

Innovation in Outsourcing: A Study on Client Expectations and Commitment

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Table of content

Executive innovation.....	3
Trends in Outsourcing.....	6
Innovation in Outsourcing: The challenges.....	7
How this Research was Conducted.....	8
What functions have been outsourced.....	9
The Importance of Innovation to Business Success.....	10
The Innovation Challenge in Outsourcing: Clients' Expectations.....	11
Enabling Innovation in Outsourcing: The Role of the Contract.....	12
Types of Innovation and Contractual and Relational Governing Approaches.....	14
Sourcing Models and Innovation in Outsourcing.....	15
Measuring Innovations in Outsourcing.....	15
How to Achieve Innovation in Outsourcing: The Innovation Ladder.....	17

Executive Summary

The outsourcing industry is set for a new challenge: to understand how innovation can be realized from outsourcing engagements. While innovation has been explored and prized within businesses for decades, it is a relatively new topic in the context of outsourcing. And as such, the perceptions what innovation in outsourcing actually means, what inhibits or enables innovation in outsourcing, and what client firms are willing to do to ensure they benefit from innovation in outsourcing are still being defined.

This report provides insight into some of the critical aspects in innovation in which both client firms and vendors have taken interest in recent years. We go beyond the simplistic approach we have seen in some recent reports, that advocates for the development of trust and close relationships between client firms and vendors as the main enablers of innovation in outsourcing. In our view, innovation in outsourcing can be properly understood only when both contractual and relational aspects are examined as well as the nature of the innovation, i.e. incremental or radical, is explored. Further, we posit that the sourcing model applied has also an impact on the ability to innovate.

The results of this study, which is based on the responses of 253 CIOs and CFOs from the largest firms in Europe, send a clear message innovation from outsourcing is critical for business performance to the majority of firms. Also, the majority of the client firms consider the innovativeness of the vendor as one of the key criteria in vendor selection. We also learned that the majority of the respondents expect vendors to turn ideas into improved processes (56%), transform existing products (55%), or help transform existing processes (53%). Clearly, client firms expect vendors to deliver innovation that has an impact on the firm's operational and strategic performance targets.

However, client firms still have reservations regarding how innovation can be facilitated in outsourcing. For example, when asked 'How such expectations will come into effect?', 66% of the client firms indicated that an outsourcing vendor should free up in-house resources, so the client firm's staff can focus on higher value activities, implying that innovation is still perceived as core and therefore should be kept in-house. From a contractual viewpoint, 53% of the respondents either did not include or were not aware of the inclusion of clauses that compensate vendors for innovation introduced in the outsourcing project. We also learned that the vast majority of the firms are using fixed price contracts (78%). Only 42% are using time and materials contracts and 21% are using joint venture with a profit sharing clause.

The analysis of data points at the following insights:

- Client firms take for granted that incremental innovation will be delivered in outsourcing; however, they now take an interest in how radical innovation can be achieved
- Multi-sourcing as a sourcing model is strongly associated with radical innovation
- Among the three contract types examined (fixed price, time and materials and joint venture), joint venture was found to be strongly associated with radical innovation

From the above conclusions, and based on the extensive research we have conducted in the outsourcing industry, we have developed the Innovation Ladder framework. The framework is made of six steps that guide executives in their quest for innovation in outsourcing. The uniqueness of this framework is that it corresponds with commonly-applied outsourcing lifecycle frameworks. These are the key steps:

- Step One: Strategize innovation, in which executives need to consider what type of innovation is expected (i.e. incremental or radical) and what the expected impact of this innovation is at the operational and strategic level;
- Step Two: Design measurement instruments, in which executives are required to develop the instruments based on which the improvements achieved through either incremental or radical innovation will be assessed;
- Step Three: Assess vendor's innovative capability, in which executives are required to develop a methodology which guides them to consider the innovativeness of the vendor as part of the other vendor selection criteria;
- Step Four: Design a contract for innovation, in which the contract should be crafted to include performance targets and compensations for incremental innovation and a clear roadmap to form partnership in order to achieve radical innovation;
- Step Five: Build relationships, in which the client firm and the vendor invest in mechanisms that support the on-going development and renewal of their relationships as a complementary element to the contractual approach;
- Step Six: Measure innovation, in which the client firm monitors and verifies meeting performance targets in incremental innovation and the health and performance of the radical innovation network.

The journey to achieving innovation in outsourcing is in infancy and as such it needs attention and nurturing from the parties involved, but at the same time it needs systematic and clear innovation delivery system to ensure value created for all involved.

Trends in Outsourcing

Recent years have witnessed an unprecedented growth of the outsourcing industry. By the end of 2010, the market for information technology outsourcing (ITO) worldwide was reported as \$270 billion and for business process outsourcing (BPO) \$165 billion. Recent estimates predict that in the 2011-14 period ITO growth will be 5-8% per annum and BPO growth will be 8-12% per annum. Soon the BPO market size worldwide will overtake the ITO market¹. It is common to talk of Brazil, Russia, India and China as the 'BRIC' inheritors of globalisation, offering both offshore IT and back-office services, and also, with their vast populations and developing economies, huge potential markets. However, the phenomenon of offshoring and offshore outsourcing is certainly expanding, with, on our count, some 120 centres developing around the world. Furthermore, as firms become more savvy consumers of outsourcing services, they apply various sourcing models. The multi-vendor sourcing model is still by far the most popular trend among client firms², though some client firms experiment with bundled outsourcing services³. Also, we have reported recently on a surge in setting up offshore captive centres in India and central and Eastern Europe and the dynamic nature of goals pursued by such centres, despite some on-going media reports about the 'death of the captive centre'^{4,5}.

In this regard, we have seen a shift in decision-makers' mind-sets from focusing on low costs, which was typically considered as the main reason for firms to engage in outsourcing, to access talent and skills not available in-house. Results of our research indicate that saving costs has become a secondary driver of outsourcing⁶. Clearly, the outsourcing industry has entered a new phase in its evolutionary path in which clients are shifting from focusing only on costs saving to realizing value. In this journey, client firms need to develop tools that will allow measuring the returns on their outsourcing investments beyond the one off costs saving and vendors are required to demonstrate how long-term commitments translate into value-adding organizational outcomes. Our 2009 study confirmed that the vast majority of client firms have not yet embarked on a systematic approach to measure the returns on their outsourcing investments⁷.

