IT-supported business process outsourcing (BPO): The good, the bad and the ugly

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IT-supported business process outsourcing (BPO):
The good, the bad and the ugly

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Abstract

Outsourcing decisions are not, technically, irreversible. But in practical terms the organizational
disruption and financial costs of bringing services back in house (“backsourcing”) mean that
few organizations revert, even when quite dissatisfied with an arrangement. Instead,
organizations typically seek to move to another outsourcing arrangement, that is sometimes less
attractive than the original in-house delivery. Preliminary evidence from studies of business
process outsourcing (BPO) experiences, like those into IT outsourcing’s success, suggests that
only a minority of organizations report their BPO arrangements as satisfactory, implying that
many are caught in this “can’t go back” bind. In this paper the authors examine two
organizations contemplating the adoption of BPO, and consider their expectations and
experiences in light of existing empirical literature. The paper concludes with a set of principles
to assist organizations to avoid BPO failure.

Keywords: business process outsourcing, BPO, IT outsourcing, requirements, outsourcing costs

1. Introduction

An investigation of the common sources of advice on outsourcing (like the Outsourcing Institute)
reveals that IT outsourcing is being overshadowed by an increasing interest in Business Process
Outsourcing (BPO), the fastest-growing segment of the outsourcing market. Recent projections
by Datamonitor predict that over the period 2002 – 2005, BPO will experience a compound
annual growth rate of 10.5%, compared to 7.5% and 7.8% for IT infrastructure outsourcing and
IT application outsourcing respectively. (Datamonitor 2004)

Just exactly what “BPO” describes is subject to question: some could argue that all outsourcing
is “business process” outsourcing, while many of the examples used (HR, accounts payable,
procurement) are really business functions. One definition given by a case study informant (see
below) is “Handing over control of the delivery of an IT-supported process to another entity”
This is similar to that given by Dataquest: “The delegation of an IT-intensive business process to
an external provider who owns, administers and manages it, according to a defined set of
metrics” (Gartner 2004). In both definitions the key elements are that the process is supported by
IT, and that the control and management of the process is handed over to another entity. A recent
Gartner “BPO model” (summarised in Table 1 below) sheds further light on what the BPO
phenomenon embraces.
Table 1: Examples of BPO, by business function (after Gartner 2002)

Table 1, together with these definitions, suggest that BPO is a rather general and poorly defined concept, as there would be few business functions that would not be captured in these broad definitions. In our discussions with organizations promoting BPO the authors observed that it is frequently contrasted with “IT outsourcing” – BPO is seen as outsourcing that involves IT supported processes, but that doesn’t involve discontinuities between the IT and the rest of the business process. The redrawing of boundaries should lead to less “tightly coupled” outsourcing and so fewer problems (Orton & Weick 1990). We were also told that while IT outsourcing is now recognized to have substantial problems, by outsourcing the whole business process instead of just IT, BPO should produce easier to manage, and more successful outsourcing. Implicit in informants’ descriptions, and examples given, is that BPO involves relatively complex processes, in contrast to the outsourcing of, say, cleaning or catering.

Figure 1, below illustrates the relationships between forms of outsourcing that are often confused. An important implication of this figure is that it differentiates between BPO; offshore outsourcing (essentially a subset of BPO); and the outsourcing of simple processes that involve no IT support. It is noteworthy that the bulk of empirical research into the cost savings from outsourcing comes from outsourcing of this latter kind.

Previous Research on BPO
Despite the growth of BPO, an examination of the literature reveals a virtual absence of academic publications on the topic. Instead, much of the literature on BPO is authored by outsourcing vendors (IBM/Price Waterhouse, Accenture, Deloittes, Fujitsu and a range of vendors of off-shore outsourced services). By way of illustration, a search of Proquest (2004) covering the period 1980 to 2004 revealed that of the 636 articles with “business process outsourcing” included in the title or abstract, only four were in journals classified by Proquest as scholarly or peer reviewed. None of these reported empirical research on the phenomenon. Lindner (2004) makes brief reference to conducting interviews while at Accenture (a BPO vendor), but provides no details of the research design or sample; Adler (2003) and Hormozi et al (2003) refer to no research at all. and while Quinn (1999) makes vague reference to consultant-based studies, his too, is essentially an opinion-piece rather than empirical research.
Figure 1: Relationship between different types of outsourcing

A search of other business databases (eg Business Source Academic and Business Source Premier) also failed to elicit additional scholarly or empirical research on business process outsourcing.

