Outsourcing? at your own risk

Before outsourcing any process or function, it's essential to assess the risks enterprise-wide.

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OUTSOURCING some of your business processes and information technology (IT) functions to entities overseas may appear to cut costs and maximize profitability. But it can also cause other, significant risks if it isn't managed effectively. In other words, outsourcing may ultimately increase, rather than decrease, the total risk for your organization. So before you decide to outsource, we suggest analyzing it from the perspective of enterprise risk management (ERM).

UBIQUITY OF OUTSOURCING

ERM analysis of outsourcing is so important because more companies are outsourcing a greater number of functions than ever before.

Business process outsourcing is expected to grow from $38.9 billion in 2003 to $1.2 trillion by 2006, according to data from the Gartner Group and IDC Consulting, Inc. A June 2003 Deloitte Consulting report, *The Offshoring Imperative*, predicted that two million financial services jobs, such as brokerage transaction processing clerks, and $356 billion in core financial transaction operations will be outsourced by 2008.

It used to be that only large companies outsourced business functions, and even those were limited to information technology (IT) and payroll. But since the mid-1990s, small-sized and mid-tier companies have also been doing it because prices have come down and more companies are able to afford it.

Outsourcing began transcending IT and payroll to include software applications through the "application service provider" model and a "managed service provider" system whereby vendors host and maintain a company's software on the vendor's off-site system or manage company networks of hardware and software at the company's site. By the late 1990s, the rise of the Internet had enabled companies to outsource entire business processes and professional staff that traditionally were internal. Internal auditors and financial reporting and tax professionals, for example, are now candidates for outsourcing. Also ripe for outsourcing are critical business processes, such as customer support, cash management, tax preparation, accounts receivable, and accounts payable.

In fact, our analysis of public announcements of outsourcing decisions by more than 300 U.S. companies in the period of 1997 to 2003 shows that all types of business processes are potential outsource candidates. Topping our list is supply chain management by 28% of the companies we looked at, with insurance claims processing at 16% and financial services also at 16% of business processes shifted to third-party providers, as shown in Figure 1. Investment securities transaction processing by brokerage firms and banks and human resources/payroll functions are also frequently outsourced, at 15% and 13%, respectively.

Among IT functions, our research shows hardware/software/help desk support representing 26% of IT functions outsourced, followed by network management at 18%, application development and programming at 16%,

Figure 1: **Business Processes Outsourced**

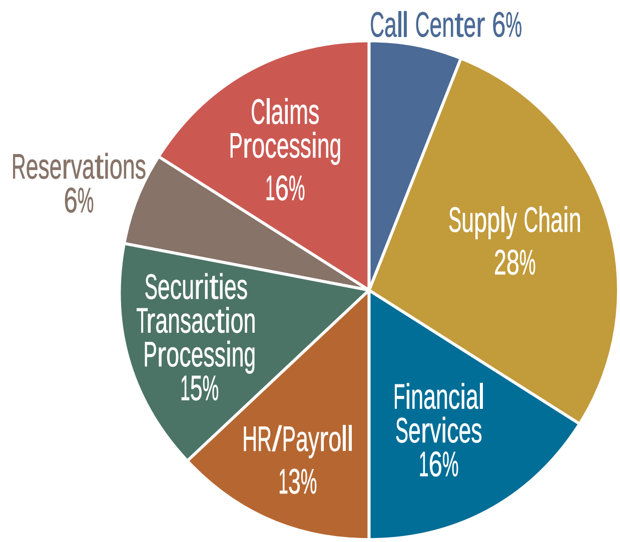
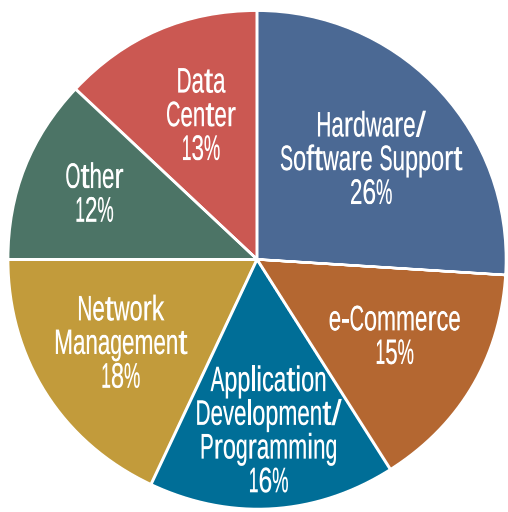


Figure 2: **IT Functions Outsourced**



e-commerce at 15%, and data centers at 13%, as shown in Figure 2.

