OFFSHORING, ITS SUCCESS AND RISKS

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Introduction

'Offshoring' is an additional term to our vocabulary now used increasingly (Gieg, 2004), to depict the procedure of transferring employment from countries with a high cost of inhabitancy to countries with a lower cost of inhabitancy and consequently a cheaper labour force (Gieg, 2004) comments that as the world economy is becoming increasingly interdependent and as developing nations embrace more capitalistic economies, employees in certain occupation sectors are aware that jobs are on the move as companies transfer work offshore.

An article from the Journal of Management raised the question of whether offshoring brings about any risk to the performance of an organisation: *"Making more by doing less: An analysis of outsourcing and its effects on firm performance"*, (Gilley, 2000). Offshoring is also referred to as outsourcing. The most interesting factor in the text arises in the conclusion where the article attempts to determine the performance implications of outsourcing strategies; however, no direct effect of outsourcing on performance was detected.

Risk Management and Offshoring

There are many objectives for outsourcing (Hewlett Packard, 2004). Minimising risk may be one of the objectives if not the main reason for contemplating outsourcing. This requires risk management strategies to be implemented as outsourcing involves risk in vital areas – ranging

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from budgetary constraints to the introduction of new technologies, securing access to company data 24/7 and managing an increasingly complex dispersed IT environment. Offloading risk is the ambition of successful organisations; with minimal risk there is an incentive to perform at a higher level. Offloading risk means introducing another risk of retention of operational control – at the same time accomplishing superior financial control of capital investments. Outsourcing must balance risk sharing and control strategies that are tailored to meet specific business objectives, with risk mitigation strategies clearly stated in transformation plans, actions and schedule. The goal is to have a smooth transition to outsourced locations – with risk greatly reduced with effective risk management (Hewlett Packard, 2004). Offshoring is used to reduce the risks threatening an organisation thereby gaining higher performance levels in particular industries.

Offshoring Definitions

(Colquhoun et al, 2004), stated that although offshoring is a term frequently used it has no acknowledged, official definition.

i. *"The outsourcing of highly-qualified services into low wage countries"* (Trampel, 2004).

ii. *"Offshoring is the practice of sending jobs from a country with a higher cost of living to a country with a lower cost of living and a therefore cheaper labour force"* (Gieg, 2004).

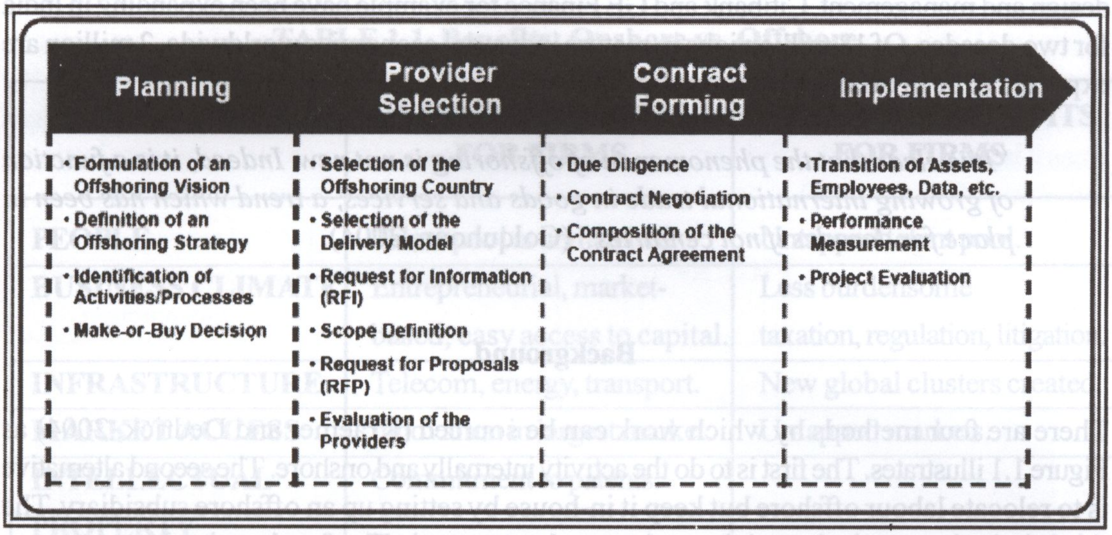
iii. *"Outsourcing involves paying other firms to perform all or part of the work"* (Structural Cybernetics, 1996).

iv. *"Work done for a company by individuals outside the company's full-time employees"* **(www.investorwords.com** [2004]).

v. *"Outsourcing is when a company employs a contractor to carry out labour, which was previously completed by the company in-house. A function can only be described as having been outsourced if the company in-house previously did it"* (Carlsson, 1998).

