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Today's Solution and Tomorrow's Problem: The Business Process Outsourcing Risk Management Puzzle

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Yuwei Shi

Recent years have seen a rapid rise in the number of IT outsourcing deals going beyond infrastructure and functional applications. The vendors in those deals take primary responsibility for their client's IT-enabled business processes. Despite this business process outsourcing (BPO) big bang, clients and vendors alike are struggling to grasp the impact of their broadened and deepened relationship, and of the extended transfer of organizational assets between them. The business literature has not stressed the risks of IT outsourcing beyond the operation of a typical outsourcing project and outsourcing's short-term performance impact on the client firm. Nor has it reflected on outsourcing risk management beyond formal contract or interpersonal relationship building.[1] The limited views of the business literature on BPO outsourcing risks are not surprising because over 90% of the outsourcing projects still handle IT infrastructure or business processes for what most companies regard as non-core activities, such as payroll, transaction processing, and billing.

This article provides a more comprehensive overview of the different types of risks that a BPO client is faced with. They include the often-cited pitfalls in managing an outsourcing project, and the damaging impact of a mismanaged project on the client companies in areas such as customer services, overall operations costs, information security, business continuity, and other short-term market performance metrics. In addition, the BPO risks include the less-discussed, potential detriments to the clients' organization and its long-term market viability. Although academics have long warned about those more strategic risks, why outsourcing managers, particularly those from the client companies, pay less attention to them or are less active in managing them is not well understood.

BPO risk management is like a puzzle similar to the difficult challenge of balancing between the short-term and long-term performance goals of a firm. That puzzle is that the mechanism for reducing BPO project and short-term market performance risks is probably the same mechanism by which the strategic risks are developed.

Outsourcing Project Failure and Its Causes

There are several clear signs of a failed outsourcing project. The most cited one is project cost overrun—or worse, an outsourcing project that results in an increase in overall operations costs for the client. It is the most visible outsourcing risk because cost cutting remains one of the most common reasons for IT outsourcing. Other common signs of an outsourcing disaster include: clients' poor service delivery, increasing customer complaints, and, in extreme circumstances, business shutdown (due to an information security breach or to the vendors' system or organizational failure). Any of these is directly harmful to an outsourcing client's short-term market performance as measured by sales, costs, strength of customer relationships, or market reputation.

These short-term market performance risks signal the imminent failure of an outsourcing project. The popular business literature, therefore, has focused mostly on identifying the causes of outsourcing project failure, calling them "outsourcing risks."[2] One major cause of outsourcing cost overruns is the client's naïve expectations on cost reduction, which is called a cost savings mirage. Many executives assume that labor arbitrage will yield savings comparable to a worker-to-worker substitution, without regard to the hidden costs and the differences in operating models. Outsourced workers absorbed elsewhere inside the client firm dissipate the expected savings. Extra project management resources earmarked for overseeing the outsourced work add to the total cost. Since vendors usually require a standardized and repeatable model, the client's lack of process model maturity[3] creates a potential gap that additional resources are required to bridge, which further undermines the expected cost savings.

Outsourcing vendors may also be responsible for project failure and the resulting short-term market performance shortfalls for the clients. A vendor's competence in technology, business function, business process, project management, and client management bears direct impact on the success or failure of an outsourcing project. Heavy turnover of key personnel across high-profile outsourcing projects—within the same outsourcing firm or across competing firms—breaks the outsourcing project continuity, ultimately resulting in additional costs to the clients. This is even more prevalent in volatile labor markets such as India and China. In addition, a vendor's slacking security practices can increase the risk of an information security breach to the clients.

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The vendor-client relationship is another risk factor. All outsourcing contracts contain project performance benchmarks and a number of assumptions on which those benchmarks are set. However, the actual work may vary from those benchmarks and the actual conditions may not be in line with the assumptions. Thus, outsourcing contracts often fail to specify in precise detail what the vendor is accountable for. Work scope and price creep are more the norm rather than the exception. Language or cultural differences between the client and the vendor may make the matter even worse, and the extra effort required to overcome these barriers only adds to the overall costs.[4] Moreover, vendors often need extra effort to understand their client's business processes, especially when these processes are idiosyncratic, complex, and convoluted. Otherwise, the outsourced processes would be loaded with errors, or at least inefficiencies. What exacerbates the situation is that the errors in business processes are often dormant in the information flows, which become active only if a certain set of decisions are made based on the information that contains these errors. Extra effort in calibrating the vendor's and client's processes is needed to reduce the number of dormant errors and, thus, the risk of performance failure. Another problem is that the client and vendor, while making asynchronous technological changes by themselves, may discover only too late that the vendor's pace of technology change is either too slow or too fast to meet the client's real needs, resulting in higher costs or lower quality in the delivery of the outsourced services. When that happens, it is not entirely the vendor's fault, since clients often do not recognize incompatible technologies, because of their own lack of understanding of the target business model.[5]

