

Making The Outsourcing Decision

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Don't overlook these five cost factors when evaluating outsourced solutions.

Outsourcing is firmly entrenched in business, so companies naturally seem to focus more on the benefit side of the decision-making process than on the accompanying costs. When both benefits and costs are fully factored into the decision-making, however, outsourcing often turns out to be only a marginally good, or even a poor investment.

Our own experience with the outsourcing of human resources functions, IT functions and, most recently, call center functions confirms this common tendency to focus on outsourcing savings while overlooking outsourcing costs. Moreover, and regardless of the function being outsourced, companies often overlook the same five cost components: process, contracts, communication, quality and change (Figure 1).

In this article, we focus on these rarely acknowledged costs, because they can materially affect the outsourcing decision. We also offer recommendations to properly address these issues and produce successful outsourcing outcomes (Table 1). The key is a complete decision model that fully recognizes all outsourcing costs and implications.

The Cost of Incomplete Process Knowledge

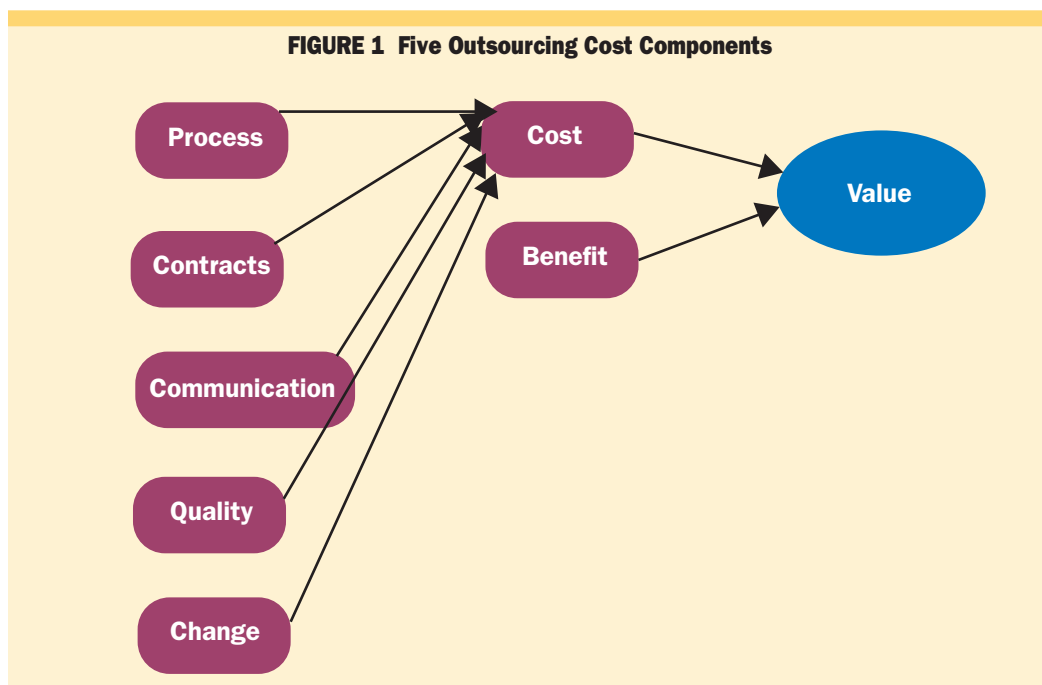
We've all known organizations where the individuals who run the business have the process for doing so stored only in their own minds. Picture one of these indispensable people suddenly unable to work—"indispensable" instantly translates into "single point of failure."

The obvious antidote to this situation is to document the business process so that others can step in if needed—or so that an outsourcing firm can take over the work.

A further step would be to analyze the documented process and identify possible improve-

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FIGURE 1 Five Outsourcing Cost Components



ments. This can be a valuable exercise, and the current methodology craze of Business Process Integration (BPI) or virtualization is fully focused on such activities—but not many companies are interested in these detailed efforts.

Instead, enterprises are likely to outsource what they think is a well-documented function, only to find that things don't run as smoothly as they used to run. Digging into the difficulties, management may discover that portions of the process were incompletely documented, or were not documented at all.

How can these oversights be avoided? First, by recognizing that a quick cut at documenting a process is insufficient. Every business function contains "hidden" and informal processes; plan for the time to find them. Encourage employees to document everything, including informal steps, "cheat sheets," etc.

