Business Process Outsourcing

Mark von Rosing, Gary Doucet, Gert O. Jansson, Gabriel von Scheel, Freek Stoffel, Bas Bach, Henk Kuil, Joshua Waters

INTRODUCTION

The great interest in outsourcing since the start of the 1980s had several causes and was influenced in numerous ways by process work. In this chapter, we will focus on what business process outsourcing is, why it is applied, and which aspects to consider before implementing business process outsourcing strategies in an organization.

Since the industrial revolution, companies have battled with how they can exploit their competitive advantage to increase their markets and their profits. The model for most of the twentieth century was a large integrated company that can own, manage, and directly control its assets. In the 1950s and 1960s, the rallying cry was diversification to broaden corporate bases and take advantage of economies of scale. By diversifying, companies expected to protect profits, even though expansion required multiple layers of management. Subsequently, organizations attempting to compete globally in the 1970s and 1980s were handicapped by a lack of agility that resulted from bloated management structures. To increase their flexibility and creativity, many large companies developed a new strategy of focusing on their core business, which required identifying critical processes and deciding which could be outsourced.[1]

Outsourcing was not formally identified as a business strategy until 1989 (Mullin, 1996). However, most organizations were not totally self-sufficient; they outsourced those functions for which they had no competency internally. Publishers, for example, have often purchased composition, printing, and fulfillment services. The use of external suppliers for these essential, but ancillary, services might be termed the baseline stage in the evolution of outsourcing. Outsourcing support services was the next stage. In the 1990s, as organizations began to focus more on cost-saving measures, they started to outsource functions necessary to run a company, but not related specifically to the core business. Managers contracted with emerging service companies to deliver accounting, human resources, data processing, internal mail distribution, security, plant maintenance and the likes as a matter of good housekeeping. Outsourcing components to affect cost savings in key functions was yet another stage as managers sought to improve their finances.

BUSINESS PROCESS OUTSOURCING: WHAT IS IT?

The short version is that business process outsourcing (BPO) is the contracting of a specific business task, such as payroll, to a third-party service provider. Business process outsourcing is a subset of outsourcing that involves contracting of operations and responsibilities of specific business functions (or processes) to a third-party

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service provider. Originally, this was associated with manufacturing firms such as Coca Cola that outsourced large segments of their supply chain.[2] Business process outsourcing is not considered only by large multinational organizations, however. Business process outsourcing is not a new field. Rochester, New York–based Paychex, for example, has been outsourcing payroll processing for small businesses since 1971. But the market is heating up these days thanks to companies' keen interest in cost cutting, their desire to improve business methods, and their growing comfort with outsourcing arrangements.[3] Business process outsourcing is something many organizations of any size apply. In this context, BPO is often divided into two categories[4]: (1) back office outsourcing, which includes internal business functions such as billing or purchasing; and (2) front office outsourcing, which includes customer-related services such as marketing or tech support. Business process outsourcing that is contracted outside a company's own country is sometimes called offshore outsourcing. Business process outsourcing that is contracted to a company's neighboring country is sometimes called near-shore outsourcing, and BPO that is contracted with the company's own county is sometimes called onshore outsourcing. Often the business processes are information technology (IT)-based, and are referred to as ITES-BPO, where ITES stands for information technology enabled service. Knowledge process outsourcing and legal process outsourcing are some of the sub-segments of the BPO industry.[5]

BUSINESS PROCESS OUTSOURCING VALUE CASE

The main advantage of BPO is the way in which it helps increase a company's flexibility. In the early 2000s, BPO was all about cost efficiency, which allowed a certain level of flexibility at the time. Owing to technological advances and changes in the industry (specifically, the move to more service-based rather than product-based contracts), companies who choose to outsource their back office increasingly looked for time flexibility and direct quality control.[6] Business process outsourcing enhances the flexibility of an organization in different ways:

- Most services provided by BPO vendors are offered on a fee-for-service basis, using business models such as remote in-sourcing or similar software development and outsourcing models.[7] This can help a company to become more flexible by transforming fixed into variable costs.[8]
- A variable cost structure helps a company respond to changes in the required capacity and does not require a company to invest in assets, thereby making the company more flexible.[9] Outsourcing may provide a firm with increased flexibility in its resource management and may reduce response times to major environmental changes.
- Another way in which BPO contributes to a company's flexibility is that a company is able to focus on its core competencies without being burdened by the demands of bureaucratic restraints.[10]
- Key employees are released from performing non-core or administrative processes and can invest more time and energy in building the firm's core

businesses.[11] The key lies in knowing which of the main value drivers to focus on: customer intimacy, product leadership, or operational excellence. Focusing more on one of these drivers may help a company create a competitive edge.[12]

