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Update

Managing Innovation During Outsourcing Engagements:

Do Contracts Harm Innovation?

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Outsourcing firms tend to market themselves as partners in innovation, and firms consider adopting an outsourcing strategy as a way to attain competitive edge. While outsourcing is a promising approach, it can also be a risky endeavor, as it may deter the firm's inherent ability to bring innovative products to market.

The purpose of this *Executive Update* is to challenge the assumption that outsourcing is detrimental to a firm's inherent ability to bring innovative products to market in the long run. In this context, "inherent" means the ability of an organization to leverage resources, activities, knowledge, and skills to bring innovative products and services to market.

A 2007 outsourcing and innovation survey of 290 IT executives by *CIO* magazine reported that only 22% believed that outsourcing activities contribute more to innovation than activities that are retained inhouse.[1]

There are numerous reasons why outsourcing could be detrimental to innovation. Perhaps one of the most self-evident is that outsourcing firms are unlikely to innovate, as their work is confined by stringent, unbending contracts. Suppliers find it difficult to justify innovation unless it directly helps their ability to meet their contractual obligations and internal revenue/profitability targets. Clients commonly assume that innovation during an outsourcing engagement will naturally come about. But the client forgets that business innovation is not something that a supplier just "does" for its clients.

Perhaps one of the most interesting caveats is the difficulty when selected activities for outsourcing may not prove to be a strategic necessity *at the time*, but could prove to be vital for the purpose of differentiation in the long term.

THE DICHOTOMY OF CORE VS. NONCORE

Outsourcing's seemingly nonstrategic activities might evoke a path that will be far less competitive in the long run. Hence, deciding what, and what not, to outsource puts firms at risk of becoming less innovative by outsourcing activities that should not have been. This is one of the seven deadly sins of outsourcing.[2]

Firms need to be able to quickly anticipate and exploit opportunities that arise in the market, while at the same time resist putting all their eggs in the same basket. This is a frustrating issue, one that can possibly be illustrated best by Nokia's example.

Nokia originally entered the Finnish market in 1865 with wooden products and then ventured into manufacturing electrical cables. By the dawn of the 1980s, Nokia manufactured all kinds of products: computers, modems, tires, and rubber boots. Throughout the 1980s, the firm was widely associated with rubber boots and was very successful in Finland. The company was also subcontracted for manufacturing the rubber casing of mobile phones, but rubber boots continued to remain its flagship product.

During the 1990s, Nokia decided that manufacturing mobile phones had the potential to outsell its rubber boots branch. It then decided to concentrate on manufacturing its own mobile phones. If it were not for the entrepreneurial spirit and retention of seemingly uninteresting activities (casing for mobile phones), Nokia would have never been as successful as it is now.

While Nokia's example is not directly related to selecting particular activities for outsourcing per se, it shows that the abolishment of seemingly uninteresting activities — with considerable potential for growth — for which there is no direct strategic need may lead to a competitive path.

David Teece et al. first described this effect in 1997.[3] The authors argued that firms must follow a certain trajectory or path of competence development that defines what choices are open to the firm today. This path puts boundaries around what its internal competence repertoire is likely to be in the future. Outsourcing may put the firm at risk of deterring its own ability to innovate by abolishing opportunities to develop core competencies.

Robert Davies, senior manager and a fellow from Cass Business School, recognizes this problem and argues that the key point is to understand "where in your organization the innovation trail starts."[4] If the client is operating in an industry where innovation starts with the customer, be sure not to outsource any of these competencies, as you might "cut yourself off from future winning ideas."

AN ISSUE OF PATH DEPENDENCY

Another interesting argument is that outsourcing transforms decision making within the client. The supplier's services become the predominant approach of "how things are done" within the client, creating tremendous reliance on the supplier's knowledge, skills, and services — even to the extent where the client is locked in by a supplier's decision.

The notion of path dependency means that the pattern of historical development determines the feasibility of a future decision. Although alternative "paths" may provide a better solution, due to lock-in with the vendor's procedures, methods, and standards, it becomes almost impossible to diverge. Software engineer Tom Huppi explained:

> Path dependency is like a cheetah sprinting full speed after an antelope. Out of the corner of its eye, the cheetah may see even bigger game, but it's already barreling after the smaller one, and changing course would require enormous energy. Therefore, it's easier just to continue in the same direction.[5]

The client may realize that alternative technologies, methods, or products provide a better alternative to what has been agreed to with the provider. But it may be simply too difficult to deviate from the current situation due to "lock-in" by either contractual obligations or overreliance on the supplier's services.

ABSENCE OF ORGANIZATIONAL AMBIDEXTERITY

For a firm to succeed over the long term, it must continually integrate new technologies with the firm's products and services. This requires a tedious dynamic capability of continuous learning, market exploration, and technology exploitation referred to as *organizational ambidexterity*.[6]

In an outsourcing agreement, this ability usually becomes the supplier's responsibility. There is no longer a need for clients to concern themselves with changing technology if the service is outsourced to a third party. However, this dynamic capability is nearly impossible to duplicate or keep alive in an external setting.

It is said that outsourcing causes growing concern that Western IT firms are at risk of becoming too converged, hollow, or virtual. If firms continue to use cost savings as a primary driver for outsourcing and consequently neglect to focus on divergence, outsourcing is bound to deter the client's ability to remain competitive. Clients need to maintain their own ambidextrous ability to capture innovative trends and differentiate.

So despite all criticism, how can outsourcing yield innovation? Whether outsourcing is either detrimental or stimulating to innovation all depends on the actions and considerations that are taken into account by both client *before* the contract is signed.

