

RISK FACTORS IN OUTSOURCING COOPERATION

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Abstract. The risk of outsourcing cooperation is one of the key issues taken into consideration by the client and service provider. Among risk factors are those that are dependent on the importance of outsourcing for the client and on the extent of integration between parties, as well as factors, that may appear regardless of the nature of cooperation. The objective of the paper is to identify and characterize risk factors grouped according to the transactional, operational or strategic nature of cooperation risk. The paper contains examples of negative scenarios, caused by these factors. Proposals of solutions, taken to reduce the risk of cooperation are also included.

Keywords: the risk, risk factor, outsourcing, cooperation, transaction.

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1. Introduction

In order to increase the adaptability of enterprises to rapid changes in the environment, the interest in the allocation of support services to specialized providers has increased (Anderson 1997; Gay, Essinger 2000; Dekkers 2000). Besides the increased flexibility of client's activity to changing operating conditions, some of the benefits of work with the service provider may be achievable in a short period after the beginning of cooperation, while others are available in strategic perspective (Dunn 1999; Linder 2004).

Considering the implementation of outsourcing, the problem of cooperation risk with service provider appears to be particularly important. Among risk factors are those dependent on cooperation, as well as others, usually occurring in the environment of cooperation, on which the parties have no influence. There are risk factors that are dependent on the importance of outsourcing for the client and on the extent of integration between parties, as well as factors, that may appear regardless of the nature of cooperation.

The objective of paper is to identify and characterize risk factors, grouped according to the transactional, operational or strategic nature of cooperation risk. The paper contains examples of negative scenarios, affected by these factors. Proposals of solutions, taken to reduce the risk of cooperation are also included.

2. Characteristics of risk in outsourcing

The problem of risk, associated with the achievement of effects below the expectations is highlighted as the important problem of cooperation in outsourcing (Cavinato 1988; Jurisson 1995; Lonsdale, Cox 1997; Lewis 1999; Halvey, Murphy Melby 2000; Gay, Essinger 2000; Bahli, Rivard 2003; Corbett 2004; Brown, Wilson 2005; Tapiero, Grando 2006; Zhang 2006; Enyinda, Gebremikael 2010; Weerakkody, Irani 2010). The risk of cooperation in outsourcing relates primarily to non-performance or unsatisfactory performance of contracted service. Therefore proper shaping of regulations in the contract between the client and service provider is seen as the most important way to reduce this risk (Bendor-Samuel 1997; Abdulwahed 2003). Terms of the contract specify in particular the relationship between cooperating parties, activities, infrastructure and devices, that should be used in adaptation to cooperation (Lambert, Emmelhainz, Gardner 1999; Dunn 1999; Knemeyer, Corsi, Murphy 2003). Rules to adjust to changes in external or internal conditions of parties activities are also included. External changes of cooperation terms concern primarily the law, politics and economy, but also disasters in environment, affecting the activity of client or service provider. Internal risk of cooperation result mostly from bounded rationality (concerning also inappropriate experience in preparation of contracts), and propensity to opportunism. These problems can be analyzed with the transaction cost

theory (Williamson 1985; Brown, Potoski 2003; Masters, Miles, D'Souza, Orr 2004), agency theory and incomplete contract theory (Hart 1995; Bahli, Rivard 2003).

It should be added that according to transaction cost theory, specificity of assets is a factor causing the risk, but its occurrence is closely related to the previously mentioned tendency to opportunism. Contracts mentioned above are incomplete, because of difficulties in obtaining comprehensive information about future conditions of cooperation. Using agency theory assumptions, it should also be noted that agents typically act for their own benefit and they represent the opportunistic attitude (Williamson 1985; Brown, Potoski, 2003; Hart 1995; Bahli, Rivard 2003).

There are several difficulties in assessment of cooperation risk in outsourcing. It is multidimensional and different types of risk have different components. Some of these components are factors, that can be controlled and others, uncontrollable. Also, the significance of risk is subjective. The essential difficulty in quantifying the risks associated with the implementation of outsourcing is that both the value of effects of outsourcing, as well as probability of these effects are not known (Jurisson 1995).

The description of cooperation risk should include the specification of negative scenarios that might occur, risk factors affecting the appearance of these scenarios, the effects of scenarios for the customer and service provider, as well as mechanisms for reducing the risk of different scenarios (Bahli, Rivard 2003).