The absence of independent research means that decision-makers choosing whether to outsource a business process have to proceed on faith. It also means that, in terms of Gartner’s “Speed of Hype” model (Gartner 1999); BPO is in the early, “hype” phase. To compound the uncertainty, the bulk of information currently available on the likely success of the strategy comes largely from outsourcing vendors (clearly not disinterested parties) and from outsourcing advisory services (like those of Shaw Pitman, the Meta Group, or the Gartner Group). While these advisors are not direct vendors of outsourcing services, they gain considerable income from advising on outsourcing practices. Such advisors would lose substantial potential fees if they argued that BPO should be avoided, so their advice, too, is not necessarily disinterested.

The problem for a decision maker investigating whether to implement BPO is that outsourcing (of IT, or of other business processes) when services were previously performed in-house exhibits a systemic property known as “hysteresis”. The path out of the outsourced state is far slower, and more expensive, than the path into the outsourced state. This is because having divested itself of the skills and expertise that were required to provide the services in-house, the outsourcing purchaser cannot immediately get those skills/expertise back even if it decides to reverse its decision only a few months into the arrangement. In addition, the costs of rebuilding the outsourced function, or of seeking external expertise (say from consultants) will be substantially higher than the ongoing costs of providing that function in-house, had the organization not chosen to outsource. Consequently, while outsourcing decisions are not,
technically, irreversible, the costs in terms of organizational disruption, and financial costs, of bringing services back in house (“backsourcing”) mean that few organizations adopt a backsourcing strategy, even when quite dissatisfied with an outsourcing arrangement (Rouse 2002). Instead, organizations typically seek to move to another, hopefully more satisfactory, outsourcing arrangement, even where that might be far less attractive than the original in-house delivery. The evidence from research into IT outsourcing’s success (Rouse & Corbitt 2003) is that only a minority of organizations report their arrangements as satisfactory, implying that many are caught in this “can’t go back” bind.

A recent McKinsey article (Bloch & Spang 2003) argues that like IT outsourcing, BPO too is quite risky, with around two thirds of organizations failing to get some or all expected benefits, and 30% forced to terminate the arrangement. However the basis for this claim is unclear. McKinsey is more cautious than many other consulting groups, although some consulting houses’ additional role as BPO vendors may colour their view of the strategy. Certainly BPO is being “talked up” generously by interested parties, who tend to downplay the associated risks. Furthermore, having chosen an essentially non-reversible strategy, few organizations are likely to be willing to admit to a poor choice. Despite these caveats, there are trade reports of cost savings of over 20% being obtained (40-50% for offshore BPO) suggesting that in the right circumstances, BPO is a very attractive proposition.

This paper considers two recent cases of organizations that contemplated BPO. Necessarily, there is no information yet on the outcomes of their decision. Instead this paper contrasts their expectations with what has been established in the existing literature on the success of IT outsourcing. It then synthesizes these two sources of data to suggest some key lessons that can be applied when contemplating BPO.

2. Method

The method adopted in this paper is a review of the existing literature on BPO and IT outsourcing, in the context of two contemporary Australian case studies. According to Gartner, Thailand, Australia and New Zealand have the highest rate of adoption of BPO in the Asia Pacific region (Gartner 2004).

These two case studies were undertaken as part of a larger study into outsourcing practices, in which 24 organizations were investigated. The majority of sites were involved in traditional IT outsourcing (of either IT infrastructure, or IT systems development). These two cases, however, were contemplating or just beginning a BPO arrangement. Details of the two BPO-related cases are included in the following table.

