Offshoring – the relocation of certain activities to foreign locations, often thousands of miles away – has existed as an option since the 1980s at least, but it is only in the last five years that it has moved from being a niche strategy, adopted by a few early movers, to an option being considered by a majority of companies. A recent survey of 275 finance executives of multinationals, found that 18 per cent currently use offshore outsourcing, with many more considering this option in years ahead. For most large companies today, offshoring is high on the strategic agenda.

The headlines in the business press suggest that offshoring is about moving IT and call centre jobs to India for the sake of cost reduction. But the reality is far more complex. Offshoring is being undertaken in a range of functions, from IT, finance and accounting through to business analysis and R&D. Location choices range from ‘nearshoring’ in countries such as Poland and Hungary to ‘offshoring’ in India, China or the Philippines. The reasons for considering offshoring include skills and expertise issues, as well as cost savings.

But while offshoring is now big business, its benefits are by no means guaranteed. For example, in November 2003, following a number of complaints, Dell announced that it would stop using its technical service centre in India for business customers. And several companies we spoke to had engaged in a lengthy cost-benefit analysis of offshoring, only to conclude that the potential cost savings of 15-20 per cent were not worth the risks.

So what should your company’s approach to offshoring be? The purpose of this article is to provide a framework for evaluating the different location choices for each support activity, and then to consider the typical activities that are undertaken in each location. We also offer some perspectives on the dynamics of offshoring, the way a company’s offshoring strategy typically evolves over time, and the challenges in implementing an offshoring strategy.

**Key messages**

- Many large companies are now either engaged in offshoring or are considering it as a strategic option.
- Offshoring is one of several location options, and its suitability depends on the nature of the activities in question and the structure of the company.
- Commitment by senior executives and appetite for change are crucial to offshoring success.
- Offshoring is not a solution in and of itself, and is best pursued as one of several complementary strategies.

**Drivers of offshoring**

The increasing use of offshoring is part of the never-ending search by large companies for efficiency and cost reduction. The trend is particularly prevalent in back-office or support activities. These, by definition, are not customer-facing, and are therefore
open to being located in lower-cost locations. Within this broad movement, it is possible to identify several related trends, of which relocation is one:

- Automation of routine activities that can be done without human intervention.
- Disaggregation of activities that used to be done by the same person. For example, an accountant could formerly undertake a broad range of tasks, from providing advice to basic book-keeping. Increasingly, accountants are now focused on higher-level advisory tasks, while the more routinised parts of the job are either automated or pushed into a shared service operation.
- Consolidation of similar activities into a shared service operation. Rather than every operating unit doing its own payroll or accounts payable, these activities can be done more efficiently in one central location.
- Commercialisation of shared activities, either by making them into a profit centre within the company, or by spinning them off through an outsourcing arrangement.
- Relocation of shared activities to a carefully chosen place, typically selected on the basis of cost or availability of employees, but sometimes for particular skills such as language.

It should be noted that relocation and commercialisation often go together. The decision to move an activity out of house to a separate facility usually requires that this activity be managed more commercially.

**Evaluating location options**

From our research, two dimensions emerged as the most critical in selecting the location for a support activity. One is the extent to which the activity can be codified or routinised. Highly codifiable activities (such as expense claims or payroll) lend themselves to automation, and can also be undertaken by individuals with limited training or skills. Non-codifiable activities (such as treasury, leasing or compensation planning) involve much higher degrees of judgement and experience.

The second dimension is the nature of interdependence between the activity and the core strategic activities of the company. A standard way of framing this is to consider three forms of interdependence: sequential (A is an input to B, which is an input to C), pooled (A and B are inputs to C) and reciprocal (A is an input to B and C, but B and C, in turn, are inputs to A). Activities that have only pooled or sequential interdependence with the core can typically be managed on a remote basis, whereas activities involving reciprocal interdependence benefit from co-location. By considering these two dimensions together, it is possible to identify some of the critical differences between the different location options. Five primary options emerged from our research, as shown in Figure 1. Each is considered in turn below, and a summary is provided in Table 1.