¹Oshri I., Kotlarsky J. and L.P. Willcocks (2009) 'The Handbook of Global Outsourcing and Offshoring', *Macmillan*, London

²Oshri I., Kotlarsky J. and L.P. Willcocks (2009) 'The Handbook of Global Outsourcing and Offshoring', *Macmillan*, London

³Willcocks L.P., Oshri I. and J. Hindle (2009) "Client's propensity to buy bundled IT outsourcing services", White Paper for Accenture.

⁴Oshri I. (2011) "Offshoring Strategies: Evolving Captive Center Models", *MIT Press*, Boston, MA

⁵Captive centre strategies are discussed in detail in Oshri I. (2011) "Offshoring Strategies: Evolving Captive Center Models", *MIT Press*, MA. In this regard, we argue that the captive center has been one sourcing model within a broad range of strategic options that client firms utilize in order to maximize the return on their outsourcing and offshoring investments

⁶Oshri, I. and J. Kotlarsky (2009) "The Real Benefits of Outsourcing", A WBS white paper for Cognizant.

<http://www.quantifyingoutsourcingbenefits.com/default.asp>

⁷Oshri, I. and J. Kotlarsky (2009) "The Real Benefits of Outsourcing", A WBS white paper for Cognizant.

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Innovation in Outsourcing: The challenges

As the on-going search for real benefits in global sourcing shifts from costs saving to adding value, and from the operational to the strategic level, client firms are also raising their expectations regarding the potential to benefit from innovations delivered by their vendors. In management terms, innovation can take the form of a new product or service offered to clients or a new process through which an organisation develops products or delivers services. Innovation can also be anything that is state-of-the-art and also anything which is new to the organization. For example, setting up a network of suppliers for certain business processes previously provided from in-house.

Innovation does not come easy, whether as an in-house process or through external partners. When in-house, inertia forces often obstruct attempts to innovate and break away from old ways. And when sought through relationships with external partners, innovative efforts face additional challenges, for example, agreeing and monitoring how each party involved in a collaborative venture should contribute to the partnership as well as benefit from the value created.

The outsourcing context poses additional challenges to achieving innovation between a client firm and a vendor. One of the main reasons often cited by CIOs for failing to achieve innovation in outsourcing is the uncertainty about the nature of innovation desired from the vendor, and also the inability to design a contract that is on the one hand mitigating client's exposure to be exploited by the vendor and at the same time offers compensation for extra work and innovation delivered by the vendor. Put simply, most outsourcing contracts do not accommodate these often contradicting requirements properly.

Despite this contractual challenge, client firms still seek innovations from their outsourcing engagements. Among the key drivers for innovation in outsourcing are limited resources and capabilities within the client firm, shortage of specialist talents, management of multiple risks, attracting talent in the company's non-specialized areas, and reducing time-to-market. As globalization intensifies and many more firms quickly become global players, the influence of these drivers will only have a bigger impact on the firm's performance, pressing executives to seek innovation through partnerships.

So how can companies innovate through various ways of sourcing? Very often client firms have an ad hoc approach to achieving innovation from outsourcing arrangements. Such an approach often fails to leverage organizational learning and may also result in the unintended loss of knowledge. An ad hoc approach also cannot create a culture in which external contributions are accepted or welcomed. Moreover, it is very difficult to measure innovative processes and outcomes when companies innovate on an ad hoc basis. As academics with over 20 years of combined experience in the field of outsourcing, we observed that the topic of

innovation in outsourcing is poorly understood. For this reason, this study is set about understanding (i) what client firms expect to receive from vendors in terms of innovation and (ii) what are the key factors that influence the extent to which innovation can be delivered in outsourcing relationships.

How this Research was Conducted

This research, conducted by Warwick Business School in collaboration with Cognizant, focuses on understanding whether CIOs and CFOs achieve innovation through their outsourcing arrangements. We also examined the factors that positively affect innovativeness in outsourcing.

The ideas presented in this paper are based on original research conducted at Warwick Business School (UK) and carried out by Dr. Ilan Oshri and Dr. Julia Kotlarsky. The researchers also conducted semi-structured interviews and held discussions with experts in the field of outsourcing, including CIOs and CFOs from leading multinationals with headquarters based in Europe. The ideas in this paper are also based on a quantitative survey, which was carried out in partnership with research organisation Vanson Bourne. The quantitative survey sampled 250 CIOs and CFOs from companies with revenues from \$500m up to over \$1bn (51%) from financial services, manufacturing, logistics, retail, utilities, telecom and other leading sectors in the UK (50%) and other European countries such as France, Germany, Denmark, Sweden, Switzerland, Belgium, Netherlands and Luxemburg.

What functions have been outsourced?

In our previous report, carried out in 2009⁸, we analysed the functions outsourced recently. Table 1 brings together the results from the March 2009 and the recent study to allow a comparison in trends and therefore make some conclusions about the expected growth of specific outsourcing segments.

Clearly, BPO has grown strongly between the two studies. While only 33% of the 2009 respondents reported that they outsourced business processes, 47% of the later study's respondents have done so. This result corresponds with other studies which predict that BPO will overtake ITO by 2015⁹.

As Table 1 shows, IT and IT-enabled business processes are still the most popular candidates for outsourcing. Based on the later study, among the vast range of services outsourced, IT infrastructure and data management is on the top of the list, being outsourced by 58% of the surveyed companies, followed by IT and technology consultancy and ERP support (53% each).

⁸Oshri, I. and J. Kotlarsky (2009) "The Real Benefits of Outsourcing", A WBS white paper for Cognizant. <http://www.quantifyingoutsourcingbenefits.com/default.asp>

⁹Oshri, I. and J. Kotlarsky (2009) "The Real Benefits of Outsourcing", A WBS white paper for Cognizant. <http://www.quantifyingoutsourcingbenefits.com/default.asp>

We also observe a significant increase in BPO projects, in particular, in ERP implementation and integration. In the later study, 53% of the respondents reported that they engaged in such projects against only 41% in 2009. Other business processes, such as Finance and Administration, HR, Payroll and many others which in the past were largely moved offshore to captive facilities because of data security and control issues, nowadays are increasingly outsourced to third parties. For example, compared with the results of the 2009 survey, in the more recent study we observe a significant increase in outsourcing of such business processes (from 33% to 47%). Furthermore, large European firms tend to outsource more knowledge-intensive processes such as CRM and business analytics (i.e. data warehousing and business intelligence systems), which were not so popular in 2009. We see a significant increase in outsourcing of these processes compared to early 2009 (29% outsource CRM in 2010 compared to 22% in 2009, and 26% outsource data warehousing and business intelligence compared to 18% in 2009).