Comet is the pseudonym for the largest business division in an Australian organization that carries out environmental investigations for commercial and government organizations. During 2003 Comet conducted a review of the services that might be outsourced within the division, concluding that neither its core business (analysis and reporting) nor the apparently “commodity” process of environmental data gathering should be outsourced, although certain accounting services might be in the future. YourBank is the pseudonym for a medium-sized Australian banking and finance organization that considered the outsourcing of several of its back office accounting function. In 2003, YourBank chose to outsource these functions, expecting to receive savings in excess of 20%.
<table>
<thead>
<tr>
<th>Pseudonym*</th>
<th>Status</th>
<th>Size</th>
<th>Industry</th>
<th>Process</th>
<th>Informants</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Comet”</td>
<td>Investigated and rejected BPO</td>
<td>$AU200 million</td>
<td>Environmental research</td>
<td>Field data gathering</td>
<td>BPO project manager, BPO consultant</td>
</tr>
<tr>
<td>“YourBank”</td>
<td>Investigated and introduced BPO</td>
<td>$AU10 billion in assets managed</td>
<td>Banking</td>
<td>Back office processing</td>
<td>BPO project manager</td>
</tr>
</tbody>
</table>

*As part of gaining University Ethics Committee approval for the study, informants were promised anonymity

Table 2: Case Study Details

Interviews with informants were semi-structured, and asked about the organization’s understanding of what BPO was, their plans for outsourcing, the reasons for choosing or not choosing to outsource a business process, and the difficulties they had encountered so far in arriving at a decision and initiating outsourcing. Informants were also asked about their major concerns in relation to BPO, and their major sources of advice on the likely success of their BPO arrangement.

3. Case Study Findings

Motivations

In both cases the move to BPO was driven largely by a push to cut operational costs. However, in each case the informant pointed to competitors who were themselves outsourcing the business process, or contemplating this, suggesting that the outsourcing “bandwagon” effect that Lacity and Hirschheim (1993) identified is still very much in operation.

In the case of Comet, the drive to cut costs was augmented by a directive from the parent organization that Comet market test the outsourcing of various labour-intensive services. The motivation behind YourBank was clearly financial, influenced by the fact that the company had recently decided to adopt an aggressive role in their business sector, and was seeking opportunities for cost cutting in their non-core business. YourBank also expected that by outsourcing, they would be able to concentrate on other, more core, business activities.

Evaluations

In both sites the decision to outsource (or not) a particular business process was made after over 6 months’ investigations. In the case of Comet the organization had made the decision not to outsource its scientific data gathering, but to consider future outsourcing of more generic services (such as accounts receivable). In the case of YourBank, the decision had been to outsource to the best bidder – an IT outsourcing vendor that had recently moved into the provision of back office financial services.

The processes behind the decisions were revealing. YourBank was expecting savings of 20 to 30% based on their comparison of the costs of in-house delivery and the winner’s bid. Since their arrangement had only just begun, it was not clear whether they would actually reap the promised savings. On the advice of consultants, their detailed costing model did not include the
activities associated with market testing, bidder evaluation, or transition. These “transaction
costs” are traditionally excluded by outsourcing consultants, on the basis that good performers
should always be benchmarking internal performance against competition, and that the costs of
going to the market are once off. However this argument ignores the fact that such costs are
incurred repeatedly, particularly when contracts are kept short. These costs are magnified when -
as happens in over half of BPO contracts, according to Bloch and Spang (2003) - the contract has
to be renegotiated before its completion. Furthermore the costs of bid evaluation and true market
testing are substantially higher than the costs of periodic benchmarking.

Comet’s decision not to outsource its data gathering function, was not on the basis that it would
not save money initially, but on the basis that it was likely to be faced with a monopoly situation
(given there were less than 5 potential bidders worldwide, some of whom might exit the
marketplace if they did not win the Comet account). Comet management reasoned that in such a
situation initial cost savings could quickly be eradicated when the first contract terminated,
leaving them with no recourse but to pay whatever the vendor demanded. However, Comet was
not against BPO in principle, and identified several areas where BPO should be explored in
future – largely those that were generic in nature, and where there was a growing vendor market
(eg some HR and accounts receivable processes).

Comet management were also concerned about maintaining quality control. While the field
data collection appeared to be relatively low in skill (and had often been, in the past, carried out
by volunteers) it was critical to the quality of the analytical models that Comet prepared.
Decision makers believed that an outsourced commercial provider would not necessarily be able
to command the loyalty that Comet had been able to garner from volunteer data collectors, who
saw the data gathering as a community activity, in most cases being users of Comet’s output
down the track. Management were also concerned that their requirements were idiosyncratic
(in economic terms, “asset specific”), and relied on substantial tacit knowledge. A temporary
failure on the part of an external vendor, or even minor errors, might corrupt longitudinal data
sets, permanently reducing their value.