Several proposals of typology of outsourcing risk have been proposed (Corbett 2004; Bi 2007; Shi 2007; Juras 2007; Gefen, Wyss, Lichtenstein 2008; Gonzalez, Gasco, Llopis 2009). Taking into account the issues undertaken in this paper, some of proposals seem to be particularly useful (Corbett 2004; Gonzales, Gasco, Llopis 2009; Shi 2007). Based on the approach of (Corbett 2004) the following types of risk can be highlighted:

- transaction risk – represented by the contract arrangements for the termination of the contract by the parties or unilaterally terminate the contract, including regulations regarding resolution of disputes, mutual commitments, guarantees, asset movement, terms of payment, as well as conditions for payment of penalties for non-performance or improper performance of contract,

- operational risk – refers to the impact of outsourcing on the employees of principal, both those who remain in the company, as well as others who may become employees of service provider, this type of risk is also associated with adjustment of service provider to the requirements of

client, but also with the possibility of changes to legislation regulating cooperation with the service provider,

- strategic risk – concerns the long term negative effects of cooperation, such as: loss of control over outsourced activities, the loss of know-how, changes in provider's activity, adversely affecting the client (examples: limitation of the range of service rendered, changes in the characteristics of transport, insufficient adaptation to changing rules of law concerning, for example the movement of hazardous materials).

It should be added that also another kind of risk, associated with undertaking cooperation in outsourcing can be highlighted. It is the risk of losing the ability to achieve the expected results (Corbett 2004). This type of risk is closely related to the others, mentioned above.

Another proposal of description of outsourcing risk (Gonzales, Gasco and Llopis 2009) can be seen as complementary to the typology presented earlier. These authors distinguished three groups of negative scenarios, taking into account the party to a contract, in which these scenarios occur:

- risks derived from client – related to the loss of technical knowledge (clients often loss the understanding of the service), dependence generated by the cooperation with the service provider,

- risks derived from provider – it concerns especially inadequate provider staff qualification, lack of compliance with the contract by the provider, also provider's inability to adapt to the new technologies,

- general outsourcing risks – concerning especially irreversibility of the decision, hidden costs, unclear cost-benefit relationship, security of information, possible opposition of the staff.

The differentiation of risk depending on the place of its occurrence described above is useful in description of responsibilities and rights of parties to a contract.

The distinction between risk of client and risk of vendor is also characteristic for another proposal of risk description (Shi 2007). It should be added, that the author identified also another kind of risk, regarding the relationship between cooperating parties. It is treated separately. Examples of factors concerning each of these types of risk are identified. The author presents also scenarios occurring in cooperation, as short term or long term effects in such areas as organization and market performance.

3. Typology of risk factors in outsourcing

The following part of the paper contains a synthesis of description of outsourcing risk, on the basis of presented model (Bahli, Rivard 2003), proposed typologies of outsourcing risk (Corbett 2004; Shi 2007; Gonzalez, Gasco, Llopis 2009) also the results of research conducted by author of paper. This research involved identification of problems and risk factors influencing the appearance of such problems in outsourcing cooperation. It was conducted in several companies operating on the Polish market. The research concerned the preparation phase of cooperation (including gaining a service provider, negotiations, due diligence and preparation of contract) and further cooperation with the service provider. The terms of cooperation in the contract were treated as main source of problems. The survey was used to obtain relevant information. Four companies, that were taken into consideration implemented logistics outsourcing. Next two companies were engaged in outsourcing of IT service. These were international companies operating in the Polish market. Their experience in outsourcing cooperation derived from operations on the markets in Western Europe, but was significantly differentiated. Survey was addressed to managers of departments, previously engaged in outsourced service and in further cooperation with service provider.

On the basis of results of these studies generalizations can be made about risk factors influencing the cooperation in outsourcing. Most important factors that influenced the preparation phase of cooperation and further short term and long term cooperation are presented (Table 1). According to phases of cooperation, such risk factors are grouped in areas of transactional, operational and strategic risk.

It should be noted, that there are risk factors occurring in several stages of collaboration and representing a number of risks, as well as others that are specific to the individual phase. As examples of factors that are listed in several phases of cooperation opportunism, asymmetry of information and insufficient experience in contract preparation and cooperation with service provider can be given. These factors affect both the preparation phase of cooperation as well as future activities, according to rules in the contract. It should be noted that these factors may also have their consequences in terms of negative effects in the strategic perspective of cooperation.

