SELECTED PROBLEMS OF RISK MANAGEMENT IN OUTSOURCING COOPERATION

Dr. Tomasz Malkus, Cracow University of Economics, Poland
malkust@uek.krakow.pl

ABSTRACT

One of the basic assumptions of outsourcing contracts is the reduction of cooperation risk between the client and the service provider. It requires recognition of the types of risk inherent in the relationship between the client and service provider, the factors influencing the risk and also the activities undertaken in order to reduce the risk concerning the achievement of results of cooperation in outsourcing. The objective of the paper is to present selected problems concerning risk management in outsourcing cooperation. Types of risk, solutions concerning risk-sharing between client and service provider are taken into consideration, as well as the ways enabling risk reduction in cooperation between the client and service provider.

Keywords: outsourcing, theory of transaction costs, risk reduction, service provider, contract

INTRODUCTION

Together with growing interest in cooperation with specialized service providers essential importance is attached to the activities focused on reducing risk of non-performance or unsatisfactory performance of contracted service. These activities concern especially the proper statement of the terms of cooperation in contracts. In long-term contracts with service providers much stress is put on forecasting negative scenarios, that may occur within cooperation, as well as on methods useful for preventing such scenarios or diminishing their impact on performance.

The aim of the paper is to present selected problems concerning risk management in outsourcing cooperation. Types of risk, attitudes concerning risk-sharing between client and service provider and the ways enabling risk reduction in cooperation between the client and service provider are taken into consideration. The first part of the paper, concerning the characterization of the risk inherent in outsourcing cooperation includes a literature review. The second part is focused on information about activities taken to reduce this risk. Identification of negative scenarios, representing risk of cooperation and actions to reduce that risk was inspired by both the literature review, as well as case studies of cooperation of
companies operating in the food, tire, and tobacco industries with providers of logistics and IT services. Case studies were conducted by the author in preparations of his doctoral dissertation.

**THE CHARACTERISTICS OF RISK IN OUTSOURCING COOPERATION**

One of the basic assumptions of outsourcing contracts is the reduction of cooperation risk between the client and service provider. It requires recognition of types of risk inherent in the relationship between the client and service provider, the factors influencing the risk and also activities undertaken in order to reduce the risk concerning the achievement of results of cooperation in outsourcing. The ability to reduce the risk can be treated as a fundamental aspect of results of outsourcing. With a growing interest in outsourcing, the problem of risk reduction associated with the achievement of effects below the accepted expectations is highlighted as the important problem of cooperation. This issue is considered by such authors as: C. Gay and J. Essinger (2002), B. Bahli and S. Rivard (2003), M. Corbett, (2004), and also D. Brown and S. Wilson (2005).

In general, the risk of cooperation in outsourcing relates primarily to non-performance or unsatisfactory performance of contracted service and, therefore it concerns the shaping of regulations in the contract between the client and service provider. These terms define in particular the relationship between cooperating units, activities and infrastructure to adapt these units to work together, as well as the change of external or internal conditions of parties' activities. Exterior modifications are concerned primarily with the law and economy, but also may be associated with the occurrence of natural disasters, or disasters affecting the infrastructure of client or service provider.

Internal risk factors in outsourcing result from bounded rationality, and propensity to opportunism. This phenomenon can be analyzed with the transaction cost theory (Williamson, 1985), agency theory and incomplete contract theory (Hart, 1995).

According to the transaction cost theory, specificity of assets is a factor causing risk, but its occurrence is closely related to the previously mentioned tendency to opportunism. Contracts between the client and the provider are incomplete, because of difficulties in obtaining comprehensive information about future conditions for 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), (Hart, 1995). Taking the different characteristics of the risk inherent in outsourcing, based on the approach presented by M. Corbett (2004, 98) 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 for service rendered, 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, operational risk is also associated with the adjustment of the service provider to the requirements of the client, the poor quality of the implementation of the outsourced tasks, 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, and thereby also reduction of control on core activities, the loss of the know-how, changes in the 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 M. Corbett identified also another kind of risk, associated with undertaking cooperation in outsourcing. It is the risk of losing the ability to achieve the expected results. It should be noted that this type of risk is closely related to the others, mentioned above. Taking into account the reduction of transactional, operational and strategic risk, as one of the main assumptions of the relationship with the service provider can be ponted out, that the ability to reduce these types of risk also reflects the ability to reduce risks of disability of cooperating units to achieve the expected results.