Table 1 lists the causes of outsourcing project failure in three categories, according to whether the responsibility is likely to belong to the client companies, the vendor companies, or both client and vendor companies jointly. These causes are the outsourcing project risks, which often lead to clients' short-term market performance shortfalls. However, short-term performance problems are not the only risks a BPO client may experience. Outsourcing can bring about changes in a client's organization. These changes can become potential hazards and lead to undesirable market performance and organizational outcomes to outsourcing clients. Outsourcing risks are beyond mere project risks and their resultant impact on

TABLE 1. The Causes of Outsourcing Project Failure

Client-Side Problems
• Cost-Saving Mirage
• Lack of Process Model Maturity
• Lack of Understanding or Consensus of Target Business Model
Vendor-Side Problems
• Competence Gap
• Heavy Turnover of Key Personnel
• Weak Security Practices or Requirements
Client-Vendor Relationship Problems
• Lack of Precise and Detailed Project Specification
• Language and Culture Misalignment
• Knowledge Transfer Difficulties
• Process Calibration Difficulties
• Incompatible Pace of Technology Change
• Incompatible Architectural Style
• Loss of Continuity Due to Employee Shuffles

clients' short-term market performance. Unfortunately, the popular business literature has little to no coverage on many of the outsourcing's organizational risks and long-term performance impacts.[6]

The Different Risks to BPO Clients

Firms undergoing outsourcing have to make changes to tasks, structures, processes, and systems that involve people across different management levels and organizational entities. In the short run, these changes can cause disorganization of work, disorientation of employees, and clashes within the IT and management systems. The client firms may lose loyal and capable employees and suffer from low employee morale and productivity due to outsourcing-induced layoffs or changes in work scope, position, and compensation package.[7] Outsourcing may also cause a leak of confidential information, spillover, and loss of IT or business expertise in the shuffle of the client's employees and vendor's rotating staff.[8] These can also result in the performance shortfalls.

Some of outsourcing's adverse effects may appear over time. Outsourcing can create operational dependency, in which the vendor's failure to perform disrupts the client's business. A change of the service terms may weaken client's competitive position in the marketplace. Gradually lost with the outsourced business functions and processes are business knowledge, organizational capabilities, and other strategic firm assets. The lock-in risks may occur, especially at the process level, when the employees of a client firm are gradually accustomed to the various interfaces between their work and the IT systems outsourced to the vendor. Changing the systems can entail costly changes in user behavior in both financial and psychological terms.

Business process outsourcing may involuntarily signal competitors, suppliers, and customers about a firm's irreversible change of commitments, assumptions, and strategies that can potentially erode its long-term competitive advantage.[9] Client firms also have to be mindful of adopting a vendor's architectural style, which may prove disadvantageous in the long run.[10] IT architectural style refers to the principles that shape and define the IT systems and structures supporting a class of IT-enabled business processes. Incompatible architectural style can cause the loss of organizational competence embedded in a business process. For example, an airline's reservation process has a distinctive high-volume, high-availability architectural style, which differs considerably from that of systems and structures supporting an R&D organization's collaborative work. Adopting the airline's architectural style to manage the R&D organization's business process can unnecessarily increase information exchange and availability, but lessen the overall effectiveness of collaborative research and development. In addition, the client's lock-in to standardized IT-enabled business processes may compromise its ability to innovate or its ability to change strategies to meet the challenges of a dynamic environment.

It is not difficult to see that these organizational changes can cause the outsourcing clients' long-term market performance to suffer. A client firm may

TABLE 2. The Client Risks of Business Process Outsourcing

	Market Performance Risks	Organizational Risks
Short-Term	• Higher Costs of Operations • Lower Quality of Services • Increase in Customer Complaints • Operation Shut-Down	• Loss of IT or Business Knowledge • Loss of Loyal and Capable Employees • Lower Employee Morale and Productivity • Loss of Confidential Information
Long-Term	• Price or Contract Creep • Low Rate of Innovation	• Operational Dependency • Loss of Strategic Assets or Control over Strategic Assets • Process-Level Lock-In • Adoption of Disadvantageous Architectural Style • Wrong Competitive Signaling • Loss of Innovation Capabilities • Loss of Strategic Flexibility

suffer from a vendor's poor performance and an upward-creeping contract price over time. It is more likely that such opportunistic behavior will occur after a vendor takes ownership of a client's IT assets and customer information.[11] The client firm may also run the risk of having fewer innovations after shedding the control over critical IT assets and customer information or after losing IT-enabled innovation capabilities. There is also a risk of strained flow of innovations due to an arm's-length relationship with a vendor, since such a relationship may encourage the vendor's opportunistic behavior and reduce the potential payoff of innovations to the client.