- Business process outsourcing increases organizational flexibility by increasing the speed of business processes. Supply chain management with the effective use of supply chain partners and BPO increases the speed of several business processes, such as the throughput in the case of a manufacturing company.[13]
- Flexibility is seen as a stage in the organizational life cycle: A company can maintain growth goals while avoiding standard business bottlenecks.[14] Business process outsourcing therefore allows firms to retain their entrepreneurial speed and agility, which they would otherwise sacrifice to become efficient as they expanded. It avoids a premature internal transition from its informal entrepreneurial phase to a more bureaucratic mode of operation.[15]

A company may be able to grow at a faster pace because it will be less constrained by large capital expenditures for people or equipment that may take years to amortize, may become outdated, or may turn out to be a poor match for the company over time. The economic benefits of BPO are clear: the CNET News report[16] states some of these benefits in numbers: Whereas IT outsourcing, such as farming out control of a data center, can cut costs by 10–15%, outsourcing a business process may shave 40–60% off the bottom line, Pool said. "What you're providing on the BPO side is much more valuable to the client."

The business case[17] for traditional finance and administration BPO is well proven; typically the service can be delivered as effectively, i.e., with no worsening in quality of service, and more efficiently in a lower cost location, typically with an improved system of controls. Most of the business case is a combination of efficiency, centralization, standardization, process improvement, and automation coupled with labor arbitrage benefits of low-cost locations. The combination of these levers can often bring benefits of 40–50% on original cost. However, the business case for procurement is about sourcing and compliance savings, i.e., effectiveness savings (doing it better or, in the case of procurement, buying the same or better for less), which can dwarf the efficiency savings (doing it quicker or cheaper). Also, the efficiency savings in procurement are often less (perhaps 20–30%) because the resources will need to be located across regional locations to support language requirements, not just in far eastern low-cost locations; hence, average savings will be less than the 40–50% above (Figure 1).

I therefore believe that the largest portion of the benefit from outsourcing can come from sourcing savings and in particular through better compliance management.

However, it is critical to approach the design of the outsourcing in a way that maximizes the efficiency (process) savings and maximizes the (sourcing) effectiveness savings. You can construct a business case for procurement BPO on efficiency savings, but you will sell it to the business on effectiveness savings.

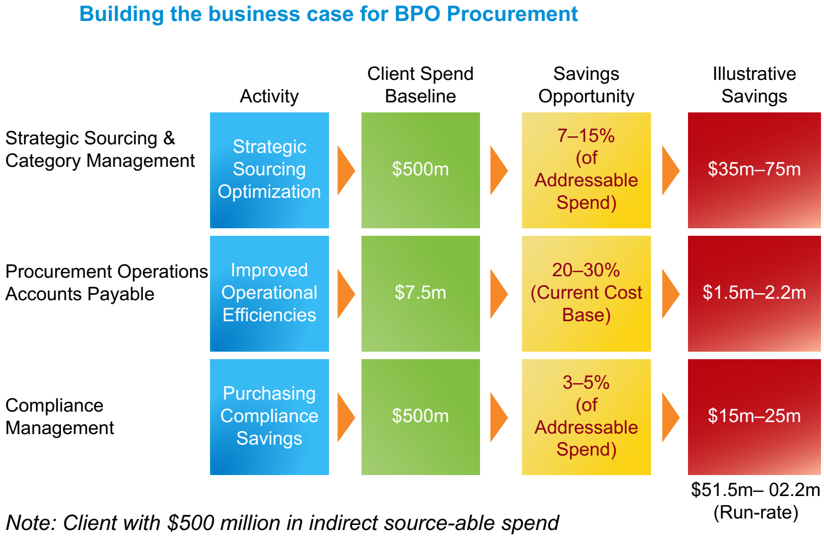

FIGURE 1

Example of BPO procurement business case.