It should be noted that outsourcing is not a synonym for contracting out. Contracting out is work issued to suppliers outside the business on a job-by-job basis. Outsourcing requires a long-term relationship involving supplier and beneficiary, with a large degree of risk sharing (Embleton, 1998).

DIAGRAM 1.1 Offshoring Project Life Cycle



(Source: Amberg & Wiener, (2004), p.4)

History of Offshoring

The notion of outsourcing was originally made popular by Ross Perot who founded Electronic Data Systems (EDS) in 1962. Today, EDS is a multi-billion dollar company with over 70,000 employees and is one of many global business process-outsourcing (BPO) firms. Not everything that creates headlines is contemporary (Rohde, 2003). Offshoring is not a new phenomenon. We are currently experiencing the third wave of offshoring. The trend began in the 1980s with the relocation to developing nations of textile and shoe manufacturing, creation of toys and cheap electronic devices. Later it was the transfer of data input activities to places like Jamaica and Barbados. This involved labour-intensive customary tasks exemplified by ticket processing for airlines, the dispensation of credit card applications or transcriptions of medical reports (Rohde, 2003).

Offshoring is not a new concept for industrialised countries (Gieg, 2004). Levi Strauss Corporation, synonymous with denim products, had sixty-three sewing plants in North America twenty years ago. January of 2003 witnessed the last plant move involving sewing operations to China. Levi Strauss offshored as they could not compete with onshore labour with pressure from expanding competitors already manufacturing offshore. Levi followed or risked disappearing from the industry. The automobile industry has been offshoring for years (Gieg, 2004); Ford manufactures automobiles in Spain and England, and GM has manufactured cars in Germany for decades. Other manufacturing industries relocated overseas in the 1970's, with minimal public outcry except those directly affected. As Gieg, (2004) explains, there is economic benefits with offshoring, developing countries have cheaper labour, government regulations are more relaxed and raw materials may be accessed comfortably. (Gieg, 2004) expects offshoring to expand over the next decade including industries such as finance, creative design and management. Citibank and GE Finance for example have been expanding in India for two decades. Of 13 million jobs in mature industrial economies worldwide, 2 million are expected to be in offshore locations by 2008.

> *"It is clear that the phenomenon of offshoring is not new. Indeed, it is a function of growing international trade in goods and services, a trend which has been in place for decades if not centuries"* (Colquhoun, 2004).

Background

There are four methods by which work can be sourced (Kraemer and Dedrick, 2004) as Figure 1.1 illustrates. The first is to do the activity internally and onshore. The second alternative is to relocate labour offshore but keep it in-house by setting up an offshore subsidiary. The third choice is to retain the activity onshore and outsource it. The fourth option is to outsource the activity to a supplier who conducts the work offshore.

FIGURE 1.1 Four Methods Work can be Sourced

	Onshore	**Offshore**
Internal	**1. Internal onshore**	**2. Offshore subsidiary**
Outsourced	**3. Onshore outsourcing**	**4. Offshore outsourcing**

(Source: Kraemer, (2004, p.1)

The focus is on offshoring through an overseas subsidiary or through outsourcing to a supplier who performs the work offshore.

Table 1.1 presents a summary of benefits to companies for onshore and offshore engagements (Seshasai, 2004).

TABLE 1.1 Benefits: Onshore vs. Offshore

	ONSHORE BENEFITS FOR FIRMS	OFFHSHORE BENEFITS FOR FIRMS
PEOPLE	Talent pool is unmatched.	Untapped talent pool.
BUSINESS CLIMATE	Entrepreneurial, market-based, easy access to capital.	Less burdensome taxation, regulation, litigation.
INFRASTRUCTURE	Telecom, energy, transport.	New global clusters created.
MARKET ACCESS	Innovation in largest market.	Untapped markets.
INTELLECTUAL PROPERTY	Commitment to patents.	
GOVERNMENT	Political stability.	
QUALITY OF LIFE	Freedom, healthcare, security, environment.	
COST		Talent, facilities cost less.
PROXIMITY TO MANUFACTURING		Plants are already offshore.