Table 2 classifies the risks, which are the potentially harmful aspects of BPO to a client, by their impact area and time horizon. A client may endure market performance risks resulting from BPO. These risks—such as operational cost increase, more customer complaints, or operational shut down—can become reality during, or soon after, a BPO project. Other risks—such as increasing dependency on, and decreasing price bargaining power over, a BPO vendor, and less innovation that will actually matter to the client's competitiveness in the marketplace—may be dormant for, or built up over, a longer period of time.

BPO can also have deleterious effects on the clients' organizational health. The short-term organizational health problems show symptoms such as the loss of loyal, capable employees (and their knowledge and expertise), diminishing morale and productivity, and a leak of confidential information. Long-term problems occur when a client gradually loses its control (over strategic assets, technology, or innovation infrastructure), its operational independency, its favorable perception (by its customers, suppliers, or competitors), or its flexibility for initiating strategic changes.

Some of these risks exist even when an outsourcing project has gone successfully and its impact on the client's short-term market performance is positive. It is obvious that all these risks should influence the outsourcing firms' decisions. What remains unclear, however, is how the different types of BPO risks are related and how they influence BPO risk management practices.

Vendor's Advantages in Reducing BPO Project Risks

The business literature has focused on minimizing the risks leading to outsourcing project failure and the resultant short-term performance shortfalls. Successfully dealing with those risks has much to do with vendor and client management competencies and their working relationship. The vendor or client competency depends on the individual learning of a client and a vendor, as well as their collective learning. Through learning, the client can adjust cost-saving expectations, standardize process models, and build a better understanding and consensus of the target business model. Through learning, the vendor can bridge the competence gap and improve security practices. Collectively the client and vendor can build common understanding and trust in different language and cultural contexts, which is critical to effective and efficient transfer of process and business knowledge, specification of contract scope, and calibration of the IT systems. However, learning by vendors and clients is not symmetrical. Vendors have a learning advantage over clients.

The Learning Advantage

Economies of Learning Scale and Scope

Although outsourcing clients learn by managing outsourcing projects, few can match the scale and scope of the practice of heavyweight vendors such as IBM, Accenture, and EDS or rapidly rising Indian firms such as Infosys and Wipro. Vendors gain economies of scale and scope in developing technology, products, knowledge, personnel, and customer and supplier relationships through managing multiple projects and serving multiple clients. IT vendors are better positioned to recruit and retain scarce IT technical experts and business process experts who may prefer a more specialized and intensive knowledge environment. Vendors' access to the variety and multitude of projects and clients expands their capacity to develop competencies, since experience-based learning can reduce the costs of investing in the knowledge-intensive business. A recent study of a large sample of detailed project-level data from a leading global

outsourcing firm found that learning from repeated interactions with a given client reduces project execution costs and helps improve project contribution.[12]

Complementary Organizational Design

Vendors also gain a natural momentum in developing competencies, because of the complementarities in organizational design.[13] A vendor's management practices targeted at one outsourcing-related competency tend to strengthen the other competencies. For example, the effort an outsourcing vendor makes in developing its project management methods is likely to enhance the technical competencies of its primary personnel, as well as the client-service competencies. Such complementarities may not exist for outsourcing clients whose core business is often remotely related to IT outsourcing. Vendors can also enjoy the benefit from the interplay between taking control over more projects and building IT competencies, which is often not the case for their clients. Clients can develop their own IT competencies instead of outsourcing. However, they may not be able to enjoy the natural momentum of the complementarities, because optimizing IT competency development and deployment can conflict with optimizing their core business activities. Such conflict rarely happens for the vendors. For example, offering high salaries for IT talent may be seen as unfair by non-IT core employees in a client firm. Such problems would cloud the implementation of in-house IT solutions and reduce the effectiveness of the internal IT organization. Non-IT organizations usually prioritize IT projects and grow IT budgets based on current business needs rather than investing in the development IT competencies themselves,[14] since they are less capable than IT specialists in generating a premium directly from those IT competencies. A recent study showed that vendors gain project management capabilities through deliberate and persistent investments in infrastructure and systems that improve the firms' software development process.[15]

The Modularization and Standardization Advantage

Modularization has brought dynamic cost advantages to manufacturing and financial services.[16] The cost advantages accrue from unbundling resources and pooling capacities. For example, supply chain modularization in the electronics industry has unbundled the design, engineering, and manufacturing resources for many manufacturers, and it has allowed contract manufacturers to pool manufacturing capacities for cost reduction. Capacity pooling also affords flexibility in dealing with volatile capacity demand. Modularization of IT and business functions and processes is also driven by firms' intent to focus on their core competencies and become networked organizations. Firms increase their networkability by standardizing business processes, products and services, communication and data standards, and even organizational structure.[17] All these are driving IT standardization beyond programming protocols and toward business process and organizational modeling and architecture.[18]

Modularization and standardization require that clients decompose one business process from another and separate certain IT functions from business

process management. This, coupled with clients' drive for modularization and standardization, offers opportunities for vendors to unbundle and pool their own resources and capabilities to become even more specialized. Vendors further their learning advantage through specialization.

