



Outsourcing: An Executive Dilemma

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Knowledge is of two kinds: we know a subject ourselves, or we know where we can find information upon it.

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A question often asked by many Senior Managers and Executives is whether to develop their proprietary products in-house or to outsource the effort. This question may be answered quite simply in many situations by asking the following basic question: “*Do we have the resources to develop these products in-house or not?*” Obviously, if the appropriate resources are lacking, the solution is to outsource the product development. The decision is less clear in those situations where you have the resources and can either contract the work out or develop the products in-house. Whether to outsource or not is usually a judgment call based upon the interaction of a number of different factors, several of which are highlighted below. Once it is decided to outsource the product development effort, there are several other issues that need to be addressed; several of these key issues are presented below.

The Pros and Cons

Some of the advantages of outsourcing include ready access to technology and expertise, flexibility, costing and access to additional contacts. Outsourcing often provides a company with access to technology and expertise, which the company needs but is unwilling to or is unable to invest in. This technology can be “breaking technology” (or resources) which the company may not have access to or it can be technology (or resources) that they are simply not yet willing to invest in.

It is more often economical for a company to outsource its product development activity. This can be due to either the capital expenditure involved with the project or simply the lower costs associated with hiring an outside contractor. Cost containment can be a powerful decision breaker- particularly in a changing marketplace.

Outsourcing provides a company with a great deal of flexibility. It allows companies to utilize in-house capabilities to their fullest potential without disrupting their on-going schedule and tap into outside sources for additional capacity. This additional capacity may be used to broaden the product base or simply to test those “high risk” waters. Probably the most significant advantage is that if an effort shows little or no potential a company is free to cut its losses without disruption of its permanent workforce or its current initiatives.

Independent contractors and consultants usually have their own network of contacts and “spheres of influence” which they have successfully nourished and built over the years. Outsourcing usually provides you with ready access to this additional skillbase and expertise.

The major disadvantages of outsourcing product development include loss of project control, potential tax breaks, and less than full utilization of in-house resources and capacity. Many companies are uncomfortable with the loss of control that results from outsourcing and feel that they must control the everyday product development effort. Additionally, companies are concerned that their proprietary information may perhaps become available to third parties or competitors.

Companies may lose certain tax breaks and benefits if they outsource their product development efforts. Product development efforts that require capital expenditures or which may involve “R&D” (i.e., Research & Development) may have very different tax consequences and benefits if conducted in-house or outsourced by independent contractors.

Outsourcing may not fully utilize the existing product development potential and capability of a company’s own in-house resource base and capacity. In-house development of new products and technologies may also yield “hidden” or serendipitous developments. Yet in today’s “lean and mean” economy most companies no longer have the luxury of additional capacity. Product Development would most likely come at the expense of other income producing endeavors.

Outsourcing

The decision whether to outsource or not can be a difficult one, particularly when a company has the resources to develop the products in-house. However, not all of the product development effort and tasks need to be outsourced. A compromise position may be to outsource only certain portions or tasks of the development effort. In particular, the best decision may be to outsource just those tasks that promise the best advantage to do so. Because of this, outsourcing is usually decided on a case-by-case basis after evaluating all of the advantages and disadvantages in a particular situation.

Several issues need to be addressed once a decision to outsource product development has been made. In addition to the obvious issues regarding “deliverables” and compensation, there are important issues regarding proprietary information, intellectual property and contractor status, which should be addressed. Professional counsel and legal assistance may be desirable and often necessary particularly as it pertains to contracts and agreements.

The issue of proprietary information can often be and is easily addressed by use of a Non-Disclosure Agreement. There are many standard “boilerplate” agreements that will usually suffice. Intellectual Property (IP)- which consists mainly of patents, trademarks, service marks, trade secrets and copyrights- can be addressed by use of a Product Development Agreement, which explicitly incorporates ownership or assignment of any and all IP developed or discovered by all parties involved in the product development efforts.

Often during the outsourcing of product development- positive, lasting working relationships develop between the company and contractor. In these situations, which usually evolve with time, the same contractor is chosen and used regularly as an outside, independent contractor. This is most often a very good thing- since it is derived from comfort and trust.

However, the company needs to be cognizant and aware of the differences between the outside contractor and what the government may potentially classify as an “employee”- temporary or permanent. The classification of a “contractor” as an employee versus an independent contractor has very different consequences as it relates to taxes (both State and Federal) as well as to how it relates to company entitlements vis-à-vis benefits and compensation.

If you often hire outside contractors for product development work, you may want to do several things. First, have all of your independent contractors sign an Independent Contractor

Agreement that explicitly addresses the issues and criteria that the government uses to classify “employees”. Secondly, amend your company benefit plans to exclude “temporary employees” from coverage, thereby allowing for the classification of contractors as employees without having to suffer additional coverage costs. Again, you may want to seek legal and professional counsel regarding these issues.

Finally, once outsourcing is decided- in part or in whole- two key factors will dictate the successful outcome of all of your present and future outsourcing efforts: (1) The development of mutual trust and respect amongst all the players, and; (2) Being able to work together as a team- in other words, the “chemistry” must be right.

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