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Business Process Outsourcing:
Understanding the Critical Role of IT

An Economist Intelligence Unit report sponsored by SAP

Preface

Business process outsourcing: Understanding the critical role of IT is an Economist Intelligence Unit article, sponsored by SAP. The Economist Intelligence Unit bears sole responsibility for this report.
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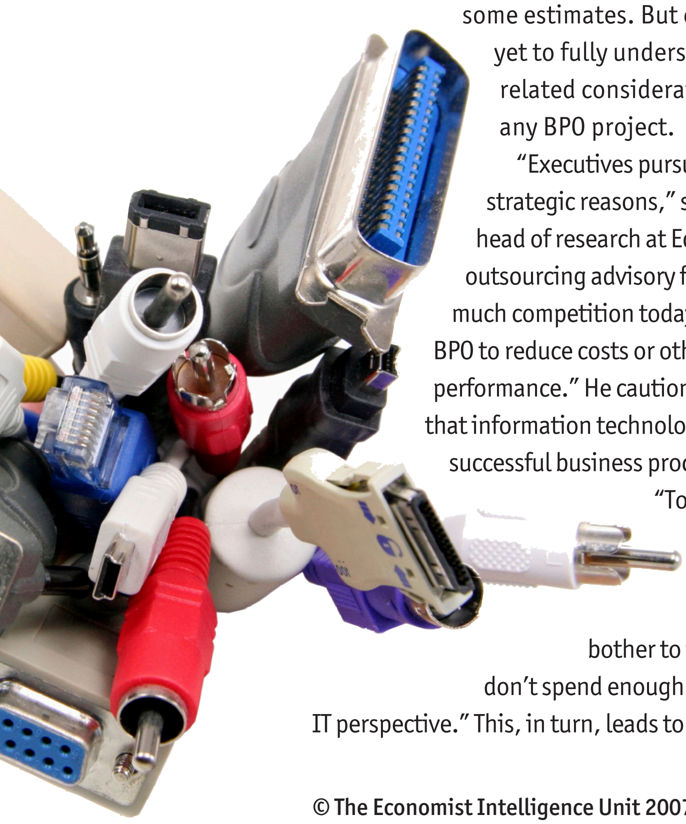
Understanding the Critical Role of IT

In the days of traditional systems integration, consultants and providers made their money on the implementation of new processes, not on the ongoing delivery of those processes. In the new age of business process outsourcing (BPO), customers, service providers and consultants focus less on the reengineering of systems and more on the quality and cost of the ongoing process output. The trouble is that neither approach generates a balanced debate about the long-term tradeoffs of technology choices. The following discussion analyses the forces shaping the surge in BPO and highlights a number of critical business issues in which the IT component is relevant and yet too often misunderstood.

The number and total contract value of business process outsourcing (BPO) agreements between providers and clients is growing at a fevered pace—over 30% per year, according to some estimates. But companies have yet to fully understand the IT-related considerations inherent in any BPO project.



"Executives pursue BPO for strategic reasons," says Stan Lepeak, head of research at EquaTerra, an outsourcing advisory firm, "There's so much competition today that they look to BPO to reduce costs or otherwise improve performance." He cautions, however, that information technology is essential to successful business process outsourcing. "Too many companies emphasise strategy, but then don't bother to involve IT, or they don't spend enough time assessing the IT perspective." This, in turn, leads to many deals that otherwise might have been structured differently and worked better for both vendor and client.

Business process outsourcing is not a new trend. As Ralf Dreischmeier, a vice president and director at Boston Consulting Group (BCG), explains, "People have been outsourcing basic processes, like payroll, for many, many years." But what is new, says Mr Dreischmeier, is that companies are outsourcing larger and increasingly more sophisticated processes—an effort that can be highly successful if firms understand both the risks and the benefits of doing so and make an informed choice.

The acceleration in BPO results from several factors, but the two most important are the widespread advances and standardisations in technology and the surge of low-cost talent in countries such as India, Eastern Europe and China. "Technology today enables access to (relatively) low-cost labour," says Peter Bendor-Samuel, CEO of the outsourcing consultancy Everest Group. In addition, technology enables one organisation to benefit from the capabilities of another. These two characteristics, says Mr Bendor-Samuel, "become the fundamental drivers of BPO."

Just about any business process is a potential candidate for outsourcing. In Mr Bendor-Samuel's opinion, BPO is most easily defined by what it is not. He considers it "non-IT outsourcing," and points out that "there are literally hundreds of niches that fit the classification—and the motivations and drivers are different in nearly every case." For example, the majority of BPO projects involve what might be referred to as back-office processes, such as finance, accounting, purchasing, accounts receivable/payable or real estate management. Still, the list is ever-expanding and today includes elements of customer service (eg, call centres), human resources and even logistics. In short, says Mr Bendor-Samuel, "any non-core, non-differentiating process is a candidate for BPO."

