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A Risk-Based Approach to Identifying the Total Cost of Outsourcing

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AS THE USE OF OUTSOURCING CONTINUES TO GROW, MANAGERS MAY NOT BE AWARE OF ALL THE ASSOCIATED COSTS. A FRAMEWORK IS PRESENTED TO HELP MANAGERS IDENTIFY AND CLASSIFY ALL THE POTENTIAL RISKS AND HIDDEN COSTS A COMPANY MIGHT FACE IN AN OUTSOURCING AGREEMENT.

At its core, outsourcing involves transferring ownership of an organization's business activities to an outside provider. The traditional outsourcing arrangement involved purchasing component parts from an outside manufacturer, but outsourcing has moved beyond that tactical arrangement to become more of a strategic tool. Strategic outsourcing is intended to do more than simply create cost savings—it seeks overall business improvement so that a company can achieve its long-term strategic goals by focusing on the activities central to its success. To this end, outsourcing has taken on three distinct characterizations: manufacturing outsourcing, information technology (IT) outsourcing, and business process outsourcing. As its application has spread, managers may not see all the costs associated with the arrangements, and they may need a framework to help decide if entering into an outsourcing agreement is the right move. This article provides a strategic outsourcing framework to help managers identify the risks that represent the hidden costs of an outsourcing arrangement.

Although outsourcing currently receives a great deal of media attention, it is not a new phenomenon. It emerged in the early 1980s as a response to prevailing economic pressures, taking many forms across many industries. In a 1997-1998 survey, two-thirds of executives indicated that they had outsourced a business process and that outsourcing market penetration was expected to grow from 6% in 1995 to 10% in 2000.[1] That predicted growth was surpassed, with demand for outsourcing exceeding a global value of $100 billion in 2006. Clearly, many companies are benefiting from the use of outsourcing agreements. Outsourcing is not without risks, however, and these risks represent the hidden costs of outsourcing.

Rewards and Risks

Historically, outsourcing decisions have been driven by potential cost savings, and it remains the motivating factor in the make-or-buy decision. Outsourcing operations, particularly to countries with lower costs, provides cost savings from a variety of sources, including cheap raw materials, cheaper labor, and reduction in overall overhead. Additional cost savings also can result from the external provider's economies of scale. Outsourcing also can help improve a firm's financial flexibility by allowing it to pay for only what it needs, thereby transforming fixed costs into variable costs. This financial flexibility enables organizations to make resource allocation and investment decisions based on developing their competencies rather than the general need to get their products or services out the door, and it reduces concerns over excess or idle capacity.

One type of outsourcing benefit that is becoming increasingly important can be broadly defined as "strategic enhancement." Through outsourcing arrangements, companies can gain access to new technologies that otherwise might not be available. Introducing an external supplier into a firm's value chain may also create opportunities to develop synergies as each party learns how its partner's processes interact. A company can jump on the fast track to innovation by focusing on those activities that drive its success, further refine its competencies, and strengthen competitive advantage.

The rewards of outsourcing do not come without significant risks. Beneath every outsourcing decision is the reality that many recent arrangements have failed. Table 1 presents common reasons outsourcing ventures fail. It also captures the most significant risks involved in outsourcing: strategy, selection process, contract negotiation, implementation, post-implementation, and overall relationship management.

A key issue is supplier selection. One need only look at the recent recalls of children's toys due to high levels of lead paint to realize that failure to conduct the necessary due diligence when selecting a supplier can create a significant number of risks in the foundation of the future outsourcing relationship. The next step after a partner is identified is contract negotiation. The legal implications of the agreement present a number of risks. Failure to be clear during the negotiations can result in an outsourcing contract that does not appropriately capture what each partner intends to gain from the relationship and what each will contribute in terms of time, materials, and other resources. The negotiation phase is also the time to establish and agree on an exit strategy to help ensure the relationship will end with minimal damage to the company.

While outsourcing arrangements present significant risks before they are even executed, the number of risks escalates after implementation because of the very nature of outsourcing, where a good is produced or a

Table 1: Common Reasons Outsourcing Arrangements Fail

- Outsource activities that should not be outsourced
- Select the wrong vendor
- Write a poor contract
- Overlook personnel issues
- Lose control over the outsourced activity
- Overlook the hidden costs of outsourcing
- Fail to plan an exit strategy

Source: Jerome Barthelemy and Dennis Adsit, "The seven deadly sins of outsourcing," Executive commentary, *The Academy of Management Executive*, May 2003, pp. 87-100.

service delivered outside the company's walls. A primary risk is an arrangement that limits flexibility to adjust to unexpected fluctuations in business needs. Additionally, outsourcing risks can arise when arrangements do not fully consider operational issues, such as a decrease in the morale and productivity of internal workers as a reaction to the outsourcing agreement.

