Risks and Rewards of Outsourcing

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Abstract— the essence of business is in bringing the right product to the market at the right price, place, quantity and quality If outsourcing enables production of products more economically then you have a competitive advantage. In this paper effort to recognize and categorize risks and rewards of outsourcing. This study tries to present new concepts of risks and rewards during the outsourcing process and how to control them. Success foundations explain completely.

Keywords: Outsourcing, Right sourcing, Risks, Rewards

I. INTRODUCTION

The essence of business is in bringing the right product to the market at the right price, place, quantity and quality If outsourcing enables production of products more economically then you have a competitive advantage. The cost of manufacturing equipment is reported to be almost consistent around the world and, if optimal utilisation is achieved, competitive advantage in direct cost can be reduced by outsourcing direct labour and the associated overhead to low-cost areas (Wraige, 2004) Extensive outsourcing allows companies to concentrate on core competency (Leavy, 2001; Michaelides et al., 2003; Purchasing, 1995). The outsourcing of commodity components that do not add to customer value is already well advocated (Venkatases, 1992). Almost the entire value chain may be outsourced (Jennings, 1997). Whilst non-core machined components and production items are frequently outsourced, Quinn and Hilmer (1994) believe that a firm should outsource any activity which is not strategic, unique or world class. Modern companies are choosing to outsource functions that are outside their core competencies and perform only functions that confer competitive advantage (Christiansen and Maltz, 2002). There are a number of opportunities to outsource functions across the enterprise. Further opportunities lie in the outsourcing of HR, where there is a growing trend to outsource recruitment. In a survey it was found that 16% of the companies admitted to not having a recruitment strategy in place and the cost associated with recruitment of the “wrong” person is estimated to be around 15 times the cost of recruitment (Golder, 2004) The IT function is becoming more commonly outsourced. Nearly all of North America’s major companies would outsource at least some of their IT functions by 2005 ( Favre et al., 2004). It is estimated that 80-90% of the service work being done in India is for either US or UK companies (The Economist, 2004). In contrast the article cites a survey of 500 continental European firms which found only 11 per cent outsourcing IT services to low-cost countries, with 80 per cent saying they would not consider doing so. In Italy 90% were against the idea, followed by France and Germany. This may give UK and US Company’s a competitive advantage and enables them to build outsourcing capability and stronger relationships in low-cost countries. When considering outsourcing it is important to discuss this decision in terms of competence and examine a firm’s resource and core competences so as to prevent a firm’s value adding activities being outsourced to a supplier. These leaders created success through a complete pre- project, in-house situational diagnosis before moving on to an even more comprehensive evaluation of the outsourcing process. The paper is designed to provide some elements to organizations, large or small, that want to learn more about achieving success through an outsourcing initiative. Successful outsourced business units and functions are developed through a combination of best- approach methodologies along with continued collaboration with a well-prepared leadership team, supported by external experts on issues that extend far beyond the anticipated financial rewards. Sustained success requires a first- class leader and a first-rate, comprehensive strategy. When considering a decision to outsource any business unit or function, companies and their leaders must weigh the potential cost savings against the potential risks - which are abundant. The paper at hand provides the required guidance on the essential issues that must be addressed if the fundamental structure of an outsourcing strategy and its implementation is to be sound. Going through the paper at hand, would bring out insights into the problems and challenges likely to be faced, with detailed advice on how to anticipate, mitigate, and manage those problems and challenges.

For the executive: Why consider an outsourcing initiative, and why now? Learn what you need to know before you make your decision. For the manager: Learn the major
hurdles that management must overcome, the new skills needed to deliver results on time and on budget, and tips on maintaining control of the project and the trust of your staff. For vendor selection: Learn how to select the best vendor for your specific needs (and get tips on how to avoid the charlatans).

Making it work: Learn how to help your team through the change in culture and dynamics that will take place, how to make the outsourcing initiative successful, how to avoid the most common outsourcing blunders, and what to do when it’s “too late.” As a reference guide, the paper at hand examines the reasons behind the successes that organizations have achieved, allowing for the analysis of decision drivers, questions, research, and considerations when developing a plan. The paper at hand has 2 parts; In part 1 there is an attempt to mention the fundamentals of outsourcing. Part 2 introduces more complex issues: the benefits and barriers surrounding outsourcing, along with “how to’s” from experts in the field. In addition it also attempts to present the real risks and rewards of implementing an outsourcing initiative.