While IT infrastructure and data management is still the most popular function to outsource, we have observed a small drop between the earlier and later surveys in the number of firms reporting on such engagements. While these results are surprising, we don't think that they represent a long term decline trend. Consistent with Gartner's recent report, we agree that the ITO market is maturing and will probably maintain a 5% compounded annual growth in the next five to seven years.

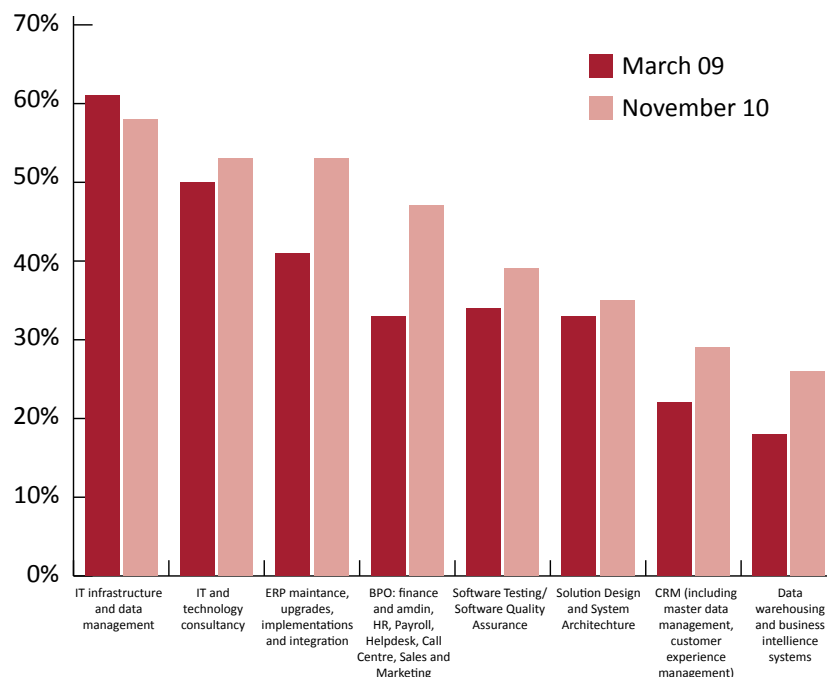


Table 1: Functions outsourced in 2009 and 2010

The Importance of Innovation to Business Success

Traditionally innovation has been perceived as one of the sources of competitive advantage in fast changing industries. To keep up with market forces and changing consumer tastes, firms need to be innovative by tapping into both internal and external knowledge. Indeed, 64% of the responding firms believed that their ability to be more innovative contributes to the financial performance of their organisation. Seventy per cent of the respondents also thought that the innovation they have achieved through outsourced business arrangements had contributed to the financial performance of their organisation. And 53% of the respondents indicated that innovative capabilities demonstrated by the vendor are either important or very important in their vendor selection criteria.

However, selecting a vendor capable of innovating successfully, either incrementally or in a radical manner, requires a robust, methodological approach that turns not only ideas into successful products, but also ensures the appropriation of value created through the innovation.

Indeed, research has persistently identified the management of innovation as one of the key weaknesses in firms' ability to build an innovation capability. It seems that firms have a flow of ideas generated either internally or through external change agents; however, translating these ideas into a successful commercial product or service has always been the challenge. When asked: 'Would you benefit from an innovation framework that could guide all your stakeholders through the journey of translating an idea to a defined product or service?' 58% of the respondents replied that they would indeed like to have such an innovation framework. And, 67% of the respondents also believed that it is possible to formalise, repeat and maintain innovation within their industry. However, when asked regarding their willingness to invest in such service, only 50% of the respondents indicated that they were willing to pay for an outsourced service which will formalise, repeat and maintain innovation within their industry, and only 45% were willing to pay rates higher than standard for an innovation framework provided as a service by their outsourcing partner and that will demonstrate a return on investment.

Clearly, client firms value innovation and acknowledge its impact on business performance. Furthermore, they also see the importance in obtaining a framework that will allow them to build and retain an innovation capability that outperforms their competition. However, the majority of firms still do not see the value in paying extra for such services, even if the vendor is able to show a return on the investment.

The Innovation Challenge in Outsourcing: Clients' Expectations

Client firms expect their vendors to help them innovate. Innovation in this regard can be delivered not only through the offering of new products, services and processes, but also via the transformation of existing processes. According to the results of this study, the majority of client firms expect vendors to either turn ideas into improved processes (56%), transform existing products (55%), help transform existing processes (53%) or help turn ideas into new products (see Table 2). However, when asked how such expectations will come into effect, 66% of the client firms indicated that an engagement with an outsourcing vendor should free up in-house resources that can focus on higher value activities (see Table 3). Clearly, such a belief implies that the vast majority of client firms still consider innovation to be core to the firm's value chain and as such should be carried out in-house. Therefore the majority of client firms still rely on their own knowledge-base for innovation, failing to recognize that innovation can in fact be a service. Often such a shift in mind-set requires not only an extensive change management process within the client firm, but also a re-skilling exercise of the retained talent and expertise to realize their ability to focus on managing relationship for innovation rather than just managing supply contracts.