THE BPO MARKET

In 2014–2015, the growth of BPO was 4% and surpassed $950 billion; it is expected to average a 5% clip each year through 2018.[18] The global BPO and related IT service market size in 2014 (in billion US dollars) by segment were the following[19] (see Figure 2):

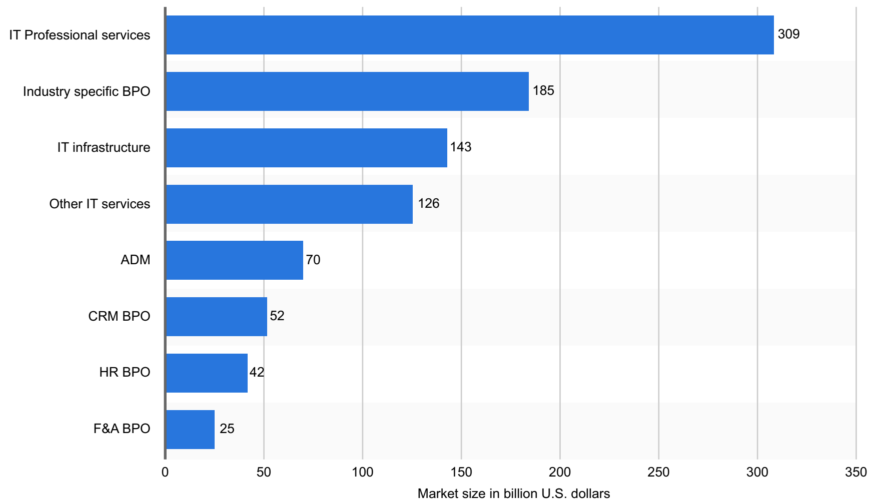

FIGURE 2

The Global BPO and the related IT service market size in 2013–2014.

BUSINESS PROCESS OUTSOURCING: POSSIBLE PITFALLS

Although the BPO value case arguments favor the view that BPO increases the flexibility of organizations, management needs to be careful with implementing it because there are issues that work against these advantages. In this section we will try to illustrate them.

These days, outsourcing is often an expression of the facility management way of thinking: that is, how I can minimize my risks and secure the best relevant price/performance, for example, in accounts departments, IT operations, staff restaurants. The challenge for all of these lies in the interfaces. What are the expectations regarding upstream and downstream to have successful outsourcing? This may vary, but it is interesting that 70% of all outsourcings are reported as failures, especially those that are primarily aimed at cutting cost.[20] This is alarming. As Chief Executive Officer Peter Bendor-Samuel of the Everest Group pointed out,[21] part of the reason is that many of BPO concepts are large contracts with durations of 3–10 years. Many of these contracts include substantial capital for assets such as people, servers, networks, and capitalized transformational costs. These contracts are notoriously inflexible, driven by a combination of factors including the need to predefine service-level agreements and scope over a long time, pricing that has to anticipate changes in volume and technology, and the substantial capital cost that must be retired over the life of the contract. As you can see from the chart, these contracts delay the profits to the service provider and deliver only modest profitability late in the contract term (Figure 3).

The combination of unrealized earnings and un-depreciated assets has the potential to create substantial stranded costs if the contracts are terminated early or significantly renegotiated mid-term. These stranded costs have been the bane of

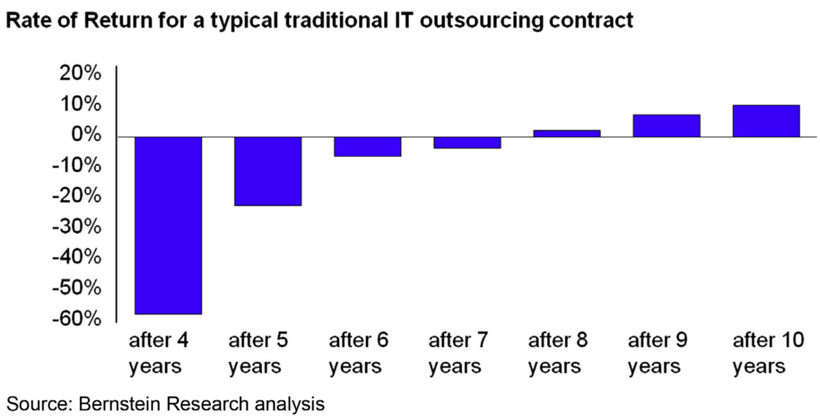

FIGURE 3

Rate of return within outsourcing.