PART 1 - THE FUNDAMENTAL

In order to create a successful, long-term outsourcing program, one must commence at the beginning, the very beginning. This section provides the buzzwords and acronyms used in outsourcing, enabling one to understand the vendors and salespeople who would come your way (and they will come; once the word is out, you will be fair game!). This section also provides you with a comprehensive understanding of outsourcing and offshoring so that you can begin to determine if this will be a wise option for the organization. To assist with the initial determining factors, this section also provides with the most recent survey data concerning outsourcing decision drivers, outsourcing markets, successes, failures, and more. Use of the data would enable better understanding of the options available through outsourcing; then one can move forward into the selection process.

1. WHAT IS OUTSOURCING?

Outsourcing is the practice of hiring functional experts to handle business units that are outside the firm’s core business. It is also a method of staff augmentation without adding to head count. Offshoring, or outsourcing offshore, is the practice of hiring experts in other countries to handle business processes that may be outside of the core business focus, or to reduce costs, enhance quality, and improve productivity. The world of outsourcing, onshore or offshore, may simply be described as delegating at an inter company level rather than an intra company level.

In order for one to make an informed decision about any outsourcing program, there are specific steps that need to be taken to ensure success. A great way to understand the complex scope of outsourcing is through a little history.

Using outsourcing as a business strategy is not new. Decades ago, ADP (Automatic Data Processing) led the way to what is now considered onshore, off-site outsourcing. After World War II, the federal debt rose to the then-astounding peak of $279 billion. By 1949, the federal government was finding new ways to pay off the debt, including the withholding of employee income taxes, and the burden on the employer of properly calculating, withholding, and keeping track of these dollars through payroll expanded. ADP realized that its expertise in payroll and taxes could be offered to other companies without such expertise, and it began offering companies the opportunity to outsource their payroll functions by simply delivering a copy of their payroll roster to ADP. ADP keypunch operators entered the data, and payroll checks, with appropriate withholding and recordkeeping, were returned to the company in time for payday.

ADP knew 50 years ago that companies that made cars, packaged consumer goods, built machines, or provided customer services all had core areas of business expertise, but payroll was not one of them. The more complicated payroll became, the larger ADP’s market became, making ADP one of the pioneers of onshore, off-site outsourcing.

OUTSOURCING ONSHORE, ON-SITE

With an office in Detroit, Michigan, and two employees, William Russell Kelly started a company to meet the office and clerical needs of Detroit-area businesses by providing calculating and inventory services, typing and copying. Initially customers sent their work to Mr. Kelly’s office, but as customers gained confidence in the new company, they began asking Mr. Kelly to send his employees to their offices to type, file, or operate business machines. Over 50 years ago, Mr. Kelly understood the importance of companies playing to their strengths. The company known in 1946 as Russell Kelly Office Services led the way in outsourcing onshore, on-site; it is now known as Kelly Services, a Fortune 500 company that is growing strong.

OUTSOURCING OFFSHORE

While the practice of offshore outsourcing began decades ago (for example, Nike in the 1970s), offshoring gained steam in the 1980s and 1990s as companies increased the outsourcing of lower-level, repetitive back-office jobs to onshore organizations that could do the work more efficiently and cost-effectively. Later in the 1990s, United States companies began hiring programmers in other countries, primarily India, to help corporate America in its race against the dreaded Y2K deadline. This need, along with the simultaneous expansion of the Internet and the telecommunications industry, made doing work remotely far less expensive and far more efficient.

While onshore outsourcing is a method by which companies can hand over work to others who can do it inexpensively through gaining greater economies of scale, offshore outsourcing, or offshoring, is the process of outsourcing functions and business units to workers and business partners who are both outside the work site and outside the home country. As the global economy chugs along, companies that want to achieve high performance must balance the need for efficient operations with the need to deliver on current earnings. In order to do both, organizations must invest in future growth that will create new shareholder value. Does this automatically point to outsourcing a business unit offshore? Maybe yes but maybe not.

Before discussing whether your firm should consider outsourcing as a strategy, let’s first take a closer look at why organizations typically choose to outsource.