There are significant differences in risk-sharing between client and service provider. In general, several situations can be distinguished:

• responsibility of the provider only for the quality of service rendered, regarding the contract arrangements for the consequences of non-performance or improper performance of service, there is the possibility of easy replacement of service provider, resulting from little specificity of assets used in transaction and a high availability of service on the market, it is characteristic for outsourcing used to eliminate the current problems of client (such as the excessive costs of the implementation of some services, low quality, high maintenance costs of workers performing outsourced tasks),
• joint ventures of client and service provider, where there is risk sharing, accountability, terms of the contract, concerning the sharing of benefits reflect agreed distribution of risk, associated with project implementation, the allocation of benefits is clearly defined, it may also include negotiated increase of risk of one party, associated with extra benefits, which are determined by agreement between the client and service provider (the client gives up part of share in the benefits of new venture to a service provider, in exchange for the increase of provider’s contribution to the construction of infrastructure, this may also apply to a situation in which the service provider uses the infrastructure of client, which enables the reduction of the rate paid to provider), this solution is characteristic for long-term contracts, concerning cooperation for mutual development through joint investments,

• increased risk of one party, but the injured party is not aware of such increase, it can result from insufficient experience of the contracting parties, but also from the asymmetry of information and opportunism of parties, this situation should be eliminated as soon as possible.

The situations described above are most common in cooperation with service provider. There are several difficulties in assessment of risk of cooperation in outsourcing. It is multidimensional and different types of risk have different components. Such 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 presented by J. Jurison (1995), explaining that both the effects of the implementation of the value of outsourcing, as well as probability of these effects are not known. According to the author, whose research has focused mainly on the effects of IT outsourcing, most of earlier research was focused on classifying types of risks related to outsourcing of specialized services to individuals with an indication of the importance of the various types of risk to principal. Next, define a management tool corresponding to the various types of risks.

Similar approach is presented by B. Bahli and S. Rivard (2003). They describe the outsourcing risk taking into consideration the expected negative scenarios for the development of events as a result of partnership with a provider, risk factors, which affect the occurrence of various scenarios, the consequences of such scenarios, as well as mechanisms for reducing the risk of different scenarios. Such description of the risks and ways to reduce this risk facilitates the formulation of assumptions about the relationship with the service provider and as a result the corresponding provisions in the contract.
There are also other studies concerning the problem of risk of cooperation with service provider. Most of them concern the risk of IT outsourcing (maintenance and development of computer network, implementation and development of software used by the client) and the main area of research are negative scenarios in the cooperation with service provider. The examples include the studies of L. Bi (2007), D. Gefen, S. Wyss and Y. Lichtenstein (2008), also R. Gonzalez, J. Gasco and J. Llopis (2009).

Taking into consideration the characteristic of outsourcing risk described earlier in this paper, the approach presented by R. Gonzalez, J. Gasco, J. Llopis seems to be particularly important. The abovementioned authors distinguished three group 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.

**RISK REDUCTION IN OUTSOURCING COOPERATION**

According to the approach presented by B. Bahli and S. Rivard (2003), the description of risk contains negative scenarios, risk factors affecting the occurrence of identified scenarios, effects for client and service provider. The following part of the paper contains a synthesis of theory presented by B. Bahli and S. Rivard and the results of research conducted by author of paper. The research involved the identification of problems and their causes in the preparation phase of cooperation (including gaining a service provider, negotiations, due diligence and preparation of contract) and further cooperation with the service provider in several companies operating on Polish market. The terms of cooperation in the contract was treated as the main source of problems. The research was concentrated on the relationship between the type of problems and relating terms in the contract. The survey was used to obtain relevant
information. Six companies, representing tire trading, tobacco trading and food production were taken into consideration. Four of them 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 concerned especially 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 the description of the risk inherent in cooperation in outsourcing.

Coming from the above theoretical considerations and the results of research a set of conclusions can be presented. The following part of paper contains the examples of description of transactional, cooperation and strategic risk.

According to the information concerning types of risk in outsourcing, presented earlier in this paper, the examples of negative scenarios concerning the preparation of cooperation with service provider should be taken first into account. The examples of such scenarios are:

- the differences between information in the offer of service provider and the actual ability to perform the outsourced tasks,
- misunderstanding of the expectations of parties to the contract (in the negotiation phase),
- disturbances in risk communication,
- insufficient knowledge about service market.

