

# Strategic Importance of Knowledge Process Outsourcing

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## 1. Introduction

The Outsourcing Industry has been extensively researched in the past decade. Business Process Outsourcing (BPO) in particular has been the topic of many analyses. Outsourcing first appeared in the IT industry in the 1980s. This was the time when companies recognized the benefits of having IT service partners in order to develop complex systems, and enhance the way that a business process or service is managed (Schumacher, 2005). Since then, the outsourcing industry has gone through its introduction and growth stages, with growth rates of around 50%, and has reached its transformation stage. Increasing globalization and high pressure to innovate have substantially shortened the product and service life cycles. Industry life cycles have therefore become shorter and shorter - outsourcing is no exception. Over the past five years a new form of outsourcing has become popular and promises, as BPO once did, huge growth and profit potential.

Knowledge Process Outsourcing (KPO) is the next step up the outsourcing value chain. While BPO provides extensive process expertise, KPO is emphasizes on business expertise. KPO indicates a major industry shift, away from execution of standardized processes to carrying out highly complex and customized processes that demand advanced analytical and technical skills as well as decisive judgment (Aggarwal and Pandey, 2004). The major strength of this approach is not the cost-saving aspect but it is more the value that these services provide. They offer a sustainable competitive advantage to its customers in all knowledge-intensive industries by providing market and industry research, data and statistical analysis, competitive analysis, and support in legal and administration processes. This and similar forms of outsourcing have forced enterprises not only to adjust their organizational and operational structure to the global trend, but also to consider outsourcing in their overall business strategy.

## 2. Risks and Benefits of KPO

**Benefits:** The main driver for outsourcing is *cost reduction*. Labour cost savings overseas are just too great to be ignored. In knowledge-intensive industries such as Analytics and Data Mining Services, Research and Development, and Intellectual Property Research, companies can save significantly – as much as 40-50% – by offshoring work to low-wage countries. Destinations such as India, China and Russia are ideal for these services as they provide a large pool of engineers and even PhDs at a substantially lower cost. According to Boston Consulting Group, a typical annual salary for an Indian IT engineer is USD 5,000, and for a graduate with a masters degree in Business is USD 7,500 – about one tenth of their American equivalents (London, 2006).

The cost differential between a PhD in the Sciences and Engineering in the US and in India (or in Russia) can range between USD 60,000 and USD 80,000, respectively. Besides India and Russia, countries such as the Philippines, Chile and Mexico are setting themselves up to provide high-end services at low-end prices as a way to boost employment and help their economies. Hence the increasing competition will drive prices even lower than the existing level (Kakumanu and Partanova, 2006).

Another early driver of outsourcing is the *shortage of skilled labour*. Developed economies such as the US, the UK, and Western European countries are already facing a shortage of highly trained and specialized professionals in some knowledge-intensive, high-skill sectors, such as R&D in very large scale integration, engineering design, IT, and financial risk management. One way to mitigate these skills shortage is to source talent from low-wage developing countries. India alone produces 441, 000 technical graduates, nearly 2.3 million other graduates and more than 300, 000 postgraduates every year (London, 2006).

According to a NASSCOM-McKinsey study this is about 30% of the available supply of skilled manpower in low-cost countries (Balaji, 2005).

Having one or more offshore centers can also provide *flexibility* in terms of human resource and time management. Outsourcing allows companies to add or reduce personnel far easier than a company can do in house, hence avoiding an expensive layoff process. By utilizing the time difference between different parts of the globe, development can take place constantly. The ability to send massive data amounts anywhere via the internet allows continual collaboration on a large scale (Kakumanu and Partanova, 2006).

**Risks:** One key issue is *security*. A company can better control access to information and protect equipment when it is in house. In Knowledge Process Outsourcing this can include confidential company data, Intellectual Property and knowledge in general. This awkward situation can be avoided by choosing a partner with international security standards such as the ISO 27000 certification.

Other forms of *control* can be lost as well. The quality of personnel and work cannot be guaranteed. Corporations risk low quality work or massive delays in work because they are in the hands of the outsource service provider. Besides quality, companies also can lose the knowledge they require to function. If a service provider goes bankrupt, the firm could be in a dire situation. The company cannot even temporarily resume the outsourced roles because the internal knowledge has been lost. This can again be avoided by focusing on a company's core activities and outsourcing non-core activities (Chanvarasuth, 2005).