Another important step is to carefully compare the proposed outsourcing solution to the current business processes. This "rightsourcing" exercise should help determine the viability of the outsourcing solution.

Recommendation: Combat the hidden costs of incomplete process knowledge by including process documentation and review as part of the outsourcing plan.

The Cost Of Contracts

Conventional corporate management typically uses a hierarchical pyramid of managers who impose tight controls over business processes and outcomes. Add outsourcing to the pyramid, however, and tight control can become problematic.

The most obvious way to impose controls in an outsourcing arrangement is through the use of comprehensive contracts. Such contracts are usually quite detailed—some are the size of telephone books—and they dwell on contingencies, such as: What do you do when a particular problem needs to be escalated?

In the case of offshore call center outsourcing, time zone differences must also be factored into

the contract. For example, what happens when the outsourcer offers the wrong solution to a customer? A lengthy delay might ensue while the outsourcer seeks direction from the client, or the outsourcer might take inappropriate independent action. To avoid both these situations, it's important that tight management control mechanisms are developed as part of the outsourcing contract.

Many outsourcing firms will gladly provide boilerplate contracts to start the process, but most companies that have been successful at outsourcing will tell you that it is better to build your own contract and enforce it with your own management team. This should raise a few warning hackles. Creating and maintaining a large contract is not trivial. The preparatory work can involve many people working many hours. Monitoring performance of the contract over its life can involve additional people.

All of this work creates overhead, typically for highly qualified and highly compensated professionals. One rule of thumb suggested by Gartner is that overhead costs associated with building a contract will run at least 5 percent of the first year price of the outsourcing deal.

On the other hand, the contractual process also presents an opportunity to ensure outsourcing success. The time and effort force the company to think through the outsourcing engagement, analyze the process contingencies and hammer out the controls desired with the outsource service provider.

Recommendation: Inappropriate accounting of contract costs can skew value assessment. Invest the time and resources to ensure tight control of the contractual aspects of outsourcing and include the costs of doing so.

The Cost Of Communications

Have you ever gone to work thinking you have a handle on what is going on, only to have a surprise announcement hit you square in the face? Whatever the new development, you didn't see it coming. Granted, not all business decisions can be

Tight control of outsourced solutions means writing and enforcing your own contracts

TABLE 1 Outsourcing Do's and Don'ts

Do's	Don'ts
1. Research your outsource service provider: ask for references.	1. Don't depend on your outsource provider to know your needs. You must define your needs and your expectations.
2. Involve your legal team early; contract execution is the "winning edge."	2. Don't assume that the current state of affairs can be outsourced without effort. This is not a plug-and-play solution.
3. Communicate your intentions early to affected employees. Remember, affected employees may be more than those whose jobs are affected.	3. Don't expect quick conversions. Good outsourcing, like any internal reorganization, requires time to stabilize.
4. Assess whether the function you are outsourcing is core or not. Outsourcing core competencies is outsourcing your competitive advantage.	4. Don't keep the outsourcing project quiet. More communication, with both employees and the service provider, will reduce friction.
5. Expect settling-in adjustments. Error rates will increase; focusing on process will bring them down.	5. Don't assume that outsourcing is transparent to the customer. Communicate with them as well.

communicated gradually and with careful explanation—but outsourcing decisions can.

Often the employees, customers and other groups that will be affected by the outsourcing decision are also the people whose input is crucial to the process documentation effort, which is instrumental in defining the outsourcing scope. Their efforts (hopefully) improve the implementation, and they deserve open, honest and continued communication about that implementation.

Provide regular updates as to the progress of the effort and establish a mechanism for feedback and open discussion. Those closest to the processes may have some of the best suggestions on how to transition those processes to another group or company. Ongoing communications also help ensure that the outsourcing project continues to receive support.

How much should such communications cost? Many consulting firms recommend budgeting for a robust communications plan, but they provide little guidance on how much funding to allocate. We have seen several outsourcing projects where the internal communications expenditures were assumed to be at normal budget levels. This, in our experience, is a prescription for problems.

Effective internal communications cost money and should be funded at 3 to 5 percent more than the typical budget. Such an investment will serve you well in the initial adoption of an outsourcing project and its continued support within the organization.

Recommendation: Recognize the importance of good communications and include time and funding for it in the outsourcing plan.