Risk factors, the consequences of scenarios, as well as mechanisms for reducing the risk of different scenarios are presented in Table 1. It should be added, that scenarios in this table represent both: the risks derived from the client and the risks derived from the provider. Differences between offer of provider and it's ability to perform services, misunderstanding of expectations and the problem in risk communication can be the effect both client's, as well as provider's activity. Such scenarios represent transaction risk, and as a result also operational risk. Lack of knowledge about current conditions on service market is the problem of client and it influences first of all the terms of transaction.
<table>
<thead>
<tr>
<th>Scenarios</th>
<th>Risk factors</th>
<th>Possible results of risk</th>
<th>Risk reduction possibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Differences between offer</td>
<td>- asymmetry of information on the service market (between client and service</td>
<td>- difficult control of subcontractors</td>
<td>- uniform formats of bids received from service providers</td>
</tr>
<tr>
<td>of provider and it's actual</td>
<td>provider)</td>
<td>- low quality of service rendered</td>
<td>- due diligence research</td>
</tr>
<tr>
<td>ability to perform outsourced</td>
<td>- opportunism of service provider</td>
<td>- conflicts between client and service provider that disrupt the cooperation</td>
<td></td>
</tr>
<tr>
<td>tasks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Misunderstanding of the</td>
<td>- insufficient client's knowledge about the possibilities in the field of</td>
<td>- long period of negotiations</td>
<td>- preparation of list of expectations (especially by client)</td>
</tr>
<tr>
<td>expectations of parties to</td>
<td>outsourced tasks</td>
<td>- conflicts with service provider in the phase of consultation and preparation of contract</td>
<td>- careful preparation of RFP (request for proposal)</td>
</tr>
<tr>
<td>the contract</td>
<td>- insufficient experience in cooperation</td>
<td>- low quality of service</td>
<td>- explanation of all doubts on issues covered in request for proposal, prepared by client</td>
</tr>
<tr>
<td>Risk communication</td>
<td>- differences in risk perception between parties</td>
<td>- disruption of cooperation in terms of unforeseen scenarios</td>
<td>- research conducted to mutual understanding of risk perception of parties</td>
</tr>
<tr>
<td></td>
<td>- asymmetry of information</td>
<td>- conflicts between client and service provider</td>
<td>(negotiating the meaning of risk)</td>
</tr>
<tr>
<td></td>
<td>- insufficient scope of information concerning both parties</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- opportunism</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lack of knowledge about</td>
<td>- fast development of service market</td>
<td>- difficulty in finding the suitable service provider (long period of search)</td>
<td>- assigning proper responsibilities to employees</td>
</tr>
<tr>
<td>service market</td>
<td>- lack of attribution of responsibility between client's employees for update</td>
<td>- waste of time in the case of change of service provider</td>
<td>- regular review of service providers available on the market</td>
</tr>
<tr>
<td></td>
<td>of market information</td>
<td></td>
<td>- update of RFI (request of information)</td>
</tr>
</tbody>
</table>

Source: own research based upon (B. Bahli and S. Rivard, 2003).
There are also negative scenarios that may occur during the cooperation. In this/her phase one can distinguish such scenarios as:

- excessive dependence on service provider,
- problems in the management of cooperation,
- high costs of adaptation to changing conditions of cooperation,
- conflicts and the involvement of court.

Description of risk, taking into account highlighted scenarios is presented in Table 2. It is worth noting that highlighted scenarios represent primarily the operational risk of cooperation with service provider. Some problems occur as a result of mistakes made in the phase of formulation of contract. The examples of such results are disturbances in the management of cooperation and also in the adaptation to changing conditions of cooperation.