*Public opinion* in the United States and Europe can also be a tremendous downside. On the one hand, companies are perceived to be sending jobs overseas, and the perceived loss of high profile jobs can cause poor publicity so that the associated costs in public relations can increase the outsourcing costs, while boycotts and protests can directly

affect the bottom line. The cost of negotiating, managing, and overseeing a detailed contract can also be great. To alleviate some of the aforementioned risks, a good contract with appropriate incentives, penalties and benchmarks is very important. On the other hand, the protectionist lobby and their anti-BPO drive in the USA and Europe are indirectly helping the proliferation of global offshoring by providing free publicity. Hence this drive has increased not only India's but also China's, Russia's and Mexico's brand images because companies now feel that these outsourcing companies are capable of almost anything. It is very likely that this protectionist movement will help these low-cost companies to improve their brand image and thereby move up the value chain even faster (Aggrawal and Pandey, 2004).

Another drawback is the *idealized expectations* regarding the return on investment and the time it will take. Many firms envision drastic cost savings of up to 80%. A company looking for a quick solution will be frustrated by outsourcing. Outsourcing goals that are too high are never reached and they often lead a company to believe that it failed in its implementation when it still achieved major gains. In most cases outsourcing can only show its real potential if it is long-term and partnership oriented.

Additionally, *legal, language and cultural barriers* can cause serious problems. Differences in dealing with problems and conflicts, and a lack of communication between the outsourcing partners can cause friction and inefficiencies. Both companies need to respect each other's corporate and national cultures and find mutually beneficial ways to develop successful cooperation (Kakumanu and Partanova, 2006).

### **3. Strategic Importance of KPO**

Both the risks and the benefits show the importance of outsourcing for an organization's competitive advantage in modern business life. It can either open new opportunities and lead to success, or end in disaster. One of the prima advantages of outsourcing is that it enables a company to respond quickly to changing market needs. In the same context, a change in the geopolitical climate or in the client's focus or profitability could necessitate renegotiation or worse, the ending of an outsourcing relationship (Ashank D. and Joydeep D.G., 2005).

In the past most companies considered outsourcing to be primarily a cost-saving strategy. As the industry evolved into more knowledge-intensive processes, more and more began to consider outsourcing on a strategic level and not just on an operational level. KPO is more than just cost savings. Firstly, it allows companies to focus on their core abilities such as R&D, Banking Services, Consulting, and Marketing. Secondly, as the product life cycles become shorter and shorter, outsourcing can significantly shorten the "Time to Market" and give the necessary flexibility in order to react much faster to market changes.

Talking about costs, it is important to realize that outsourcing is not about firing people in the home country and hiring people in the outsourcing vendor's country and saving a big part of the labor costs. It is more about reallocating human as well as financial resources. It is about allowing key people to focus on what is really important and not on what is really urgent. It is about using the full range of an engineer's skills and giving him/her the opportunity to focus on Research and Development and actually inventing something rather than doing extensive secondary research or patent drafting. It is about investment in future markets and products or services.

In other words, outsourcing can help companies to be more efficient, focus on their key success factors, and work on their unique capabilities and so actually create new, high-value employment in the home country. In order to reach this efficiency and these advantages it is crucial to have a long-term strategic relationship with the service providers. A large number of companies did not anticipate the complexities of managing outsourced projects and relationships. Instead of working on a holistic approach from the elaboration of the outsourcing idea over its concept and finally to its execution, they started to outsource services on an *ad hoc* basis. This led to significant performance diffusing throughout the organization. As a result, organizations began to lack coherent policies and conditions and were unable to leverage the full potential of the benefits of significant outsourcing volume (Ashank and Joydeep, 2005).

**Multi-year strategic relationships** can provide a number of benefits which are normally impossible to cover in the short timeframe of a project. A well articulated multi-year agreement could provide benefits such as:

- A better assessment of the capabilities needed for an organization to become world-class in sourcing.
- A predictable but flexible way to build these capabilities – through strategic level agreements on various parameters.
- Year-on-year improvements in many of these Strategic Agreements – in productivity and efficiency, quality and goal orientation, cost savings and reinvestments.
- The simplification, standardization, re-engineering and transformation of processes and activities.
- Vendor investments and the sharing of business risks/rewards. Over the years real trust-based partnerships can be developed.