Modularizing and standardizing business processes often entail such serious financial and organizational commitment that not all clients approach them with ease. An alternative is to develop custom solutions and adopt as few standardized modules as possible. However, custom development and integration not only incur a much higher cost, but also hinder clients' adoption of industry best practices, which vendors are increasingly claiming to have encoded in their standard modules.

The Vendor Advantage and Client Risks

While benefiting clients for reducing their outsourcing project and short-term performance risks, the learning asymmetry and vendors' advantage amassed through the variety and multitude of outsourcing projects may actually increase clients' organizational risks and the ensuing long-term market performance risks.

Competency Gap, Dependency, and Price and Contract Creep

The client-vendor relationship is, ideally, a matter of specifying all the precise details of the contracting parties' responsibilities. In reality, it is either too expensive or altogether impossible to enumerate all the details. Overseeing and enforcing seemingly complete contracts may also incur prohibitive costs. On the other hand, any contract not fully stipulated or enforced provides room for opportunistic behaviors—for a vendor to creep up the price, work amount, or work scope. This moral hazard increases when clients are less effective in contracting with vendors. The competency gap due to asymmetrical learning by a vendor and its client makes the client the more vulnerable contracting party.

A client may entrust more business processes and functions to its vendor, whose learning advantage appeals to the client. On the other hand, the vendor can take advantage of larger economies of scope, for example, by increasing revenue per employee and by spreading overhead costs over more services by cross-selling. Therefore, there is an economic reason for each side of BPO to accept the competency gap, which may nevertheless cause potential price or contract creep.

Price or contract creep is also likely to occur if the clients' business decisions depend asymmetrically on one or a handful of vendors' solutions and services. When vendors have to undergo large-scale custom development, the dependencies are mutual. Such dependencies may require that outsourced activities be carried out with co-location, specialized hardware, custom-code software, custom-built process, dedicated personnel, and specialized training. These requirements may restrain vendors' opportunistic behaviors. However, custom development is often not a deliberate strategic choice but results from

serious complications, such as legacy systems, immature client or vendor processes, fragmented solutions, and the more guarded attitudes toward outsourcing in general.

As the competency gap between vendors and clients widens, it becomes easier to convince the clients to use vendors' cutting-edge computing facilities and adopt their best-in-class (and yet vanilla) solutions, process-modeling tools, and best-practice embedded business process modules. Clients more satisfied with the outsourcing services are likely to delegate more IT decisions to their vendors, which will in turn help widen the competency gap between them. This positive feedback loop amplifies the clients' dependency on their ever-improving vendors. Growing dependency on vendors increases the clients' risk of price and contract creep over time.

It is less of a problem if more than a handful of vendors share a client's one-way dependency. Competition among vendors keeps them in check. However, that balance is likely to upend when the outsourcing industry consolidates. Unfortunately for outsourcing firms, as the outsourcing business grows and its scope expands, so does the pace of consolidation.[19] IBM's strategic shift toward business-process and transformation outsourcing has led to its acquisition of PricewaterhouseCoopers Consulting and twelve IT-services companies over the last two years. The broader and deeper scope of outsourcing services is not only heating up the rivalry among its existing competitors (such as EDS, Accenture, and Hewlett-Packard), but it is also making some of its former customer/outsourcing specialists nervous. Human resources service provider Hewitt Associates, insurance services provider AIG, and Fidelity National Financial, a provider of mortgage-processing services, start to worry whether IBM has targeted, or is planning to target, their respective turf. As the outsourcing industry matures, it may be subject to the "rule of three," that only a small number of dominant players will remain in the industry.[20] The risk of price and contract creep will increase as dominant players emerging from the consolidating outsourcing industry.

Knowledge Decomposition and the Loss of Strategic Assets

Outsourcing clients face the challenge of deciding whether an outsourced asset, activity, function, or process embeds key sources of competitive advantage. The challenge has become increasingly serious as vendors broaden the scope of their services. Firms that have reaped the initial benefits of outsourcing find compelling reasons not to stop further engagement. Those that have not outsourced are hardly apathetic to the outsourcing tsunami. The question of whether an asset is strategic or core to a firm is gradually reduced to a query about which asset is more or less important. The management bandwagon is leading firms to identify an ever-narrowing set of assets as strategic. For example, until a few years ago there was a straightforward answer to which IT function is strategic and which is not.[21] IT planning, systems development, overall architecture, data, applications, infrastructure and new technology research and development were considered core functions that firms should not outsource.

