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Business Process Outsourcing

A catalyst for innovation

By Manish Sharma, Mary Lacity and Leslie Willcocks

In the early years of business process outsourcing, you outsourced, you took out a bunch of cost, you streamlined processes, you got more efficient. Game over. But these days, a new generation of BPO is focused on creating business value beyond cost savings. And as expectations have risen, more and more organizations are looking to their providers for innovation.

According to several recent surveys, a common concern of BPO client organizations is the failure of their providers to deliver innovation.

But are clients and providers alike thinking about innovation in a BPO context in the right way? And do they understand the unique way that the best relationships deliver on BPO's potential for real innovation?

New research from the Outsourcing Unit of the London School of Economics and Accenture finds that innovation is, in fact, a characteristic feature of BPO at its best and actually distinguishes high-performance BPO relationships from typical ones. At one organization studied, for example, over a three-year period, the client and provider completed more than 50 innovation projects that delivered bottom-line results including cost savings, faster product delivery times and higher fulfillment rates.

Nonetheless, the traditional vocabulary of corporate innovation is often inadequate to describe the distinctive possibilities of the BPO environment, and can lead organizations either to set the wrong goals for BPO innovation or to overlook the real results delivered. For example, BPO innovation is rarely "disruptive," to use a term popularized by, among others, A.G. Lafley and Ram Charan in their book, *The Game-Changer*. If organizations are looking for the equivalent of an iPhone revolution from their outsourcing relationship every year, they are likely to be disappointed. Those kinds of revolutionary innovations are possible, yes, but rare.

On the other hand, neither is the full potential of BPO innovation captured by the rather tepid word *incremental*, which often implies a more static environment in which one can evaluate single innovations based on size of impact.

We prefer to call this phenomenon "dynamic innovation"—a phrase that better connotes not only what the results are but how they are achieved.

First, dynamic innovation produces results that are cumulative and expansive as the BPO arrangement deepens and matures over time. The effects of numerous innovations accumulate to significantly improve the client organization's business outcomes—measured in such terms as operational efficiency, process effectiveness and even strategic performance.

The problem: It may not be sufficiently obvious to the client organization how such innovations have actually accumulated to produce substantive improvements. Like living day to day with someone losing weight, the results are often not apparent until a current photograph is compared against one from a year or so before.

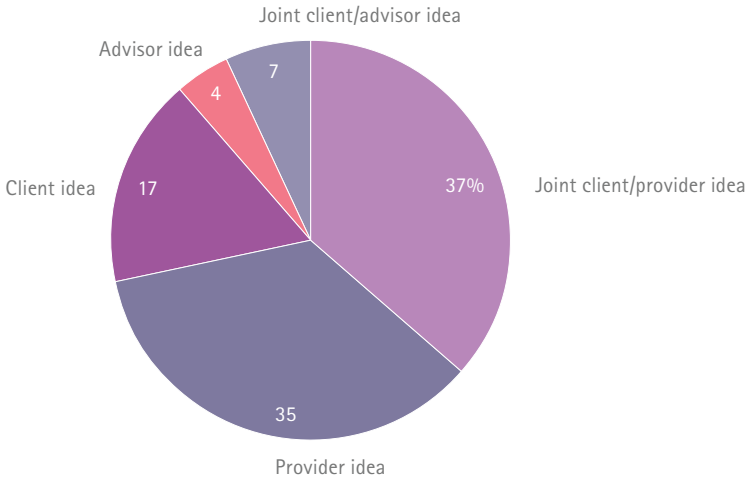
This fact can trip providers up if they are not careful. In one case, a provider came under fire when its BPO contract was up for renewal from a client that felt the provider had not delivered promised innovations. An executive at the provider recalls how things played out when the two parties sat down face-to-face: "We made a major presentation to the client where we detailed everything we had accomplished over the past couple years. In 90 minutes, it was over and we had a new, five-year contract in place."