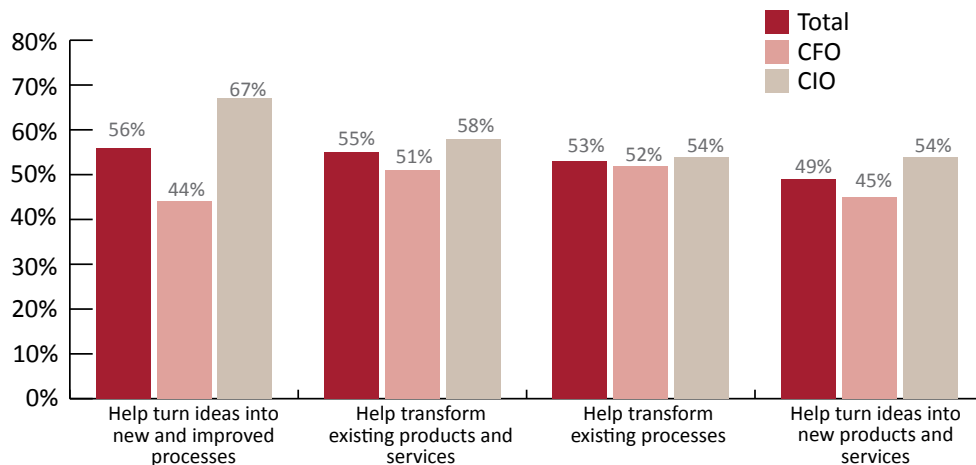


Table 2: Expectations from the outsourcing partner in terms of innovation

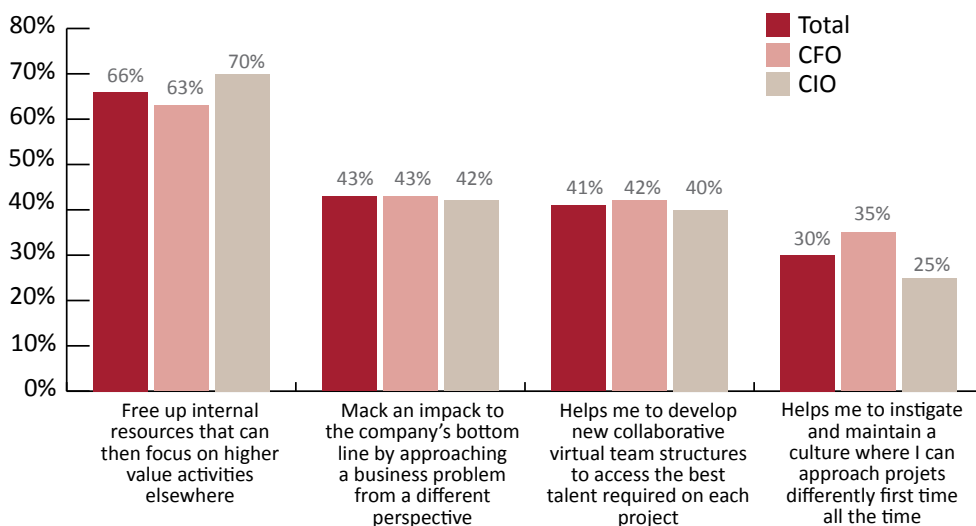


Table 3: How your outsourcing engagement will result in innovation

Enabling Innovation in Outsourcing: The Role of the Contract

Outsourcing arrangements are based on contracts and therefore understanding which contract is more likely to accommodate innovation is key. To our knowledge, the link between contract types and innovation in outsourcing has never been studied before and the implication for how firms set up contracts to achieve innovation is therefore poorly understood. To start with, in order to achieve innovation in outsourcing, both clients and vendors need to craft contracts that offer incentives and that nurture innovation. In this regard, contracts should include clauses that incentivize vendors to think about innovations regardless, of the nature of the process or system outsourced. There is a misperception that some contracts are not designed for innovation, such as ticket-based contracts or fees for service. However, we came across several examples that demonstrated the wide possibilities available to the vendor to innovate, despite relatively unfavourable contract terms. For example, in one ticket-based contract, the vendor improved the service provided, a process innovation that resulted in a reduction in the number of tickets generated by the client firm's clients. The vendor was motivated to innovate by the contract that offered higher margins per ticket should the number of tickets drops down, while the client firm was satisfied with this improvement as their customer satisfaction feedback has significantly improved.

Our study shows that the vast majority of contracts are fee for service (78%) and ticket-based (47%), suggesting that most deals are based on fixed fees for a specified service. Non-fixed price contracts, such as time and material account for 42% of all outsourcing contracts¹⁰. Considering that the vast majority of the firms opts for fixed price contracts, we see a challenge to achieve innovation in outsourcing engagements. One executive we interviewed discussed the challenge as one that is similar to the chicken and egg analogy. He explained that setting up a collaborative environment for innovation depends very much on the steps each side take. But because of resource management, there will always be the issue of 'who is paying for all the goodwill'?

Yet, this scenario does not mean that innovation in outsourcing cannot be achieved in relatively rigid and inflexible clauses in the contract. We would expect that clients would include clauses in the contract that will improve flexibility in payments when the vendor is 'going the extra mile'. However, when asked, our results show that 53% of the respondents either did not include, or were not aware if such clauses were included in their contract to compensate vendors for innovation introduced in the outsourcing project.

¹⁰Total percentage of contracts is higher than 100% because some client companies surveyed engaged in several outsourcing relationships, some with different types of contracts.

Types of Innovation and Contractual and Relational Governing Approaches

There are numerous types of innovations that academic and professional literature have discussed in recent years. Among the more popular innovation types are incremental, radical, systemic, architectural, autonomous, disruptive and discontinuous innovation. At the same time, innovation can be in the form of a new product, service or process. Incremental and radical innovations have, by far, been at the centre of academics' and practitioners' attention. For this reason, we have focused in this study on how either incremental or radical innovation can be achieved in outsourcing. There are two governing approaches to manage outsourcing arrangement: one is a contractual approach that emphasizes the formality of the relationships between the client firm and the vendor through the relatively high dependence on the contract as a governing mechanism. The second is a relational approach which brings to the fore the interpersonal relationships between staff from the client and vendor firms that drive collaboration between the parties and form partnership as the cornerstone of the outsourcing governing structure. We actually see contractual and relational governing approaches as complementary rather than substitutes, which means that client firms will seek to leverage on relational aspects to promote a collaborative attitude while ensuring that the outsourcing project meets the clauses specified in the contract. In this regard, our study sought to understand the link between innovation types and the governing approaches.

Our results show that radical innovation is strongly associated with both contractual and relational governing approaches. The results of this study also suggest that client firms seeking radical innovations in outsourcing should first develop strong contract management capabilities and then complement those with relationship management capabilities to ensure that the parties shift their attitudes from a transactional approach to a collaborative mode.