Nor is outsourcing unique to any particular industry. Outsourcing among the 300 companies we examined spans numerous industries but is dominated by sellers of services, led by finance and insurance at 22%, as illustrated in Figure 3.

Why are we seeing these outsourcing trends? One of the primary rationales is either cost containment or cost reduction.

With growing frequency, outsourcing decisions are spurred by opportunities to capture huge labor cost savings by shifting core business processes to highly capable overseas providers whose labor rates are dramatically low-

Figure 3: **Outsourcing by Industry**

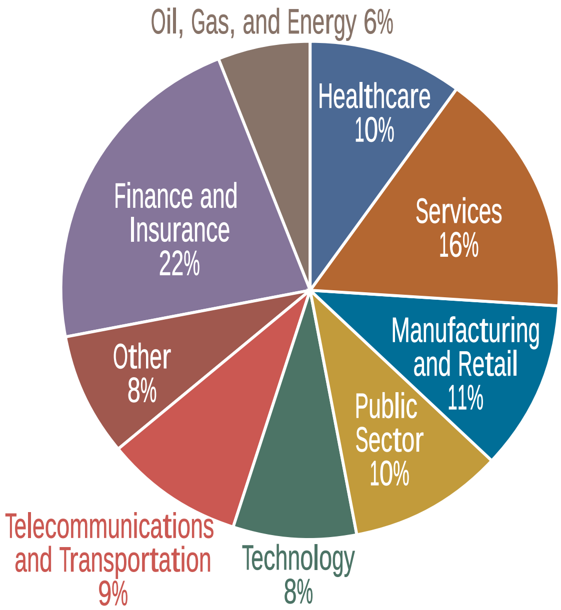
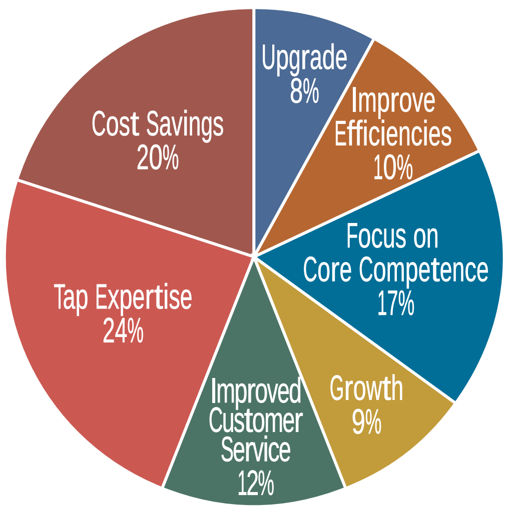


Figure 4: **Reasons for Outsourcing**



er than comparable ones in the U.S. IBM Corporation, for example, is shifting programming and project management work from the U.S. to China, where labor costs are estimated to be less than $25 per hour compared to $80 in the U.S. Others are doing so for the same reasons, making global outsourcing of services a pervasive part of U.S. corporate strategy. We should also mention that these jobs are not only going to Chinese or Indian companies—they're also going to companies in Malaysia, Pakistan, Singapore, South Africa, and Australia.

Executives claim they aren't compromising on expertise to obtain these costs savings. In fact, the most frequent reason cited for outsourcing, showing up in 24% of the decisions announced, is for external expertise that's either equivalent to that available in the U.S. or unique. It even exceeds cost savings, which were cited in 20% of the decisions (see Figure 4). Outsourcing announcements by the 300 companies we studied also shows outsourcing would help them focus on core competencies by shifting noncore activities off-site and improve customer service.

Opponents of outsourcing, however, scoff at any reason other than cost savings, arguing that anything but cost savings is merely a public relations tactic to shift the debate over labor costs.