(Source: U.S. Department of Commerce Office, 2004)

Beneficial reasons for outsourcing other than simply trying to improve performance are listed by Johnson, (1997) in Table 1.2, from details provided by companies that have already outsourced:

TABLE 1.2 Tactical and Strategic Reasons for Offshoring

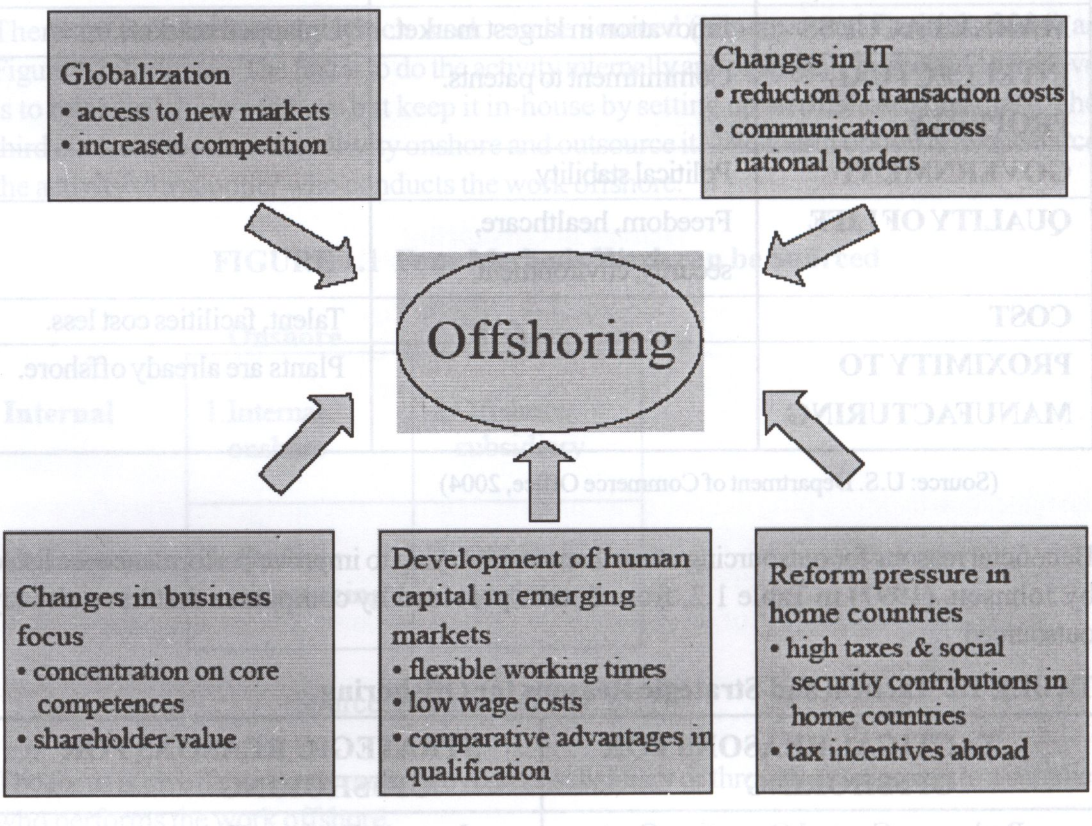
TACTICAL REASONS FOR OFFSHORING	STRATEGIC REASONS FOR OFFSHORING
• Reduce or Control Operating Costs	• Improve Business Focus
• Make Capital Funds Available	• Access to World-Class Capabilities
• Cash Infusion	• Accelerated re-engineering benefits
• Resources not Available Internally	• Shared risks
• Function Difficult to Manage or Out of Control	• Free resources for other purposes

(Source: Johnson, (1997), p.49)

"Outsourcing is being seen less and less as a tactical, cost saving drive and more and more as a strategic direction that the organisation follows" (Johnson, 1997).

Johnson (1997) details the main benefits that are categorised in the area of most interest to a board of directors. If the benefits were presented to a board of directors in particular the Chief Information Officer (CIO) and it was explained that the company would benefit in these areas it is probable that the directors would accept the proposal to outsource non-core business activities (Williams, 1998).