The remaining outsourcing candidates were functions such as systems maintenance, hardware, and user training. As vendors gain more expertise and capabilities that clients increasingly depend on, the list of core IT functions has shrunk dramatically. At present, several trailblazing firms have chosen to shed their entire IT infrastructure, outsource applications and systems development, adopt vendors' architecture, or end concerted internal effort in scanning and experimenting with new information technologies.

However, there is a sound argument for these trailblazers. Leading outsourcing vendors are developing technologies and services that initially take the pain away from their client in managing those IT-embedded business functions and processes. As those technologies and services improve, clients will find it more compelling to concede to their vendors the management of those functions and processes once regarded as core or strategic.

The other side of the coin is that the basic understanding about strategic assets is that they are critical to a firms' long-term profitability. However, firms develop and deploy those assets as a result of imperfect and discretionary managerial decisions, which are often made under ambiguity, complexity, and intrafirm conflict.[22] The IT functions in most firms are support activities in their value chain. Firms tend to identify their core processes within the primary activities in the value chain. IT-embedded business processes often fall into a gray area, in which the distinction between core and non-core assets blurs easily. Vendors often have to learn a great deal about the client's business—from strategy to business model, and from business processes to firm assets—to fulfill their contractual obligations. To mitigate the risk of incompatible architectural styles, for example, client firms need to articulate their current and target business models. They also need to periodically engage their vendor during the planning process to explore how to reshape the business processes for possible future scenarios. Client firms also need to calibrate their processes with those of their vendor to reduce the dormant errors. Calibration, like planning, is an intensive knowledge-transfer process that requires that little be kept secret from the vendor.

Although spillover of strategic assets (in the form of confidential information or tacit knowledge) is a well-recognized outsourcing risk (presumably contained by contract and by trust between client and vendor), spillovers in BPO projects can be subtle. A client's firm knowledge may have to be decomposed to make knowledge transfer more efficient or to better fit the vendor's standardizing modules. Decomposed knowledge is easier to analyze and to combine with other knowledge pieces to create new knowledge. BPO vendors are in a better position than their clients in analyzing and creating new knowledge because of their exposure to the variety and multitude of projects. In that regard, vendors act like an extended organization of their clients. On the other hand, vendors, as supplier of expertise, also engage themselves in market-based transactions. A vendor's shareholders, as well as its clients, expect the vendor to leverage the new knowledge gained from its client engagements, although for different purposes. Leveraging new knowledge is often essential to fulfill a vendor's

contractual obligation to its client. Therefore, vendors have little incentive to be too concerned about a client's gradual loss of strategic assets or of control over those assets.

Innovation and Change Agents and the Loss of Innovation Capabilities

A recent survey by *InformationWeek* shows outsourcing client firms demand that their vendors help them innovate and make strategic changes, not just run the back office.[23] With the improving business performance management software that tracks and analyzes business processes and their changes, vendors such as IBM believe they can run their clients' business functions at a lower cost and direct them to innovate their business and supply chain. Although leveraging a business process for innovation is not a new idea or practice,[24] the advent of IT is enabling real-time or near real-time connectivity of business functions, processes, and organizations. It also makes performance at all levels more analyzable than before. As firms look into the enabling technologies, they find that those technologies and the expertise to make them work reside increasingly in IT specialists. The tricky question is whether a firm's reliance on its IT vendors for business process innovation will eventually risk its long-term innovation capabilities.

Firm innovation capabilities are distinctive processes and activities that explore and exploit internal and external competencies to create a competitive advantage in a changing environment.[25] Companies develop those capabilities through two primary learning mechanisms: gathering and sharing tacit experience; and articulating and codifying it into explicit knowledge. When learning tasks are sporadic, diverse, and ambiguous (which is often the situation under a changing and uncertain environment such as BPO), knowledge articulation and codification are the more effective mechanism.[26] This means current information technologies—for their inclination in processing explicit, not tacit, knowledge—play a more significant role where innovation capabilities are most needed. Given BPO vendors' learning advantage, and advantage in dealing with IT-embedded process innovations, clients' innovation capabilities are likely to rely more on their vendors.

From an organizational angle, the client firms structure their everyday work and business processes routinely over cross-functional systems. This structuring requires them to take responsibility for the entire process in order for the clients to value functional knowledge and expertise and to seek opportunities for the application of the knowledge and expertise.[27] When the client firms outsource business process innovation, they are asking their vendor to assume at least partial responsibility for that task, thus surrendering an important space for developing innovation capabilities.

