

## **Outsourcing, innovation and risk**

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*The phenomenon of the 1960s, in which companies opened and closed factories at a ferocious rate and sought the cheapest labor, is over. Outsourcing is the new way of driving innovation, and should be regarded as so much more than a cost-saving exercise: the most successful outsourcing strategies make the most of changes in technology, protect IP and take added risk into account.*

Companies are seeking to innovate by assessing where they can best find the skilled labor to add value to their products. Their outsourcing strategies are reliant on new technology, using modern telecommunications to facilitate sending their back-office processes or projects abroad. But at what risk?

### **Definitions of outsourcing**

Outsourcing can be defined in a number of ways depending on the type of service and the form of relationship with the supplier. It is frequently also referred to as contracting out or buying in, and may be defined as 'the delegation or handing over to a third party (external supplier), mediated via a contractual agreement, all or part of the technical, process and human resources, including management responsibility for transferred staff . . . '.

Complete outsourcing occurs when an entire department or function is externalized, and this may be handled by one vendor or multiple suppliers. A broad range of activities has been transferred in this way including catering, cleaning and security – which are often regarded as 'secondary' or 'noncore' functions. There has also been a recent increase in the outsourcing of professional activities, including HR, IT and financial services.

### **Insourcing**

The process of insourcing refers to bringing in external contractors to assist with processes which are understaffed in the host company, or that the company is trying to expand.

Fitting in as part of the team can be a problem for insourced personnel, and insourcing is still not a highly developed variant of outsourcing. Insourcing seeks to create temporary teams of the most talented innovators who fit in with specific company needs, and who will help add value and protect IP with their expertise. Using insourcing to address new global production methods, whether in services or manufacturing, needs to be analyzed within the context of added value, IP, risk and the complexity of service rendered. A lack

of this understanding can lead to contracts that are not negotiated properly and misread the dynamics of human resources (HR).

### **Backsourcing**

Another variant of outsourcing is backsourcing: when a process that has been outsourced is brought back in-house. This is an increasing phenomenon, and occurs where outsourcing partners have been found to be underperforming, negligent or even engaged in criminal activity. Most companies do not even consider backsourcing as an option until they are forced to accept it, and is at risk of occurring when the lifecycle of an outsourcing agreement is not considered right from the beginning of the process.

### **Offshoring**

Offshoring is another term that is often confused with outsourcing. It is possible to outsource to an offshore destination such as a free-trade zone in another country, however outsourcing does not have to occur in the process of offshoring. It is possible to hire people in a free-trade zone without lifting out or externalizing a company department or section. Offshoring was developed many years ago, especially in IT and semiconductor sectors where there was a constant search for cheap, semiskilled labor. Tasks undertaken in offshoring are often more akin to selective outsourcing, such as dealing with non-current accounts in the insurance industry, payroll activities in HR management, or some repetitive tasks in component manufacturing.

### **Risk and HR solutions**

When an outsourcing agreement is negotiated, a clear understanding of responsibilities within a flexible context should be accomplished at the outset. Over-rigid service level agreements (SLAs) can lead to disappointment and conflict. A clear set of aims backed up by some form of insurance also serves to clarify the risks involved. Risk assessment and an understanding of enterprise risk management (ERM) are vital to successful outsourcing, multi-vendor outsourcing, insourcing, backsourcing or offshoring within an outsourcing context.

Yet risk and its management will usually entail hidden outcomes that corporate strategy is unable to foresee. This is especially the case in relation to HR management. Humans, according to organizational behavior theory, are unpredictable, especially when thrust into an unfamiliar way of working such as transferring processes outside their organization, or when they feel adrift in a new situation within their original company.

HR outsourcing strategy is nowhere weaker than within a rigidly rule-based corporate agreement that results in high attrition rates, resentment, and insecurity concerning company identity. Poorly negotiated SLAs lead to high-risk profiles, and many of the risks taken in outsourcing are inaccurately perceived as not being subject to insurance, or as being unable to be hedged against or securitized.

Frequently, risks often only become a corporate strategy item once performance targets remain unmet. Enterprises usually divest a part of their operations because they believe that those to whom they are outsourcing are better equipped and more capable of handling the task and risks. This is certainly the reasoning behind much of the outsourcing of computer and information systems, especially those from financial institutions. Outsourcing is there to deal with the risks of technological obsolescence and systems failure. One dimension that does not seem to be factored into this equation is the unreliability of HR, and analysis of how adequately companies are able to deal with these risks, whether in-house, outsourced, insourced or backsourced. A rigid contract can never cope with elements of organizational behavior, psychology and personal relations, yet these will ultimately affect the outcome.

### **The importance of flexible contracts**

Outsourcing arrangements that are poorly executed, and/or rely on rigid SLAs with little understanding of what Enterprise Risk Management (ERM) constitutes, are doomed to fail. In 2005 McKinsey carried out a study of 30 outsourcing deals that had occurred four years prior to the study and were worth a total of 20 billion dollars. The conclusion was that up to 50 per cent of outsourcing arrangements did not deliver the anticipated value and/or protect IPR. These failures were found to be linked to over-reliance on standard procurement approaches and cost/price as the primary consideration. Such rigid procedures all fly in the face of what ERM should constitute.

Rigid and detailed rules handed down to implementation teams often contain more risks than utilizing an approach that contains fewer detailed, directional procedures. Lesser risks are taken if trust and personal relations are built up over the long term rather than in distant, proscribed, short-term confrontational business practice. A flexible approach that builds on these relationships by sharing strategic intent, and involves regular and transparent communications, is essential - and this needs to occur throughout the lifecycle of the project.

Simply handing a proscribed set of rules to those implementing the outsourcing, and then leaving it unattended until problems occur, can result in extensive damage. If no

foundation exists between the two parties to enable dispute resolution, results can be disastrous. The preferred method should be a loose framework that includes a lucid assessment of core competencies and skills, particularly in relation to the outsourcing suppliers. For example there are many documented cases in which confidential customer data that has been outsourced from banks have been illegally sold by members of the supplier team.

### **Reassessing the role of human resources, risk and IP**

Companies seeking to insource effectively need to bring in flexible, thoughtful problem solvers who can enter a company and adapt themselves successfully to the particular situation facing them. Insourced staff should become trusted members of the team who will not breach confidentiality or allow IP to be infringed. The recruiting company needs to understand that such talented people are part of a movable, elite workforce, able to work in any metropolis around the world but who will not tolerate boredom, and therefore require extras such as challenging, dynamic work and social networking events. It is impossible to innovate, reduce risk, or protect IP without having innovative people as part of the team.

### **About the author**

Prof. Ruth Taplin, Director of the Centre for Japanese and East Asian Studies, is the author/editor of 14 books and over 200 articles. Her most recent book, just published by Routledge, is **Outsourcing and Human Resource Management - An International Survey**. Prof. Taplin has been editor of the *Journal of Interdisciplinary Economics* for 12 years. She can be reached at [ruth.taplin@btinternet.com](mailto:ruth.taplin@btinternet.com).