Source: *Bernstein Research analysis*.

the industry, creating a steady stream of blow-up deals, some of which consistently further suppress earnings in the sector. Sometimes a decision to transfer assets to a service provider was driven by an artificial increase in return on capital that the buyer would show after assets were moved from its books to those of a provider. Nonetheless, even this benefit eventually disappeared owing to changes in assets accounting in an outsourcing transaction.

Among other problems that arise in practice are a failure to meet service levels, unclear contractual issues, changing requirements and unforeseen charges, and a dependence on the BPO, which reduces flexibility. Consequently, these challenges need to be considered before a company decides to engage in business process outsourcing.[22] A further issue is that in many cases there is little that differentiates the BPO providers other than size. They often provide similar services, have similar geographic footprints, leverage similar technology stacks, and have similar quality improvement approaches.[23]

Possible pitfalls and risks are major drawbacks with BPO. Outsourcing an information system, for example, can cause security pitfalls and risks factors from both a communication and privacy perspective. For example, security of North American or European company data is more difficult to maintain when accessed or controlled in the Indian subcontinent. From a knowledge perspective, a changing attitude in employees, underestimation of running costs, and the major risk of losing independence, outsourcing leads to a different relationship between an organization and its contractor.[24] Pitfalls, risks, and threats of outsourcing must therefore be managed to achieve any benefits. To manage outsourcing in a structured way, maximizing positive outcome, minimizing risks, and avoiding threats, a business continuity management model is set up. Business continuity management consists of a set of steps to successfully identify, manage, and control business processes that are or can be outsourced.[25]

BUSINESS PROCESS OUTSOURCING: HOW TO GO ABOUT IT

As mentioned earlier, BPO has to link to the aspects of the core businesses.[26] Therefore, the link between the organization's competencies and process execution provides the means of identifying ways to appropriately define which areas to outsource and thereby increase flexibility and/or innovation to support value creation and revenue growth, or where to improve the effectiveness and efficiency of operations or reduce cost. Without this context there is no means to judge the goodness of a particular process outsourcing strategy. For example, if it is not possible to detect that a process contributes to the unique value creation of the business and helps it differentiate, it is best not to outsource to cut cost; however, if you have business areas and thereby processes that are non-core and do not compete or differentiate in a business context, it should be done in the cheapest way possible.

Figure 4 shows a summary of the concepts for categorizing the six domains of business models, the competencies that enable the business models, and the type of practice standards that correspond to the different competencies.

For non-core competencies, it makes sense to do BPO with standard BPO best practices, in an effort to optimize operations and minimize cost. Similarly, industry

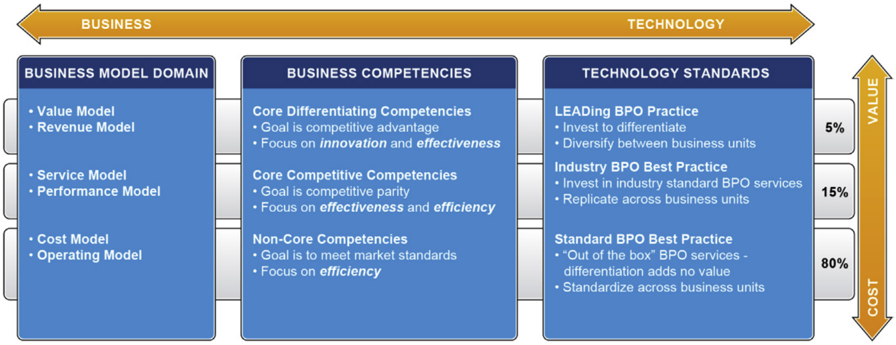

FIGURE 4

When to apply BPO practices and services.[27]

BPO best practice may be adopted for core-competitive competencies because the business only aims to compete effectively with its competitors and maximize its performance. However, to drive growth in revenue and value, new products and services have to be developed to give the business a competitive advantage. By its nature, an advantage requires something that is not offered elsewhere; thus, the business strives toward developing and nurturing core-differentiating competencies. However, applying such differentiating competencies in a standardized BPO offering will at best result in high performance, but not differentiating value.

