Chapter 10
Application—Mitigating Outsourcing-Related Risks

Abstract While outsourcing part of the company’s manufacturing can appear attractive owing to reduced assets and headcount, many firms continue to be disappointed with their outsourcing experience. In this chapter, we identify the underlying causes of outsourcing failures and discuss ways to avoid these underlying causes. Specifically, we use real examples to describe eight different outsourcing-related risks and ways to avoid or mitigate them so as to improve the chances of outsourcing success.

10.1 Introduction

In Chapter 7, we mentioned outsourcing as part of a “make-and-buy” robust strategy. In this chapter, we describe some risks of outsourcing, and present ways to avoid eight common pitfalls so that firms can increase the chance of realizing the true value of outsourcing.

 Outsourcing is an increasingly important part of supply chain management, and therefore provides an increasingly important context for supply chain risk. Since the 1990s, more firms have been improving the way they select and manage suppliers, and suppliers have become more sophisticated in managing customer relationship. Despite these improvements, disappointing results and failed relationships between firms and their suppliers persisted. As outsourcing is quite common for most firms, it is critical to develop successful outsourcing strategies.

 To compete for market share and to improve financial performance such as return on assets quickly, manufacturers often outsource labor- and capital-intensive operations so that they can transform themselves as product designers (e.g., Nike), supply chain integrators (e.g., Boeing’s 787), or business solution providers (e.g., IBM). With improved information technologies, tax benefits, and lower labor cost, outsourcing enables firms to exploit suppliers’ capabilities and skills. (For IT projects or call centers, firms can take advantage of the time difference between US and Asia to operate around the clock at low cost.) By 2006, the manufacturing sector accounted for less than 13% of the jobs in the United States. Consequently, there is
no surprise that 80% of the toys sold in the US were made in China, and 97% of the HP notebook computers were manufactured by contract manufacturers such as Taiwan-based Quanta and Compal. Another telling statistic is that worldwide spending on business process outsourcing (BPO) projects, whether onshore or offshore, has exceeded $302 billion in 2004, according to a study conducted by the Gartner group.

Manufacturers are under tremendous competitive pressure to develop new products frequently and quickly. To reduce product development time and cost, many manufacturer outsource the product development tasks to external suppliers. Outsourced efforts for new product development include Apple’s decision to outsource its IC chip development for iPods to Pinexe Systems in India and its operating system development to Pixo Inc. in California. Besides electronics companies, Boeing outsourced 70% of the development tasks of the Boeing 787 to external suppliers. We shall use the case of Boeing 787 development in Chapter 11 to illustrate different supply chain risks arising from new product development and discuss various strategies to mitigate these risks. In the pharmaceuticals industry, there is an emerging market of a $30 billion contract drug-development with annual growth rates of 20% (c.f., Perry, 2001).

While outsourcing can be beneficial, many firms are disappointed with their outsourcing experience. First, in 2000, Dun & Bradstreet reported that 20 to 25 percent of all outsourcing relationships (manufacturing, finance, information technology, etc.) fail within two years and 50% fail within five years. Then, in 2005, Deloitte Consulting surveyed 25 world-class organizations and found that a quarter of these companies brought business functions back in-house after realizing that they could do the work themselves better and cheaper; 44% of the companies reported that outsourcing did not save any money; and half of the companies found ‘hidden’ costs to be unexpectedly high. Similar responses were reported in a recent survey study conducted by Bain & Company. Bhalla, Sodhi and Son (2008) looked at Fortune Global 500 companies and did not find any evidence that IT offshoring, including outsourcing, was linked to any of the different performance metrics over five year. These discouraging results raise the following questions:

1. What are the underlying causes of outsourcing failures (or at least lack of success)? Are there ways to avoid these underlying causes?
2. Why was it the case that some companies did not realize that they could perform tasks under consideration for outsourcing better and cheaper in-house?
3. What are the hidden costs associated with outsourcing? Is there a way to get a better handle on these costs to avoid unpleasant surprises down the road?

The answers to the above questions are caused by risks that can be avoided or mitigated. We describe eight such outsourcing-related risks and ways to avoid or mitigate them so as to improve the chances of outsourcing success.