YourBank had four final bidders to its request for tender, though it is revealing that it chose a
vendor that had no previous experience in providing back end banking functions – the vendor did
have, though, experience in providing IT infrastructure and development services. While not one
of the first tier outsourcing vendors (i.e. IBM, EDS, CSC), the vendor had an international
presence and a number of references sites in the banking industry that could be investigated in
relation to its provision of IT services. Nevertheless, the fact that the vendor had not delivered
banking-related financial services before introduced a substantial element of risk.

Sources of advice
YourBank reported that the major sources of advice on their likely success with BPO included
trade journals (in the banking field), ‘Big 5’ management consultants, and the vendors
themselves. Comet reported that the major impetus for outsourcing was their parent company,
and the management literature that senior management had been exposed to. This encouraged
market testing of all key processes for their outsourcing potential. Comet had engaged an
independent outsourcing advisor for a period of 6 months to help them make the decision
whether to outsource a range of business processes. He was employed by a boutique consulting
company that did not have an outsourcing advisory service. Comet were also influenced by
several peer organizations that had undertaken investigations of the potential for outsourcing and had arrived at the conclusion that it was difficult in high-technology scientific research organizations.

Concerns
The major concerns informants reported were in the following areas:

- Small marketplace of potential bidders – and problems finding vendors with a track record in the business process to be outsourced (Comet)
- The need to accept a standardized version of the business process, that did not necessarily match the purchasing organization’s needs (Comet, YourBank)
- Lack of leverage with the BPO vendor (Comet, YourBank)
- Concerns about what would happen at the end of the first contract, and the danger of “lock in” (Comet)
- Concerns that the contract is a poor mechanism for controlling the quality of the business process delivery, and that despite having outsourced the service, the level of managerial attention that needed to be devoted to dealing with the vendor might be high (Comet)
- Concerns that the costs of overseeing the arrangement, combined with the transaction costs (measuring internal costs, developing the bid, seeking vendors, choosing vendors, changeover) would eat into the potential savings (Comet)
- Inability to find a vendor with substantial experience in the services outsourced operating in the local marketplace (YourBank, Comet).

4. Discussion
A limitation of all case study research is that the cases may or may not be representative of organizations generally (Yin 1994). Consequently this paper does not attempt to suggest that these organizations are necessarily typical. Instead, this discussion will concentrate on the evidence provided by the literature to date on outsourcing (most of which comes from the IT outsourcing domain), and the implications this has for Comet and YourBank.

Motivation
The evidence from a large body of literature is that a major motivation for outsourcing is to reduce operational costs, so in this regard both organizations are quite typical. However, the evidence for actual savings from outsourcing is at odds with the rosy pictures painted by vendors and academics. According to a detailed meta-analysis conducted by Hodge (1996) average savings for outsourcing of low-complexity services (e.g., cleaning, catering) is in the realm of 8 to 12% (excluding the management costs and initial costs of market testing and establishing the contract). Savings for high complexity services were substantially lower. Domberger (1998) determined that while savings for low-complexity services were often 20% or more, those for high complexity services (particularly IT-related) were negative, i.e., costs rose after outsourcing. Like Hodge, Domberger did not include management costs or initial contracting costs in his analysis. Rouse and Corbitt (2003) reported that savings for IT outsourcing were infrequent - only 7% reported achieving “substantial” savings when outsourcing IT, while only 42% reported any savings at all. Over a fifth of their respondents (n = 240) reported that costs increased. The
latter authors’ qualitative studies suggested that the low savings from IT outsourcing were due to high management costs, and high costs associated with changes needed to maintain business flexibility. Rouse and Corbitt also reported that the costs of setting up the outsourcing arrangement and choosing the vendor (transaction costs) were substantial when compared to the relatively small cost savings. Thus while it is possible that YourBank could achieve savings of 20%, it is unlikely, unless its own processes were very inefficient to start with.

