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KEYNOTE

Outsource, Don't Abdicate

Regardless of what business processes you move outside your corporate borders, you can't lose sight of your ultimate responsibility for ethics and the end result.

By Ben Gomes-Casseres

My favorite post-Enron cartoon, by Dan Wasserman, has two captains of industry discussing what to do about the fallout from corporate scandals. "We are seen as ethical disasters," says one of them. "How are we going to rebuild public trust?" In a flash of brilliance, the other answers: "We could outsource it!"

Behind the sarcasm there lies an interesting question: When a company sheds operations through outsourcing, does it also shed its responsibility—ethical and otherwise—for how those operations are run? Companies today rely more and more on partnerships with third parties for everything ranging from supplies and manufacturing to product design and distribution. In this so-called extended enterprise, where does management's responsibility for good governance begin and end?

Lawyers and accountants will surely have an answer (or several) to this question, based on their reading of Sarbanes-Oxley and other regulations. But top management's answer should go beyond current laws and professional practices, as the question also relates to performance, reputation and, yes, even ethics.

Corporate governance, writ large, means how and to what ends top management exercises its authority and influence. But authority over what? The financial statements of a company begin and end at the legal boundaries of the company's property. What it owns or controls is included; what it doesn't, is not. The problem is that partnerships and outsourcing often fall in a gray zone—they are not usually owned or controlled by the company, but they can be critical to its economic performance.

In effect, the economic boundaries of the company stretch well beyond the legal boundaries. And it is this broader economic scope of operations that companies should govern well, not just the legally defined core. Those who don't, risk suffering penalties—perhaps not legal penalties, but penalties no less in their performance, their brand reputation, or in the public's perception of their ethical integrity. A few examples will illustrate what I mean.

Auto Alliances: Turbocharged or Stalled?

Compare the tales of two automotive joint ventures. Such ventures are common ways for automobile companies to extend their reach into new markets, share manufacturing costs and source technology abroad. Toyota, the world's second-largest auto company, is often cited for the critical advantages it derives from its well-managed network of external suppliers.

Not so for General Motors. While GM has had foreign joint ventures and sourcing arrangements since the 1970s, somehow it never got the hang of how to govern assets it did not fully own and control. Its recent failed investment in Italy's Fiat is only the latest example to prove this point. In 2000, GM paid $2.4 billion for a 20 percent stake in Fiat, with the aim of gaining access to Fiat's diesel-engine technology and sharing manufacturing costs in Europe. But their efforts in managing this joint venture were ineffective, and within two years, Fiat was hemorrhaging money. After difficult divorce proceedings, with a court battle looming, GM agreed to pay $2 billion to terminate the deal in 2005. Moody's Investors Service cited this costly settlement as a reason for downgrading GM's credit rating.

Contrast this with the story of Renault and Nissan. Like GM, Renault was not known for its savvy management of alliances. So when the French company paid $5 billion for 37 percent of an almost-bankrupt Nissan in 1999, most observers frowned. But Renault sent a top-flight management team to Japan, headed by Carlos Ghosn, a French-educated Brazilian who grew up in Lebanon, and launched a serious effort to coordinate operations between the companies. Nine cross-functional teams, backed by cross-company task forces, were charged with reducing costs at Nissan, promoting global integration of operations, and reviving lagging product development and sales. Top management of the two companies met regularly in a process that engendered mutual trust. Within a few years, Nissan was making healthy profits and boosting Renault's share price. Ghosn was promoted to CEO of Renault and became a superstar in Japan—with his own comic book character!

Why the difference? The answer is no doubt complex, and the facts hard to ascertain—companies are always loath to talk honestly about their failed alliances. But we know that more than half of such ventures fail. The reasons usually lie in a combination of poor up-front design and poor post-deal management. In the case of GM and Fiat, one must wonder whether the two companies really had much to add to each other: Both were struggling with heavy payrolls, outdated designs and declining market positions. Two weak companies seldom make a strong one. It seems that the same Fiat management remained in place after the deal was signed, and that GM's contribution amounted to a few new joint projects. This was evidently not enough to pull Fiat out of the red.