The Cost Of Quality

A frequently heard complaint about outsourced services is that the quality level is less than that of internally provided services. This is generally true in the short term as an outsourcer comes up to speed on specific requirements and processes.

Some industry estimates place the increase in “defects”—that is, unacceptable quality experiences (as defined for the particular outsourced function)—at 200 percent or more over internal defect rates for up to a year after an outsource arrangement begins. Through the year, this defect rate usually decreases and settles at or below the rate prior to the outsourcing implementation.

Remember that the user’s perception of poor quality or defective service can vary. For example, in a manufacturing process, a rejected part can be

a defect, while in a customer service process an unmet expectation can be a defect.

Regardless of their source or type, defects clearly have two effects on an organization. First, and especially if the defects are associated with a product or with a customer service function, defects can harm the customer’s perception of the company and its products and may even affect revenue. Second, defects can add to company overhead by increasing rework or the cost to manage the delivery of service.

Defects in help desk outsourcing can be particularly aggravating for both customers and outsourcing companies, particularly if cultural differences are not addressed upfront. For example, an Indian help desk worker may “jump the gun” and

escalate a caller’s question to the next tier of support without recognizing that the customer wanted a simple answer to a simple problem. In this case, the help desk worker’s reaction not only delays getting the solution to the customer, but it also creates additional work at the next support tier, as well as frustration

for the caller that the

answer wasn’t simple, quick and decisive.

The costs to ramp up and appropriately manage defective quality must be factored into the outsourcing decision. The actual costs of such defects would be simply the cost of correcting the defect and can be assumed to be the labor associated with reworking the problem.

Another way to estimate such costs would be to assume that the outsourcer will only be able initially to handle half the capacity (number of parts, calls, or other metric) of the former, in-sourced process. Figure the outsourcer will be able to handle 75 percent capacity after a calendar quarter or a half-year, and full capacity after a year.

Recommendation: Plan for the costs associated with some level of defects during an outsourcing transition, and remember that some “defects” are in the eye of the beholder.

The Cost Of Change

Change is at least unsettling and at worst paralyzing, no matter how disciplined an organization may be. To keep the rest of the organization running effectively while a major business function is being transitioned to an outsourced solution is a major challenge.

The suggestions we have already made will help, but there are other hidden and hard-to-measure costs of organizational change. These include the loss of productivity on the part of the out-

**Assume the outsourcer will
be half as effective
in the first few months,
and fully effective
after a year**

sourcing team and customers, as well as decreased morale and confidence in the products or services provided.

Outsourcing consultant Martha Young of Nova Amber, LLC, points out another common area of hidden costs: preparing employees affected by outsourcing for their next job or career. Those employees will need funding and time to learn new skill sets and prepare to move on, either inside or outside the company. Young recommends including the budget and time needed to support these employees as part of your outsourcing plan.

An outsourcing venture that pays too little attention to organizational change risks rejection by the employees. They may develop new hidden processes to work around the outsourcing function. Such clandestine acts can lead to virtual sabotage: the outsourcing team gets a bad reputation, client satisfaction deteriorates and the original intent of the executives to save time, money and energy completely backfires.

Of course, outsourcing doesn't always lead to mutiny, but management should be aware of the impact that organizational change can have on effectiveness, accuracy and morale. Plan for the human reaction to change by communicating the outsourcing decision and what the impact will be. One crucial element is a good rollout strategy that includes the change impacts.

Recommendation: Address the psychological factors involved in outsourcing: Expect a loss of productivity, resistance to change and higher defect rates. Funding the necessary communications, career counseling and training costs to address these factors as early as possible will increase the chance of a successful outsourcing solution.

Conclusions

Outsourcing alternatives are a fact of modern business. For many companies, outsourcing can be a viable and smart way to focus on core competencies, thin the business model and achieve significant improvements in revenues. As opportunities to outsource non-core functions present themselves, however, we strongly urge an approach that includes these five factors which are not normally considered, factors that can make or break the success of the venture.

Recognizing the value of processes and tight control can help a company understand the full scope of the outsourced function and establish mechanisms for managing the outsourcing relationship. Recognizing the hidden costs of change and defects introduced by outsourcing can save the company not only time and money, but also the reputation of the management team and the outsourcing vendor. And, above all, communication of the outsourcing decision and implementation can go a long way to smoothing the roadblocks inherent in such projects□