ENTER ERM

The strategic decision to outsource activities to an external provider can be an effective response to managing key risks. As companies face the financial risks of increasing labor and other process costs, management's decision to outsource portions of labor-intensive activities to lower-cost markets may be an effective risk-reduction strategy. But if management makes the decision to reduce these financial risks on a "silo basis," it fails to control for the presence of other risks created by the outsourcing decision. Thus, the total portfolio of risks facing the enterprise may exceed the risk reductions sought, and the outsourcing decision may have increased the enterprise's risk profile beyond levels that stakeholders would tolerate.

It's critical for management and the board of directors to take an objective, comprehensive view of all the risks associated with any outsourcing decision. Merely focusing on potential cost savings without looking at the new risks associated with the outsourcing decision may result in a naive denial of significant risks threatening the company's survivability. Some of those risks can be significant alone, while others may not be significant individually but can be catastrophic when they interact with other risks.

Again, before outsourcing, evaluate and monitor it from an enterprise risk management perspective.

Enterprise risk management is a growing business paradigm in the U.S. and abroad. The recent corporate scandals in the U.S. and Europe only further pressed the importance of ERM on senior executives and boards of directors because of their ultimate responsibility to effectively manage risks across the entire organization. Moreover, U.S. think tanks have been advocating that management design and implement enterprise risk management guidelines and processes. These are needed to ensure that key risks affecting the enterprise are identified and measured and that effective responses are implemented to monitor and control risk exposures—at least within a level acceptable to the entity's stakeholders, such as investors, creditors, and regulators.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is helping management and the board of directors implement effective ERM processes. COSO released an exposure draft of a proposed new ERM conceptual framework in June 2003, and the final release is expected later this year. That framework builds upon COSO's 1992 *Internal Control—Integrated Framework*, which most public companies now use as their benchmark to meet the Sarbanes-Oxley Section 404 internal control reporting requirement. COSO's proposed ERM framework provides guidance for boards of directors and senior management for analyzing all core business strategy decisions from an ERM perspective. Other enterprise risk frameworks have been developed in the U.K. and jointly in Australia and New Zealand, indicating ERM's growing global significance.

RISKS

An ERM view of the risks involved with outsourcing attempts to identify, assess, and respond to *all* significant risks associated with the outsourcing decision.

Outsourcing can create risks to an enterprise's strategy/market, operations, finance, human capital, IT, legal/regulatory, and reputation (see Figure 5). The mere occurrence of one incident, such as an IT shutdown, can exponentially increase the enterprise's risks, so these risks should be considered collectively in an ERM decision-making process. Also, the risks may vary across organizations, so the board of directors and management should identify which ones their outsourcing decision may affect.

Next we elaborate on how outsourcing can affect different aspects of enterprise risk.

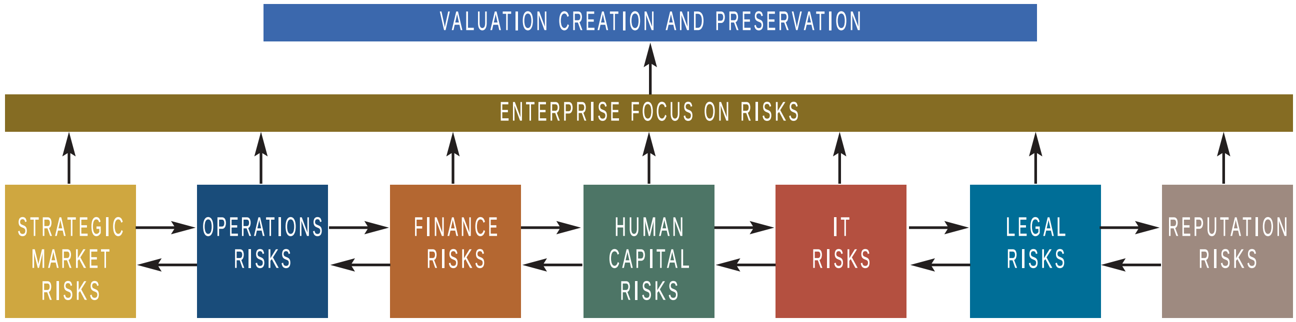
Strategic / Market Risks. In outsourcing, management typically wants to shift processes related to core strategy and market position—such as customer call centers, help lines, reservation centers, or complaint response—to offshore providers. But when outsourcing core business processes begins to involve outsourcer interaction with customers and other vital business partners, any breaches in the effectiveness of product or service delivery and maintenance can directly hinder a company's ability to accomplish its strategic objectives. Poor training and suboptimal delivery of customer services may affect the company's ability to maintain and expand its customer base, and communication breakdowns due to cultural differences can result in providers failing to interpret customer needs and concerns accurately. Thus, in an effort to save on labor costs, the organization may threaten its strategic/market position.