A poorly governed extended enterprise can cost the company dearly. The cost can come in the immediate bottom line, as for GM, or in reputation, which can be just as important in the long run. Ford and Firestone learned this lesson the hard way.

The relationship between Ford and Firestone goes back to the birth of the modern automobile industry. In those days, the devotion to quality and innovation of each generated a halo effect on the other. But over time this relationship became driven more by cost concerns, as the auto and tire industries turned fiercely competitive. In the summer of 2000, both companies were put on the defensive by deadly accidents involving Ford Explorers equipped with Firestone ATX tires.

Who was to blame? Was it the tires or the vehicle? Were the companies aware of the risk? Did they do anything about it? In a sense, the precise technical answers did not matter. Both companies were sued by consumers and by state governments. Both eventually settled out of court. And both took a hit to their reputations. A Harris Poll of corporate reputation found both companies near the bottom of a list of 60 major companies in 2002, just above Enron, WorldCom and Adelphia. To be sure, Ford and Bridgestone (Firestone's parent) both have since moved up in subsequent polls, but wounds remain.

Your Partner's Reputation Is Your Reputation

Can companies avoid such hits to their reputations by improving the governance of their relationships with external parties? The evidence suggests they can. In the airline industry, Star Alliance, led by United and Lufthansa and including 14 other members, aims to give customers a seamless global service. It has strict standards of service, safety and customer orientation that new members must meet to join and use the Star logo that is shared by the group. The group knows that the reputation of one member airline can help or hurt the reputation of the others.

Pharmaceutical companies have taken the concern with reputation one step further. For most of them, good relationships with innovative biotechnology firms can be a key source of new drugs. As a result, they have vied with each other to be seen as "partner of choice," and so attract the most promising partners to their network. Eli Lilly, for example, created an extensive alliance management organization and trained its professionals how to effectively govern these sensitive external relationships. They introduced processes and practices that helped Eli Lilly communicate better with its partners and resolve conflicts more rapidly. As a result, Eli Lilly developed a reputation for good alliance management and its ranking rose in industry surveys that aim to measure partner attractiveness.

Thus, good governance of the extended enterprise can generate both better performance, and better reputation. What about corporate ethics? Where does management responsibility for ethical behavior begin and end?

The idea of outsourcing social responsibility together with outsourcing manufacturing is, in fact, not far-fetched. But it seldom works. Early in the controversy around dangerous chemicals in the workplace, Allied Chemical tried to distance itself from responsibility for dangerous emissions and spills at a supplier in Hopewell, Va., to which it outsourced production of Kepone, a DDT-like pesticide. Public outcry, legal suits, and congressional action eventually led to a settlement, and to strict new industry regulations.

Nike, too, initially distanced itself from charges of child labor and unhealthy conditions at its suppliers offshore in the late 1990s. In this case, the risk to its brand image no doubt helped lead to a change of heart. Today, Nike periodically produces an extensive corporate responsibility report that reviews working conditions at all its suppliers. "Corporate responsibility challenges us to take a good, hard look at our business model, and understand our impact on the world around us," concludes Nike's 2004 report. Evidently, its leaders have come to believe that their responsibility for good governance extends well beyond the boundaries of their firm.

The lessons from Ford, GM, Nike and others do not apply only to their industries. In fact, technology and service companies are just as exposed to the risks of poor governance of their extended enterprise, if not more so. Outsourcing of production, design and marketing has gone further in technology and service industries than elsewhere. With that trend comes the risk that a delegation of operational tasks will become confused with abdication of responsibility.

In this sense, the term "outsourcing" is an unfortunate one. With every outsourced task, comes a new responsibility to govern that task properly. The burden of manufacturing a part or running a call center of course is shifted outside the company. But the responsibility for managing the supplier and for ensuring customer satisfaction doesn't budge. Denying this amounts to governance myopia.

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