REALLOCATION OF INTERNAL RESOURCES

Essentially, if we take the assumption that "outsourcing saves money" as an axiom, assuming that the firm managed to actually save on capital expenditure through outsourcing, this would yield a higher availability of capital resources, which in turn could be used on expenditure for product differentiation.

In other words, a more strategic focus can be obtained by outsourcing the activities that do not contribute to the firm's strategic positioning. Hence, outsourcing could yield a bigger availability of financial resources when only those activities that truly create value are retained. The saved financial resources may consecutively be leveraged to expand R&D or other activities that boost the firm's inherent capability to innovate.

GAINSHARING AND LEVERAGING COLLABORATION

A possible practice that could structurally encourage the emergence of innovation is to create a platform where client and supplier work together to generate and exploit ideas. Many clients see outsourcing as a strategy to pass the complexity or burden of activities on to someone else. What they do not realize is that a close working relationship with the outsourcing provider could be a very powerful strategy to leverage knowledge.

For example, Gothaer AG, a large insurance agency in Germany, contracted with IBM to handle all its data processing, networks, and application development. Then, together with IBM and two other industry incumbents, they formed a joint venture called Allgemeine Versicherungs-Software Gmbh (General Insurance Software) to create and sell new insurance software based on IBM's application platform.

However, a caution of such a joint venture is that it may have a limited life. Conflicts of interest can arise when the companies become greater rivals. This was one reason that Eric Schmidt, CEO of Google, eventually resigned from his membership to Apple's board of directors in August 2009. Increased scrutiny from economic regulators and Google's entering more into Apple's core business with Android and Chrome OS were reasons for him to resign, as he had to excuse himself from many meetings due to conflicts of interest.

AN APPROPRIATE GOVERNANCE MECHANISM

Earlier, we discussed the effects of path dependency and a lack of ambidexterity. These effects may arise during the outsourcing engagement and are detrimental to the emergence of innovation. For this reason, it is important that organizations remain flexible and maintain a flexible contract. Misalignment due to rigidities involving the firm, its outsourcing partners, and the shifting technological environment is a notorious cause for the decay of IT organizations.

Innovation is an abstract concept, with no clear tasks, path, or outcome. Hence, it's difficult to put into contracts that "innovation" is part of the deal. One possibility is to state KPIs on the number of idea pitches; however, this is questionable whether commitment to a specific number of minimal pitches would increase the "quality" of the ideas.

More important, outsourcing can encourage innovation if the retained organization is infused with the role of ambidexterity.

A council of business analysts and project managers then, from both supplier and client, can be made responsible for discovering and exploiting new market opportunities. For innovation to arise, people inside the client organization are needed with a clear vision about where the business and future market conditions will converge. This part of the retained organization then takes ownership of the agreement and plays a critical role in mitigating the risk of getting stuck in the rigidities of operational contracts and reaching risk/reward (and possibly auxiliary) agreements with providers.

The main issue is understanding that both provider and client have roles to play to produce innovation. In a traditional outsourcing agreement, the relationship is purely transactional and fixed in stringent contracts. This leads an inherent inflexibility to introduce new designs, products, and ideas. On the other hand, when both entities bring together the investment requirements and attain an agreed stake in the success of the engagement, the resources and core competencies from both supplier and client can be leveraged to increase innovation.

ENDNOTES

[1]Johnson, Carolyn. "Outsourcing Your Way to Innovation: IT Leaders Question the Value." *CIO*, 26 September 2007.

[2]Barthelemy, Jerome, and Dennis Adsit. "The Seven Deadly Sins of Outsourcing." *Academy of Management Executive*, Vol. 17, No. 2, 2003, pp. 87-100.

[3]Teece, David J., Gary Pisano, Amy Shuen. "Dynamic Capabilities and Strategic Management." *Strategic Management Journal*, Vol. 18, No. 7, August 1997, pp. 509-533.

[4]Davies, Robert W. "Outsourcing Problems and Disadvantages Revisited." Drrobertdavies.com (www.drrobertdavies.com/bpoandoutsourcingproblems.php).

[5]Huppi, Tom. "Path Dependency" (www.huppi.com/kangaroo/Pathdependency.htm).

[6]O'Reilly, Charles A., III, and Michael L. Tushman. "Ambidexterity as a Dynamic Capability: Resolving the Innovator's Dilemma." Harvard Business School, Working Paper No. 07-088, May 2007.

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Dr. Cullen is a widely published author. Her publications include *The Contract Scorecard*, *Intelligent IT Outsourcing*, *Outsourcing: Exploding the Myths*, *Contract Management Better Practice Guide*, *Best Practices in ITO*, *Lessons Learnt in Outsourcing*, *Service Provider Management*, *Outsourcing Guidelines*, and *Outsourcing: What Auditors Need to Know*, in addition to research with various universities since 1994, including the London School of Economics, University of Melbourne, Oxford University, and the University of Warwick. She has been featured in such publications as *Australian Financial Review*, *Business Review Weekly*, *Computerworld*, *Directions in Government*, *European Journal of Information Systems*, *Information Economics Journal*, *Journal of Strategic Information Systems*, *Information Technology Report*, *Insurance Directions*, *Oxford Handbook*, *MIS*, and *MISQ Executive*. Her expertise is globally recognized, and she performs peer reviews of outsourcing research for *Harvard Business Review*, *California Management Review*, and *European Conference on Information Systems*. Dr. Cullen has lectured at many universities, including the University of Seoul, the University of Melbourne, the University of Monash, the University of Swinburne, Queensland University of Technology, and the Royal Melbourne University of Technology. Dr. Cullen earned a BS in accounting from St. Cloud State University (US); she was awarded a master's of management (technology) from Melbourne Business School, and earned her PhD from the University of Melbourne. She is also a Chartered Accountant in the US. She can be reached at scullen@cutter.com.