FIGURE 1.2 Drivers of Offshoring



(Source: Trampel, (2004), p. 2)

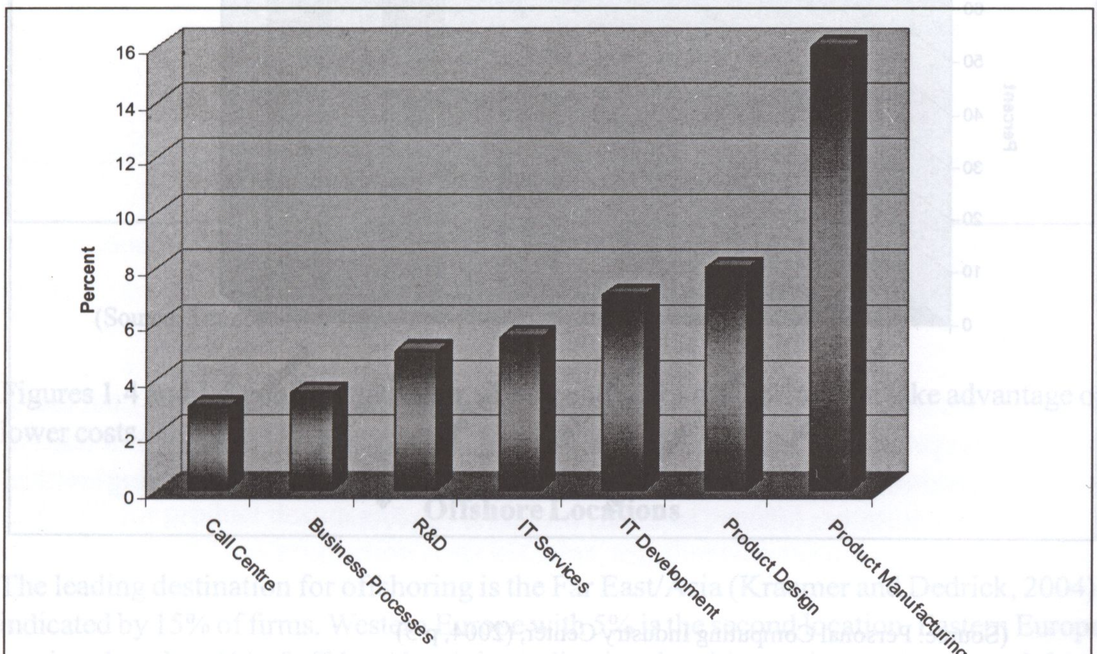
Figure 1.2 details the drivers associated with offshoring (Trampel, 2004).

What is Being Offshored

The activity offshored by most firms is manufacturing (Kraemer, 2004), with 16% of firms moving in this sector. Next is product design or development at 8%. The movement of services offshore is relatively new and began pre 2000 and the Internet boom. Services being offshored include (and are illustrated in Figure 1.3):

• R&D activities (5%)	• BPO (3.5%)
• IT Services (5.5%)	• Call centre activities (3%)
• Software development or maintenance (7%)	