Another strategic risk of outsourcing is revealing confidential information, and bringing an outsourcing partner into a company's core business processes inherently reveals part of a company's strategy. A breach in confidential strategic and competitive market information can come from differences between the two companies' corporate culture, ethics, and governance and can threaten the outsourcer's competitive advantage and heighten strategic/market risks if they're not managed effectively.

Operational Risks. Outsourcing business processes can lead to operational cost savings involving labor, supply chain management, and infrastructure. But outsourcing parts of the operations, such as supply chain management, requires investments in infrastructure.

Moreover, selecting the wrong vendor can significantly affect operational risk, which often increases as the transition of processing from internal to external operations begins. Vendors need to be capable of learning complex operational processes, and you may need to invest in training and education for them. Also, thorough investigation of a vendor's reputation and capabilities is critical to ensure core business operations are maintained at desired production and quality levels. In addition, basic processing needs must be addressed, such as technology

Figure 5: **ERM Brings Together All Risks**



and IT personnel, to ensure that the transfer of operations goes smoothly.

Additionally, the risk of not achieving core operational objectives in an outsourcing arrangement can adversely affect the enterprise's strategic/market risks. A breakdown in production or service delivery quality, for example, may not only halt operations temporarily but also make customers frustrated because of delays and back orders. This, in turn, would threaten the company's strategic/market position.

Financial Risks. To a company's finance professionals, outsourcing can increase cash flow and financial reporting risks. While outsourcing is designed to increase net cash flows, many hidden costs may actually decrease cash flows if the costs aren't managed effectively. There can be extensive, unpredictable costs involved in performing vendor due diligence, including travel and other investigation costs to avoid surprises when the relationship gets under way. Costs of developing infrastructure to support off-site operations can be extensive and not fully anticipated because of the complex IT hardware and software requirements. There also are ongoing costs that can't be ignored or completely predicted, such as monitoring contract performance of availability, security, and quality metrics. Finally, there may be unanticipated costs, such as employee layoffs in U.S. operations or other restructurings in both U.S. and overseas operations, that can impact the total cost of outsourcing.

Financial reporting of outsourcing arrangements can add significantly to your reporting process and risk. U.S. public companies are rushing to comply with the multitude of requirements for the Sarbanes-Oxley Act of 2002, particularly the new Section 404 requirements for management reporting on internal control effectiveness. As companies begin to outsource key business processes—including finance and accounting—there will be more risk concerned with supporting, maintaining, and monitoring the effectiveness of internal con-

Effects of Proposed Federal Outsourcing Legislation on Enterprise Risks

The U.S House of Representatives and U.S. Senate are considering several proposed bills related to outsourcing. Some call for studies about outsourcing to be conducted, while others would ban any company that outsources overseas from receiving federal grants, federal contracts, federal loan guarantees, and other federal funding.

We are uncertain if these bills will pass. But if similar provisions are enforced, there are significant risk-related ramifications for the enterprise. Here's a brief overview of how some of the provisions might affect enterprise-wide risk:

Strategic / Market Risk: If an entity that outsources overseas is prohibited from receiving a federal contract, that entity may face significant cuts in its existing customer base, which may threaten its strategic market position and related market share. For example, any company that works in the defense-related industry would be cut from any opportunities to enter into defense contracting relationships. That may put many defense contractors out of business.

