Appendix 1. Outsourcing Models

Sourcing organizations follow outsourcing process as discussed in the previous section in which one of the most critical stages is the selection of the supplier and the kind of relationship to create with the vendor teams. Selection of the relevant model is primarily driven by the requirements of the sourcing organization which also drives the duration of the contract. Industry has various arrangements but there are 5 prevalent models (M1 to M5) as discussed in Table A1-1 (IT World, Executive Brief, 2008). The most basic model, M1, is based on the resource needs. The sourcing company is looking for outsourcing project for which there is a need of resource having general set of skills which may be customer support or back end support for some of the in-house processes. In this case client will look for quick ramp up and ramp down of resources. The vendor delivers services at low cost since the vendor has the benefit of scale in favour.

Model M2 is primarily driven by the need of resources with niche set of skills. In this case, sourcing organization looks for specialized knowledge in certain domains. In case of a product company, client will look for skills in design and development, research and development, system testing, etc. Vendor has responsibility in this case to ensure that special

<table>
<thead>
<tr>
<th>M1 Access to Resource</th>
<th>M2 Access to niche skills</th>
<th>M3 Project based</th>
<th>M4 Managed Services</th>
<th>M5 Build-Operate-Transfer BOT</th>
</tr>
</thead>
<tbody>
<tr>
<td>This is the most basic of all outsourcing models. Client adds contractors to increase output as demanded by the organization. Client still controls all resources. This has the least risk among all the outsourcing models.</td>
<td>Client identifies skill gaps and gets access to required skills and competencies from a vendor. In this case vendor has the responsibility that client's requirements are met as tasks which were earlier done in house have been outsourced.</td>
<td>This is an example of selective sourcing. Client does not outsource all the processes but only the ones that are required to be outsourced. If there is a difficulty in separating tasks in a process then better solution is to outsource the entire process as a project.</td>
<td>Client decides on a long term engagement of services of a vendor. Key performance indicators are defined and identified by the client which become part of the contract with a vendor. Vendors act as consultants and has much larger role in managing skills and competencies required in the projects which are part of the system.</td>
<td>Client opts to contract an offshore partner to start its own subsidiary through the build-operate-transfer (BOT) model. The offshore partner handles all the local issues for the client from start to finish. Client takes over the operation after a certain set period of time.</td>
</tr>
</tbody>
</table>

Table A1-1: Outsourcing Models
resource requirements are met as the task is critical and client is outsourcing it for the first time.

Earlier clients have outsourced end to end processes or functions to single clients. This has changed in the past few years as the supplier market risk has been low suggesting there are number of service providers with required resources. Selective outsourcing is one of the latest trends in outsourcing. Model M3 is called Project based outsourcing model. This model provides an opportunity to the sourcing organization when client’s team has difficulty in separating various tasks in the process. In such cases, he total process is outsourced to a single vendor.

Many clients are establishing strategic partnership with vendors. The working model M4 is discussed in the Table A1-1. This model creates a win-win situation for both as the relationship involves high level of trust, sharing of risk and rewards, teams get integrated, and the focus remains on meeting objectives of the client and adding value to the organization.

Build-operate-transfer (BOT) model, M5, is also one of the options to the sourcing organization. In this type of arrangement, the sourcing organization signs a deal with a local company in a specific country where the sourcing organization has planned to establish a centre, hire required resources, deal with local political and social agencies, local tax laws, and work with local unions. The contract usually spells out terms and conditions for the duration of the contract after which the sourcing organization takes over the entire operation.
Appendix 2. Outsourcing Contract Pricing Models

Costing an outsourcing contract is a challenge for the sourcing organization. As discussed previously detailed costing of basic level tasks needs to be undertaken for the process that is a candidate to be outsourced. The outsourcing industry had adopted time and material costing model in early days but in recent years new pricing models have emerged as described in Table A2-1. Clients realized that time and material pricing was not a true representative of the actual efforts put in by vendor teams hence there was a room for manipulation. The pricing model changed to fixed fee contract in which client organization clearly defined service level agreements or deliverables for a fixed fee which prompted vendor organisations to deploy resources and govern projects tightly for delivering on time or even before time.