The clients' potential loss of innovation capabilities can be subtle and take a long time. Vendors often contribute to a client's business process innovation, the so-called best practices, distilled from the leading companies in the client's industry and beyond. Despite vendors' self-interest in chasing economies of scale

and scope in solution and service development and provision, the so-called best practices for business process innovation may prove to be an oxymoron. Innovation capabilities should be idiosyncratic in their detail and path dependent during their development in a firm.[28] However, best practices, by definition, assume commonalities among high-performance firms, which may not afford the firms adopting those practices a competitive advantage much beyond the near term, before most competitors adopt the same practices. Today's best practice will be tomorrow's industry norm. In the sprint to technology commoditization and vendor consolidation, the vendor-enabled innovation process may become essential to competitive survival, but inconsequential to superior strategy.

In addition, IT in management practice is often a preceding factor in net-enabled business innovations, even though most managers acknowledge the importance of aligning IT with corporate strategy.[29] Vendor-enabled innovations may suffer from a weaker profit regime for the clients due to their dependency on vendor-controlled complementary assets.[30] In other words, innovations built on specialized processes under vendors' control may have a lower return on investment, even if the innovation process is managed efficiently. The consequence of lower profit prospects from innovation is likely to lower clients' motivation to innovate and reduce innovation activities within a client firm.

Accidental transformation can also cause loss of innovation capabilities. This effect occurs when a vendor's solution produces unanticipated adverse effect on its client firm. For example, a global transportation and logistics company found that its vendor performed as expected in managing the efficient transaction processes. The company managed to substantially cut the operating costs by agreeing to pay a lump sum for all regular transaction processing, plus an out-of-pocket charge for each ad hoc report and special database analysis. What the company later discovered was that its own managers made fewer queries and even suppressed interest in new possible ways of looking at the company's information. The change deteriorated the company's probing culture, a significant source for innovation.[31]

Rigid Competency and the Loss of Strategic Flexibility

One of the traditional reasons for firms to outsource is to remain flexible in a volatile labor market. Outsourcing makes available to a firm the value-added expertise on a transaction-by-transaction basis, so that the firm can avoid the long-term commitment to any specialized knowledge or a fixed price. In a dynamic technology and labor environment, firms making long-term commitment to specialized technology or personnel may experience diseconomies of scale or scope, internal slack, or a higher fixed cost.

More recently, firms have outsourced to focus on core competencies. That is also why outsourcing has become increasingly strategic, because core competencies—manifesting themselves in a set of skills, in-depth knowledge, and management systems that create unique value to the customers—espouse the strategic value to a firm. The idea of linking core competencies and outsourcing was straightforward until the greatly expanded universe of outsourcing appeared

just a few years ago. A 2002 Accenture study found that only 35 percent of the companies were outsourcing processes of low strategic value, whereas 65 percent were outsourcing processes of medium to high strategic value.[32] For example, firms consider general customer service, such as statement mailing or e-mail support, to have low strategic value in customer relationship management. Processes dealing with product and offer management, marketing campaigns and promotions, and policy and strategy decisions are of high strategic value. The broadening and deepening of outsourcing is pushing firms to focus on a narrowing set of core activities in which the firms believe their core competencies dwell.

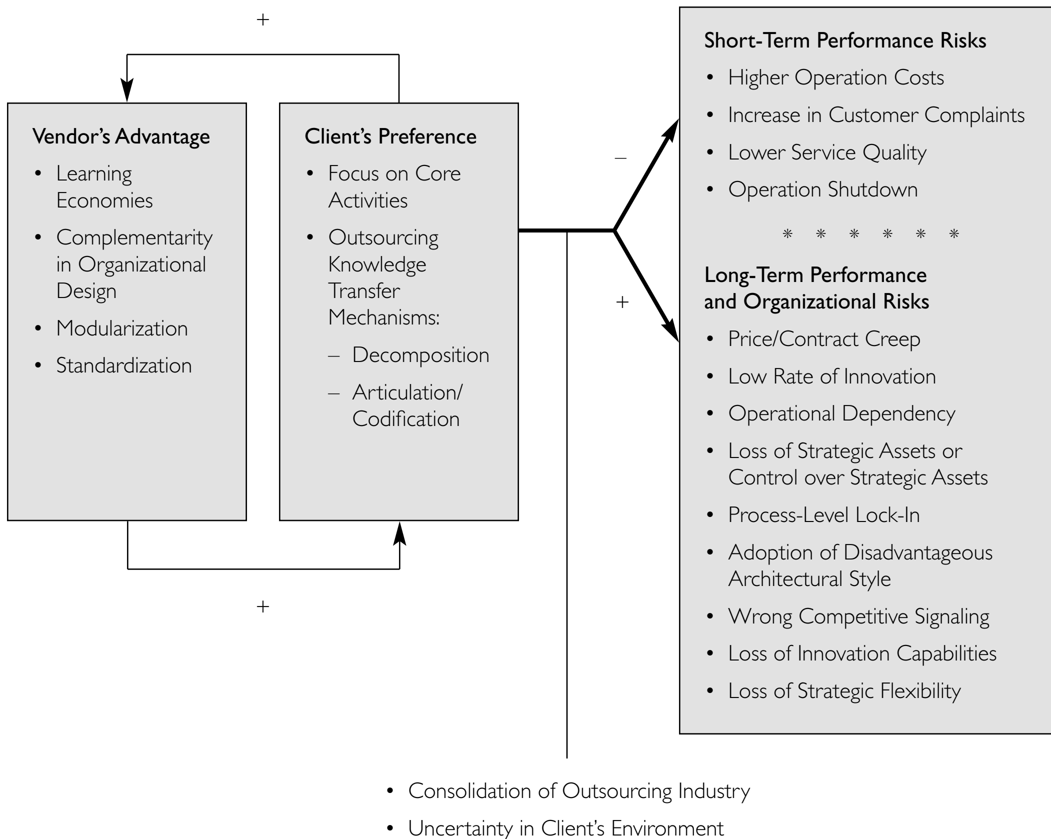
This narrowing focus makes an outsourcing firm more vulnerable to developing the wrong set of competencies, or to experiencing the depreciation of the value of the competencies caused by environmental changes. There is the risk that an outsourcing firm may be stuck with a set of strategic commitments, an organizational mindset, and tightly coupled activity systems that provide efficiency now but will turn ineffectual in future.[33] Uncertainty only increases that strategic risk. The Accenture study reports of the case of a large insurance company that outsourced major IT development projects to support its aggressive strategy for driving growth through door-to-door sales agents. Unfortunately, by the time the project was completed and tens of millions of dollars spent, the competitive game in the industry had changed. The competitors were laying off their agent sales forces and were marketing products directly to consumers. The company was caught in the middle of that change with an outsourced, efficient agent-based sales process, while its own IT capacity had shrunk to almost nonexistence, leaving it with little chance of adopting the direct-sales business model in a timely manner.