Second, dynamic innovation in BPO is an intensely collaborative endeavor. Our previous research into high-performance BPO found that a collaborative, partnership attitude was one of eight distinctive practices that characterized high-performance BPO relationships. For example, nearly 85 percent of the high performers we studied consider their BPO provider to be a strategic partner; by contrast, only 41 percent of typical performers operate according to that mindset.

Any bright ideas?

In a February 2012 survey, 189 respondents—comprising client, provider and advisor representatives—agreed that the majority of innovation ideas were either jointly created between clients and providers (37 percent) or by providers creating innovation ideas on their own (35 percent).

Primary source of innovation ideas in BPO



Source: 2012 IAOP Outsourcing World Summit survey

So if a client organization has to ask its provider, "Where's my innovation?" responsibility can likely be ascribed to both sides.

It is fine that the provider noted above was able to save the day by detailing the innovations it had delivered; it would have been far better, however, to have actively involved the client in those innovative solutions so that the question had never been asked. From the other perspective, a client organization must realize that innovation is not a spectator sport. It must actively involve itself, with the provider, in asking, "What can we do better, *together*?" and then working in partnership to achieve that goal.

So dynamic innovation in BPO produces results that most often are not, as noted, like the disruptive impact of an iPhone. They are more like the difference between the first-generation iPhone and the iPhone 4S. It's not just "incrementally" better but offers substantive new functionality enabling users to do things they simply could not do with the first version. In the same way, dynamic innovation in BPO can create new generations of solutions that deliver business outcomes with a dramatically higher impact on the performance of the client organization.

How can dynamic innovation be achieved more predictably in BPO relationships? By motivating and nurturing innovation: motivating by putting the right contractual incentives and structures in place; nurturing by working to create a culture and leadership style that inspires, perseveres and drives toward measurable performance improvements.

The right goals

What does effective collaboration innovation in BPO look like? In 2010, Netherlands-based KPN, a provider of information and communications technology services throughout the Netherlands, Belgium and Germany,

Breakthrough performance: How to nurture dynamic innovation

High-performance BPO relationships are good at dynamic innovation. How do they do it? Based on our research, here are some guidelines for action.

Put effective change management in place.
Incentives to providers lay the foundation for dynamic innovation. But the execution of dynamic innovation requires strong change management to transition individuals, teams and organizational units from the current state to the desired future state.

Innovations have to be accepted by two groups of clients—the client leads responsible for the BPO relationship and the cadre of globally dispersed end users. If the client leaders are excited about an innovation and if those leaders are respected within their own organizations, then they are often successful in their change management efforts.

Use leadership changes as an impetus for dynamic innovation.
Leadership changes—on either the client's or provider's part—can often be a cause for concern in terms of the continuity of the BPO arrangement. However, such changes can also reinvigorate the innovation agenda.

On one account we studied, the contractual clauses addressing innovation stayed dormant for several years until a new client executive took over the account. Before his arrival, the client never used the 100-plus days allocated to innovation in the contract. Under the new leadership, the partners used half the innovation days his first year in charge and 100 percent of those days the second year. Both parties benefited because the provider increased the scope of the work and the client realized greater cost savings generated by the innovations.

Focus on structure and outcomes to reap the greatest value from innovation.
The value of innovation can come from operational efficiency, process effectiveness and strategic impact. But clients and providers need to agree that the ultimate purpose of their outsourcing relationship is to drive measurable business outcomes. It's also important to institutionalize innovation by putting more predictable structures and processes for innovation in place.

The effective innovators recognize that creating ideas can take you only so far. Delivering business value from those ideas needs a hard-headed implementation and behavioral infrastructure.