As shown in Figure 4, true differentiating competencies typically comprise a small portion of the business (only 5%), although it may be a much larger percentage in truly innovative enterprises. Although it could be argued that there are relatively few cases in which a BPO organization could offer unique or even market-leading products and services in a field where you are differentiating, it is crucial for the business to find partners that can support you in your process of innovation and differentiation in the market. Until recently, it had been axiomatic that no organization would outsource core competencies, those functions that give the company a strategic advantage or make it unique. Often, for core-differentiating competencies and all processes involved, some organizations that do not know which competencies are core-differentiating just define it as any function that gets close to customers. In the early 2000s, when BPO matured in the market, this concept of only outsourcing non-core competency areas and the various related processes started to change with the realization that outsourcing some core functions may be good strategy, not anathema, that threatens nether the business model nor the operating model. For example, some organizations outsource customer service, precisely because it is so important.[28]

The key lies in knowing which of the main value drivers and related competencies to focus on, and which produce customer intimacy, product leadership, or operational excellence. Focusing on the drivers that build uniqueness will help a company create a competitive edge (Figure 5).[29]

Before consideration is given to whether to undertake a BPO program, a diagnostic of a company's expenditure must first be undertaken.

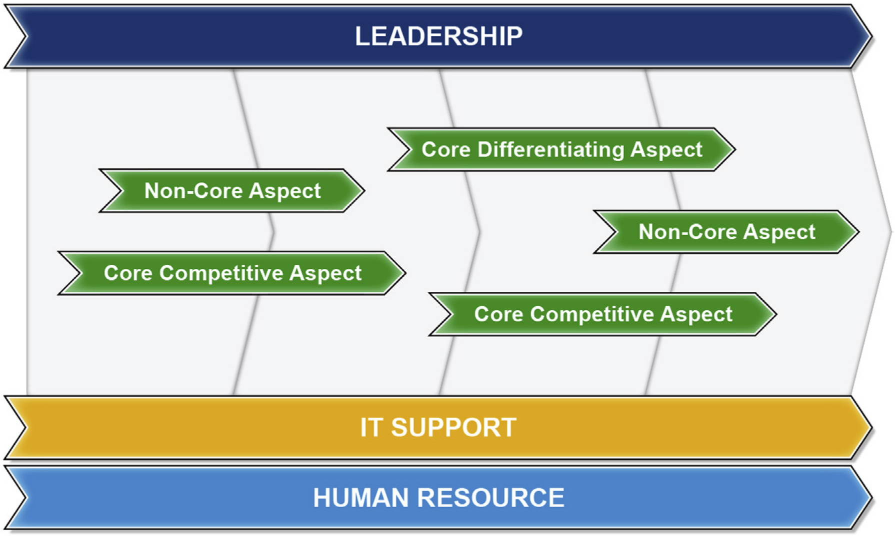

FIGURE 5

Specific processes are within the organization's non-core, core competitive, and core-differentiating aspects across business units.[30]

- Divide the total corporate expenditure into categories that relate to the supplier markets, and then further divide expenditure categories by business units or locations to identify each supplier.
- This initial diagnostic is required to be only around 80% accurate to have relevance and to offer valuable insight.
- If and when BPO teams need to refine spend data for each category, the supplier may be a more accurate source (this is discussed further below).

Diagnostics can provide a expenditure map by category. These expenditure categories should be classified according to competitiveness in the supplier marketplace compared with how important they are to the organization. This results in an expenditure category matrix that will help direct the team toward a potential sourcing strategy for each category.

The Kraljic portfolio purchasing model plots categories as strategic (low supply market competitiveness, high business impact), leverage (high supply market competitiveness, high business impact), bottleneck (low supply market competitiveness, low business impact), and routine (high supply market competitiveness, low business impact) (Figure 6).

Once diagnostics are complete, the business must decide which categories to address immediately and which to delay until internal or external conditions are better. For categories that need immediate attention, the seven-step process begins.