Table 2. Description of risk in the cooperation phase

<table>
<thead>
<tr>
<th>Scenarios</th>
<th>Risk factors</th>
<th>Possible results of risk</th>
<th>Risk reduction possibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excessive dependence on service provider</td>
<td>- asset specificity (resulting with small number of service units)</td>
<td>- poor quality of service rendered by provider</td>
<td>- cooperation with several service providers</td>
</tr>
<tr>
<td></td>
<td>- insufficient client's experience in cooperation with service providers</td>
<td>- loss of independence of client on the market</td>
<td>- integration of activities between client and service provider (mutual benefits)</td>
</tr>
<tr>
<td></td>
<td>- opportunism of service provider</td>
<td></td>
<td>- joint investments</td>
</tr>
<tr>
<td>Problems in the management of cooperation</td>
<td>- insufficient client's experience in cooperation with service providers</td>
<td>- misunderstandings and conflicts between client and service provider (also between service provider and other units cooperating with the client)</td>
<td>- support of consultancy firms</td>
</tr>
<tr>
<td></td>
<td>- insufficient client's experience in contracting with service providers</td>
<td>- disruption of cooperation</td>
<td>- use of informal mechanisms for influencing the behavior of employees (including informal control)</td>
</tr>
<tr>
<td></td>
<td>(asymmetry of information)</td>
<td>- high cost of cooperation management</td>
<td>- partnerships based on mutual respect, trust (as opposed to formal control mechanisms)</td>
</tr>
<tr>
<td></td>
<td>- cause-effect relationships of tasks divided between the client and the provider (requiring coordination, participation in problem solving, mutual adjustment)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


Difficult adaptation to changing conditions of cooperation  
- volatility of competition and demand  
- changes of technology  
- changes in the law  
- difficult estimation of effects of cooperation  
- interruption of client's activity  
- disruption of cooperation  
- high costs of changes  
- phased development of relationship  
- flexibility of contract concerning the renegotiation of terms of cooperation  

Conflicts (resulting with the involvement of court)  
- lack of agreed principles for measurement of outcomes and indicators used  
- insufficient client's experience in his/her own activity  
- insufficient client's experience in contracting with service providers (asymmetry of information)  
- opportunism  
- interruption of client's activity  
- the need to change the service provider  
- high cost of outsourced services  
- support of consultancy firms  
- use of informal mechanisms for influencing the behavior of employees (including informal control)  
- partnerships based on mutual respect, trust (as opposed to formal control mechanisms)  
- use of alternative ways of resolving conflicts (mediation, arbitration)  

Source: own research based upon (B. Bahli and S. Rivard, 2003).  

Taking into consideration long-term cooperation with the service provider, based on supporting the development of customer operations and joint investments, the possibility of occurrence of strategic risk should be emphasized. The examples of negative scenarios representing the strategic risk of cooperation in outsourcing are:  
- loss of control over outsourced activities,  
- loss of know – how,  
- difficulties in the development of core activity (influenced by the decrease of quality of outsourced service),  
- excessive influence of service provider on client's strategy.  

Highlighted scenarios with risk factors, probable effects and activities proposed to reduce such kind of cooperation risk are presented in Table 3. Such scenarios occur often as results of inefficient mechanisms of risk reduction used both in the phase of preparation of contract terms, as well as in cooperation phase. Most of mechanisms used for reduction of strategic risk are the same, as activities used in the reduction of operational risk in the cooperation phase.
<table>
<thead>
<tr>
<th>Scenarios</th>
<th>Risk factors</th>
<th>Possible results of risk</th>
<th>Risk reduction possibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss of control over outsourced</td>
<td>- insufficient control mechanisms of provider’s activity</td>
<td>- uncertainty of quality of outsourced service</td>
<td>- cooperation with several service providers</td>
</tr>
<tr>
<td>service</td>
<td>- inefficient client’s experience in cooperation with service providers</td>
<td>- loss of independence of client on the market</td>
<td>- use of informal mechanisms for influencing the behavior of employees</td>
</tr>
<tr>
<td></td>
<td>- inefficient client’s experience in contracting with service providers</td>
<td>- uncertainty of the results of client’s core activity</td>
<td>(including informal control)</td>
</tr>
<tr>
<td></td>
<td>- opportunism of service provider</td>
<td>(depends mostly on the influence of outsourced service on client’s activity)</td>
<td>- integration of activities between client and service provider (mutual benefits)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>- partnerships based on mutual respect and trust</td>
</tr>
<tr>
<td>Loss of know – how</td>
<td>- mistakes in the description of core activities</td>
<td>- loss of independence of client on the market</td>
<td>- support of consultancy firms</td>
</tr>
<tr>
<td></td>
<td>- too wide range of service outsourced</td>
<td>- loss of ability to create own image on the market by the client</td>
<td>- phased development of relationship</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- decrease of client’s position on the market</td>
<td></td>
</tr>
<tr>
<td>Difficulties in development of</td>
<td>- insufficient engagement of service provider in improvement of cooperation</td>
<td>- decrease of client’s position on the market</td>
<td>- partnerships based on mutual respect, trust (as opposed to formal control mechanisms)</td>
</tr>
<tr>
<td>core activity</td>
<td>- decrease of quality if outsourced service</td>
<td>- difficulties in planning of client’s activity</td>
<td>- flexibility of contract concerning the renegotiation of cooperation terms</td>
</tr>
<tr>
<td></td>
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<td></td>
</tr>
<tr>
<td>Excessive influence of service</td>
<td>- insufficient client’s experience in cooperation with service providers</td>
<td>- inability to build client's own strategy without the agreement with service provider</td>
<td>- support of consultancy firm</td>
</tr>
<tr>
<td>provider on client's strategy</td>
<td>- insufficient client’s experience in contracting with service providers</td>
<td>- loss of independence of client on the market</td>
<td>- cooperation with several service providers</td>
</tr>
<tr>
<td></td>
<td>- opportunism of service provider</td>
<td></td>
<td>- phased development of relationship (related to the flexibility of contract enabling the renegotiation of cooperation terms)</td>
</tr>
<tr>
<td>Source: own research based upon (B. Bahli and S. Rivard, 2003).</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
It should be added, that there are several limitations of presented results of research. Scenarios listed in this paper are only examples of conditions, that may occur in cooperation with service providers. In the practice of outsourcing cooperation, there may be much more different scenarios, occurring in the phase of preparation of cooperation, in everyday collaboration and also in strategic perspective. The ability of parties to reduce the risk depends first of all on the ability of identification of such scenarios, preparation for the occurrence of these scenarios, as well as on the preparation of activities to reduce the probability of occurrence of such scenarios, if possible.