An example provided by the CIO Downstream of Shell illustrates how innovation in outsourcing can take place. We have learned that the most acute and contemporary challenges are shared with the vendors of Shell's outsourcing ecosystem, with the hope that one or more vendors will come up with a proposal how to tackle such challenges. Once a proposal is made, Shell's management will seek funding for the solution and will form a joint venture with the vendors to arrive in a contract that clearly defines the investment required by each party as well as the appropriation of value created and intellectual property issues. In this regard, Shell's approach confirms our results that joint venture contracts are more likely to lead to radical innovation.

Sourcing Models and Innovation in Outsourcing

There is an on-going debate around which sourcing model is more likely to deliver innovation to the client firm. This debate has centred around two sourcing models: bundled services and multi-sourcing. On the one hand, a bundled service sourcing model, in which the client outsources multiple business functions to a single vendor, implies strong relationships between the client firm and the vendor, a trait which is imperative for the collaborative innovation attitude in outsourcing settings. However, bundled services also pose a threat to client firms lacking strong sourcing capabilities in the form of being 'locked in' and therefore not being able to switch vendors when performance deteriorate and innovation is not delivered. The alternative, which is now the dominant sourcing model, is multi-sourcing, in which the client firm outsources part of its value chain to multiple vendors.

The results of the survey show that multi-sourcing settings are more likely to deliver client firms radical innovation from their vendors than any other sourcing models.

Measuring Innovations in Outsourcing

The results of the survey show that multi-sourcing settings are more likely to deliver client firms radical innovation from their vendors than any other sourcing models.

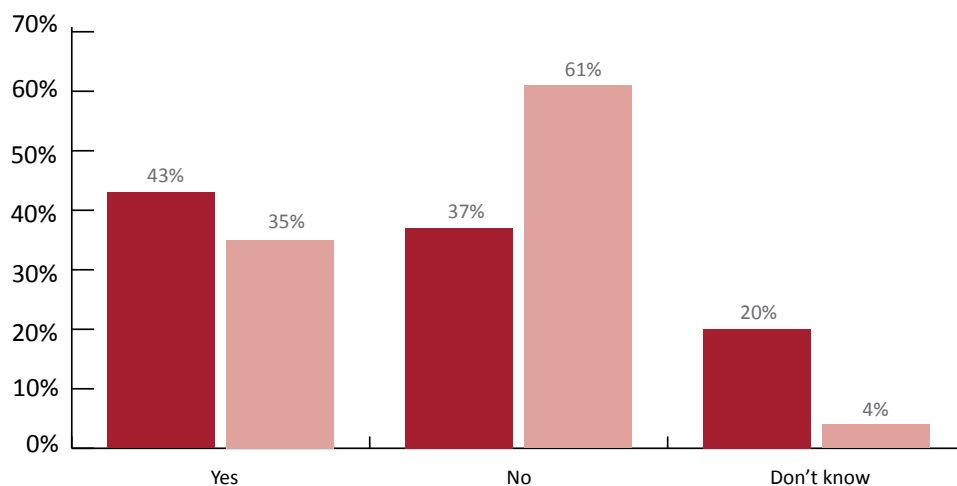


Table 4: Do you measure the value or the innovation delivered by your vendor (CIOs and CFOs perspective)?

From the above results, it is evident that the vast majority of C-level executives fail to measure the returns on either outsourcing or innovation investments made in their relationships with vendors. From interviews we have held, we learned that many client firms do not quantify the value that a business function contributes to the competitiveness of the firm but rather prefer to compute the cost-base of this business function. Such an approach drives client firms to focus on cost reductions as the main objective sought from vendors while expressing desires to see value and

innovation delivered in outsourcing engagements, yet without building a capacity that allows them to properly manage and measure innovation outcomes and impact. This attitude is in particular a source of concern as 64% of the respondents in this study confirmed that they are now investing more in outsourcing partnerships than they did three years ago, hinting that client firms seek to tighten relationships with vendors and leverage on the relational approach in order to incentivize the vendor to innovate. Such a combination of desires and deeds calls for the examination of required steps that we believe will lead clients firms to benefit from innovation in outsourcing.

How to Achieve Innovation in Outsourcing: The Innovation Ladder

We developed a framework that we call The Innovation Ladder (Figure 1) to help client companies to incorporate innovation in their outsourcing strategy. The emphasis in our approach, as opposed to some other studies we have seen, is that we believe that the innovation strategy should be integrated into the outsourcing strategy of the client firm. We acknowledge that some firms, such as Shell, prefer to execute innovation with their outsourcing vendors outside the on-going outsourcing relationship; however even such firms should consider implementing some of the steps described below. In this regard, the Innovation Ladder is a full cycle approach from the beginning of the outsourcing relationship until the delivery of innovation. Yet, client firms can pick and choose some steps depending on the breath of innovation sought and on the nature of the relationship they establish with their vendors.

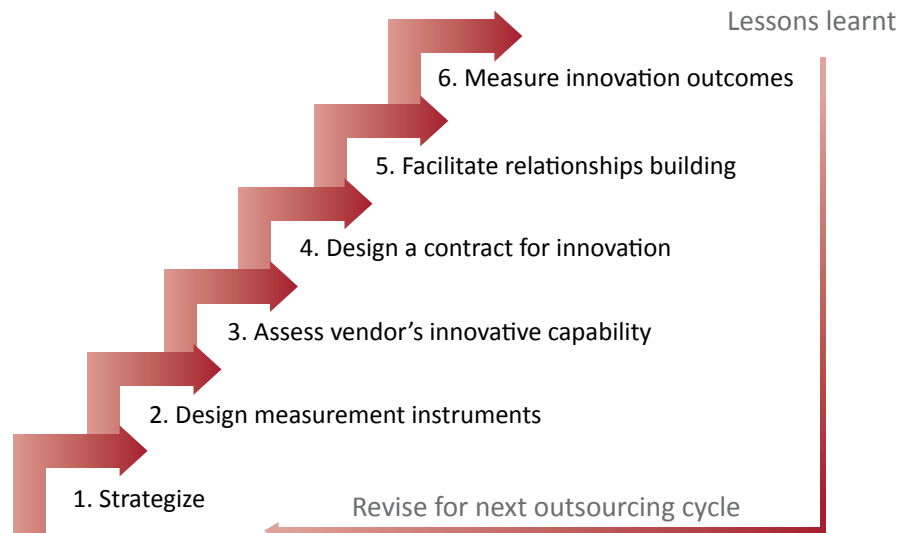


Figure 1: The Innovation Ladder in Outsourcing

Step 1: Strategize innovation

A journey into innovation in outsourcing should start at the early stages of strategizing the outsourcing project. These early stages of the outsourcing life-cycle often involve the identification of objectives and the potential areas for improvement derived from the outsourcing engagement. At that point in time, it is imperative that executives will consider the impact expected on the firm, from operational or strategic perspectives, and the two levels of innovations: incremental and radical (see Figure 2).

