

Editorial

**Offshoring Without Profit or the
New Global Model?**

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Currently, one of the most widely discussed topics is "offshoring." Often, offshoring is associated with a substantial reduction in corporate work force and lay-offs. For example, some estimations point out that in the past three years between 250,000 to 500,000 often highly-paid positions were eliminated due to offshoring (Pinto 2005). In addition, according to the Forrester Research, roughly 3.3 million US jobs, primarily related to information technology (IT), will migrate abroad until 2015 (Randall 2004; Pinto 2005).

Overall, it seems that offshoring is a global phenomenon and a very fashionable business model gaining popularity across many industries and countries (Tjia 2003). For many executives in the technology sector, the combination of low wages and faster work flow has made offshoring a necessity in protecting their competitive edge.

In essence, offshoring is moving business processes such as order processing, account management, and customer support to foreign low-cost locations (Venkatraman 2004). The main motivation of this business practice

is to obtain a cost advantage by reducing costs for company business activities. In addition, offshoring may shorten the work flow and reduce product development time, as teams distributed across the different time zone may virtually work around the clock. For example, a California high-tech company was able to almost double its output and reduce development time for its products by having engineering development teams in California and India (Konrad 2005). They were able to take advantage of the 12 hours time difference by passing the work back and forth.

In spite of numerous reports about successful offshoring projects, for many companies the expected cost savings do not materialize (Pinto 2005). In general, offshoring decisions are complicated and their payoffs uncertain (King 2005). One of the key challenges is the selection of the offshore location. Every offshoring option represents a unique combination of advantages and disadvantages (Vestring et al. 2005). One location may, for example, offer low labor cost but poor infrastructure, while another location may offer decent infrastructure and a good pool of qualified workers but also a highly regulatory environment. Furthermore, Farrell (2004) suggests that a company can evaluate its relocation sensitivity, which is how feasible or attractive it is for a firm to relocate all or part of its production processes and location specific advantages (labor intensity, skill requirements, economies of scale and scope, etc.). Relocation sensitivity can be computed from the value chain (raw material costs, lead times) and location specific advantages metrics can be derived from proximity to raw materials and labor.

In this work, we provided our supplementary view why many offshoring projects may fail to deliver expected payoffs. It is well discussed that for an offshoring project to be successful, an assessment of costs and benefits related to this project is crucial (Venkatraman 2004). While performing this cost-benefit analysis, managers need to examine their business activities and decide which operations should be kept in-house and which should be moved out (Preston 2004). Simplified, when conducting offshoring decisions, the managers should follow the well-known value chain analysis (Porter and Millar 1985).

For many companies, especially for those with less powerful cost management systems, obtaining estimates needed for value chain analysis is not an easy task. Often these companies are cost laggards in their industries and rely on a very primitive traditional cost accounting which fails to provide true cost estimates for their processes (Ness and Cucuzza 1995). Essentially, traditional cost accounting allocates so-called overhead (expenses such as facility maintenance, retirement obligations, equipment depreciation, and administrative salaries) based on direct labor hours.

Rising overhead and decreasing direct labor make such a simplistic overhead allocation highly questionable (Miller and Vollmann 1985). This cost management is not very useful for decisions regarding outsourcing of traditional manufacturing jobs and is even less practicable for modern IT offshoring. Basically, since the traditional cost accounting, by design, fails to provide true cost, the executives are forced to guess regarding the costs of their value chain. In many cases, they may overestimate the true cost of in-house

operations, and offshore activities which, in reality, are performed efficiently. In addition, they are less likely to predict the possible impact of offshoring on the other activities in their value chain and identify the hidden costs.

The estimation of various costs and benefits related to the offshoring projects is a highly complex process. An offshoring agreement can, for example, reduce the cost of in-house software and hardware maintenance but substantially add to coordination and legal costs needed for keeping a business relationship with an outside outsourcer company. In many cases, management of geographically distributed teams may require substantially more effort than expected. For all these issues, offshoring may trigger a chain of unexpected costs.

In summary, we are not attempting to discourage companies regarding their outsourcing activities. There are many advantages such as reducing engineering development time and many disadvantages such as governmental or organizational barriers, protectionist restrictions, or union opposition. Therefore, the offshoring decisions need to be backed by a careful analysis that considers full costs and benefits.

For academic researchers in the field of IT the current trend of offshoring represents a set of opportunities and challenges. First, not only did IT make the offshoring possible but also plays a critical role in most offshoring projects. Second, many of the IT theories were developed in the context of a single country or region and need to be validated from a more global perspective. Third, IT offshoring itself still represents a relatively unexplored topic, and its long-term impact is uncertain.

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