WHY OUTSOURCE?

Rapidly changing and increasingly complex business issues are creating key shifts in organizations and the manner in
which they do business. The advancement in technology, the sophistication of business operations, and the need for constant growth are circumstances that suggest a focus on functional core competencies. As companies struggle to adapt to and keep up with the demands of customers and shareholders alike, that focus on core competencies may suggest outsourcing as a potential strategy to remain competitive. A recent study of some five thousand executives conducted by Ventoro.com demonstrated that there are decision drivers for outsourcing that are valid and other decision drivers that are a pathway to failure. Typically, outsourcing decision drivers fall into the following categories:

1. To respond to a power play - Whether the pressure to outsource is imposed by the board of directors, shareholders, or other senior management, coercion is the least effective primary decision driver. According to research conducted by Ventoro.com in 2004, almost 20% of the respondents stated that their outsourcing initiative was driven by pressure from shareholders, boards of directors, or C-level executives. A best-practice response to this pressure is to choose an outsourcing strategy only after first establishing that it is the best solution for your specific business requirements.

2. To alleviate pain - Pain can be a powerful motivator, and when pain in the form of operating challenges exists, it may be an appropriate driver for an outsourcing solution, specifically to:
   - Reduce and control operating cost
   - Reduce labour costs
   - Balance competitive pressure

Tip: When a business process is in trouble while it is still in-house (that is, when the process is broken), shutting it off-site or offshore will just move the problem. Fix the problem first, then outsource off-site or offshore.

3. To fill a need - When you can envision the gap between where you are now, or what is and where you want to be, or what could be, your decision drivers may be in the category like:
   - Improve company focus
   - Achieve cost savings
   - Achieve revenue goals through round-the-clock shifts
   - Gain access to world-class capabilities
   - Improve time to market
   - Achieve development schedules not possible with internal staff
   - Avoid historic problems with projects that have been difficult to manage
   - Scale up for a project without increasing the number of permanent staff
   - Create a global market for your product or service
   - Improve efficiency
   - Focus on core business
   - Redirect your internal resources for other purposes
   - Become truly customer focused

   *Take advantage of potential tax incentives

Organizations that are experiencing pain will want to seek relief, and organizations with a need or desire will work to improve the status quo. Again, outsourcing may be the right move - but it may not be.

WHO SUCCEEDS, AND WHY
As a strategic business tool, outsourcing allows organizations to identify those functions that are not directly creating value for customers or shareholders (those that are not core business functions) and consider them as possible candidates for outsourcing. Depending on the strength of the foundation of your outsourcing initiative, outsourcing even the “good to go” business units may result in outcomes that aren’t always successful. Here are some examples.

POTENTIAL OUTCOMES WITH A WEAK FOUNDATION
The objectives are not achieved because:
   - There was not enough pre contract due diligence; the organization’s expectations were unclear to the vendor.
   - The implementation team or the ongoing management team was unprepared for the challenges of the new process.
   - The implementation team lacked the skills, knowledge, and style required to succeed.
   - The managing executive did not establish a performance baseline prior to sending the functions to the vendor.
   - The client-vendor relationship was rushed; roles and responsibilities were unclear.
   - Mid contract, the ongoing management team changed the scope of the project; the vendor agreed to the change in scope (but was unable to complete the project on time or within the budget).
   - Outsourcing was not the right solution in the first place.
   - Internal support dissipated. (If the entire organization does not support the initiative, lowered morale will impede your progress).
   - There was a lack of communication or management in-house.
   - There was a lack of proper project management.
   - Decision making was delegated to the vendor.
   - There were cultural, language, or communication issues with the vendor.
   - The vendor simply failed to execute as expected. The objectives are achieved, but:
     - The organization was displeased with the vendor relationship because of ethical issues.
     - Brain drain left the company without key knowledge centres.

POTENTIAL OUTCOMES WITH A STRONG FOUNDATION
   - Both client and vendor are satisfied with each other, and both benefited from the arrangement.
   - The outsourcing arrangement achieved more benefits than anticipated at the outset.
   - Both parties view the other as a “trusted partner” and continually work to create new opportunities to forge a deeper, more integrated relationship; share risks rewards; and move their objectives to increasingly higher levels.
   - Outsourcing resolved the organization’s needs and desires.