Operational Risk: Any prohibitions for outsourcing an entity's operations to overseas providers may threaten the entity's ability to maintain core operations cost effectively. In some instances, companies choose to outsource to tap into professional expertise not available internally. If those options are prohibited, the companies may face challenges that threaten their ability to continue existing operational processes cost effectively.

Finance Risk: Some of the proposed federal legislation would prohibit any entity from receiving federal grants or other financial assistance. That would directly affect an entity's cash flows and access to other financing alternatives, especially if federal loan guarantees are prohibited.

Human Capital: Some of the proposed legislation would provide federal assistance to displaced U.S. workers. Those provisions might actually reduce human capital risks because assistance to workers reduces some of the burden of the company (e.g., funds for retraining workers would be paid by the federal government rather than by the enterprise).

Legal / Regulatory: Most of these provisions, if passed, increase the volume of legal provisions that would apply to enterprises that outsource, and some would prohibit certain types of outsourcing. Entities would have to ensure they comply with numerous new federal laws.

Technology Risks: Some of the proposed legislation would increase reporting burdens. For example, the Jobs for America Act of 2004 would require companies outsourcing overseas to report how many jobs are outsourced, where they are going, and why to the Department of Labor, state agencies that help laid-off employees, and local government officials. As a result, any enterprise that outsources overseas must have information systems capable of tracking required data.

Reputation Risk: If a company doesn't comply with a federal law related to outsourcing, its reputation may be damaged.

trols. Creating a uniform control environment is more difficult when operations are spread across cultures around the globe. As more financial data reside on offshore servers, controlling the backup and recovery of that data becomes more important. Outsourcing may make documenting, testing, and evaluating the operating effectiveness of those offshore controls more difficult. All of this creates a risk that the board of directors and management must address. In addition to management's ability to assess outsourced controls, external auditors will need to evaluate those controls as well.

Human Capital Risks. Of course, outsouring jobs also has inherent risk. Labor cost savings through outsourcing typically come from laying off U.S.-based employees. As the outsourcing trend continues, employee groups, including labor unions, are paying closer attention to the relationship between outsourcing and unemployment. In many cases, employee groups are becoming more vocal, often taking their concerns to state and federal politicians in an attempt to encourage legislative initiatives to curb the growth of offshore outsourcing arrangements.

Anger among American workers is building as outsourcing is predicted to grow. Grassroots efforts in New Jersey and California, for example, have prompted protectionist legislation. In fact, the New Jersey Senate is considering a bill (Senate No. 494) to outlaw offshoring of state jobs. The bill, which is being evaluated at the Senate Committee level, would restrict outsourcing of state government work by forcing government contractors to pay American wages regardless of where the work is being done. That, in effect, would take away a major incentive for state government agencies and state government contractors to outsource.

This backlash to outsourcing jobs, particularly from unionized labor, could lead to significant new costs for companies. For example, if a class action suit were brought against a company, the company would have to mount a legal defense. In addition, companies often need laid-off workers during the transition period to help train their overseas counterparts. So not only must these workers be paid severance but also retention bonuses. All of these costs could ultimately threaten the labor cost-savings potential that motivated the outsourcing decision in the first place.

In-house survivors of outsourcing can also become demoralized. If their sentiments aren't addressed properly, employee turnover, operational slowdowns, or even employee strikes can ensue. These threats not only affect the organization's human capital, but they interact with key operational and strategic risks discussed earlier. For example, employee work stoppages halt operational processes that delay production and complicate other supply-chain relationships. The resulting lack of timely delivery of goods or services leads to customer frustration and ultimate loss of strategic market share for the company.

So there's clearly a crying need to evaluate the potential effect of outsourcing on human resources and across the entire enterprise.

IT Risks. Because many outsourcing arrangements depend on information technology, IT is a particularly risky area.

Traditionally, outsourcing has shifted portions of a company's IT infrastructure to third-party providers. Many people say IT outsourcing will continue to lead the overseas exodus, with the Internet enabling its growth. The speed and availability of the Internet to capture, share, and transfer information globally has enabled companies to shift functions to any location around the world that has Internet access. Accompanying this, however, are the inherent risks associated with Internet activity. Computer viruses, denial-of-service attacks, privacy issues, and electronic data transfer concerns are all IT risks that must be managed with constantly updated technologies, such as firewalls, encryption, digital signatures, and other security prevention techniques.

