investigate potential suppliers, but this investigation is critical to understanding key supplier-specific risks.

  o Without adequate knowledge of prospective suppliers, many companies simply evaluate potential providers on their size and marketing presence.

  o Companies may overpay service providers or limit themselves to suppliers without the skills and experience the firm really requires.

  o Without adequate knowledge of prospective suppliers prior to engaging, firms face hidden costs, performance failures, and other business risks - too late for remedial action.

- **Supplier-Driven Pricing:** Using the uninformed firm’s typical marketing-based offer approach, it becomes very difficult to evaluate the complex contracts that are often necessary in outsourcing engagements.

  o Under the marketing-based offer approach, suppliers respond to the RFP with a complicated mix of solutions, prices, and alternatives that too often are skewed to benefit the supplier.

  o Ideally, suppliers would respond to a RFP that includes specific, structured arrangements with pre-defined best practice alternatives. This method would help to ensure that comparable bids are submitted by all prospective suppliers, with well-understood pricing and service delivery expectations.

- **Inefficient Negotiation:** Many negotiations focus on driving down rates, ignoring the Total Cost of Offshoring (TCO).

  o Driving down costs too far almost always causes problems for both the supplier and the client, leading to cost increases in the longer-term.

  o Fact-based negotiations that incorporate knowledge of current market cost, performance, and supplier benchmarks allow all parties to have a common understanding of the initiative requirements.

  o A variety of offshore contract alternatives (multi-supplier, functional or technical segmentation) should be considered to maximize flexibility.
Non-comprehensive Contracting: Firms that do not incorporate the terms and conditions unique to an offshore environment into a contract increase their risk.
- A weak contract can put a client’s business operations at significant risk.
- Contracts that do not include offshore-specific terms and conditions (for example performance audits and bonds, buffer staff, retention incentives, experience profiling, tax, and currency clauses) greatly increase the chance of performance, financial, relationship or contract management delivery problems.

Inadequate Offshore Program Management: Beyond traditional oversight, specific offshore issues often are not proactively addressed.
- Without offshore program management, much of the value negotiated and planned for during the sourcing phase can be lost.
- Structured, performance-based reviews prevent the omission of service levels identified in the contracting phase.
- Cultural, geographic, and offshore-specific issues must also be addressed to ensure maximum value and operational efficiency.

How to mitigate the risks of offshore outsourcing?

Risks related to outsourcing engagements can be managed using various processes that are diligently set up during the contracting phase and mapped, compared and developed over the course of the engagement. Specifically, to successfully manage outsourcing risk, firms should follow the four-stage process detailed below.

Stage 1: Risk assessment and assimilation
Outsourcing risks vary in number and magnitude depending on the specific operation that is being outsourced, the destination country, and the capability of the vendor. These factors must be adequately and accurately assessed in order to minimize the associated risks. Those responsible for the outsourcing decisions need to be informed about these risks and the potential impact they could have on the success of the engagement. This process is extremely critical as it paves way for the creation of risk mitigation tools and procedures down stream that will help minimize potential loss. Organizations need to create a ‘portfolio’ approach to identify the risks associated with each factor. The risks outlined in the portfolio, then, must be incorporated in the contracting phase of the initiative.

Stage 2: Establishing sponsorship and creating internal buy-in
More often than not, many outsourcing initiatives have not generated the benefits that the sourcing firm expected because of a lack of executive sponsorship at the corporate level. Such initiatives driven by divisional or departmental heads does not necessarily put the organization’s overall long-term goals into perspective. It is important for someone at the executive level to sponsor the entire effort; and govern it through various phases of execution and internalizing the project’s potential benefits. It is important for the sponsor to communicate with employees frequently and consistently - the project’s objectives, realized benefits, value created, and new opportunities. It is also important for the sponsor to articulate how such benefits and opportunities create change at all levels of the organization. Strategies to mitigate resistance cannot stand
alone. Rather, someone must continually champion the project, honestly and fairly communicating the project’s impact on the firm’s employees.

**Stage 3: Establishing controls**

After gaining a shared understanding of the impact and relative importance of each risk, organizations must determine the appropriate risk control mechanisms. These control measures can be classified as preventive, detective and corrective, as explained in the table below.