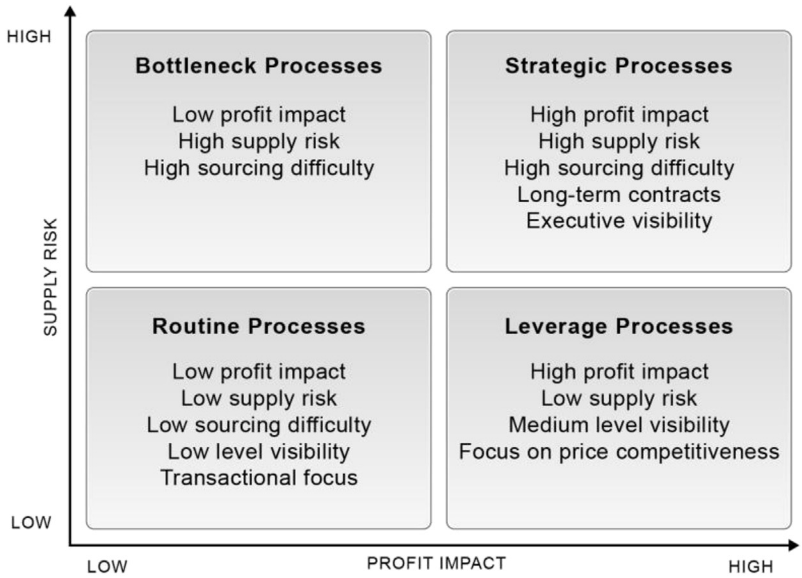

FIGURE 6

Kraljic's purchasing model.

Step 1: Fully Understand the Expenditure Category

This step, along with the next two, is conducted by the business process sourcing team. At this stage, the team needs to ensure it understands everything about the expenditure category itself. For example, if the category is corrugated packaging at a consumer products company, the team will need to understand the definition of the category and usage patterns and why the particular types and grades were specified. Stakeholders at all operating units and physical locations would need to be identified: for example, logistics, which may need to know about shipping specifications, or marketing, which may need to understand certain quality or environmental characteristics, where applicable.

The five key areas of analysis are:

- Total historic expenditure and number of processes
- Expenditure categorised by main, management, and supporting processes
- Expenditure by division, department, or user
- Expenditure by supplier
- Future demand projections or budgets

Step 2: Supplier Market Assessment

Concurrently run supplier market assessment for seeking alternative suppliers to existing incumbents. Understand the key supplier marketplace dynamics and current trends. Prepare should-cost information from the major components of the key products. Take a view on the key suppliers' sub-tier marketplace and analyze for any risks as well as opportunities. Should-cost analysis is not appropriate for every item. In many cases, traditional strategic sourcing techniques work well. However, in cases where strategic sourcing cannot be applied, should-cost analysis provides a valuable tool that can drive cost reductions and supplier continuous improvement efforts.

Step 3: Prepare a Supplier Survey

Next, develop a supplier survey for both incumbent and potential alternative suppliers. This survey will help evaluate the supplier capabilities. At this point, consider verifying spend information using data that incumbent suppliers have from their sales systems. The survey is to assess the capability and capacity of the market to meet your requirements. It enables you to assess at an early stage whether your proposed project is feasible and can be delivered by the identified supply base. It also provides an early warning of your requirements to the market, and enables suppliers to think about how they will respond. The key aim here is to encourage the right suppliers with the right structure to respond to you.

Look to gather knowledge in these key areas:

- Feasibility
- Capability
- Maturity
- Capacity

Step 4: Building the Strategy

This step involves developing the business process sourcing strategy. The combination of the first three steps provides the essential ingredients for the sourcing strategy. However, for each area or category it will depend on:

1. How competitive the supplier marketplace is: Armed with the supplier information, you can build the competitive landscape in the supply marketplace. This can help demonstrate the size of the prize to alternative suppliers and communicates the seriousness of a potential sourcing exercise to incumbent suppliers.
2. How supportive your organization's users are to testing incumbent supplier relationships: A business process sourcing team has two sets of internal stakeholders: people who use the services that are bought and executives who manage overall costs. The people who consume the expenditure category will accept cost reductions as long as the process is started in another department, does not mean a change in suppliers, and does not jeopardize a good relationship with the supply base, generate complaints, or affect issues such as delivery reliability, service, or payments. For executives, cost and service competitiveness is a key objective, but they, too, are users of various corporate services, and so are often caught between the pursuit of cost improvement and a user mentality

of resisting change. To mobilize users' and executives' support for the category strategy, it is vital to communicate all benefits and overcome any potential risks.

3. What alternatives exist to competitive assessment: If the supply base is competitive, you can harness those forces to leverage better pricing or terms owing to increased number of a streamlined product or service specification. Once the result of the competitive sourcing effort is determined, it will be useful to set up a collaborative program that will run until the next competitive sourcing event takes place. If a competitive approach to sourcing is not a viable option, it is worth considering what the alternatives are, such as collaborating with suppliers:
   a. To reduce complexity and in turn increase productivity
   b. To create corroborative process improvements that reduce the cost of doing business
   c. To change the way the relationship is structured. For example, firms may invest in supplier operations to guarantee access to supply, new technology, or process improvements.