There are 4 different types of pricing models (P1 to P4) adopted by the industry with each one having a very specific objective behind it. There are pros and cons for each model hence it is imperative for clients to select appropriate model that will fulfil business requirements. These models are based on gain-sharing, consumption-based or pay-per-use concept, incentive-based and sharing risks-rewards based (Overby and Stephanie, CIO, 2012). In all of these models, client expects vendors to work partners and help in achieving business objectives. Pay-per-use model has been extensively used by There is a clear intention on the part of clients to recognize and award vendors for delivering excellent performance.

Another important factor for selection of any of the models mentioned in the Table A2-1 depends on the importance level of the activity that is to be outsourced and the kind of relationship client has decided to have with the supplier teams and organization. This is discussed in the previous sections. Selection of a certain pricing model depending on the level of supplier market risk dictates the type of relationship that will exist between the client and vendor teams during the execution of the contract.
<table>
<thead>
<tr>
<th>Model Type</th>
<th>Objective</th>
<th>Pros</th>
<th>Cons</th>
<th>Risks</th>
<th>Best for</th>
</tr>
</thead>
<tbody>
<tr>
<td>P1</td>
<td><strong>Gain-sharing based</strong> Pricing based on the value delivered by the vendor beyond contractual terms and conditions and using its expertise.</td>
<td>Encourages collaboration and creative problem-solving.</td>
<td>Requires high level of trust and upfront investment. Distribution of risk and reward must be equitable.</td>
<td>Since the concept is of gain-sharing there could be exploitation on both sides.</td>
<td>Clients looking for substantial jump in top line and bottom line.</td>
</tr>
<tr>
<td>P2</td>
<td><strong>Incentive-based</strong> Bonus paid to service provider for delivering performance beyond SLAs agreed upon in the contract. Often used with time and material or fixed price contracts.</td>
<td>Incentives can make up for the gap in the initial contract, if any.</td>
<td>Vendors getting paid extra for what they are supposed to deliver anyways.</td>
<td>Exploitation by vendors.</td>
<td>Vendors who could invest for performance improvement.</td>
</tr>
<tr>
<td>P3</td>
<td><strong>Consumption-based</strong> Costs are allocated on usage basis.</td>
<td>Pay per-use model hence capital expenses become operational expense.</td>
<td>Utility pricing requires good accurate estimate of demand of services and promise for a certain minimum service requirements.</td>
<td>Clients teams reluctant to identify more tasks to outsource.</td>
<td>Clients who have variable demand.</td>
</tr>
<tr>
<td>P4</td>
<td><strong>Shared Risk-Reward</strong> Client and vendor jointly invest in products and services.</td>
<td>Encourages vendor to be productive, efficient, and innovative.</td>
<td>Difficulty in measuring outcomes and sharing proportionate rewards.</td>
<td>Disagreements between client and vendor on investments, ROI, resource allocations, etc.</td>
<td>Clients willing to share risk or reward.</td>
</tr>
</tbody>
</table>
Appendix 3. The Outsourcing Process

It is noted that vendors providing services for the outsourced contracts have failed to deliver desired results. Almost 75 per cent CIOs in a survey conducted by American Management Association reported that the anticipated outcomes of outsourcing had failed to meet their expectations (Greenberg and Canzoneri, 1997). This may have happened as most companies may have taken a short term view of cost reduction instead of taking a long term strategic view. Many companies do not go through necessary details of the outsourcing process decision fail to anticipate hidden cost during the execution of projects.

A3.1 Stages in Outsourcing Decision Process

There are number of stages involved in outsourcing process and several teams within the sourcing company need to be involved before a final decision is arrived at. This is important as outsourcing impacts functions and processes in the company which alters roles and responsibilities of the personnel involved with the project. The stages involved in the decision of outsourcing are outlined below:

- Understanding the organization
- Activity analysis
- Competence and capability analysis
- Sourcing options analysis
- Relationship strategy
- Execution strategy

A3.2 Understanding the Organization

This stage of the process is the first step during which teams must understand various activities carried out in the organization. As discussed in the previous section on vertical integration, there are activities which are performed in-house and activities which are customer facing. It is important to analyse each activity and costing of that activity. This costing exercise eventually determines the contract value. Companies gain competitive advantage when similar activities are performed better than other competing companies. Since it is expected that vendor will improve process performance, it is imperative that internal teams analyse each activity to the task level and cost each task. Companies outsource customer support function without understanding potential implications of poor customer
support service. Customer dissatisfaction due to poor customer support could be highly damaging and company may not gain competitive advantage that is expected after outsourcing.

