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Critical Issues in Offshore Outsourcing

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AS U.S. COMPANIES GROW LARGER and reach out to a broader customer base, offshore outsourcing has become an increasingly attractive option. It has proven to be an effective way to cut costs by taking advantage of lower production and labor costs in developing nations. On the other side of the contract, many service providers in developing nations have embraced the chance to specialize in one practice area or another, selling themselves and their country as a haven for software development or call centers and reaping the benefit of the job creation and foreign investment that results.

But there are risks involved with offshore outsourcing, and companies need to recognize them and undertake the necessary due diligence. To determine the utility and value of an outsourcing arrangement and to sculpt a successful outsourcing contract, companies must define their expectations and understand the risks they may be assuming in an unfamiliar environment.

Many nations have developed programs and industries based on attracting outsourcing business. Among them are a few specialists. Each has its advantages and disadvantages as an outsourcing destination for American companies, but as a whole the service providers in these countries have proven themselves worth investigating by any company looking to outsource overseas.

It is important to note that the countries profiled below are by no means the only viable outsourcing options. The Philippines, Panama, Romania, and Colombia also offer outsourcing capabilities, as do many other developing nations in Central and South America and Eastern Europe. But a list of the primary destinations for oursourcing currently would need to include India, China and Russia.

INDIA

India is at the forefront of offshore outsourcing for U.S. and Western European companies. Indians have a strong command of the English language, and they have an English law-based system. India has the most established and broadly based knowledge of mainframes of any of the outsourcing countries, and it produces hundreds of thousands of computer science graduates every year.

For these reasons, India is often the first stop for companies wishing to outsource computer programming and other computer or Internet-based projects.

That said, U.S. and European companies often report trouble with frequent power outages in India, and they encounter a wide cultural gap between themselves and their Indian service providers. While Indians often speak English very well, their accent can make it difficult for U.S. managers to understand Indian employees.

RUSSIA

Russia is another option for Western companies seeking to outsource computer and IT-based projects. Russian workers are highly educated in the sciences, and Russian service providers are known for their strong process and delivery methodology, a result of the nation's once-pervasive military.

For these reasons, Russia is particularly suited to research and development tasks. The government also has lent its support to the software development industry.

However, English is not as widely spoken in Russia as it is in India, although now more people, especially in computer programming, are learning it. In addition, perceived political instability sometimes deters investment, as does the notion that Russian law does not adequately protect intellectual property. Piracy of consumer software programs remains a problem, although Russian authorities say they are stepping up enforcement of intellectual property laws.

Keep in mind also that Russian corporate culture is closer to Europe than it is, for example, to India or China. The country has a stable power grid and certainly has no shortage of oil. The standard 2008 corporate tax rate is 24 percent on Russian-sourced income, although this may vary by region.

BRAZIL

Brazil represents an up-and-coming outsourcing option, especially for U.S. companies. Its geographical proximity to the United States gives it the advantage of other nearshore locations, like Canada and Caribbean countries, and compared with India, Russia, and China, the time difference is minimal.

With relatively cheap labor, a large educated labor pool, a stable economy, and both government and private support for service providers, Brazil has become a key player in offshore outsourcing. The nation has a state of the art telecommunications infrastructure and a history of embracing new technology.

However, although Brazil's president, has dedicated substantial funding to advertising and enabling Brazil's outsourcing capabilities, there are drawbacks that must be taken into account when considering it as an outsourcing destination. For example, while labor costs are lower than other South American or European nations, labor in Brazil still may cost up to 30 percent more than it does in India, and the corporate tax rate can be as high as 34 percent.

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English is not so widely understood, although the government has started a pilot program to train workers in the language. In addition, urban centers like Rio de Janeiro and Sao Paulo have serious crime problems. In the past, Brazil has suffered from skyrocketing inflation and high interest rates.

More germane at the moment, the Brazilian tax system is complicated and burdensome for employers, despite numerous attempts at reform The states control the rate of a Value Added Tax, leading to major price differences among the states as well as inequality of local government services.

CHINA

Western companies often cite the Chinese work ethic and the nation's emerging new systems expertise as advantages of working with Chinese service providers. However, while private support for Chinese service providers is robust, the Chinese government is only beginning to

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recognize and support the service providers and allow Western companies to invest in their services. The tentative grasp of English sometimes proves to be a roadblock for foreign outsourcers, especially those without sufficient e-mail and instant message capabilities.

The actions of the Chinese government also may pose public relations problems. The nation has come under international scrutiny for internal human rights violations, as tensions continue with Tibet and Taiwan.

Like India, China can tout its time-zone difference from the United States as an advantage. Often a project assigned by a U.S. manager to a service provider in China at the end of the day will be finished when he or she returns to work the next morning. However, this can make real-time communication difficult and frequently leads to confusion, especially at the outset of the outsourcing relationship.

LOCAL CONDITIONS

A new entrant to the outsourcing game must take many factors into consideration in order to establish a successful and reliable outsourcing relationship. Stability concerns in the political arena loom at the beginning of any relationship and must be addressed.