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**Figure 1: Framework - Location choices for support activities**

**Co-location**

For those activities involving a high degree of expertise and significant interaction with the senior executives in the company, co-location is necessary. This is, of course, the default arrangement because such activities, including business analysis, treasury and legal affairs, have historically been located within the business. However, it is important to underline that even within such functions there will be sub-activities that end up shifting to other locations, or being automated. For example, Procter and Gamble has recently announced it will outsource the data entry elements of its accounts payable process to Hewlett-Packard, but those aspects of the process that affect P&G’s internal customers will be retained within the organisation.

**Virtual centres of excellence**

Many activities involve a high degree of expertise or professionalism, but there are few benefits from locating the individuals in question together either at the corporate headquarters or in a business location. For example, in the human resources function, activities such as compensation and benefits and management development do not need to be co-located with other business activities. As such, they could be best managed in what is sometimes called a ‘virtual centre of excellence’. All of the compensation and benefits experts would be part of this centre, but they would continue to reside in their existing operations, travelling between sites and coming together for meetings. The virtual centre of excellence requires active management because the default is
Nearshoring

Nearshoring is typically a centre or a series of centres that perform codified, routine activities for a number of corporate customers, outside the main business but still within the same geographical region. For example, a business wishing to establish a shared service organisation to serve its western and eastern European operations would locate the centre or centres somewhere in Europe. If more than one centre is to be established, the choice of location can be assessed on the basis of quality and cost parameters to take advantage of differences in wages between countries or areas within the region. Alternatively, different centres can focus on individual activities, such as accounts payable in one location and HR transaction processing in another.

Nearshoring typically has a higher cost profile than offshoring, but it also has several important benefits. These include lower risk, easier communication with the business, and often a greater cultural affinity to the core customer groups. The latter can be particularly valuable in customer-facing entities such as call centres.

For example, Oracle has regional service centres based in Ireland, the USA and Australia. The EMEA centre in Dublin services 42 countries, covering 16 process areas, and at its peak had almost 400 staff. A number of these activities are currently being moved to India, and soon there will be 105 staff supporting EMEA in India (and additional staff covering similar activities for USA and Australia centres). This is now made possible for smaller companies too, thanks to the wide range of options in countries such as Spain, the Netherlands, Switzerland and Ireland.

Offshoring and outsourcing are more complex issues than is usually suggested, and are usually part of a much larger strategic picture. Until recently, it was only large multinationals who could afford to think about strategic sourcing globally – and that was usually in the realm of manufacturing, procurement or perhaps logistics. Modern technology (and frequent flyer miles) have made it possible for smaller companies to think about working with Bangalore and Beijing with as much familiarity as Baltimore or Bristol. Regardless of the politics of the debate, it is an accepted fact today that the outsourcing of IT-enabled services can lower costs and improve productivity.

The practical aspects of outsourcing cannot be easily generalised. Companies will need to make decisions based on cost, quality and productivity considerations when deciding whether to outsource a particular function. The domain expertise, value addition and credentials of the service provider will always need to be examined in a cost-benefit analysis, just as they would in any non-IT outsourcing decision. This decision-making process also makes companies analyse the criticality of each part of the value chain in delivering the best possible customer experience, and finding the right solution provider to assist in that process.

One aspect that has perhaps received less global attention is the socio-economic impact of outsourcing among workers in emerging markets. In a country such as India where there is high unemployment, or rather disguised under-employment, the business process outsourcing (BPO) industry has created more than 200,000, much-needed, well-paying jobs for young people. For many BPO employees, especially for those from a lower middle-class background, these opportunities are full-time careers, not merely jobs. Those Westerners lamenting the loss of North American jobs can take heart from the increased consumption of essentially Western products in these markets, as call centres and their young staff stock up on Domino pizzas, Cokes, Reebok trainers and Dell computers.

Psychologically, the impact is mixed. In India, for example, traditionalists point to the negative effects of a more westernised lifestyle, as young Indians start accepting live-in relationships with their partners, and begin smoking and drinking. Other white-collar knowledge workers sniff at this blue-collar work, with its odd nightshifts, as new age shopfloors multiply. Others believe that call centres have a significant positive impact on Indian society and industry.
enabling Oracle to achieve an appropriate balance between the lower cost environment of offshoring and the benefits of nearshore locations.