FIGURE 1.3 Activities Offshored 2004

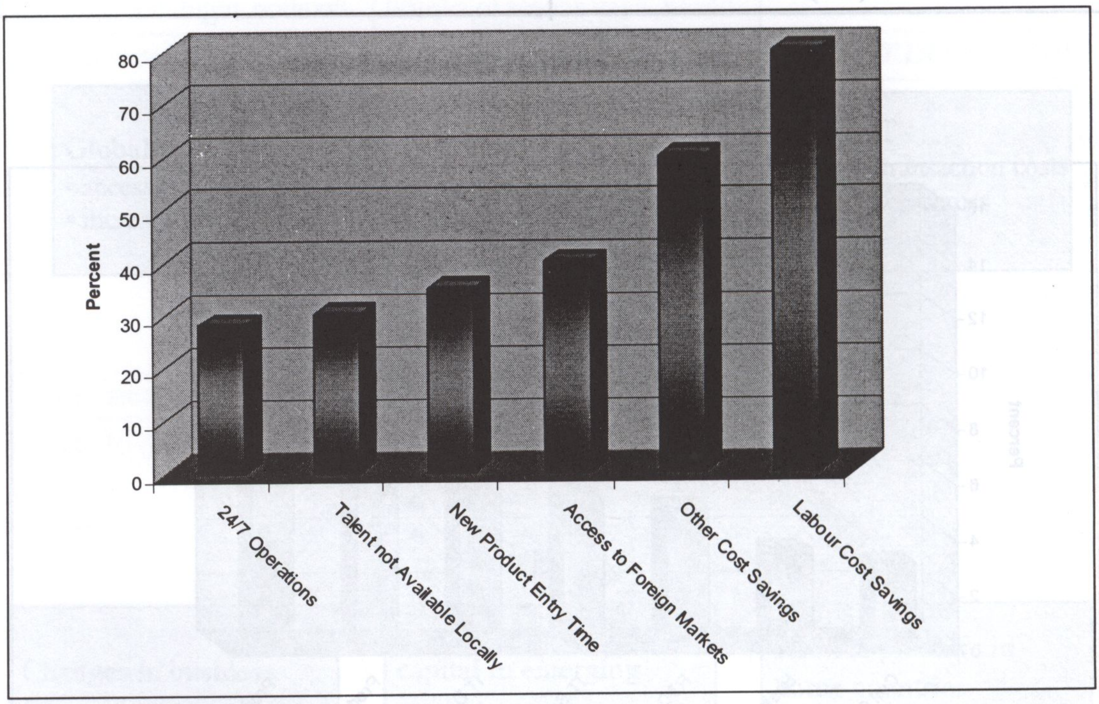


(Source: Graduate School of Management, (2004), p.2)

Reasons for Offshoring

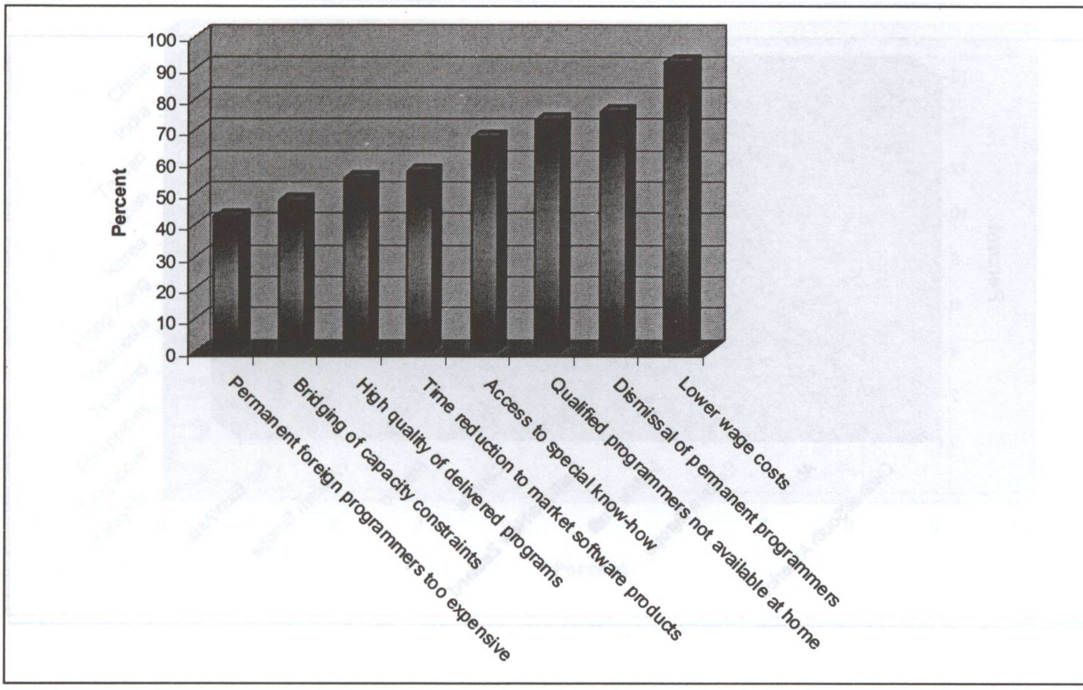
The core reason for offshoring is cost (Kraemer and Dedrick, 2004), in particular labour cost savings identified by 80% of firms while 60% mentioned other costs savings associated with land, physical facilities, taxes and environmental regulations. Gaining entry to foreign markets such as China was the second principal reason for offshoring cited by 40% of firms. Figure 1.4 illustrates the reasons for offshoring, and percentage value.

FIGURE 1.4 Reasons for Offshoring



(Source: Personal Computing Industry Center, (2004, p.3)