It was not clear from the information provided by our case study informants whether YourBank’s vendor intended using offshore labour. Savings of 20% or more are frequently only possible if the vendor uses this strategy, in which case “salary arbitrage” is the major source of reduced costs. Offshore outsourcing introduces a range of new challenges, which need to be planned for if the BPO business case depends on this source of labour. As with BPO, evidence about the extent of savings achieved from off-shore outsourcing is still only anecdotal as no systematic studies have yet been done.

**Evaluation**

In an important article, Ang and Straub (1998) established that decision makers who adopted outsourcing in the US Banking industry tended to downplay the substantial transaction costs involved, instead concentrating on the production costs they would save from outsourcing. Those who considered, but rejected outsourcing, tended instead to focus on the transaction costs involved. This may be related to the common cognitive bias (the “confirmation” bias), where decision makers are frequently observed to pay attention only to information that tends to confirm an existing world view. Certainly our two case studies exhibited the phenomenon.

YourBank based their decision to outsource back office accounting functions largely upon their comparison of the difference between their projected in-house production costs and those of the winning vendor. Yet research conducted by Rouse (2002) and Rouse and Corbitt (2002) indicates that such a comparison is often erroneous because the projected savings are frequently eaten up by unforeseen changes, as well as the transaction costs associated with finding, selecting and briefing vendors, and managing the contract on a day to day basis. Rouse and Corbitt also identified that the organizational attention that was associated with changing vendors was so high that many organizations were choosing at the end of the first contract to remain with their current vendor without market testing, in which case their production costs were likely to be higher than the market rates (and previous in-house production costs).

YourBank’s decision-makers were also strongly influenced by the banking-related trade literature, which suggested that a number of banks (particularly North American banks) were reaping substantial financial benefits from the strategy. Yet the evidence for such savings tends to be anecdotal, and does not separate out the savings attributable to the use of off-shore labour, rather than outsourcing. The fact that YourBank chose to outsource to a vendor with no track record in the processes involved suggests a thin vendor marketplace, a situation that transaction economists warn may lead to opportunistic price rises in the future when few or no bidders bid against the incumbent vendor for future contracts. There is also the possibility that the vendor was bidding low in order to enter that service market, a situation that would change once the vendor established itself with a number of clients.
Comet, on the other hand, was particularly focussed on the transaction costs they would expend in ensuring the service quality from outsourced data collection. They were also concerned about the danger of “lock in”. Unlike the banking industry, the number of potential purchasers in their scientific field worldwide is relatively small (less than 300 corporations) and there are currently only a handful of vendors worldwide engaged in supporting the industry, none in Australia. Without a robust vendor marketplace, decision-makers at Comet felt there was no guarantee that there would be alternative bidders in future. In addition, there was the perceived danger that specialist staff who moved from Comet to the outsourcing vendor would leave the industry completely, resulting in a major loss of intellectual capital not just for Comet, but for that industry in Australia. In fact, Comet is a classic example of a situation that transaction economists suggest does not encourage outsourcing: it had relatively unique quality assurance requirements, a small number of potential vendors, and a process that involved substantial tacit scientific knowledge.

**Other Issues and Concerns**

The banking industry in North America is characterised by a large number of relatively small banks (often much smaller than YourBank) operating at a local state level, resulting in a sizeable body of potential purchasers with relatively homogenous needs. However, this is not the situation in Australia, where a small number of comparatively large banks tend to operate nationally. This may explain the thin vendor marketplace in back-end banking services. In the North American marketplace, many of the savings associated with BPO are obtained because the vendor can provide a range of standard (“plain vanilla”) services to a large number of clients, and so amortize costs, leading to lower fees and a cost-saving for the purchaser. Vendors are also less dependent on each individual client. However, the trade off is that purchasers must accept these vanilla services.

YourBank staff were somewhat concerned that as their chosen vendor gained additional clients, they would have less sway in being able to demand business processes that matched their unique needs. However, they believed that their “first mover” role with the vendor would help avoid this situation. Research reported by Rouse (2002) suggests that this is not necessarily the case. As the vendor picks up additional clients (necessary for the vendor’s profitability and viability) the earlier customers lose leverage over the vendor. Theoretically the purchaser would be compensated by lower prices because of the economies of scale the vendor would get in a more robust marketplace, but this did not always occur in cases those authors studied, because the initial bids made by vendors seeking a toehold in the marketplace were deliberately unprofitable, and prices rose substantially at the end of initial contracts. In robust marketplaces, with a large number of purchasers with common (vanilla) requirements, this situation doesn’t occur, however few BPO arrangements are yet of this kind.