The BPO Risk Management Puzzle

The road to BPO success is a minefield of risks that may fail an outsourcing project and the client firm's short-term performance. Vendors and clients are making separate and joint efforts in clearing that minefield. Their efforts and success, however ironic, may impose conditions that can fail the clients' organization and market performance in the long run. That is the BPO risk management puzzle.

Figure 1 explains that puzzle by integrating the arguments presented here. It shows that clients and vendors co-evolve to reduce the outsourcing project and short-term performance risks, but that co-evolution simultaneously increases clients' long-term risks. Vendors center their part of the co-evolution on their advantages: learning economies of scale and scope, complementarities in organizational design, and modularization and standardization in technology development. Clients' penchant for a narrow set of core activities and the practices of decomposing, articulating, and codifying knowledge (of their activities, functions, and processes) provides the other cornerstone for co-evolution.
This co-evolution is a positive-feedback loop that is effective in reducing the

FIGURE 1. Client-Vendor Co-Evolution and the BPO Risk Management Puzzle



outsourcing project and short-term performance risks. Nevertheless, it may increase clients' dependency on their vendors, reduce the value of clients' strategic assets, shrink their innovation capabilities, and stifle their long-term strategy. Uncertainty and consolidation of the outsourcing industry are likely to elevate those strategic risks.

Discussion

This article is not the first to sound the alarm about the long-term strategic risks of outsourcing. Academics have long warned that a whole series of incremental outsourcing decisions, while making economic sense taken individually, may collectively cause competitive decline of many Western firms. Bettis et al. argue that,

> "Sourcing amounts to renting the skills and competencies of a potential competitor. Renting may appear cheap relative to ownership (and a large mortgage), but

> the lease may not be renewed or the rent may be dramatically increased. Furthermore, you are accumulating little if any technological knowledge (equity) and are unlikely to benefit if the skills and competencies appreciate in value due to future business opportunities that cannot be clearly foreseen."[34]