**The role of the CEO and the C - Level Management:** Knowledge Process Outsourcing, if it is done thoroughly, can be really complex, and this is why the entire organization from the strategic decision making unit down to the operational level should be involved in the process. The reason is that it can create profound anxiety across entire organizations. Employees are put in jeopardy of losing their jobs or being transferred to another department or even to an unfamiliar part of the world. Such weighty issues necessitate the attention and full commitment of the senior management or even the CEO who will have to manage the company through any economic, social and political repercussions that can arise from the offshoring initiative. Hence it is important to reinforce and promote entrepreneurial thinking and behavior among the staff of every modern company. This is why it is the task of the C-Level and senior management to overview and control the outsourcing process and to adequately communicate the outsourcing strategy internally to all employees, and externally to the public and investors (Sinha and Rice and Thogmartin, 2005).

**Outsourcing Management Office:** Day-to-day outsourcing, and especially the outsourcing of high-value, knowledge-intensive processes, must have a home within a department in the organization. This department must oversee all outsourcing efforts at the operational, tactical and strategic levels. The department's manager must have a direct connection to senior officers in other departments and must present issues at the strategic level. Here are some of the central tasks a strategic outsourcing office has to perform:

- Ensure consistency of outsourcing and business objectives.
- Conduct feasibility analyses of outsourcing projects at a global level and determine opportunity costs.
- Coordinate efforts among managers and the assignments on their departments to ensure that they are not duplicating or undoing each other's work and are managing their outsourcing efforts effectively.
- Conduct reviews and assessments such as post-mortem analyses, develop "lessons learned and lessons to be learned," and manage the knowledge base.
- Integrate information – that is, provide vital information on outsourcing projects underway at the organization and exchange knowledge gained from outsourced projects among the relevant departments.
- Ensure adherence to standardized outsourcing methodologies and processes.
- Routinely evaluate the portfolio of outsourcing endeavours to calculate their business value, avoid redundancies and manage risks and metrics.

Most outsourcing offices need only a small group of dedicated personnel to oversee the daily operations. In terms of knowledge intensive processes, this office has the task of overseeing and coordinating the outsourcing activities. It is not its task to lead and manage the projects; this is something that the dedicated experts are responsible for. The team should include both insiders and outsiders, such as outsourcing consultants, in order to anticipate new outsourcing trends and implement them efficiently into the organization's operations. However, they must have access to various functional sectors so that they can draw on them as needed (Power and Desouza and Bonifazi, 2005).

**Outsourcing Relationships:** As you begin to build a lasting relationship with your knowledge process provider, an important thing to remember is that there is no off-the-shelf approach. Establishing a relationship that is geared toward long-term success is as much an art as it is a science. Today, fulfilling outsourcing contracts is just the price of admission to the relationship – not the guarantor of value or satisfaction. The trick is communicating properly so that any disagreements become an impetus for moving the relationship and initiative forward. Outsourcing should be considered as a partnership between companies and each has to be diligent about its responsibilities. Experienced outsourcing clients and providers know that the best partners are dependent upon shared expectations, flexibility, collaboration and mutual accountability (Tompkins, 2005).

The most successful and satisfying outsourcing relationships are built around the concept of value exchange. A value-based relationship framework can serve as the cornerstone for a partnership, beginning at the proposal, to contract, to implementation and renewal. According to an IBM-Study, a framework for relationship alignment should include:

- Knowledge-Sharing and keeping the lines of communication open.
- Creativity, innovation and aligning competing interests.
- Building trust and reconciling differences between organizational cultures and operating procedures.
- A good governance structure and process that focus on joint decision making, problem- and conflict solving, planning and change management.
- Shared measurements and incentives/formal lessons-learned roundtable meeting.
- A communications process that facilitates exchange of information and knowledge.

- Criteria – jointly developed and agreed upon – to help ensure the continuing health of the relationship (Weiss, 2003).