Table 1. Main risk factors in outsourcing cooperation (Source: own research)

No	Type of risk	Main risk factors
1	Transaction risk	opportunism, asymmetry of information, insufficient client's knowledge about the possibilities in the field of outsourced tasks, insufficient experience in cooperation, differences between organizational culture between client and service provider, differences in risk perception between parties, fast development of service market, lack of attribution of responsibility between client's employees for update of market information
2	Operational risk	opportunism, asset specificity, insufficient client's experience in contracting and further cooperation with service providers (asymmetry of information), cause-effect relationships of tasks divided between the client and the provider (requiring coordination, participation in problem solving, mutual adjustment), volatility of competition and demand, changes of technology, changes in the law, difficult estimation of effects of cooperation, lack of agreed principles for measurement of outcomes and indicators used
3	Strategic risk	insufficient control mechanisms of provider's activity, mistakes in the description of core activities, too wide range of service outsourced, insufficient engagement of service provider in improvement of cooperation, decrease of quality of outsourced service

The examples of risk factors, specific to the individual phase are: differences in risk perception between parties (in the risk of the transaction), lack of agreed principles for measurement of outcomes and indicators used (in the operational risk) and mistakes in the description of core activities or too wide range of service outsourced (in strategic type of cooperation risk).

4. Reduction of impact of risk factors

According to presented model of risk description (Bahli and Rivard 2003) and taking into account the results of research conducted by the author of a paper, the impact of risk factors on the occurrence of negative scenarios in cooperation will be presented. Examples of risk factors, scenarios that may occur under the influence of these factors and

proposals of activities to reduce the significance of these risk factors are included.

Regardless of the importance of cooperation with vendor for client's strategy, taking into consideration short term and long term effects of cooperation, transaction risk plays fundamental role. Therefore it is particularly important to identify risk factors occurring especially in the stage of establishing cooperation and activities to reduce the impact of these factors on the relationship between the parties. Examples of risk factors, negative scenarios and activities for risk reduction in the area of transactional risk are presented (Table 2). It is important to add that in the preparation stage of cooperation, both internal and external risk factors should be carefully analyzed. Taking into account the relevant regulations in the contract, preparation stage can reduce the likelihood of changes in contract, during day-to-day cooperation.

Risk factors, whose influence is not reduced in the preparation stage of cooperation may significantly affect the activities of customer and supplier. There are also external risk factors, that appear during day-to-day cooperation. Examples of such types of risk factors, negative scenarios occurring as a result of the impact of these factors and the actions proposed to reduce the impact of these factors are presented (Table 3).

In long term cooperation with the service provider, both risk factors that occur in the short term, as well as other, characteristic for strategic perspective should be taken into consideration. If there are problems not eliminated before the beginning of cooperation or during day-to-day activity, it can result with long term, negative effects. Such effects concern not only excessive reliance of client's activity on decisions of provider, but also a progressive reduction of client's market position. Examples of risk factors, negative scenarios, occurring under the influence of these factors and actions for reduction of impact of listed factors are presented (Table 4). It is important to point out, that impact of risk factors in strategic perspective depend mostly on tendency to opportunism. It regards first of all opportunism of service provider.

It should be also added, that actions to be taken to reduce the impact of strategic risk factors do not guarantee success, but increase the likelihood of success. There are also other risk factors, in the environment of cooperation that can spoil the cooperation, in spite of the preventive actions taken.

Table 2. Reduction of transactional risk factors (Source: own research based upon Bahli, Rivard 2003; Malkus 2011)

No	Risk factor	Negative scenario	Risk reduction possibilities
1	asymmetry of information (between client and vendor)	differences between offer and actual ability of vendor to perform outsourced task	uniform formats of bids received from vendors, due diligence research
2	difference in risk perception between parties	problems in risk communication (as a result: increased risk of one party, but the injured party is not aware of such increase)	research conducted to mutual understanding of risk perception of parties, negotiation of the meaning of risk
3	opportunism of vendor (use of insufficient client's knowledge about effects of outsourcing)	misunderstanding of expectations of parties to the contract	list of client's expectations, careful preparation of RFP (request for proposal), explanation of all doubts on issues covered in RFP
4	fast development of service market (external factor)	insufficient knowledge of service market	assigning proper responsibilities to employees, regular review of service providers available on the market

Table 3. Reduction of impact of operational risk factors (Source: own research based upon (Bahli, Rivard 2003; Malkus, 2011))

No	Risk factor	Negative scenario	Risk reduction possibilities
1	asymmetry of information (between client and vendor)	problems in management of cooperation	use of informal control mechanisms, building partnerships based on mutual respect, trust (as opposed to formal control mechanisms)
2	high specificity of assets	excessive dependence on service provider	mutual development and share of benefits, joint investments