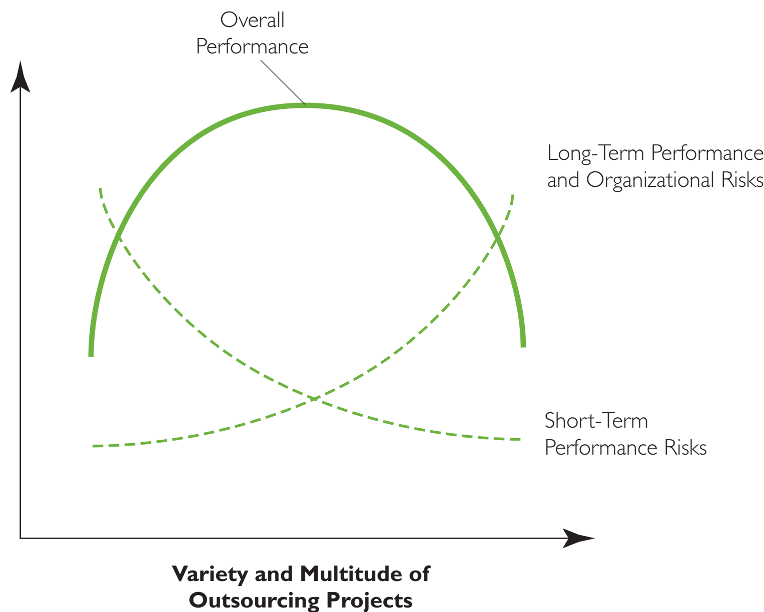
However, the mechanism of creating that short- versus long-term performance puzzle is not well understood. The co-evolution mechanism (Figure 1) introduced here intends to fill that gap, in the context of business process outsourcing. The framework and related arguments are grounded in the widely known theories on technology design, market failure, resource dependency, dynamic capabilities, and complementarities in organizational design, as well as in published anecdotal observations of business process outsourcing. These arguments imply that sounding the alarm about the strategic risks of outsourcing, alone, does not reveal the real difficulties in managing those risks. The problem is not that managers may not be aware of those risks. The problem is the inherent difficulties in managing those risks, because the mechanism for creating BPO strategic risks cannot be easily removed. It is also the very mechanism that managers rely on in reducing the BPO project and short-term performance risks.

The implication that client firms succeeding in managing BPO projects may impose limits on their long-term strategies and organizational viability is a serious one. It means that vendors and clients, in their joint effort in reducing project risks, may actually be embarking on the path to strategic failure of the client firm. Figure 2 shows the BPO risk management puzzle and its implication on client-firm performance over time.

This paradoxical nature also infers that popular managerial practices for dealing with long-term outsourcing risks will need to be examined more carefully. For example, outsourcing client firms use multiple vendors for different parts of an outsourcing project, hire a sleeping vendor as backup, or prepare for switching back or between vendors to reduce dependency and prevent price and contract creep. The logic in those decisions is sound and clear. The tradeoff is sacrificing the potential gain from a single vendor's learning advantage, which may compromise the success of the outsourcing project itself. Modularization and standardization of business processes may also help reduce dependency on any single vendor, if the modules and standards are adopted across the industry, and they are nonproprietary. However, that benefit may be limited to the extent to which the outsourcing industry is not excessively concentrated. In addition, the more standardized the technologies and the underlying business processes, the less unique a client firm may be, and the less valuable those technologies and processes are to its long-term strategies. This may explain why vendors who urge clients to standardize processes often face resistance.

How can client firms solve the BPO risk management puzzle? First, managers must realize that the effects of outsourcing on the firm's immediate bottom line may not always be consistent with the effects on the long-term well-being of the firm. Today's solution is tomorrow's problem. A project management solution is probably a corporate strategy problem. Unless managers at all levels grapple with this puzzle, outsourcing decisions are more likely to be made in a

FIGURE 2. The BPO Risk Management Puzzle and Client Firm Performance



sequential fashion, continually solving immediate and low-level problems, but simultaneously increasing strategic risks. The outsourcing firms will likely be caught between a rock and a hard place and not know it. Second, managers should expand outsourcing decisions to include factors such as outsourcing industry structure, client-vendor learning dynamics, and future business models. They should give those factors equal or more significant treatment than the more traditional factors, such as operational costs, technical competencies, process maturity, industry expertise, and culture compatibility of vendors. Armed with that knowledge, managers will be more capable of assessing the value of such real options as multiple vendors, switch-back, and second (or sleeping) vendor strategies. Third, as another real options strategy, managers can specify shorter durations for outsourcing contracts to force more frequent assessment of the projects' long-term impact. Finally, managers under market pressure are often biased toward short-term performance targets, and outsourcing project managers are often biased toward dealing with project risks. Perhaps it will be better to require senior management and even board-level scrutiny of BPO projects to recognize and deal with the more strategic risks before it is too late.

Notes

1. A number of scholars and management consultants have had similar observations over the past decade: D. Davison, "Top 10 Risks of Offshore Outsourcing," *Meta Group Report*, 2004; B. Caldwell, "Outsourcing Cost Reduction Creates Paradox: How to Still Make a Profit," *Gartner Dataquest Report*, Stamford, CT, April 12, 2002; B.A. Aubert, S. Dussault, M. Patry,

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2. The author has surveyed several popular IT business print and online magazines (including *InformationWeek*, *Intelligent Enterprise*, *Baseline*, and *Outsourcing Pipeline*) for the past few years as well as relevant reports published by major IT research companies (including Gartner, Forrester, Monitor Group, and Accenture).
3. Process model maturity is determined by the Capability Maturity Model (CMM), a methodology used to develop and refine an organization's software development process. The model describes a five-level evolutionary path of increasingly organized and systematically more mature processes. CMM was developed and is promoted by the Software Engineering Institute (SEI), a research and development center sponsored by the U.S. Department of Defense (DoD).
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