Keep raising the bar.
Both the excitement and the challenge of dynamic innovation in BPO come from the fact that, once put in place, both the results delivered and the consequent expectations will continue to grow. At the beginning of a BPO relationship, experienced providers will offer their clients best-in-class innovations in technology, tools, processes and methods. But once those have been absorbed, both provider and client should focus on the next, higher stage of business outcomes to strive for.

was moving into the final phase of a dramatic business transformation with a rollout of a next-generation, all-IP network. As part of this transformation, the company was looking to radically simplify its business, both at the front end in retail segments and at the back end in network operations. The cost reductions generated by this simplification were to be reinvested in the company to drive revenue growth. Looking at the maturing BPO marketplace, KPN realized that its outsourcing relationships now had the potential to generate the large, strategic innovations that could fuel revenue growth.

According to Hans Wijns, former vice president of IT innovation at KPN, a driving force was the greater source of ideas possible through broader collaboration across sectors. A great deal of sector-based innovation in the telecoms industry, he felt, was hitting a wall in terms of value delivered. "Innovation can only be done if we use a lot of capacity outside of the company," Wijns said in an interview with *MIS Quarterly Executive*.

Having the right goals was also very important. For KPN, innovation in outsourcing deals had to be about driving new opportunities and capabilities, not simply about cost cutting. "We were

Research has shown that even large innovation funds have rarely produced lasting, important innovations.

looking to suppliers that could help us in transformation—and not only in the existing network," Wijns said. "It had to be a combination of cutting costs and innovation together."

This required an emphasis on the dynamism of long-term outsourcing relationships, not merely the service levels agreed to in a contract. KPN wanted not only to retain responsibility for the overall vision (in Wijns' words, "You can't outsource innovation"); it also wanted to manage the interactions of its providers in a process of co-creation. "We do not consider ourselves to be the most innovative party," noted Wijns. "We are the facilitator, challenging our providers to innovate, and not just in technology but around processes and products—wherever there is knowledge to be released."

This approach quickly paid off. KPN brought the design teams from its providers together in one location, and in five months of working together, they built the new IT solution.

The innovation paradox

One important lesson from KPN, and from other companies studied as part of our research, is that incentives and motivations for driving innovation need to be designed and managed with care in the course of a BPO relationship. This is because of what we might call the innovation paradox of BPO—that innovation is defined by its consequences on the *client's* performance, but the *provider* must play a clear and decisive role in making those consequences happen.

To put the matter bluntly, when it comes to innovation, what's in it for the provider?

One answer is that a provider seeks to avoid the negative consequences of losing a contract in the long term. One provider in a BPO relationship our research identified as achieving high performance implied that a provider can rely on solid performance and cost savings for only so long. "In my mind," he told us, "if we can't prove that we are delivering value beyond more efficient transactions at the time of contract renewal, the client will take its business somewhere else."

Another self-motivating factor for a provider is the opportunity to increase its overall competitiveness in the outsourcing marketplace. On one BPO account for a major manufacturer, the provider delivered numerous incremental innovations that resulted in significant bottom-line results. In addition to the benefits to that client, the provider saw the innovations as a way to differentiate its services in a highly competitive market.

Beyond these motivations, however, contract-based incentives are needed if providers are to focus on innovations that improve the client's performance and not just their own.

Financial incentives

When it comes to innovation, several different kinds of financial incentive programs have been tried over the course of BPO's evolution.

One is an "innovation fund"—money set aside for improvement programs suppliers can bid on. However, research has found that even large innovation funds have rarely produced lasting, important innovations.

The same applies to many joint venture and equity share initiatives designed partly to stimulate innovation. Their poor performance usually results from the fact that they are mere add-ons to fee-for-service deals where, in practice, both clients and providers end up prioritizing service and cost issues above innovation goals. So although such funds claim to spur innovation, in practice they often produce fairly low levels of sustainable development and performance transformation.

Another incentive is a contractual clause intended to improve the overall productivity of the outsourcing

arrangement. This approach is one way to overcome the disincentives that often arise from traditional pricing, in which an arrangement is priced based on staffing inputs such as the number of FTEs, or full-time equivalents.