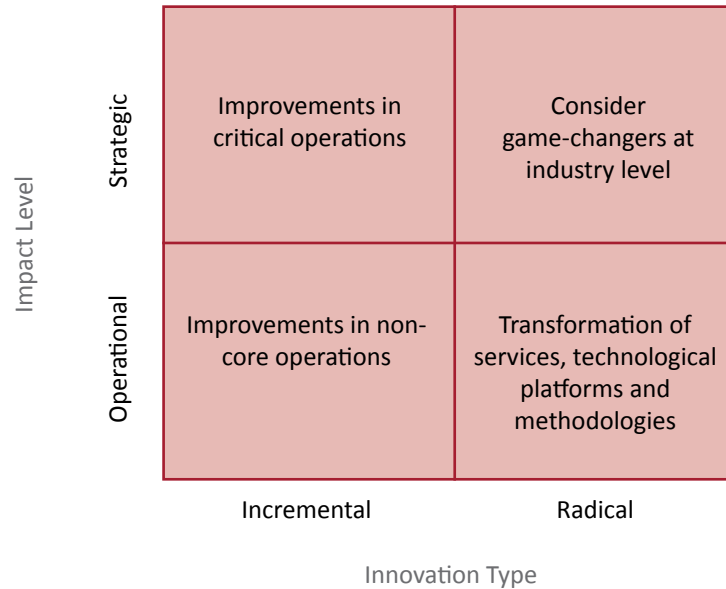


Figure 2: Impact of Incremental and Radical innovation on the Operational and Strategic levels of the client firm

In principle, executives should consider the four areas of improvements when strategizing innovation in outsourcing. To start with, executives should discuss the incremental improvements expected at the operational level in business processes that are considered to be non-core to the firm's competitive position. Such business processes can be, for example, finance and accounting, human resource management and procurement, which are becoming prominent candidates for outsourcing; however, with little attention to the improvements sought to be achieved from the vendors.

Client firms should also seek incremental improvements in critical operations outsourced to a third party service provider. One example of such business process is business analytics. Our study reports that 26 % of the respondents outsourced business intelligence to a third party service provider. In this regard, executives should consider incremental innovations in a critical business function that benchmark with best practices in the industry. For example, executives can ask: what gaps exist between our level of critical operations and the industry best performer's level of these critical operations?

Combining the areas of improvements in non-core and critical business operations will allow executives to form their 'wish list' of incremental improvements. These can be clearly specified and described in any type of contract and that corresponds with the enhancement of the firm's operational competitiveness. In including in the contract rewards, such as sharing of savings achieved from improved processes would motivate vendors to put efforts in such improvements.

Executives should also consider radical innovation that can be achieved in their outsourcing engagements. This would require executives to consider the transformation of existing services and technological platforms but also scenarios in which the solution or the process through which the desired outcome will be achieved is not yet defined. In terms of the impact at the operational level through radical innovation, executives should discuss what services and technological platforms are candidates for major transformations. Such decisions can be made by considering specific service performance, cost/value ratios, and benchmarking against cross industry service performance.

The fourth, and most challenging strategize stage, should be about problems or strategic moves that are still unknown and therefore the solutions for them are still to emerge. Here we are considering the impact at the strategic level of radical innovation. Executives should discuss scenarios of major shifts in the industry landscape and competitor strategies as a threat and an opportunity to shape their competitive environment. In this regard, executives should ask the following questions: what business models may emerge in the industry? What business models may become obsolete? What new services and service delivery methods may emerge and how prepared are we to either shape the environment or benefit from such changes? Decision makers at this stage may also consider entry to new markets and/or new industries as a strategic move of the firm, or as a result of mergers and acquisitions that create a need for executives to re-consider how to maximise benefits from new markets / industries. The purpose of such discussions is two-fold: first, to shift executives' attention from focusing on the operational/transformational level in outsourcing to consider strategic issues that are still to emerge, as a response to the dynamic and highly competitive environment; and second, to discuss and formulate a framework within which such challenges will be shared with trustworthy vendors.

By bringing together these four aspects of innovation in outsourcing during the early stages of the planning, the client firm will be able to devise an approach to realizing the innovation potential from each setting. Below we describe in depth each of the following steps.

Step 2: Design measurement instrument

As a second step, client firms need to develop the measurement instruments for the incremental innovation expected to be delivered by the vendors and design a framework for which radical innovation will be pursued with selected vendors. The measurements for incremental innovation should be developed against the benchmark in the industry. With this, the objectives captured in Step 1 will be translated into specific expectations regarding incremental improvements expected from their prospective vendors. While designing measurements for incremental innovation (e.g., % of cost reduction, % of improvement in time-to-marker or a % reduction in process duration), it is important to relate these targets to Key Performance Indicators (KPI) of the client's firm and

to Key Success Factors (KSF) at the industry level. In this stage executives should ask the following questions: which of our services/technological platforms/methodologies are lagging behind the standard performance in the industry? Which of our business function candidates for outsourcing are key for our operational excellence? The answers to these questions will assist executives in identifying the services and technologies that are candidates for incremental innovation and also to realize the expected improvement measurement as benchmarked against industry performance. This analysis will address the design requirements of incremental innovation in the early stages of the outsourcing engagement. The contract should also have a clear reference to how the vendor will be rewarded if it improves the measurements further (e.g., bonus as % of additional cost savings that result from process improvement).