When company segments activities it becomes easier for management to understand cost of each activity and also identify which tasks cost more while the value addition is limited to the core of the company. This helps in identifying those tasks which potentially become candidate tasks or activities for sourcing from outside.

A3.3 Activity Analysis

This is the second step in the outsourcing decision process. Processes are broken down to various task levels such as level 1, level 2, level 3 tasks, and so on. For example, pay roll could be a process in the Finance department and it will involve several of level 1 functions which further are broken down level 2 such as mapping employee name with designation and salary band, applying additional allowances to basic pay, taking care of all deductions including taxes, depositing final amount after all deductions to employee bank account, and mailing a pay slip to the employee. This exercise is important to understand which processes and tasks are critical in the organization and which of them add substantial value from customer point of view, in this case an employee.

Any task which adds substantial customer value must also provide strategic advantage to the company and if this task is done better than competitors, company enjoys healthy market share and sound competitive position. In such case, management may not want to outsource such functions and retain them in-house. Several companies identify critical success factors (CSF) for the success of the company. These CSFs must be performed well for the organization to be successful. Some of CSFs could be development global sales network, superior product development capabilities, and development of highest quality supply chain. If activity analysis exercise is not conducted properly then there is every possibility that wrong process or tasks may be outsourced and company may lose competitive advantage.

A3.4 Competence and Capability Analysis

Once the activity analysis is conducted, next task is to understand what all skills and competencies are required to perform those activities. Prahalad and Hamel (1990) have discussed this issue extensively in their paper. It is logical to think that activities which
provide competitive advantage and are related to core processes should be performed internally. At the same time one has to undertake an exercise to find out if similar activities are performed by service providers better than what in-house staff can provide and also at lower cost.

There may be internal resistance for outsourcing critical activities if they have been performed internally over the years. Outsourcing critical activities creates a sense of insecurity and instability among employees. Internal teams must undertake cost analysis and understand relevance of activities to the core line of business. Service providers have the advantage of scale in their favour which enables them to provide service at lower cost to sourcing organization.

**A3.5 Sourcing Options Analysis**

Analysis in this step uses two important factors as discussed before, that is, activity importance and internal capability and competencies analysis. Decision of outsourcing is based on these factors which provide various options to the management as shown below in Table A3-1:

<table>
<thead>
<tr>
<th>Activity Analysis</th>
<th>Competence and capability analysis</th>
<th>Decision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Critical</td>
<td>Less capable</td>
<td>Strategic outsource/Invest to perform internally</td>
</tr>
<tr>
<td>Critical</td>
<td>More capable</td>
<td>Perform internally and develop/Strategic outsource</td>
</tr>
<tr>
<td>Not critical</td>
<td>Less capable</td>
<td>Outsource</td>
</tr>
<tr>
<td>Not critical</td>
<td>More capable</td>
<td>Outsource/Keep internal</td>
</tr>
</tbody>
</table>

In the first scenario, if the activity is critical in nature but the level of internal competency or capability is limited in carrying out that activity then the options are either company can invest internally to build up the competency level and perform activity internally or outsource it to an external service provider. If the company were to decide on investing internally for building up the competency level, it will take time as employees will need additional training, hands on practice, and also getting familiar with required hardware, software, tools, etc. This
is a critical decision as company may not have luxury of time if the competition is intense. The other best option to the management would be strategically outsource to a service provider. The activity being critical in nature and knowing that the activity is too difficult to replicate. The management has one more option of acquiring a company which will bring required skills, competencies and augment the capability of the organization.

In the second scenario, if the activity is critical in nature but the company has strong internal capability to perform it then management can either decide to keep it internally and further develop it to gain competitive advantage or outsource to a service provider. If the company is strong in carrying out an activity then it will be difficult for an external service provider to meet expected level of performance hence it is critical to choose a right service provider who can deliver the same level of performance as internal teams can. Keeping it internally would most likely be a preferred choice. If the management decides to outsource for reasons such as to free up the resource for other strategic projects or deploy resource to work on next generation products/services or company may not be able to sustain the level of present performance level in the future.