The company must consider turnover, an increasing problem in India, much as it was during the U.S. Internet boom of the 1990s. Companies may need to identify and contractually bind key employees in the event the relationship does not go as planned.

Arranging a letter of credit or a performance bond to guarantee satisfactory performance of the outsourced project might be a good option for companies that are unfamiliar with or unsure about the capabilities of their service provider. Alternatively, some companies have chosen to spread the work among multiple service providers to ensure the same peace of mind.

Finally, while each party should enter the relationship with the hope and expectation that it will be a continuing one, it would be unwise not to plan an appropriate exit strategy should the need arise. By building an exit strategy into the initial contract, including a dispute resolution mechanism, companies can help ensure a smooth transition out of the relationship if it becomes necessary.

CONTRACT ISSUES

Once a company has chosen a service provider, it must focus on building and negotiating the outsourcing contract. It is important to clearly define what services are included.

Often cultural and translation differences can create a gulf between the company's expectations and the service provider's performance. A company should have a good idea of its own needs and goals before it even begins to negotiate. It should be able to articulate its concerns in writing at the outset.

Knowing what to ask for and expect goes a long way towards avoiding disputes throughout the relationship. It also may make it easier for the company to extract itself if the cost savings aren't as expected.

In order to avoid future problems, a company should prepare a detailed statement of work as part of its request for proposals. It should address, for example, the scope of the work to be done, its location, the period of performance, the deliverables schedule, the applicable standards (including industry and company-specific standards), the acceptance criteria, and any other special requirements that might apply to the contract.

Contracts sometimes contain implied services or the assumption that services will evolve over the duration of the relationship. A company's recognition of this fact–and its attempts to address implied and evolving services in the contract itself–is key. Spelling out exactly what is expected and how progress will be evaluated is essential to avoid performance problems and possibly litigation in the long run.

Any company preference that the services be performed by the designated service provider and not subcontracted to another company in the service provider's country should be explicit, and any possible expansion into new services must be included at the outset, in order to eliminate confusion or disappointment later in the relationship.

COMMUNICATION AND GOVERNANCE

Communication difficulties often lead to problems in outsourcing relationships. In the short-term, a lack of communication between the company and the service provider can result in missed opportunities and increased costs. In the long-term, it can cause once easily fixable problems to get complicated and intractable.

Avoiding these problems is possible if the company fully commits to regular meetings between management

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and the service provider, establishment of a steering committee to monitor and problem-shoot the relationship, hiring of account managers to keep an eye on payment under the contract and how it accords with the progress being made, and other mechanisms that allow appropriate governance.

It is not realistic for a company to expect a foreign service provider to take the reigns of the project, disappear for the extent of the performance period, and reappear with a satisfactory project in time for evaluation. To ensure that the relationship grows and evolves, the company must be willing to sufficiently invest in governing it.

PERFORMANCE

Even with a detailed contract, sufficient communication and comprehensive governance by the company, services may not be what the company expected. Whenever possible, the company should enter, as part of the contract, a service level agreement that records the common understanding about performance during the term of the relationship. The company also should try to retain the right to modify or add service levels as the relationship develops, even if that means periodic reevaluation of the agreement in light of changing circumstances.

Companies also should keep in mind that the day-to-day progress of the service provider directly affects the users of the outsourced project, whether those users are external customers (as in the case of call centers) or internal customers (in the case of internal software development). Circulating a customer satisfaction survey is often the best way to recognize problems and address them before investing too heavily in the project.

The contract should contain a clear statement of charges without overly complex mathematical formulas. When setting charges, companies should allow for commercial and regulatory audits, and they should address any cost-of-living adjustments in the country where the service provider is located.

To ensure that the charge rates remain competitive during the duration of the relationship, companies should write benchmarks into the contract and retain the right to compare future costs with those offered by other service providers providing similar services.

Many other issues merit inclusion in an initial outsourcing contract. A company must strive to clarify rights with regard to the use and transfer of intellectual property, tax law differences, potentially applicable tariffs and duties, and the rights to transfer and terminate employees.

In addition, a company should consider the nature of local laws and local employment patterns when drafting their contracts. For example, in China, where transfer is common and intellectual property enforcement is weak, a company might require the service provider and its employees to contractually agree to confidentiality.

In Russia, noncompete agreements may be illegal if they tend to restrict competition. And in Brazil, an outsourcing company may be liable on claims brought by employees of the service provider under a "dual employer" theory. A company may also wish to know that in Brazil, a service provider is, ironically, prohibited from outsourcing some of its less-important functions.

In the event that a dispute arises, the contract should specify whether the dispute will be referred to informal mediation, arbitration, or litigation. Wherever it is to be resolved, the parties should agree in writing on the venue and governing law of the proceeding and any local rules that may apply. While the dissolution of the relationship may be an uncomfortable topic at its outset, termination and termination acceptance from the service provider must be addressed to have an effective contract.

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