The design of a collaborative framework for radical innovation should take a different approach. As the challenge is not clearly defined at the operational and strategic levels, client firms should devise a radical innovation framework to create conditions within which preferred vendors will be introduced to significant and game-changing challenges that require radical innovation. The radical innovation framework includes procedures and processes within the client firm that scout threats from competition and markets, and translate those into descriptive scenarios that can be shared with external partners. The radical innovation framework should also outline the knowledge sharing platforms, their participants, structure and frequency of interactions between the participants, to ensure that vendors bidding for the outsourcing project are aware of the commitment required from them in exploring radical innovation opportunities, which would allow them to budget for additional resources required for such activities. Last but not least, the radical innovation framework will include a proposed contractual approach once the client firm and vendor(s) have agreed on the best way to tackle transformative and game-changing challenges. Our recommendation is that a joint venture arrangement, separate from the on-going outsourcing engagement, will be the main vehicle through which radical innovation is carried out.

Step 3: Assess vendor's innovation capability

Having carefully crafted the measurement requirements for incremental innovation and devised a plan (and a framework) for achieving radical innovation, it is now the time to develop a set of criteria upon which the innovativeness of the bidding vendors will be assessed. While the results of this study suggest that most client firms consider the innovativeness of their vendors as one of the vendors' selection criteria, to our best knowledge, no study has so far revealed what these criteria were, as well as how they should be applied in the context of incremental and radical innovation.

Based on research we have conducted and input from leading consumers of outsourcing services, we come to the conclusion that in incremental innovation, the relevant selection criteria should seek proven evidence of improvements made in same scope, complexity and

criticality to operational excellence of business processes, services and IT platforms. This proven evidence can be in the form of referral letters from the vendor's existing and past clients, vendors' case studies about improvements made in business processes and IT platforms and an outline of the approach to meet improvement measurements submitted as a project plan. Further, vendors should also provide similar evidence for their relationship capabilities, which, in the case of incremental innovation, are complementary to proven abilities to provide solutions according to the specifications. These inputs will allow the client firm to systematically compare between the various bidders concerning their incremental innovation capabilities.

Assessing capabilities to carry out radical innovation is far more challenging. Based on our research we argue that client firms should put the emphasis on understanding the relationship capabilities developed by the potential vendors and then seek complementary delivery capabilities in the form of technical and service development capabilities. We advocate for this approach for two reasons: first, as the challenges requiring radical innovations at the operational and strategic level are still not clearly defined, and because the success of setting up a collaborative framework depends to a large extent on the relationship developed between the client and vendor, client firms should focus on clearly mapping out the relationship capabilities developed and applied by the vendor firm. Second, in many examples of radical innovations we have come across, it was the result of a 'consortium' of several firms (usually client and several vendors) that were able to bring together expertise and knowledge from various domains to arrive in a game-changing product or service. Once again the relationship aspect is coming across as imperative for facilitating collaborative framework between multiple vendors that are part of the 'consortium' of firms that bring together distinct expertise and capabilities.

The relationship capability implies a supplier's willingness and ability to align its business model to the values, goals, and needs of the customer¹¹. For example, this capability is evident in the vendor's attitude to continuously educating existing customers about state-of-the-art developments in the areas related to the client's business; flexibility to accommodate changing or additional client requests, and adapting organisational design and governance structures to those of the client¹². To assess the relationship capabilities of the bidding vendors, client firms should seek evidence from past projects regarding the procedures, processes and personal interactions set up and used by the vendor. We believe that only by examining the wide range of communication channels between clients and vendors, one can in fact understand how the relationship side has been accommodated. Therefore, client firms should seek evidence about weekly and bi-weekly meetings set and held between the vendor and its clients; evidence regarding forums, portals and databases as knowledge sharing mechanisms; and evidence regarding

¹¹Feeny, D., Lacity, M., and Willcocks, L.P. (2005), "Taking the measure of outsourcing providers," MIT Sloan Management Review, 46(3): 41–48

¹²Oshri, I., Kotlarsky, J., and Willcocks, L.P. (2007a), "Managing dispersed expertise in IT offshore outsourcing: Lessons from TATA Consultancy Services," MIS Quarterly Executive, 6(2): 53–65.

interpersonal relationships between the vendor's staff and client's personnel. This information can be gathered through referrals to the existing customer and information available on the Internet such as blogs, social media websites and professional magazines.

Step 4: Design a Contract for Innovation

Once the vendor selection phase has been concluded, the attention of the parties involved is shifting to the contract and its content. One very clear result from this study is that most outsourcing contracts are not designed to accommodate innovation. Many of these contracts focus on defining service levels, pricing and penalties, tilting the attention of the vendor to a 'maintenance' mentality as well as the client's mind-set to monitor outsourcing performance based on well-defined SLAs. Accommodating innovation in outsourcing contracts requires a different attitude.

Contracts that accommodate incremental innovations should elaborate on both improvement targets and innovation process that will commit both client and vendor to follow and monitor, including desired targets and rewards if these targets are outperformed. In this regard, and often beyond the regular SLA clauses, the incremental innovation clauses should be specific regarding the relationship mechanisms put in place by both client and vendor that will support the vendor's effort to deliver incremental innovation according to the improvement measurements.

The clauses in the contract that refer to radical innovation should provide an elaborative description of the methodology through which vendors will become partners. In this regard, the contract should describe the process put in place to share transformative and game-changing challenges with the vendors, the expected participation from the vendors in such forums and the preferred legal agreement to pursue solutions in the form of radical innovation by one or more vendors. Our recommendation is that this kind of partnership will be established where a clear specification of resources, capital is defined as well as the approach to appropriate value and manage intellectual property is outlined.

While our guidelines for tailoring clauses for incremental and radical innovation stand in various contexts, we also took note of a general approach by client firms regarding fixed price contracts and innovation. For example, client firms refrain from offering open-ended clauses in the contract that incentivizes vendors to innovate. Such clauses could have been in the form of bonuses for innovation delivered beyond the scope of the project or 'a time and materials' pricing component for innovation within a fixed price contract. Our study provides additional support to such client's tendency to refrain from offering incentives to actual innovation delivered by the vendor. We examined this matter in view of contract types and have come to the conclusion that such an approach harms the relationship aspect in the outsourcing engagement. Indeed, the client firm's concern, which is anchored in the belief that client firms should avoid having loosely-defined clauses, is well justified; however, it is also

a risk that clients can mitigate. For example, we have learned that in a ticket-based contract, the client and vendor devised a pricing model which incentivized the vendor to reduce the number of tickets logged onto the system through significant end-to-end service improvements and as a return the vendor gained from higher margins per ticket processed. We view this example as radical innovation at the operational level which was mitigated based on the actual outcomes delivered by the vendor.