**Table 2: Risk Control Mechanisms**

<table>
<thead>
<tr>
<th>Control type</th>
<th>Control objective</th>
<th>Control tools</th>
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| Preventive controls  | Prevent the realization of a risk or (at least) mitigate its impact.              | • Comprehensive Request-for-Proposal  
• Comprehensive Service-Level-Agreement (SLA)  
• Diligent vendor selection  
• Careful establishment of a transition and governance framework |
| Detective controls   | Reveal the existence of risk.                                                     | • Project status reports  
• Utilization reports  
• SLA adherence reports  
• Internal and external feedback loops |
| Corrective controls  | Determine a risk’s impact and establish measures to prevent future occurrences.   | • Root cause and impact analysis  
• Redefined control measures |

**Stage 4: Communicating with interfacing components**

An outsourcing initiative deals primarily with back-end activities and often results in a lack of focus and attention on the end-users and/or customers who utilize the firm’s services or products. Potential for customer complaints and dissatisfaction is not as great with back-end operations as compared to front-end activities. Engagements can nonetheless not be forgotten when mapping an outsourcing initiative - because back-end activities feed into front-end interfacing activities. Lack of focus on the latter results in an inability to pass the benefits of the outsourcing initiative down the line.

While customer interfacing factors are hard to measure in terms of risk, it is crucial to consider these factors in the offshoring portfolio of risks. An additional benefit of publicly considering the customer factor is that it adds a sense of ownership and responsibility to the service provider’s work. This takes the engagement from a fee-based relationship to a more partner-based rapport. Such relationships lead to better service, cohesive value creation, and improve the longevity of the relationship. The latter is most important as it gives end-customers and stakeholders a sense of consistency, continuity and security.
Tholons’ proprietary ‘Globalization Strategy and Readiness Framework’ formulates and implements successful outsourcing strategies for its clients. The framework offers insight into the controls and risk-mitigation strategies that Tholons, understands need be part of the client’s outsourcing initiative. These controls and strategies may be implemented through third-party sourcing, internal operations, or a mix of both.

The elements included in this framework consist of aspects relating to the parent organization as well as the new entity (the sourcing partner or captive center, for example). The process of creating an outsourcing strategy and successfully managing its implementation demands prudent trade-offs between these elements.

Source: Tholons
Conclusion

Unfortunately, not even the most experienced business leaders can predict the future. It is impossible to know with certainty the outcomes of their decisions; that is why risk is inherent in most decisions made particularly in outsourcing. But by educating themselves about the most likely potential consequences, by utilizing the experiences of sourcing consultants like Tholons, and by adhering to frameworks like Globalization Strategy & Readiness Framework, business leaders can increase the predictability of the outcomes, thereby minimizing the risk associated with their decisions.

Outsourcing does not make sense for every firm. But its potential value compels most firms to at least consider such an initiative. In considering the potential benefits and costs of an offshore sourcing initiative, the firm must look at its unique requirements and investigate whether any offshore locations have labor resources that could meet those requirements at a lower cost than they are currently met onshore. If a firm decides to proceed with an offshore arrangement, it must first identify the potential consequences, hidden and obvious, associated with the decision. Once it has diligently explored the potential consequences, the firm can weigh the costs and benefits associated with those consequences and make an informed decision about proceeding with the initiative. While there can be no guarantees in business, the chances are good that if a firm carefully studies and plans for the consequences of its outsourcing initiative it will find success in globalization.
About Tholons

Tholons is a Services Globalization and Investment Advisory firm that combines "Best of Breed" consulting experience with deep execution expertise and investment insights to deliver truly effective services to its clients. Tholons offers a detailed understanding of business processes and combines it with practical hands-on expertise in executing the strategy. Tholons draws upon the considerable experience of a hand-picked team, which has successfully formulated and executed globalization strategies to unlock value for Global Fortune 1000 companies. Service providers leverage Tholons expertise to optimize their global delivery model. Tholons advisors engage with government bodies to build compelling strategies for making countries attractive destination for outsourcing.

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