The evidence of widespread problems with enterprise resource planning (ERP) systems illustrates that many organizations over-estimate their capacity to rely on standard, vanilla (often marketed as “best practice”) processes (O’Leary 2002). This evidence was cited by the informants from Comet as justification for their concerns about BPO. A similar phenomenon is certainly likely to be at work with BPO. It is often only when a process is outsourced that purchasers realize that what they had thought was inherently-understood in their requirements statement means something different to their vendor, leading to expensive changes to make the process match the organization’s needs, as well as considerable tension between the
organizations (Lacity & Hirschheim 1993). In certain circumstances the costs to the purchaser of “bending” the outsourced business process are so high that the organization is advised to adapt its other business processes to fit in with the outsourced business process, itself an expensive endeavour. While the cost savings associated with the outsourcing may warrant organizational change of this type, the literature on IT outsourcing to date suggests that only a minority of purchasers recognize, and learn to adapt to, the trade offs they need to make to get high levels of cost savings.

5. Conclusions and recommendations for decision-makers

Although the analysis of Comet and YourBank’s thinking has been brief, their experiences to date, considered in the light of the other research into the experiences of those who choose to outsource, suggest several lessons for decision-makers. These include:

- **Outsourcing works best when you have a requirement that is common to many purchasers**

  When BPO leads to substantial cost savings, it tends to be because the vendor can obtain significant economies of scale, or scope, and so provide a lower-cost service despite the need to factor in a profit margin. Such economies tend to occur when there is a large body of purchasers with common needs. In this environment the risk to purchasers is reduced because the large number of purchasers attracts vendors and leads to a robust marketplace. Hence if the original BPO arrangement proves unsatisfactory, the purchaser can move onto another vendor. Neither YourBank nor Comet were in this situation, although only time will tell if a vendor marketplace grows for the services contracted by YourBank.

  Comet’s determination that it would require a highly customized service, and that the vendor marketplace would be thin, while cautious, seem appropriate, as these situations provide the conditions for opportunistic behaviour. Protecting against opportunism would be costly both for Comet and for its vendor (which would be highly dependent on Comet’s custom), so the likelihood of substantial cost savings are low. Furthermore, without a robust marketplace, Comet would be highly susceptible to a “lock in” situation. Many of the services being offered by BPO vendors are common, well-established processes (like payroll and accounts payable) that fit the “vanilla” description, and hence relatively low-risk. However, many BPO vendors are promoting newer services where they have no strong track record, hoping to “make a market”. These latter forms of BPO are substantially more risky.

- **Recognize what you are trading off**

  The experiences of IT outsourcing are that many vendors over-promise, a situation that does not come to light until the contract has begun, and the option of turning back is no longer there (Kern et al 2002). A common problem is that purchasers find that services they thought were included in their contract are not, frequently because the terms used in the contract are general and open to interpretation (Lacity & Hirschheim 1993). The experience of over a decade of research into IT outsourcing is that despite labels like “partnering” and “alliance” outsourcing is a fee for service arrangement, with substantial risks for the purchaser (Hirschheim & Lacity 2000). Understanding exactly what is being purchased and what is being given up in order to get cost savings (the trade offs) is critical to successful outsourcing.
Vendors do not willingly provide “for free” services that are not specified in the contract, so expectations of “added value” as part of an ongoing relationship are unlikely to be met without additional costs (Rouse 2002). In many cases what is being traded off includes ad hoc advice, a customized service, or short-term flexibility. Where the purchaser can do without these aspects, or is prepared to pay a premium price for them, BPO is likely to be successful (Rouse 2002). Another area where BPO is likely to be successful is where the purchaser is seeking fast access to a particular service. While such outsourced arrangements are often more expensive in the longer term, the purchaser is able to gain access to the services when it needs them and benefits from immediate access to excess capacity, or a faster scale-up period (because the vendor has more expertise at introducing the service than the purchaser). In recognizing and accepting this cost vs. speed trade off, many organizations find their outsourcing meets expectations. Others, though, who expect to get both speed and cost savings are frequently disappointed.