Offshoring
Offshoring refers primarily to relocation to emerging economies, such as India, the Philippines and China. The distinction between nearshore and offshore is particularly relevant for European and US companies, which have access to medium-cost locations (Poland, Turkey, Mexico) that are closer than emerging economies of Asia.

Offshoring is the preferred option for those activities that are easily routinised, and that offer substantial returns to scale. Enormous amounts of back-office banking work and call-centre services are carried out in offshore locations.

Increasingly, companies are experimenting with higher value-added activities. For example, in August 2003, Citigroup and HSBC announced they would be moving some of their investment bank analyst jobs to India. The jury is still out on whether such moves really make sense. Companies participating in our research say that this approach entails some significant risks.

Automation
For those activities that can be entirely routinised, it is possible to remove the human component altogether and automate them. However, even for such activities as cheque processing or payroll there will always be exceptions that need processing with human intervention. This means that so-called ‘lights-out processing’, in which there is no human intervention at all, is a vision rather than a reality. At the moment, automation almost always occurs in tandem with one of the other options.

For example, several investment banks have automated the majority of cash settlement activity, the automation being carried out by outsourc e service providers. However, those elements of the process that cannot be automated are still co-located with the business. The rationale is that the cost of creating complex, dynamic systems would be greater than to retain human intervention.

Trends in location choice
While these different location options are fairly well known, our research suggests that there is scope for thinking through the costs and benefits of each more carefully. As so often is the case, the challenge is how best to use these alternatives in an integrated way, and how to manage them dynamically according to the evolving needs of the business. Our study identified three important trends:

Disaggregation of activities into constituent parts, with each done in a different location.

Many business process outsourcers (BPO) now operate on a ‘layered’ model. In one case, the company in question was providing an outsourced accounts payable process to a Scandinavian customer. The processing of invoices and payment activity were carried out in India, while an operation in Poland was used for handling queries from internal customers and external suppliers. The additional costs this latter entailed were offset by a better quality of service than could currently be achieved in India.

Shift of activities between locations according to the shifting demands of the business.

For example, Diageo was formed in 1997 as a result of the merger of Guinness and Grand Metropolitan. This gave the business an opportunity to take advantage of greater economies of scale within its back office apart from job creation.

Working daily with North American and European companies allows young Indians to benefit from constant feedback and positive thinking. As individuals are trained to become more customer-focused, they are encouraged to improve their professional skills such as counselling, coaching and mentoring, and taught how to deal with anger, rejection, frustration - skills that help in personal life, too. Instead of the more conventional Indian relaxed and laid-back work culture, BPO employees are taught time management and discipline, as every moment of their work life is monitored. In a country where professional career guidance is limited, a call centre can provide individuals with some ideas on how to fulfill their potential.

This is especially in the case where BPO employees acquire domain expertise in a certain industry such as healthcare, or in a function such as HR, and find it easy to move to that industry.

While the BPO industry in India is still young, relatively small and concentrated in a few Indian cities, it is worth speculating about the ripple effects it may have on Indian industry. One can quite imagine that the very same Indians who service demanding European or North American customers daily will in turn start demanding an equally satisfactory customer experience from product and service providers back home. This could propel Indian manufacturers towards becoming much more customer-focused. Outsourcing entails being process-driven and detail-oriented: aspects that are generally missing from the Indian work culture. Again, as call centre employees migrate to other industries, there is the possibility that they will bring these processes and tools to their new employers.

In conclusion, it seems that the BPO march is inevitable. The trend will certainly deepen as more and more companies aspire to become world class, stretch to retain their competitive edge and push to innovate. However, as companies across countries come together and as they become more interdependent - a necessity if all the benefits of outsourcing are to be garnered - some managerial challenges will increase. The sharing of knowledge will raise intellectual property rights issues over time. Equally, organisations may find it increasingly difficult to apportion the share of value addition, raising questions such as who brings what to the table. In a sense, such challenges are the same as in any joint venture.

The BPO business is as much about knowing and appreciating your vendor as it is about bringing down costs. Let’s not forget, the vendor is not the barbarian at the door, but your partner.

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processes. The merged service centres were initially located in the UK and Ireland. Subsequently, Diageo moved its finance and customer service operations for a number of its European markets, from London to Budapest, taking advantage of the new business environment.