In addition, transferring key IT operations from the U.S. to overseas markets takes more than flipping a switch from servers in the U.S. to those overseas. Vendors need technology specifications and other infrastructure requirements before they can deliver services in overseas IT centers, and there may be struggles to communicate IT specs to vendors. What used to be accomplished internally, informally, and face-to-face may now need to be more formal. Once IT operations are developed off-site, they must be tested and documented to ensure they're fully functional at desired performance levels. You should also expect long lead times in hardware acquisitions and software development, which can threaten perceived cost savings in many outsourcing arrangements.

Still further shifting of an enterprise's IT "backbone" to offshore locations makes it more important than ever to assess the continuity of operations and disaster recovery controls. Also, geopolitical risks, such as threats of terrorism and war, are obviously real in numerous areas around the globe. Any shutdown of an IT operations center or the IT backbone failing to operate for prolonged periods may threaten the IT investment and significantly increase other risks, including operations risks and strategic/market risks. In addition, you should address the costs and time to bring outsourced IT operations back in-house if that becomes necessary.

We believe all of these IT risks should be viewed from an enterprise basis to ensure that individual and interactive risk exposures are monitored effectively and managed to a level acceptable to stakeholders.

Legal / Regulatory Risks. In addition to emerging legislation designed to slow down the shift of U.S. jobs overseas, numerous other legal/regulatory risks must be considered in any outsourcing decision. Legal issues related to the privacy, confidentiality, and security of business transactions may increase legal risks for the enterprise if they aren't managed effectively. When customers, suppliers, and other business partners suffer damages from unsecured transactions, legal and regulatory actions can ensue.

Companies also must monitor regulations to make sure outsourcing decisions don't lead to violations. For example, banking industry regulators have their own guidelines and bulletins aimed at clarifying a bank's duties for managing risk in outsourcing relationships. Companies and their outsourcing partners must stay informed about evolving regulations that could affect any aspect of their operations.

Enterprises should also stay abreast of legal and regulatory requirements of the country hosting the offshore operations. Those countries may have different tax and labor laws than the U.S., and those laws may affect how an entity conducts business there. Acceptable ways of transacting business in the U.S. may not comply with legal provisions in the host country.

Reputation Risks. Of all the risks, one of the hardest to measure—but often the most crucial—is threats to a company's reputation. Enterprises are wise to invest in efforts to maintain and enhance their external image so they can retain and attract vital business partners and market share and protect and increase the price of their securities in the capital markets.

As outsourcing trends continue to catch the attention of the American public, negative perceptions can create huge reputation risks. Fear of job loss, particularly in slow economic times, can profoundly impact the local or national reputation of any enterprise considering offshore outsourcing. Negative publicity regarding outsourcing to overseas markets has led to protests and demonstrations across the country that have attacked the image of some companies. These demonstrations have attracted media attention because they have been well organized and widely publicized. If American public opinion suddenly swings toward intense opposition to offshoring, enterprises already in outsourced arrangements may be in situations they never anticipated when they made the outsourcing decision, such as being directly targeted by negative ads, boycotts, or other protests highlighting the company's outsourcing contracts. Customers and business partners may avoid doing business with companies that transfer jobs from U.S. citizens to foreign workers, which harms their reputations and threatens the enterprise's strategic/market position.

MANAGING OUTSOURCING RISK

There are numerous opportunities to outsource many different types of business and IT processes, including those not traditionally outsourced. While these opportunities have generated benefits for many companies, particularly labor cost savings, numerous risks can arise that affect multiple aspects of the organization. Not only should these risk exposures be evaluated and monitored across the enterprise, but their interactive or cumulative effect must also be managed on a portfolio basis. Failure to evaluate and manage outsourcing risks from an enterprise risk management perspective can lead to an accumulation of risks far greater than the risk savings offered by the outsourcing arrangement, thereby exposing key stakeholders to greater amounts of risk than they desire. An enterprise risk management approach to outsourcing can help management and the board of directors live up to expectations related to effective risk management for the organization. ■

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