Scenarios presented in this paper are not differentiated according to their importance in presented types of outsourcing. When cooperation concerns supporting service, widely available on the market and the main objective of cooperation is cost reduction of client's activity, the scenarios representing the transaction and operational risk seem to be most important. In such conditions scenarios characteristic for strategic risk are rarely taken into consideration. Cooperation with service providers, focused on cost reduction is also often based on short-term contracts. In long term cooperation with service provider, focused on joint investment and mutual benefits, the strategic risk plays more important role.

It is also worth noting, that 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. Logistics, as well as support of IT service have very important influence on the results of activity on the market. Clients pay significant attention on preparation of cooperation with logistics and IT service providers, particularly in terms of comprehensive service outsourced.

**CONCLUSIONS**

Negative scenarios included in the paper, representing the risk of outsourcing cooperation are mainly stemming from the problems occurring in the preparation phase of cooperation. This applies both to identification of experience and skills of provider, as well as the subsequent negotiations on the terms of cooperation, resulting in the development of terms of the contract between the client and service provider. These problems result predominantly from insufficient experience in cooperation with service providers, bounded rationality of parties, related to the asymmetry of information and also opportunism. Careful recognition of provider’s capabilities to satisfy client needs, subsequent detailed specification and
understanding of obligations and powers of the client and the provider, as well as the conditions of mutual adaptation to changing external conditions stand out among the main factors that occur before the conclusion of the contract, affecting the relationship between the parties and as a result the quality of cooperation. Taking into account the possibility of errors during the preparation of terms of cooperation it should be emphasized, that there is a possibility to reduce the effects of these errors by the relevant provisions in the contract. Assuming a positive attitude of the parties to cooperation (based on mutual trust and understanding), the following examples of solutions can be applied in the contract:

- submission and explanation of every doubt concerning regulations in the contract, occurring during cooperation (specification of required activities of parties to the contract and approved period of time),
- the ability to renegotiate the terms of the contract if (specified) changes of external conditions occur,
- requirement of agreement of any change in terms of cooperation, introduced by each party,
- adaptation of methods to perform the outsourced service according to best practises in industry,
- the autonomy of service provider concerning the methods of supply of outsourced service (used usually in the case of long-term cooperation based on joint investments and mutual benefits),
- preparation of plans for extraordinary situations (concerns activities of parties taken for adjustment to new terms),
- description of procedure for informing about the changes of those responsible for cooperation both in client’s, as well as provider’s company.

The examples of solutions of cooperation problems presented in the paper increase the flexibility of contract, which is particularly important in conditions of long-term cooperation with service provider in outsourcing. It should be added, that the scope of regulations affecting the flexibility of contract depends on the type of client’s activity and related, detailed legal regulations affecting this activity.
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