The final category of outsourcing risks is relationship management. An effective outsourcing relationship requires strong communication both within the outsourcing company and between it and its supplier. An understanding of internal costs on both ends and an emphasis on a long-term collaboration between the outsourcing partners are essential to the survival and success of the relationship over time.

Strategic Outsourcing Decision Framework

Outsourcing is a strategic decision that requires forethought and planning—not an ad hoc approach that is shortsighted and ineffective. This assessment is the motivation for offering a framework for evaluating an outsourcing arrangement. The framework will address the risks articulated within the *Enterprise Risk Management—Integrated Framework* proposed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

The goal of the enterprise risk management (ERM) process is to identify potential events that can adversely affect the organization. Risks are identified in relation to strategy, and alternatives are evaluated to determine the effect on the organization's overall risk profile. Essentially, COSO's ERM framework encourages a holistic view of risk management that identifies all possible risk events, assesses the likelihood and impact of those risks, and responds to them through a combination of avoidance, acceptance, reduction, and sharing.

The ERM framework proposes four distinct but overlapping categories of risk: strategic, which concerns the entity's achievement of its overall mission and goals; operational, which addresses the entity's use of people, processes, assets, and technology to achieve its objectives; financial/reporting, which emphasizes the reliability of the entity's financial statements and reports; and compliance, which focuses on the laws and regulations that affect the entity.

Business Questions

The considerations within the four risk categories can be articulated through a series of questions. In addition to categorization by type of risk, the questions presented in the framework are organized into six groups: who, what, when, where, why, and how (much).

Questions within the "why" category seek to answer the basic questions about outsourcing. No company should enter into an outsourcing agreement before it clearly identifies the objective of outsourcing a particular process. The "what" category is presented next because, after a company determines the objective of outsourcing, it needs to determine how to best realize the potential benefits by identifying what process or product to outsource. "Who" questions include the critical considerations and risks surrounding the people aspects of the outsourcing process, such as who is making the decision, who is the outsourcing vendor, and who will remain after the transition is complete. The next category is "how (much)," which addresses such diverse issues as how the outsourcing arrangement will be implemented and measured and any concerns over technology migration. "Where" questions focus on where the outsourcing vendor will be located and any associated risks, and the "when" category addresses the general time frame and related issues.

Analysis of the "why" is critical because the resulting discussion attempts to identify the primary reasons the company is considering outsourcing. Failure to identify whether outsourcing is part of the core strategy or merely operational will only result in unclear objectives and ineffective measurement systems as outsourcing becomes a more critical part of the company's operations. With these thoughts in mind, Table 2 shows three main questions every company should ask to explicitly identify its preference and move forward accordingly.

If outsourcing makes sense, the next question in the outsourcing decision framework is "what" to outsource. The "what" issue comes with its own risks. For instance, companies excited about the benefits of outsourcing may fall into a copycat trap of outsourcing simply because a competitor does. With such an approach, the potential outsourcer has failed to consider how cus-

Table 2: "Why" Category Questions

Framework Question	Enterprise Risk Management Classification
What does the company seek to achieve through the outsourcing arrangement?	Strategic
Has a convincing business reason for outsourcing been developed?	Strategic
Are the goals of the outsourcing arrangement strategic or operational in nature?	Strategic, Operational

tomer service is integrated within the organization.

When determining what to outsource, it is important that a company think about whether the outsourced product or process is tactical or strategic. A tactical process is likely to be uniform among competitors, while a strategic process creates competitive advantage and distinguishes the company from others in the marketplace. Outsourcing a strategic process can create a competitor out of a vendor, undermining the value of an outsourcing arrangement. For this reason, outsourcing companies need to carefully consider the source of their competitive advantage before determining what exactly they are willing to transfer outside their own walls. Table 3 provides some questions to help management decide what to outsource.

Consideration of the "who" is critical because it deals with the people involved in the outsourcing decision and cannot be controlled as carefully as some of the other aspects of the process. Appropriate questions and their related risks can be discussed within four subcategories: the in-house outsourcing team, the potential vendor, surviving employees, and new employees.

The in-house outsourcing team has the crucial role of effectively defining and carrying out the company's outsourcing strategy. For this reason, it is essential that the outsourcing team be composed of individuals representing all stakeholder groups.

Outsourcing usually results in one of two outcomes for employees: They are transferred to another role within the company, or they are let go. Whether employees are moved into new jobs or are terminated, plans for their transition should be laid out carefully to make sure the process is as smooth as possible. Additionally, employees who survive the outsourcing may be demoralized, which can lead to the risks of employee turnover and operational inefficiencies. As a result, these risks should be considered thoughtfully, and an appropriate response should be formulated.