Low cost, high quality

At its heart, BPO enables labour arbitrage, and cost is indeed a fundamental driver of the process. But within the broad drive for cost savings, there can be significant variation and nuance. For example, outsourcing back-office processes can offer efficiency gains as well as cost savings. A BPO provider might help a client standardise processes within an ERP system or a shared services framework. This form of standardisation, says Mr Bendor-Samuel, "is one of the most significant sets of benefits a company can obtain [from BPO]."

Another reason for outsourcing business processes—especially human resources functions—is companies' desire to improve quality. Not every enterprise can justify investments in technology or afford the resources necessary to stay abreast of global labour regulations. Particularly in HR, Mr Bendor-Samuel explains, BPO tends be driven by a provider's economies of scale.

Evaluating IT capabilities

Ultimately, BPO is enabled by IT. So as executives weigh the potential risks and rewards of BPO, it is especially important, says EquaTerra's Mr Lepeak, that they take time to "carefully evaluate the role of IT."

But as obvious as this may seem, it is not always the case. Mr Lepeak says that his company has been researching the role of information technology in BPO for some time, especially during the past year. "What we've found is that people who make investments in BPO very often overlook the IT aspects; some try not to involve the IT department at all." Either approach, says Mr Lepeak, "can lead to less than remarkable results" or certainly poorer performance than could have been achieved if IT had played a larger role in up-front analysis and implementation.

The following are the most critical IT issues to consider in a BPO project:

How do our current processes perform? Before a company can have effective discussions with a BPO provider,

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What is BPO?

Business process outsourcing (BPO) occurs when a company gives a third party the responsibility of operating what would otherwise be an internal system or service. For instance, an insurance company might farm out its claims processing program to an external contractor. Other functions commonly outsourced are call centres, payroll, accounting and human resources. The BPO vendor may be located within the client's own country or offshore.

Migrating from an existing set of processes to something different can create many problems.

it needs to understand its own environment. "Most processes have a heavy IT component," says Mr Lepeak. So it is essential, he maintains, "that you know your current IT costs and your current process performance levels."

This view is shared by Juliane Kronen, a vice president and director at BCG. According to Ms Kronen, executives might be tempted to view BPO as a means of assigning cumbersome, poorly functioning, misunderstood or unwanted tasks to third parties. But in reality, says Ms Kronen, "for BPO to be successful, you have to have a very clear understanding of your processes, including the outputs and the interfaces. Undeveloped or immature processes are not well-suited for BPO. That's where you're likely to run into trouble."

Another misconception is the degree to which a BPO provider can reduce a client's costs. "How much of your company's current cost component is actually driven by IT?" asks Mr Lepeak. "Are your processes inefficient because of IT? Is it a legacy environment and the interfaces aren't working? Or are they expensive because your people are being paid too much?"

These questions, Mr Lepeak maintains, highlight a common weakness in many companies' analytical capabilities. "CFOs have a lot of data on processes, but maybe they don't have people with the right skills to do the analysis, or maybe they don't have the right analytics," he says, adding that in order to make appropriate decisions in BPO, a company needs to both "know IT" and have "the people who can get to the root cause of their cost structure."

My processes or yours? Next up, companies need to evaluate whether they want an outsourcing provider to emulate existing processes or reengineer them entirely. As Mr Lepeak explains, because an outsourcing

CASE STUDY Wachovia's BPO Uses 'Structured Methodology'

ONE OF THE more notable examples of business process outsourcing is a deal inked in November 2005 between Wachovia, a US-based banking and financial services company, and Genpact, a business and technology services provider based in India. The relationship is noteworthy in at least three areas: close collaboration in deciding which processes to outsource; establishment of a "virtual captive" workforce; and meticulous, ongoing attention to IT issues.

CLOSE COLLABORATION According to Wachovia CIO Martin Davis, the two companies used what he calls "a very structured methodology" to assess and prioritise their relationship. "We wanted help assessing opportunities, but there are some things you just can't outsource," says Mr Davis. The two companies worked together to evaluate such issues as process maturity. Notes Mr Davis, "A process that's new to our organisation is something that probably shouldn't be outsourced because it isn't well defined."