Clients like the simplicity of FTE-based pricing. But they also realize that it can discourage the provider from implementing innovations that would reduce the number of FTEs, because the provider's revenues would decrease. To overcome this disincentive, many BPO clients include productivity improvement requirements in the contract. Such a clause requires the provider to increase productivity by a certain incremental percentage each year—perhaps 4 percent to 5 percent. The idea is that the provider will drive innovation every year as one important way to meet the required productivity increase.

Both clients and providers in our research reported positive outcomes with productivity improvement clauses.

For example, the provider for one consumer goods company implemented a number of innovations, including new dashboards for better reporting and performance transparency that are driven by the provider's analytics capabilities. According to the client, "We are finding that, in the spirit of partnership, once we identify an area that is having difficulty, we can get very creative together in terms of how to go and attack that particular problem."

Contractual incentives

As BPO matures and extends its reach, however, outsourcing relationships based primarily on productivity improvements become less distinctive in their ability to generate competitive advantage. The focus of a new generation of BPO, therefore, is now on the business outcomes delivered from innovation—a more challenging goal demanding different kinds of incentives.

The contractual incentive that is currently seen as both most promising and most difficult in this regard is gain-sharing, where both client and provider share in the rewards of innovations that result in improved financial performance. In the innovation survey we conducted, gain-sharing generated the most support as a way to build innovation into outsourcing contracts, favored by 79 percent of clients, 77 percent of providers and 78 percent of outsourcing advisors.

But there's a catch: A follow-up survey question to all three communities indicated that only 40 percent of innovations delivered were the result of gain-sharing. Why the gap between aspiration and reality?

One challenge is setting precise gain-sharing targets that find a middle ground between too easy and too difficult to achieve. Another is agreeing on a performance baseline. One telecommunications company and its BPO provider hoped to use gain-sharing to prompt innovations in the training of new hires; they had difficulties, however, establishing a clear and defensible baseline of how training was performed prior to the outsourcing deal. Many positive outcomes of outsourcing are qualitative in nature, and that's great—but gain-sharing requires financial specificity and accuracy.

One challenge is setting precise gain-sharing targets that find a middle ground between too easy and too difficult to achieve.

Another significant challenge with gain-sharing is measuring the actual benefits to share fairly as gains. For example, automation that reduces 50 percent of the work handled by staff will not necessarily translate to a 50 percent staff reduction. So how can the true benefits be allocated?

In several companies we studied, clients and providers had to climb a particularly steep learning curve until both parties were comfortable. This was a consistent finding from our research: BPO relationships often need to "age properly" and reach stability before gain-sharing can be successfully exploited.

For further reading

"Partners in high performance," *Outlook* 2012, No. 2: http://www.accenture.com/us-en/outlook/Pages/outlook-journal-2012-partners-in-high-performance-outsourcing-bpo.aspx

Edgar A. Whitley and Leslie Willcocks, "Achieving Step-Change in Outsourcing Maturity: Toward Collaborative Innovation," *MIS Quarterly Executive*, Vol. 10, No. 3, 2011

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About the research

The research into dynamic innovation, conducted by the Outsourcing Unit of the London School of Economics in association with Accenture, included several streams of work. At the 2012 Outsourcing World Summit of the International Association of Outsourcing Professionals, we surveyed 202 delegates (85 customers, 90 providers and 27 outsourcing advisors) to determine how they understand the definition, identification and delivery of innovations in outsourcing relationships. We also conducted in-depth interviews between October 2011 and February 2012 with client-provider executive pairs in 20 organizations. The sample was drawn from across sectors and countries, with outsourcing deals ranging in size from small to very large. Nearly 50 percent could be identified as high-performance BPO relationships.

Despite these challenges, more than 95 percent of the innovation survey respondents indicated that when gain-sharing was used, both clients and providers were satisfied with the gain-sharing mechanism.

One of the best examples: a finance and accounting BPO arrangement at Microsoft. Client and provider have worked to overcome several gain-sharing challenges. For instance, the partners agree upfront on the savings goals. The provider is guaranteed a share of those savings and pockets the difference if it outperforms the goals. If the provider underperforms, it absorbs the loss.