Careful monitoring of the costs and benefits of different locations, and openness to change Dell, the world's largest PC maker, opened a shared service centre in Bangalore in April 2001, and rapidly expanded its workforce to over 3,000 employees. However, complaints from business customers led the company to re-evaluate the costs and benefits of this operation, and in November 2003, Dell announced plans to scale back its Bangalore service centre, and move its business customer call centre activities back to the USA.

Implementation issues
The primary constraint on offshoring is usually a lack of confidence that the shared service organisation being established will be able to deliver to existing quality and service levels (although using an outsourcer service provider usually ameliorates this concern). Establishing shared services involves significant change, for both individuals within the back-office functions and the businesses themselves. The elements of change are many:

- Individual jobs often end up being disaggregated, into those tasks that are strategic to the business, those that are advisory but can be undertaken remotely, and those that can be automated entirely. Each task typically has a different place in the new organisation.
- Sharing of services means a de facto loss of influence and control over activities that were previously operated directly by the businesses. Not surprisingly, the process of giving up these activities is undertaken with great reluctance.
- The new approach involves implementing common systems and processes across the businesses. This often means that compromises have to be made on the functionality for each specific business.
- The way that businesses interact with their back-office functions changes. The new approach typically offers a higher level of business discipline, including more self-service technology, higher levels of transparency of cost of service, and ‘extra services’ being charged for separately.

As a result, most organisations choose an implementation path that both achieves cost reduction and manages risk by choosing a location with which managers are already familiar. Customers are brought into the model in a phased way. Offshoring is usually considered as a second step. Consider the case of Oracle, the leading database and software company, referred to above.

In January 1999, in response to a need to create a single global brand while also reducing its cost base, Oracle decided to implement standardised global finance processes and establish a shared services delivery model. It took eight months to agree standardised global processes across sixteen process areas. Through a process of ‘brown papering’ with the best and brightest resources from within the company, these processes were then mapped to the standard Oracle release of the time. Five months of integration testing followed, covering all scenarios from all parts of the business.

Three service centres were subsequently established, the EMEA centre in Dublin and two other centres were established in California and Sydney, Australia. Forty-two countries were serviced by the Dublin service centre within four years from programme inception, which processed $3.5 billion in revenue and at its peak had almost 400 staff. Some of these activities are now being eliminated through technology or process optimisation, and others are being moved to India.

Plans included 105 service jobs in India by the end of July 2004, with 230 jobs remaining in Dublin. Improvements will not stop there. “You have to keep changing and reinventing,” observed Nicky Sheridan, Oracle Vice President and Managing Director, Ireland. “We are always looking to bring in further work to the centre and automate or offshore the most routine work.”

Whatever the company’s chosen back-office strategy, two critical factors are the level of commitment to the initiative from senior executives, and the overall appetite for change within the organisation. These factors are important in all change projects, but are particularly crucial here, given the number of people who will be directly affected and the inherent uncertainty of moving activities overseas.

As one of our interview respondents observed: “If senior executives are not spending at least an hour a week on the project, it’s not going to be successful. It’s tough selling to local country MDs that it’s going to be a worse system than before, because they previously had a customised system and process to suit their needs. It’s not easy to see the global benefit, if I had my time again, I’d concentrate even more effort and attention to managing the process of change, and getting the active involvement of the top executives.”

Conclusions
In this article, we have put forward a way of thinking about the location choices facing a company as it considers how best to manage its back-office operations. Offshoring can provide important benefits, but it represents only one of several choices, and it carries substantial risks. Our approach involves taking a disaggregated view of back-office activities, and thinking through the locational choice on a task-by-task basis. Once this analysis has been done, attention can shift to issues of how best to co-ordinate the tasks across the various locations, and how to ensure an effective implementation process.

Offshoring is not the solution to low-cost, high-quality shared service centres, but it is certainly one effective approach that can be pursued in combination with other, complementary strategies.

References
- This parallels the distinction made in academic literature between codified and tacit knowledge. Codified knowledge can be shared between individuals without loss of integrity once the syntactical rules for deciphering it are known; tacit knowledge is experience-based, and cannot be transferred without enormous effort on both sides. This is based on the work of J.D. Thompson, Organizations in Action (1967).

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