End of table 3

No	Risk factor	Negative scenario	Risk reduction possibilities
3	lack of agreed principles for measurement of outcomes and indicators used	conflicts between client and vendor regarding quality expected and delivered	careful preparation of principles for measurement outcomes and indicators in SLA (Service Level Agreement), support of consultancy firms
4	changes of technology (changes of the law) (external factors)	expensive adaptation to changing conditions of cooperation	flexibility of regulations in contract, regulations enabling renegotiation of cooperation terms

End of table 4

No	Risk factor	Negative scenario	Risk reduction possibilities
4	insufficient engagement of service provider in improvement of cooperation	difficulties in development of client's core activity	partnerships based on mutual respect, trust (as opposed to formal control mechanisms), flexibility of contract

Table 4. Reduction of impact of strategic risk factors (Source: own research based upon (Bahli, Rivard 2003; Malkus 2011))

No	Risk factor	Negative scenario	Risk reduction possibilities
1	inappropriate definition of core business (with opportunism of vendor)	loss of client's know-how	support of consultants, phased broadening of services contracted with vendor
2	inadequate control mechanisms over provided service (with opportunism of vendor)	loss of control over outsourced service (concerning low quality of service)	cooperation with several vendors, partnerships based on mutual respect and trust, integration of activities between client and service provider (mutual benefits)
3	insufficient client's experience in outsourcing (with opportunism of vendor)	excessive influence of vendor on client's strategy (at last: loss of client's independence on the market)	cooperation with several vendors providing the same service, phased development of relationship (related to the flexibility of contract enabling renegotiation of cooperation terms)

There are several limitations of presented results of research. Risk factors listed in this paper, are only examples of conditions that may occur in cooperation with vendor. In the practice of outsourcing, there may be much more different risk factors influencing negative scenarios, particularly in long term perspective of cooperation.

Presented risk factors are not differentiated, according to their importance for objectives of outsourcing. When cooperation concerns supporting service, widely available on the market, the main objective of cooperation is cost reduction of client's activity and cooperation is based on short-term contract factors representing the transaction and operational risk seem to be more important. In such conditions risk factors, characteristic for strategic perspective are rarely taken into consideration. In long term cooperation with vendor, focused on joint investment and mutual benefits, the strategic risk plays more important role.

Most of examples of outsourcing cooperation, taken into consideration in this paper concern logistics and IT service. The client's attention paid to the preparation of contract and building the partnership with service provider depends mostly on influence of cooperation with service provider on results of client's activity. Clients pay significant attention on preparation of cooperation with logistics and IT service providers, particularly in terms of comprehensive service outsourced. It results from the important influence of logistics and IT service on the results of activity on the market.

5. Conclusions

In outsourcing cooperation, there are both risk factors resulting from the attitudes of parties, as well as other determinants associated with internal conditions of client's or vendor's activities and emerging in the environment of cooperation. It should be emphasized that the lack of appropriate action to reduce the factors, resulting from the attitudes of parties in the preparation stage usually results with difficulties in reduction of impact of mentioned

earlier risk factors, occurring in the cooperation phase.

Factors, resulting from attitudes of cooperating parties are first of all: insufficient experience of client in cooperation with service providers, bounded rationality of parties, related to the asymmetry of information and also opportunism of client and vendor. In general, activities taken to reduce the impact of risk factors mentioned earlier concern first of all identification of experience and skills of provider, mutual understanding of expectations of parties, as well as the subsequent negotiations of the terms of cooperation, resulting in the development of terms of the contract between the client and service provider. Careful recognition of vendor's capabilities to satisfy client needs, detailed specification and understanding of obligations and powers of the client and the provider, as well as conditions of mutual adaptation to changing external conditions stand out among the main factors, that occur before the conclusion of the contract. It affects the relationship between the parties and as a result the quality of cooperation. Regulations in the contract should facilitate subsequent adaptation to changing conditions of cooperation.

As mentioned earlier in the paper, such risk factors as limited rationality, associated with the asymmetry in access to information and asset specificity are closely related to the propensity of parties to opportunism. Therefore, considerable attention must be paid in the contract regulations concerning the reduction of the impact of this factor. In short-term contracts detailed specification and understanding of required service quality, obligations and powers of the client and the provider, as well as the conditions of mutual adaptation to changing external conditions may be sufficient. The long term contracts concerning provision more complex service should also consider the involvement of service providers in joint investments with the customer, sharing of benefits and risks in such investments.

It is important to add that the actions proposed to reduce the impact of the mentioned risk factors increase the likelihood of success in cooperation, but do not guarantee its success. There are also other risk factors, especially in an environment of cooperation, which may cause difficulties, which may hinder the achievement of cooperation objectives. From this perspective it is important to provide flexibility to the contract, allowing adaptation to changing conditions of cooperation.

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