Understand the source of apparent cost savings provided by the vendor

In view of the failure of over a decade’s research to substantiate high levels of cost savings for outsourcing of all but very simple services (catering, cleaning, etc), a healthy scepticism is required on the part of purchasers in relation to proposed savings. If a vendor offers substantial savings for an IT-supported business process, it is important to investigate what the sources of these savings are. In many cases the source is the willingness of the purchaser to trade off idiosyncratic requirements by accepting a “vanilla service” where the vendor can reap economies of scale or scope (discussed above). In other cases the source of savings is salary arbitrage, and while offshore outsourcing can suit many organizations, it does introduce a range of new problems, and may not, in the long-term be sustainable. Other potential sources of savings are a vendor’s capacity to invest in productivity enhancements (such as remote support of computer systems) and ongoing process improvements. Many of these benefits can also be replicated in-house, and one choice the purchaser might make is to follow Lacity and Hirschheim’s (1995) advice to implement these cost cutting measures before, or even instead of, outsourcing. Alternatively, the purchaser should contract to ensure the sources of savings do exist. For example, if the vendor claims technology investments as the source of cost savings, purchasers should contract for, and verify, that these investments are actually made, as some vendors prefer to eke out old technologies that have been written off. This strategy can be highly profitable to a vendor but leads to a noticeable reduction in service quality.

Analysing the source of savings also allows the purchaser to better plan for (and contract for) contingencies, such as changes in foreign exchange rates (for offshore outsourcing); changes in technologies supporting the business process, or legislative changes (that might call for higher levels of customization from the vendor).

Factor in all the costs in your outsourcing business cases

It may seem superfluous to suggest that organizations pay attention to their financial analyses when outsourcing, but the evidence from a range of sources is that this is still poorly handled. Both Comet and YourBank spent substantial time and effort on their financial business case, however it appears that some important transaction costs for YourBank were left out of their
analysis. Because of the hysteresis effect discussed above, the costs to revert outsourcing arrangement are much higher than the original in-house service delivery – yet the existing evidence suggests that having to revert occurs quite frequently with BPO (Bloch & Spang 2003), and a contingency budget should be factored into the business case.

The ongoing transaction costs for seeking out, negotiating with, and if necessary changing a vendor may occur every three to five years (depending on the length of the contract), and should also be factored into the business case. If the organization chooses to avoid these costs by staying with an existing vendor, without competition it is likely that the vendor’s costs will rise substantially viz a viz market prices. Either way, substantial costs are involved.

Other important costs are those to manage the BPO arrangement. The evidence from IT outsourcing research is that for complex services these can be between 5 and 8% of the contract price (Lacity & Willcocks 2001). If the BPO case includes a much lower management allowance, decision makers should ask why their BPO arrangement is likely to be so inexpensive to manage. As part of the cost of management, purchasers may need to include contingencies for obtaining strategic advice related to the business process from an entity other than the vendor (who cannot give independent advice).

The business case depends on the purchaser documenting the full range of services that are provided by its internal group, so that the vendor can offer an alternative price. Our studies of 24 cases revealed this to be a major problem, as many important tasks are often missed through the use of general terms and labels. Unless the purchaser knows (before it loses the services) exactly what it is getting, the price the vendor quotes is probably misleading, as it may be the price for a different set of services. Establishing what is actually delivered internally can take many months, and is costly (another transaction cost often missed) which is why many of the cases we have seen attempt to shortcut the process, despite its criticality to successful outsourcing.

In summary, the best evidence we currently have on outsourcing success comes from the large body of research into IT outsourcing. This suggests that in certain circumstances (about one third of the time) outsourcing is quite satisfactory and provides good value to purchasers (Rouse & Corbitt 2003). However in many cases outsourcing fails to meet (perhaps unrealistic) expectations. At the time IT outsourcing was first advocated, promises of 30% savings and widespread benefits were similar to those being made now for BPO, but the contemporary evidence is that many promises were unattainable. This suggests that decision makers considering BPO should plan carefully and move cautiously. Outsourcing of services beyond simple activities is still high risk, and using the definition at the start of this paper, much BPO would fit this description. BPO should be given the attention that is paid to any other risky strategies.
6. References