A key here has been to avoid focusing only on reducing employee numbers. If the gains are seen only in terms of fewer personnel, then the provider loses revenue for those people in a way that cannot be made up for by the corresponding profits. So the partners found a way to split the gain-sharing to make it attractive for both parties. The overall effect is stronger incentives for the provider to innovate.

How can BPO relationships create the right cultural and leadership environment to encourage dynamic innovation? In the high-performance BPO relationships we studied, client executives actively encourage people at all levels of the provider organization to challenge the status quo and to question assumptions.

One client executive, whose BPO provider uses a large portion of India-based employees, put it this way: "We know that in some areas we are our own worst enemies. We absolutely want our partner's people to point those things out. I not only tell them this is not disrespectful; I tell them that I will find it disrespectful if they say nothing and I have to figure it out myself. That approach has generated lots of good ideas that we've been able to put into practice."

Finding ways to bring the brightest people from both parties together is also important. In high-performance BPO relationships, the partners allocate dedicated time each year to drive the innovation agenda—through events called "innovation days" or "innovation forums" that are held annually or even quarterly. Clients use these opportunities to learn more about the provider's latest tools, technologies and capabilities.

In some cases, such forums become free consulting days offered by the provider's more experienced and creative executives. From the provider's perspective, the forums are an opportunity to expand the relationship into new areas.

An innovation day can also be a time to define the innovation agenda for the coming year. At one bank, for example, the BPO partners jointly develop an innovation plan every year. Most recently, that innovation agenda involved plans to move more of the bank's enterprise learning programs to online and mobile channels. Based on that plan, the provider then put programs in place to move 40 percent of the training courses online, including mobile learning capabilities through smartphones.

It is also important to remember that although bringing client and provider together is essential to innovation, so are opportunities to "crowdsource" ideas within the provider or client itself.

For example, one provider regularly hosts a day in its outsourcing delivery centers when employees from all areas and staff levels can discuss their ideas live and in person with a committee of people including the local leadership team, operations personnel and service delivery staff. Because of the face-to-face nature of the event, it's called "Unconferencing Day." And it's truly an event, advertised in advance with scoreboards counting down the days. At the event, each idea is discussed seriously and openly by the committee, and employees submitting the best ideas are given awards in front of thousands of their colleagues.

Another reason that BPO offers such potential to drive innovation is that there is a great deal of latent energy in the emerging economies of Asia, Eastern Europe and Latin America—young, bright and well-educated people in their twenties whose ideas are not always effectively being tapped. It will be increasingly challenging in today's labor market to hold onto such talent if they are tasked merely with executing routine transactions. Providers that are able to tap into this new generation will help themselves and their clients alike.

One ultimate goal of driving the cultural change that encourages dynamic innovation is to make it clear to all parties in the outsourcing relationship that innovation is not a spectator sport. It is not something that clients watch happen, or something that providers wait for, but something that requires everyone to actively participate.

One of the most promising findings from our research is that it's never too late to innovate. We found several high-performance BPO relationships in which innovation really did not take off until several years into the contract. Some turbocharged relationships drive innovation from the beginning, but others move more slowly up a curve, from focusing on contract management and efficiency, to productivity improvements, to more advanced forms of dynamic innovation. Innovation may lie dormant, then spring to life with gusto.

Triggered by leadership changes, marketplace pressures or technology developments, BPO clients and providers can generate at any time the excitement to set out for uncharted places. ■

About the authors

Manish Sharma is the managing director of Accenture's BPO global delivery and solution development. He is based in Bangalore.
manish.sharma@accenture.com

Mary Lacity is a professor of information systems at the University of Missouri-St Louis.
mary.lacity@umsl.edu

Leslie Willcocks is a professor of work, technology and globalization at the London School of Economics.
willcockslp@aol.com

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