Table 3: "What" Category Questions

Framework Question	Enterprise Risk Management Classification
Can the process or activity to be outsourced be discretely identified?	Strategic, Operational
Are the product specifications/process descriptions available and easy to follow?	Operational
Has the provider been trained on the unique issues associated with the outsourced product or process?	Operational
Has the potentially outsourced process been benchmarked against "best in class"? If so, have any potential improvements been made before handing the process off to an outsourcing provider?	Operational
Does the outsourced process provide a competitive advantage, or can it be easily duplicated by competitors?	Strategic

Table 4: "Who" Category Questions

Framework Question	Enterprise Risk Management Classification
Have all relevant parties been consulted in arriving at the decision to outsource?	Strategic
Does the potential outsourcing initiative have the full support of senior management?	Strategic
Has someone been elected to play "devil's advocate" in order to ensure that all sides of the issue are considered?	Strategic
Has the outsourcing team been allocated adequate resources for selecting a vendor, in terms of both dollars and skills?	Operational
Has a dedicated outsourcing governance organization/relationship management team been formed to monitor and facilitate all outsourcing arrangements?	Strategic
Have all potential outsourcing vendors been considered, or has the company limited itself to "sole-source" outsourcing?	Strategic
Have explicit criteria been defined for selecting the outsourcing vendor?	Strategic
Has a thorough and complete financial due diligence been completed on the potential outsourcing provider?	Financial Reporting, Compliance
Has an assessment of the potential vendor's reputation been conducted?	Strategic
Is the culture at the outsourcing provider supportive of quality-minded and ethical operations?	Strategic
Have all capacity issues (and limitations) been addressed with the outsourcing vendor prior to execution of the agreement?	Operational
Does the outsource provider have the skills necessary to carry out the arrangement? If not, can those skills be easily trained?	Operational
Is the potential outsourcing provider working with any other companies? If so, what other demands on their time exist?	Operational
Has the full outsourcing arrangement been planned and articulated before an announcement is made to employees?	Operational
Does the outsourcing arrangement provide for employee transition plans?	Operational
How are the risks associated with in-house survivors of outsourcing being addressed?	Operational
Have employee communication issues, such as how to schedule meetings, evaluate performance, and escalate critical issues, been addressed?	Operational
What particular steps have been taken to improve communication within a cross-cultural environment?	Operational
Have applicable employment laws been considered and addressed?	Compliance

Finally, the outsourcing arrangement will involve employees at the outsourcing vendor, which has its own set of issues and risks. Table 4 contains the "who" questions that can help management think through these issues.

An outsourcing strategy cannot be implemented effectively until it has been articulated. The outsourcing agreement should provide for all the logistics contained in the arrangement, including who will do what, how payment will be exchanged, and when the transition will take place. "How (much)" questions concern how the outsourcing strategy will be determined, how the outsourcing arrangement will be implemented, and how costs will be captured and measured appropriately. Any statements the outsourcing company has made about its anticipated contributions should be incorporated into the outsourcing agreement. Likewise, the outsourcing company should carefully review the agreement to ensure that it is not agreeing to provide services it has not planned to provide. The time

Table 5: "How (Much)" Category Questions

Framework Question	Enterprise Risk Management Classification
Has a concise outsourcing strategy been developed, including specific process requirements and service expectations?	Strategic
Are the goals and benefits expected to be realized from the outsourcing arrangement thoughtfully articulated? Is the potential vendor aware of these goals and objectives?	Strategic
Has the outsourcing company made express statements about what it expects to contribute in terms of time, equipment, inventory, etc. to the outsource provider?	Operational
How will the outsourcing arrangement be structured in order to get the greatest benefit without jeopardizing the sourcing company's strategy?	Strategic
Does the outsourcing agreement provide for flexibility in terms of business requirements and needs? In particular, does it address change orders?	Operational
Have any "shortcuts" been taken in drafting the outsourcing agreement?	Strategic
How have information technology needs been addressed within the outsourcing agreement?	Operational
Will the outsourcing company and its provider's systems be able to interface effectively?	Operational
Will appropriate controls be put in place to safeguard the security and confidentiality of transmitted information?	Operational, Compliance
How will customer service and customer expectations be addressed within the outsourcing arrangement?	Strategic, Operational
What is the sourcing company's intended exit strategy, and how will it minimize damage if the outsourcing arrangement sours?	Strategic, Operational
What is the estimated total cost of outsourcing? Does the outsourcing agreement truly capture all costs?	Strategic or Operational
How will the continuing costs of the arrangement be managed, and are they appropriately accounted for in arriving at the initial decision to outsource?	Operational
If outsourcing to a faraway country, how will shortages and stock-outs, as well as the inevitable obsolete inventory, be handled?	Operational
Is there a clear basis for measurement? How will the company know if the outsourcing arrangement has achieved what it set out to achieve?	Strategic
How will the benefits of continuous improvement and productivity gains be shared between the outsourcing provider and the sourcing company?	Strategic, Operational
How will "lessons learned" from mistakes in the past be translated into improvements for future outsourcing relationships?	Strategic, Operational

spent up front to define the arrangement will be significantly less than the time it takes to untangle a misunderstanding down the road. Therefore, any company considering outsourcing should first formulate an outsourcing strategy and then test its comprehensiveness.