Similarly, the methodology assessed the strategic value of various processes as well as risk. Here, says Mr Davis, it is important to make a clear distinction between information technology outsourcing (ITO) and business process outsourcing (BPO). Many companies are already familiar with outsourcing systems development or maintenance, but unlike IT, "BPO is production work," he says. An interruption in IT outsourcing delays only software or systems maintenance or development, but if a BPO arrangement is disrupted, especially by a natural disaster or geopolitical event, "work

provider usually works with many clients, "it may have better, more standardised and efficient processes." Still, migrating from an existing set of processes to something different can create many problems. The bottom line, says Mr Lepeak, is that "you need to involve someone who knows IT in order to be in a position to assess all the issues and make the right decision."

When should we update our systems? A critical IT component within a BPO agreement relates to timing. For instance, many companies that installed enterprise resource planning (ERP) systems between 1998 and 2001 are now ready to upgrade or replace those systems. Therefore, if one of those firms is contemplating a BPO project, it must decide whether to upgrade its systems first or charge the BPO vendor with the task. Furthermore, asks Mr Lepeak, "Are you factoring in the potential disruptions to your processes and generally including these costs in your evaluations? What will the outsourcer have to do in order to get your processes where you want them to be?"

Who is an appropriate provider for us? Companies need to pursue due diligence in assessing the capabilities of would-be providers. Fortunately, says Mr Bendor-Samuel of Everest Group, the market is becoming more mature and now features many reputable companies with proven capabilities and long lists of references.

But Mr Lepeak asserts that from an IT perspective, it may be especially important to evaluate a BPO provider's systems integration abilities, which will become crucial as more companies upgrade and consolidate their ERP systems. In particular, he says, "BPO firms that were never in the systems integration business might have some troubles when a client says it's time to consolidate ten versions of SAP or Oracle into one or two."

How will the provider manage the transition? According to BCG's Ms Kronen, companies should involve IT executives in examining the practices of each potential provider. "One question we've found is very important to ask is how they will manage the transformation," she says. "We like to see providers who will send their people

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on your core business stops."

For this reason, says Mr Davis, BPO calls for redundancy. "You have to make sure you can accommodate the workflow, shifting work from one site to another within different geographic locations. [And] you never outsource 100% of your capabilities."

Working together, the two companies were able to make better decisions about which processes were appropriate for outsourcing and the best ways to structure the workflow. So far, says Mr Davis, both are "very satisfied with the progress."

"Virtual captive" workforce. A second innovative element of the Wachovia/Genpact agreement is the "virtual captive" nature of the relationship. As Mr Davis explains, in a typical "captive" arrangement, the offshore workers would be Wachovia employees. But in this case, even though all of the workers are Genpact employees, "they're all 100% dedicated to Wachovia," he says.

FOCUS ON IT Technology, according to Mr Davis, is a critical enabler of BPO, but it presents a number of challenges. For example, he says, "it's important that you establish the necessary infrastructure for your systems to be exposed to offshore partners." Internal applications that work well at home must be modified to perform the same way on the other side of the world. A paper-intensive process may need to be converted to image format to be sent offshore, and systems that are set up to run in batch mode cannot be shut down because in a BPO situation, employees may be working on those platforms in other time zones. "Some processes and systems respond well, but others have to be tweaked and tuned," observes Mr Davis. "Each application and each process brings its own challenges to be addressed individually."

to work at your site so they get a real understanding of the process and why you do things the way you do. That shows that the provider invests in its people and its relationship with you—and that they aren't just going to pound your process into their mould."

Ultimately, there is never a valid reason to exclude IT executives from what is clearly technology-intensive endeavour.

Are we meeting regulatory and compliance requirements? Any publicly traded US company will need to involve its IT group in evaluating the impact of Sarbanes-Oxley mandates on BPO arrangements. Mr Lepeak points out, "An outsourcer can manage my receivables and payables, but what are my assurances surrounding my 404 (internal control) audits?" That question concerns systems and compliance, he says, "and it's important to have your IT people closely involved."

Exclude IT at your own risk

It is hard to imagine BPO without IT. Technology not only enables process outsourcing but in many cases can be leveraged to maximise efficiency and effectiveness. Yet, surprisingly, internal IT departments are sometimes intentionally excluded from the process. "It could be a need to get a deal done quickly—'If we don't get the balance sheet where we need it right away, we're in default on a loan'," says Mr Lepeak. Or worse, he says, there are cases where "a department head just wants to minimise the role of IT and goes out on his or her own."

But ultimately, there is never a valid reason to exclude IT executives from what is clearly technology-intensive endeavour. "IT involvement and all the due diligence that goes with that might slow you down," says Mr Lepeak. But in the end, he maintains, "you're going to be far better off in the long run if they play an active role."

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