Successful outsourcing initiatives begin with a strong foundation, executive support, a well-paced and comprehensive strategy, and a vision for success that serves all parties.
SUCCESS FOUNDATION, PART 1
Brian Maloney, the former COO of Perot Systems, was responsible for the company’s market-facing activities, including its major vertical industry concentrations—financial services, health care, industrial services, and strategic markets—its global infrastructure support unit, and its consulting businesses. Maloney’s success resulted from his ability to base the decision-making process on a return to value. In order to experience that return to value and the financial rewards associated with it, Maloney simply asked, “What does success look like? That is our starting point.”

SUCCESS FOUNDATION, PART 2
Industry expert Geoff Smith, principal and founder of LP Enterprises, recommends that CIOs (Chief Information Officer / IT Director) take a proactive view of their own operations, rather than waiting for the CEO or CFO to ask about the merits of outsourcing or offshoring. “At that point,” Smith states, “you’re playing defence.” He also recommends that you take your time, as rushing into a project is a fast path to failure.

RIGHTSOURCING
Clearly, both Brian Maloney and Geoff Smith understand the outsourcing decision-making process as strategic, building strong foundations on which to build their entire programs. In order to secure a successful outsourcing program, on or offshore, leaders must ask and answer the following questions:

1. What is our definition of success?
2. Why are we even talking about this?
3. Is outsourcing right for us, and if so, why?
4. What should we outsource, and what must stay here?
5. Where should we outsource, on or offshore?
6. How much will it cost?
7. How long will it take to implement?
8. How long will it take to realize our objectives in money?
9. What skills must remain here?
10. What skills must stay here?
11. What are the economic risks and rewards?
12. What cultural or language issues might exist?
13. What are the ethical issues that we might encounter?
14. What are the tax advantages or disadvantages of an onshore or offshore outsourcing initiative?
15. What are the psychological effects on the retained and outsourced employees?

2. RECENT SURVEYS ABOUT OUTSOURCING THAT AFFECT YOUR BUSINESS DECISIONS
As you think about your own outsourcing needs and plans, there is a great deal that can be learnt from the data that is currently available. Several surveys and studies on outsourcing and offshoring have recently been conducted. Some of the less-than-objective (and less-than-scientific) studies and surveys are often used by outsourcing consultants to drive a business to one of their partner companies offshore. The survey results presented here are the product of long-term studies conducted by objective parties’ researchers with a balanced and realistic view of the landscape for outsourcing and offshoring.

The outsourcing market may be an example of history repeating itself. While organizations may be able to achieve significant cost reductions, many do not. Organizations that launch an outsourcing initiative before completely developing and understanding their own definition of success often find failure knocking at their door.

I don’t frown on outsourcing or offshoring—moving existing business functions to outsourced service providers is one of the most powerful tools an executive can use to improve both bottom-line and even top-line numbers. However, outsourcing must be done after establishing a sound business case and with a full understanding of the effort and planning it takes to be successful.

PART 2 - BENEFITS AND BARRIERS
Outsourcing is not simply packing up IT jobs and shipping them overseas—it is much more than that, and it has been a staple of Multi - National Corporations for years. When planned and executed well, an outsourcing initiative can be extremely successful.

MEASURING THE RISKS AND REWARDS
Twenty-five years ago, what now is called outsourcing was then called time-sharing. This practice, the on and offshore sub-contracting marketplace, has grown dramatically over the last several years, and will continue to do so as corporations focus on a return to value.

It might be thought that after 25 years, the process of defining and implementing an outsourcing initiative would be relatively simple and painless, that there would be no hurdles to overcome and no snags to work out, and that all of the risks associated with outsourcing would be mitigated to the point that an organization could easily create an outsourcing initiative that would deliver immediate results. Unfortunately, that is not the case - each outsourcing program, on or offshore, differs in complexity, and each has its own set of risks and its own set of rewards that must be identified and measured.

If you can answer the question, “Why should we outsource?” with a hearty, “I don’t know yet!” then you are on the right track. Your thorough and systematic due diligence process will answer that question fully. A significant part of this investigative process must include a review of the risks and rewards experienced by those who have gone before.

THE RISKS
First, let’s take a closer look at the risks, some of them clearly visible and some hidden, associated with an outsourcing initiative.