The cost dimension of outsourcing should not be buried deep within this discussion because it is often the impetus for making the decision to outsource. For the sake of organization, however, it is appropriate to classify it with the other "how (much)" considerations, which appear in Table 5.

Some of the most significant risks associated with outsourcing involve the "where" dimension. Much of the outsourcing coverage in recent years has focused on moving operations to countries with low labor costs, such as China and India, but there are other options that vary based on a company's outsourcing needs. One consideration is diversifying into several countries to minimize political risks and ensure security of labor

Table 6: "Where" Category Questions

Framework Question	Enterprise Risk Management Classification
Will all outsourcing activities be concentrated in one country, or will the risk be diversified across countries?	Strategic, Operational, Compliance
Have the environmental factors specific to the outsourcing provider's locale been considered?	Operational, Compliance
Is the outsourced process heavily automated or labor intensive?	Operational

supply. For these reasons, a company needs to decide whether to outsource to one or more countries. Another important consideration is whether the process being outsourced is heavily automated or labor intensive. Companies have outsourced all kinds of processes and products from plastic toy assembly to telemarketing to payroll processing. Each requires different skills and manual processing. Integral in the "where" decision, therefore, is identification of the relative requirements for manual vs. automatic processing, which relates to operational risk.

The risks associated with any location are as diverse as the countries themselves, but there are a few common threads that can be addressed through the questions presented in Table 6.

The final dimension of the outsourcing decision is "when" considerations, which cover a variety of issues relevant to the timing of the outsourcing process. Outsourcing involves significant risk for all parties involved. The crucial element in this aspect of risk assessment is that it takes place before any exchange of money, processes, or other resources. An organization's failure to fully understand the operations of its outsourcing partner can lead to much larger problems upon discovery of unfavorable policies or procedures. Another time-related question is whether the process is outsourced at once or in stages. This consideration relates to assurances that the outsourcing company's operations will not be affected negatively by a business interruption. The "when" questions appear in Table 7.

Table 7: "When" Category Questions

Framework Question	Enterprise Risk Management Classification
Is the current business environment supportive of expanding operations? What is the future outlook for the outsourcing company's industry?	Strategic
Has a thorough risk assessment taken place *before* making the decision to outsource?	Strategic
Will the entire process be outsourced at once? Or will it be implemented in stages, such as handing off sourcing, then assembly?	Operational
How long will it take from the initial stages of the outsourcing arrangement to implementation and full production through the outsourcing provider?	Operational
Is the timeline for implementation of the outsourcing arrangement reasonable in light of the needs and requirements of both parties?	Operational, Strategic
In the event of an emergency, what kind of contingency/disaster recovery plan is in place?	Operational

Figure 1: Risk Matrix

Impact of risk event	High			
	Moderate			
	Low			
		Low (remote)	Moderate (possible)	High (probable)
	Likelihood of occurrence			

Source: Stephen Bodine, Anthony Pugliese, and Paul Walker, "A Road Map to Risk Management," *Journal of Accountancy*, December 2001, pp. 65-70.

Classify the Potential Risk Events

The business questions proposed in Tables 2-7 can help management identify general and context-specific risks associated with the decision to enter into an outsourcing arrangement. Not all the risks identified through this process, however, should be given equal consideration. The likelihood of a risk event occurring and the potential impact such an event could have on the company should also be considered. The risk matrix presented in Figure 1 is a tool that management should use when evaluating various risk events. Management uses its judgment to place each potential risk event into the categories listed along each axis. Events in the upper right of the matrix are of greatest concern, and those in the lower left require little, if any, management attention.

The potential rewards of outsourcing can be classified into four main categories: cost savings, financial flexibility, technological improvement, and strategic enhancement. The decision framework presented in this article attempts to guide management in its outsourcing decisions as the company shifts its approach to outsourcing from that of a "quick fix" to more of a long-term strategic solution. The framework presents a series of questions grouped together by the information they seek to gather—why, what, who, how (much), where, and when—and their accompanying ERM risk category. Although this framework is not comprehensive, it provides a reasonable starting point for the major issues that companies need to consider when deciding whether or how to outsource. Answering these questions will enable the outsourcing company to better identify the risks in its outsourcing relationships, which helps identify potential costs both now and in the future. ■

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1 "The Outsourcing Advantage," *Logistics Management*, October 1996, p. W4; and Amega Group, "Strategic Outsourcing: Analyzing the Cost Benefits," 2003, retrieved September 16, 2003, from http://www.amegagroup.com/reference/strategic outsourcing.html.