#### **4. Future Trends and Strategies of KPO**

After analyzing the challenges and the importance of strategic thinking in knowledge-intensive industries it is now time to show some future trends and strategies. Companies are acting in more and more turbulent markets and are forced to react ever faster given the opportunities and risks they face. Global competition is becoming stronger and innovation cycles and product lifecycles are growing ever shorter. At the same time, a greater diversity of products is flooding the market, with much faster delivery times than even two years ago. Here are some of the major trends that most of the companies will face in the next five to ten years:

- They will have to further cut costs, especially by transforming fixed costs into variable costs through resource reallocation.
- Continuously examine the external environment for new opportunities to grow and develop their business. This can be done through Research & Development and global expansion through mergers and acquisitions.
- They will have to be more reactive and adapt to market changes and this also includes the internal environment. Market challenges require changes and adjustments within the corporate structure. They will have to create smaller entrepreneurial units to increase flexibility and the reaction speed to these changes (Boetzel and Luehrs and Rechtensteiner, 2002).

One of key factors to achieve these goals is the implementation of knowledge outsourcing in the overall corporate strategy. But even the best outsourcing strategy is worthless if it is not communicated to the service vendor adequately. Only if both partners understand the outsourcing of knowledge-intensive processes as a strategic tool can both of them benefit, and only then can it provide all of the success factors mentioned above. But even if the executives know about the importance of outsourcing, they might not know how to do it best. According to Corbett (2005), there are some good ways to improve the outsourcing success rate:

1. **Training:** It is important to know what, where and how to outsource. This should be the subject of internal and external analysis, and training sessions should be conducted with outsourcing experts who have a deep understanding of the industry and who know how to create and manage outsourcing relationships.
2. **Standard Certificates:** One way to verify the reliability of outsourcing vendors is professional certification based on recognized industry standards. Standards for outsourcing professionals, such as those being developed by the International Association of Outsourcing Professionals (IAOP) and the Outsourcing Standards Board (OSB) will bring better skills and more professionalism to the knowledge outsourcing industry. Standards for security quality, scope definition, financial analysis, contracting, pricing, negotiating, contract management, and dispute resolution will help both sides to set up their outsourcing business.

3. **Goal Orientation:** It is very important to find evaluation criteria in order to be able to improve the outsourcing strategy based on facts and not on opinions. Although it is so important, very little work has been done to establish a benchmarking system for high-performance outsourcing outcomes and to identify the processes that lead to superior results. Here it is up to the partners to find individual criteria to determine the success of the outsourcing process.
4. **Challenge the Providers:** It is no longer good enough to offer customers a better, faster, cheaper solution for something that they are already doing today. If providers want to convince customers to change their outsourcing strategy (from project-orientated to process-orientated), they must work with their clients to keep developing and implementing new solutions well ahead of their customer's needs. This implies that the KPO-providers have to develop deep domain expertise and know-how and invest in R&D – just like any other industry – if they are to continue to out-innovate and out-perform their customers.
5. **Technology:** Technology helps to improve the flow of information and management's control. Tools such as knowledge- and project management help companies to improve their outsourcing ROI in three different ways:
  - a. They avoid duplication of services and billing errors.
  - b. They increase the quality of outsourcing processes.
  - c. They reduce the management costs that tend to grow exponentially as the amount of outsourcing activities increases. Using technology to link all of the company's internal and external people and processes will enable companies to build and manage the strategic outsourcing partnership much more efficient.

6. **Governance and Management:** Long-term orientated outsourcing programs require governance and ongoing management to ensure success. *Governance* ensures that the client and the supplier understand the what, when and how of outsourcing, along with the role each partner plays. One way to solve this conflict is to determine a process framework. *On-going Management* ensures that return on investment does not just come from labor arbitrage solely, but also from improved productivity. As already suggested, this task can be managed by the outsourcing management office. The most successful outsourcers invest 5-8% of the contract value in governance and on-going management. This investment ensures that the value of costs, productivity, quality and speed are captured now and in the future.

As the Knowledge Process Outsourcing industry is in its nascent stages it is very hard to predict how this new trend will evolve. But if this outsourcing discipline is to continue to grow over the next five to ten years as it has over the past five, organizations need to produce better results with greater regularity and at lower costs. To achieve this it will take a stronger consideration of knowledge outsourcing on the strategic level across the global community of outsourcing professionals, customers, providers and advisors alike.

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