Step 5: Facilitate relationships building

It is without doubt that building relationships between the client firm and the vendor is imperative for the success of either incremental or radical innovation. However, as opposed to some recent studies on innovation in outsourcing which advocated for an investment in trust regardless of the type of innovation sought, we posit that relationships play a different role in incremental and radical innovation. We have already discussed the various ways client firms can represent the potential leverage for innovation through relationship management. At this point in time, we wish to discuss how relationship management should be executed in incremental and radical innovation.

Our results indicate that in the case of incremental innovation, the relationship between client and vendor comes second to the contract regardless of the contract type (all but joint venture). We therefore advise client firms seeking incremental innovation to focus on developing relationships with their vendors as a complementary element to monitoring the contract. Further, we argue that relationships in incremental innovations should in fact be facilitated through the formal channels, which are already captured in the contract. Some examples of such mechanisms include the regular meetings, shared portals and communication procedures which are elementary in each outsourcing project; however, becoming imperative for incremental innovation.

Radical innovation, however, begs for a different approach according to which client firms need to invest in the interpersonal side of the relationship with the vendor, as a complementary step to the contractual approach. Our extensive research about outsourcing suggests that it is imperative that trust and rapport between senior managers (e.g., relationship manager) will be developed and renewed to encourage a collaborative atmosphere between client and vendor staff. While personality clashes and cultural differences might play a negative role in developing rapport and trust between individuals from the client and vendor teams, there are always opportunities to enhance the relationship dimension by organizing informal social events, the use of social media tools and through open and preferably face to face communication channels. Clearly, it takes a major commitment from senior managers to develop a collaborative atmosphere, which in our view is only one enabler among many to set up and launch a radical innovation project.

¹³Oshri I., Kotlarsky J. and Willcocks L.P. (2007) "Global Software Development: Exploring Socialization in Distributed Strategic Projects", *Journal of Strategic Information Systems* 16 (1), pp. 25-49.

We also see opportunities in harnessing social media and open source platforms to support relationship building between clients and vendors. Social media platforms that serve as collaborative tools will enhance the collaborative experience of the client firm in particular when vendor and client teams are remote. Similarly, Web 2.0 platforms will enable stakeholders to co-innovate and co-create services regardless of their physical location.

Step 6: Measure innovation performance

As reported above, client firms fail to measure the return on innovation delivered by their vendors. In the academic literature there is general agreement that innovation improves business performance. It flows from this that client firms should invest more in understanding the nature of innovation delivery, its impact on the operational functions within the value chain, as well as on the firm's strategic positioning within the market. Such an exercise will allow decision-makers to realize the value delivered by partners and will inform executives regarding the opportunities that emerge in outsourcing relationships. We think that most of firms can, in fact, measure the return on the outsourcing investment, in a quantifiable form, should they follow steps 1 and 2 of the Innovation Ladder. For incremental innovation at the operational and strategic level, client firms should have developed clear measurement instruments as part of step 1 and 2. These measurement instruments may have to be revisited during the project lifecycle. Using the measurement instruments as reference points, the client firm should seek to evaluate whether its incremental innovation targets have been met.

Radical innovation is more challenging to measure; however, the client firm should seek both qualitative and quantitative inputs regarding performance. In terms of qualitative feedback, the client firm should seek input regarding the quality of the network created to arrive in radical innovation. Periodical surveys among members of the joint venture consortium regarding the quality of collaboration, motivation to contribute, assessment of each partner's contribution and intention for future collaboration can provide an indication regarding the 'health' of the joint venture consortium and the potential to tap into this pool of expertise in future projects targeting radical innovations. Quantifiable measurement tools to assess the impact of the radical innovation on business performance should be in the form of benchmarks against industry performance. In particular, as radical innovation was sought to improve the competitiveness of the firm either through operational excellence or strategic positioning, the client firm should judge the impact of the radical innovation through industry-wide performance indicators. For example, the quality of service provided, represented through various measurable indicators such as customer satisfaction, is one performance indicator that can be used by service firms.

Step 6 is not the last step in the innovation ladder. If anything, it is a step that calls for reflection and a stage that offers an opportunity redesign the innovation framework. Feedback collected during these six steps should serve the client firm in its journey to achieve innovation in outsourcing.

Summary

As the outsourcing industry matures and the range of outsourcing services extends to higher value activities, client firms raise the bar regarding their expectations, seeking the delivery of high impact innovation from their vendors. This report brings together the expectations of client firms regarding innovation in outsourcing as well as the willingness of client firms to invest in creating the conditions for innovation in outsourcing. It is evident from our findings that client firms seek both incremental and radical innovations. Further, client firms see the engine of growth fuelled by innovations delivered by their vendors across technical business domains. However, only vendors with both innovative and relationship building capabilities will be able to take on the challenge. In particular, vendors who traditionally invested in long term relationships with their clients, understanding their business processes and technical platforms, and closely collaborating with them on improvement project across the value chain will be able to offer high impact business and technical innovations to their clients. Yet, both client and vendor firms will need to ramp up their innovative capabilities to address acute challenges revealed in our study. First and foremost, clients and vendors will need to follow a systematic innovation lifecycle, outlined in this report, to ensure that the desired innovation is captured in the objectives of the outsourcing project as well as aligned with the business objectives of the client firm. Further, understanding how value is delivered to the client firm through innovative projects and agreeing on methods to measure value of innovation in outsourcing is another imperative aspect of this latest trend in outsourcing.

As the outsourcing industry is facing additional changes, such as a growing adaptation of the multi-sourcing model and the emergence of cloud computing as the technological platform through which business services will be delivered, vendor's innovativeness is becoming ever so important to differentiate its services from competition and enhance its competitiveness in the industry. In this regard, innovativeness should go beyond the technical domain to demonstrate the vendor's ability to transform business processes across the value chain as well as introduce management innovations that offer flexibility and agility to the client firm. For example, vendors can innovate around contracts to seek a sweet point that brings together the ability to rely on long term relationships with the rigor needed from a detailed contract. Indeed, the path to achieve significant innovation in outsourcing travels through the crossroads of a relational and a contractual approach.

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