FIGURE 1.5 Motives for Offshoring



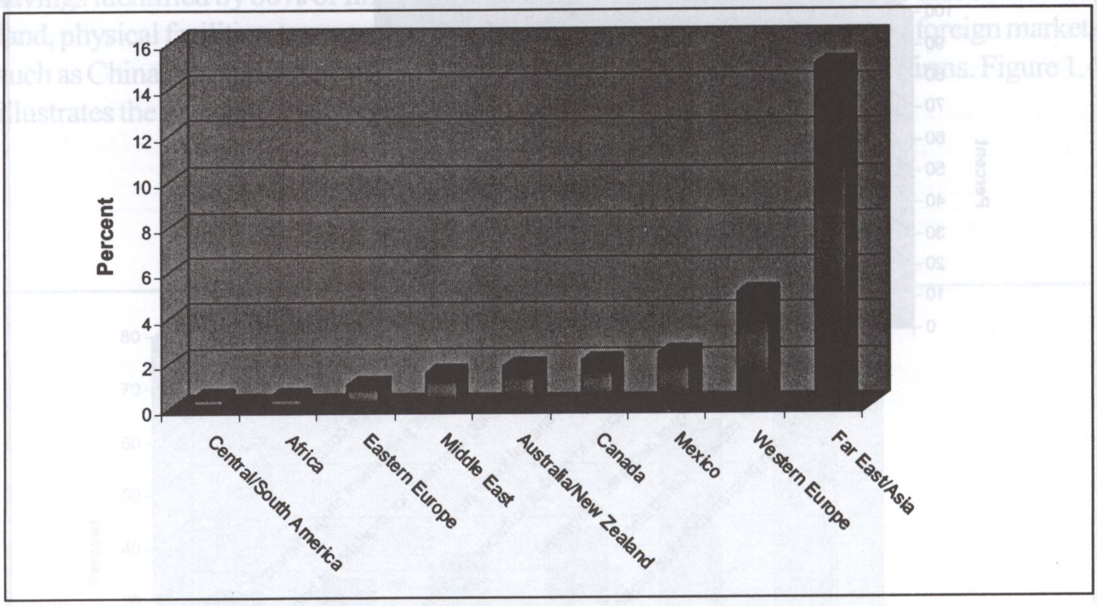
(Source: Trampel, (2004, p.5)

Figures 1.4 and 1.5 confirm that the major incentive for offshoring is to take advantage of lower costs.

Offshore Locations

The leading destination for offshoring is the Far East/Asia (Kraemer and Dedrick, 2004), indicated by 15% of firms. Western Europe with 5% is the second location. Eastern Europe receives less than 1% of offshored activity, indicating that this area is more concerned about targeting markets than transferring production of commodities or services for lower labour costs (see Figure 1.6).

FIGURE 1.6 Firms' Offshore Destinations

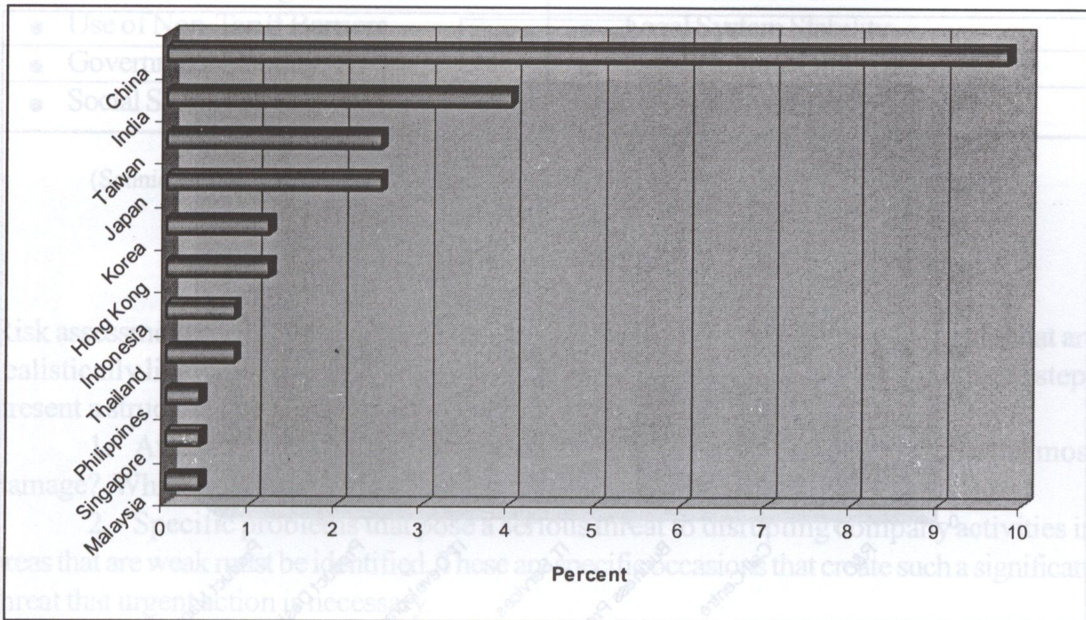


(Source: Graduate School of Management, (2004, p.4)

China versus India as Offshore Locations

Within the Far East/Asia, China is a primary location (Kraemer and Dedrick, 2004), indicating offshoring is primarily for product manufacturing or design and development related to production. Almost 10% of firms indicate they offshore to China with India receiving less than 4%. Figure 1.7 illustrates offshore locations within Far East/Asia.