In the third scenario, activity is not critical and company is less capable to conduct in house then obvious decision would be to outsource. It will not be necessary in this case to have strategic relationship with the supplier due to non-critical nature of the activity. There may be number of service providers available for sourcing this activity in which case sourcing company could negotiate hard for lower cost.

In the fourth scenario, activity is not critical but company has required capability to carry out internally then management could either keep it internally or outsource it. Preferred option would be to outsource such an activity and use resources for building up competitive advantage in other areas.

**A3.6 Relationship Strategy**

Relationship strategy with suppliers is important as buyer teams have to work with supplier teams for the duration of the contract. Similarly relationship at executive levels and middle management levels on both sides is equally important. The buyer decides on the kind of relationship that will be established with the supplier. The first and foremost important task for the buyer teams is to establish clear objectives expected from outsourcing. The outsourcing objectives must be linked with the strategic goals of the sourcing organization.
Once the relationship strategy has been decided then it must be monitored throughout the execution of the contract.

Another important factor in deciding the nature of relationship with the supplier organization is the supplier market risk. If there are number of suppliers who can provide required services then adversarial relationship will be the preferred option. Similarly the level of importance of the activity that is being outsourced will also have a bearing on deciding the kind of relationship that could be preferred during the course of contract. If the number of suppliers is small then adversarial relationship will not be the correct option. Following Table A3-2 shows various options:

### Table A3-2: Relationship Strategy

<table>
<thead>
<tr>
<th>Activity Analysis</th>
<th>Supply Market Risk</th>
<th>Relationship Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Critical</td>
<td>Low</td>
<td>Competitive collaborative</td>
</tr>
<tr>
<td>Critical</td>
<td>High</td>
<td>Close collaborative</td>
</tr>
<tr>
<td>Not critical</td>
<td>Low</td>
<td>Adversarial</td>
</tr>
<tr>
<td>Not critical</td>
<td>High</td>
<td>Secure supply</td>
</tr>
</tbody>
</table>

In the first scenario in Table A3-2 above, the activity to be outsourced is critical in nature while supply market risk is low which means there are many suppliers who can provide required services. Suppliers have limited bargaining power and buyers can easily switch to other supplier. The strategy that is preferred would be competitive collaborative in which case the sourcing organization may work with a supplier as long as the supplier delivers better than expected performance and establish a close long term strategic collaborative relationship with the supplier.

In the second scenario, the activity is critical but the supply market risk is high which means there are not many suppliers in the market who can deliver expected services. In this case supplier may want to establish close collaborative relationship in long term with the service provider so that supplier delivers value to the sourcing organization and delivers benefits which are unavailable to competitors.
In the third scenario, the activity is not critical and supply market risk in low. In such situation adversarial type of relationship is preferred where sourcing organization negotiates hard to sign a contract at low cost. The sourcing organization must expect best of the price, delivery, and quality from the supplier. The sourcing organization must be cautious to ensure that supplier organization is not going to build any dependency in the relationship which could be exploited later by the supplier.

In the fourth scenario, activity is not critical but the supply market risk is high. In such situation recommended relationship strategy would be to ensure that there will be no discontinuity in the contract. There are factors in the supply market which can create uncertainty and vulnerability in supply. The sourcing organization must secure relationship with a supplier for long term and establish strategic relationship.

A3.7 Execution Strategy

Execution strategy consists of factors such as supplier relationship, monitoring performance of suppliers, managing relationship, contractual issues, level of dependency, and strength of the relationship. As discussed in the previous section supplier relationship strategy will be the outcome of an exercise undertaken by the sourcing organization taking into consideration the level of importance of the activity to be outsourced and supplier market risk.

Both the parties must understand business and legal issues with outsourcing and make sure they are addressed in the contract. The terms and conditions must be drafted correctly along with identifying escalation levels in case the dispute could not be resolved by the middle management. The contract must spell out all the service level agreements (SLA) to be met and proper tools and techniques must be discussed and mutually agreed upon for measuring the performance. In certain cases where ambiguity could not be addressed in the contract then teams from both sides need to work together and develop collaborative working culture.

Once the contract is signed, the transition to vendor teams begins. The success of the relationship will be largely determined by how well the relationship is managed at all the levels on both sides.