These alternatives are pursued typically when a buying company has little leverage over its supply base. They will be relying on good faith that suppliers will share the benefits of a new approach. The sourcing strategy is an accumulation of all the drivers thus far mentioned.

Step 5: RFx Request for …

Where a competitive approach is used, which is the general case for most expenditure categories, a request for proposal (RFP) or bid will need to be prepared (request for quotation (RFQ), electronic request for quotation (eRFQ), etc.). This will define and make clear the requirements to all prequalified suppliers. It should include product or service specifications, delivery and service requirements, evaluation criteria, pricing structure, and financial terms and conditions. A communication plan should also be implemented at this stage to attract maximum supplier interest. Ensure that every supplier is aware they it is competing on a level playing field.

Once the RFP is sent out to all suppliers, make sure they are given enough time to respond. Follow-up messages should also be sent out to encourage a greater response.

Step 6: Selection

This is about selecting and negotiating with suppliers. The sourcing team should apply its evaluation criteria to the supplier responses. If extra information beyond the RFP response is required, do not be afraid to ask for it. If carried out manually, the negotiation process is conducted first with a larger set of suppliers, then narrowed to a few finalists. If the sourcing team uses an electronic negotiation tool, a greater number of suppliers may be kept in the process for longer, giving more diverse suppliers a better chance at winning the business.

Compare outcomes in terms of total value or implementation cost differences. Departments directly affected can be brought into the final selection process. Senior executives should be briefed on the final selection, to gain their approval and also be given the rationale behind the decision, to prepare them for any calls they receive from disappointed suppliers.

Step 7: Communicate with Your New Suppliers

Once the winning supplier(s) are notified, they should be invited to participate in implementing recommendations. Implementation plans vary depending on the degree of supplier switches. For incumbents, there will be a communication plan that will include any changes in specifications, improvements in delivery, and service or pricing models. These ought to be communicated to users as well. Because the company may have significantly benefited from this entire process, it is important that this be recognized by both company and supplier.

For new suppliers, a communication plan has to be developed that manages the transition from old to new at every point in the process that is touched by the spend category. Department, finance, and customer service are affected by this change, and their risk antennae will be particularly sensitive during this period. It is particularly important to measure closely the new supplier's performance during the first weeks of engagement.

Being able to demonstrate that performance matches, or is superior to, that of the former supplier will be vital during this sensitive time. It is also important to capture the intellectual capital your sourcing team has developed during the seven-step process so it can be used the next time that category is sourced.

CONCLUSIONS

In this section we have gone through what BPO is, and how and why it is applied. We have furthermore detailed where it can or should be applied. We have also elaborated on the current stage in the evolution of outsourcing and the development of strategic partnerships, including the steps and the to-do's such a partnership as well as BPO tendering would include. To gain maximum benefit, a BPO program should go through a formal close-down. There is no point in arguing lost causes once irrevocable decisions have been taken. Staff and companies alike need to accept the new situation and move forward. However, there will be a lot of information generated during the life of the program, and this will have been stored with varying degrees of formality by the team members. This information needs to be formally filed away for future reference.

In this light, there are no simple criteria to conduct an outsourcing versus in-house analysis. The benefits associated with outsourcing are numerous, and one should consider each project on its individual merits. Ongoing operational costs that may be avoided by outsourcing are also a consideration. In a nutshell, outsourcing allows organizations to be more efficient, flexible, and effective, while often reducing costs.

When considering a BPO program, a few main factors influence successful outsourcing. Critical areas for a successful outsourcing program as identified are:

- Understanding company goals and objectives
- A strategic vision and plan
- Identify a business model and operating model in which are core differentiating, core competitive, and non-core competencies
- Map the relevant processes for the chosen business competencies and business functions that are desired to be outsources
- Selecting the right vendor
- Ongoing management of relationships
- Properly structured contract
- Select value and performance measures that are the basis for the service-level agreement
- Open communication with affected individual/groups
- Senior executive support and involvement
- Careful attention to personnel issues
- Short-term financial justification (value case and business case)

Some of the top advantages brought about by outsourcing include the following:

- Staffing flexibility
- Acceleration of projects and quicker time to market
- High-caliber professionals who hit the ground running
- Ability to tap into best practices
- Knowledge transfer to permanent staff
- Cost-effective and predictable expenditures
- Access to the flexibility and creativity of experienced problem solvers
- Resource and core competency focus

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