FIGURE 1.7 Far East/Asia Offshore Destinations

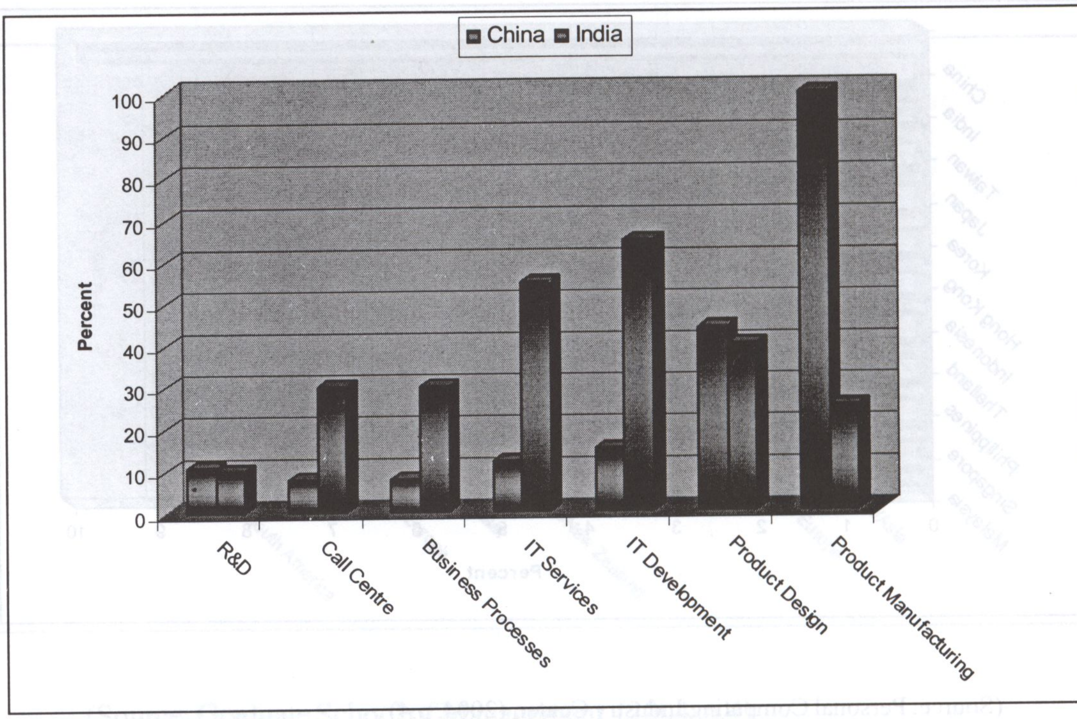


(Source: Personal Computing Industry Center, (2004, p.4)

Patterns of Offshoring to China vs India

The pattern of offshoring to China and India is considerably different (Kraemer and Dedrick, 2004). Offshoring to China is associated with product manufacturing and India with the provision of services, Figure 1.8. Company's offshoring to China, 100% do so for product manufacturing and 40% for product design and development. This movement is stimulated by market opportunities and low production costs in China, together with the prospect of serving the Asia-Pacific market from China (Kraemer and Dedrick, 2004). India however, has more than 50% offshoring IT software development and maintenance, or IT services. The incentive, principally is low cost production of services, mutually IT and broad business services such as customer-support and human resources (Kraemer and Dedrick, 2004).

FIGURE 1.8 Offshoring Comparison: China vs. India



(Source: Graduate School of Management, (2004, p.5)

Summary

Location is no longer an issue in the business world as technology continually enhances world communication. The Internet enables businesses to transfer processes from the West to offshore destinations. In India alone there will be revenues approaching five billion dollars from offshoring in 2005 (Davies, 2004).

Offshoring, is a new term within the business world not contained in the Oxford English dictionary. Currie, (2004), refers to outsourcing to firms in foreign countries, mainly to take advantage of cheap labour. BPO contracts have increasingly been provided to firms in developing countries over the last decade. As expected, employees educated in developing countries, India and China, work for lower wages than individuals educated to similar levels in developed countries such as Japan. Capital raised from the lower wage rate must be surplus to the increase in costs of management and the risk linked with offshoring for it to be economically feasible (The Outsourcing Times, 2004).

Risk Factors Associated with Offshoring

• Currency Exchange Rate	• Social/Cultural Differences
• Use of Non-Tariff Barriers	• Legal System Stability
• Government Stability	• Legal/Cultural Differences
• Social Stability	

(Schniederjans, 2004)

Risk Assessment

Risk assessment is a methodical process for revealing and aiding potential dilemmas that are realistically likely to transpire and damaging if they do (Williams, 1998). Four basic steps present a structure for the risk assessment process:

1. Areas of weakness are identified. Where could the company receive the most damage? Which periods of time may affect a company strategically?
2. Specific problems that pose a serious threat to disrupting company activities in areas that are weak must be identified. These are specific occasions that create such a significant threat that urgent action is necessary.
3. Methods are determined to avoid occurrence of potential problems. These methods are focussed on the source of the threat.
4. Contingency plans and actions are identified and put in place to minimise business disruption that may be caused by potential problems that cannot be totally prevented.

Risk assessment presents a negative impression; however this is a false impression, as it is really a positive tool used to reduce and eliminate risk that may occur in the future. Because of this, risk assessment can be the most powerful tool available when offshoring, to make it happen successfully and efficiently as possible. It provides businesses with the opportunity to build a future in accordance with vision when outsourcing. It also provides the business with optimal security and confidence to conduct business as usual and increase performance (Williams, 1998).

If outsourcing is planned and executed properly it can operate effectively (Johnson, 1997), however, when organisations fail to outsource effectively, outsourcing receives a negative view, and it is due to media reporting controversy and failure rather than successful implementation (Johnson, 1997).

Conclusion

From the definitions presented it is appropriate to determine that outsourcing occupations occurs where employment has been removed from the parent company and transferred to a subsidiary. Diagram 1.2 provides an example of how real an issue offshoring has become in the current economic environment and supports (Gieg, 2004) with the view that offshoring will expand over the next decade and with (Kraemer and Dedrick, 2004), to conduct work in an overseas subsidiary or through outsourcing to a supplier who performs the work offshore.

DIAGRAM 1.2 Reality of Outsourcing

(Source: Montgomery, (2004), 15.12.2004)

Table 1.3 concludes both the advantages and disadvantages, from a managerial, financial, operational and human resource perspective of offshoring, taking into account, already analysing Table 1.1, The Benefits of Onshore versus Offshore, and Table 1.2, The Tactical and Strategic Reasons for Outsourcing.

TABLE 1.3 Advantages and Disadvantages of Offshoring

ADVANTAGES	DISADVANTAGES
MANAGERIAL	
• Focus on core activities	• Loss of control over critical functions
• Focus on key strategic objectives	• Loss of control over suppliers
• Shared risks	• Questions over performance
	• Potential violations of intellectual property rights
	• Anticipated benefits exceed actual benefits
FINANCIAL	
• Lower/stabilised overhead costs	• Failure to realise cost savings
• Reduce investment in technology	• Cost of reverting to insourcing
• Transfer fixed cost into variable cost	
OPERATIONAL	
• Increased access to resources	• Dependence on suppliers
• Improved quality	• Responsibility for quality of suppliers work
• Decrease product/process design cycle time	
• Tap suppliers existing capacity	
• Increased flexibility	
• Access to leading edge technology	
HUMAN RESOURCE	
• Access to sophisticated, specialised knowledge of suppliers	• Lower morale amongst permanent employees
• Flexibility to adjust staffing levels	

(Source: Schniederjans, (2004, p.976-977))

Digby Jones, director general of the Confederation of British Industry (CBI, 2004), alerted UK workers that skill levels must be increased. If this does not occur unemployment is a serious possibility with the increase of British businesses offshoring. This is associated with the advantages and disadvantages in Table 1.3 and the fact that the benefits of offshoring outweigh the disadvantages (Jones, 2004).

> *"Offshoring is now part-and-parcel of doing business in the global economy. Make no mistake, this is a survival issue. Anyone who believes that firms have a great deal of choice are naïve...It is short-sighted simply to see all this as a bad thing. Offshoring means greater productivity and more efficient goods and services. It also means UK jobs will be of higher quality, more skilled and in many cases more secure"*, Digby Jones, (Griffiths, 2004, p.1).

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