- Customer service risks
This scenario is not unique. If you outsource customer-facing functions, you must recognize the need to exercise close control over the processes that most directly affect your relationships with your current customers. Your outsourcing initiative may be developed to create cost savings for shareholders, but when you outsource a customer-facing process your success will be gained or lost on the basis of your customers’ experience. Customers expect predictability. Insist that your outsourcing provider has the same commitment to service as you do; establish metrics for what you
define to be “predictable,” including service results; and measure your outsourcing provider against those metrics regularly.

Key point: Keep the value close to your customers.

- **PRIVACY AND SECURITY RISKS**
  That is evaluating outsourcing on - or offshore must first question whether their vendors have integrity, and also question whether the vendors have a sufficiently vigorous security system. Service vendors must meet security requirements and period. This issue goes beyond an angry offshore vendor threatening to post personal data on the Internet; as banks, tax preparers, loan processors, medical records companies, and other organizations outsource (and offshore) sensitive materials, privacy concerns must be completely addressed. Organizations evaluating an outsourcing initiative need to ensure that their outsourced service vendors have suitably tough security practices that will meet the organization’s internal requirements. The risk of security breaches or loss of intellectual property is amplified when working internationally, as legal systems in other countries may not offer the same intellectual property protection. Privacy concerns must be completely addressed; security requirements must be documented, monitored, and reported regularly; and the methods and integration with service vendors must be clearly defined.

Key point: Watch the valuables.

- **DELIVERY RISKS**
  A major issue facing organizations that choose to outsource involves delivery: the delivery of quality products or services, on time, within the scope of the contract, yet allowing for growth and innovation. Having a great product with a great cost base, but an outsourcing vendor cannot get it to market on time then the outsourcing initiative is not working. If the vendor can get the product to market, but the product lacks quality, the customers will fill their product needs elsewhere, and the outsourcing initiative would fail. Delivery issues - quality, growth, timing, and scope creep - must be addressed during the initial stages of the investigation. One must consider the following areas -

- **Delivery and Quality**
  Successful outsourcing is dependent on how well the customer requirements are defined and how well it is measured as to how those requirements are being met. If you cannot define or measure the requirements, one is doomed to fail. Delivery may be measuring call centre turn-around time on responses to customer inquiries, and an added value (or additional quality) is the metric that keeps track of how many similar requests come in. On or offshore, one must be specific and deliberate when documenting the expectations for delivery and quality.

- **Delivery and Growth**
  An outsourcing vendor needs to be prepared to meet potential growth requirements, so it is a must to evaluate the vendors’ ability to ramp up when it is needed. It is a must to identify their ability to increase staff and skills to react to your needs.

- **Delivery and Deadlines**
  If your outsourcing vendor is unaware of, uninterested in, or unable to meet your delivery deadlines, you have a big problem, and big problems have big price tags. You must identify the vendor’s sense of urgency by checking references, and, during the contract stage, metrics must be set to measure the vendor’s observance of your timetables.

- **Delivery and Scope Creep**
  Fixed-price contracts just do not exist in outsourcing. Since outsourcing contracts contain baselines and assumptions, when the actual work varies from estimates, the organization will pay the difference. This risk has become a major difficulty for organizations that are surprised when the service vendor expects to be paid for incremental scope changes. Most projects change from 10 to 15% during the development cycle, so a vital part of due diligence is to get your hands around the scope of your project before you begin. Do your homework at home first, and then do your homework outside.

Key point: Assess delivery from every angle; validate goals, objectives, and deliverables.

- **Risks of rules and regulations**
  Utilities, financial services institutions, drug companies, and health-care organizations, among others, face various degrees of government regulation. Non-compliance with government standards or insufficient “transparency” during an audit can spell big trouble. The issue of transparency is becoming more significant as requirements such as the Sarbanes-Oxley Act place greater burdens of accountability on all American corporations. Sarbanes - Oxley holds senior management accountable for the accuracy of financial statements; outsourcing financial activities requires great confidence in the service vendor’s controls, abilities, and integrity. Outsourcing could make compliance more cumbersome and costly - and certainly more risky.

Key point: Outsourcing does not minimize management’s accountability; it intensifies management’s accountability.

- **Risks of the human element**
  Unfortunately, organizations often underestimate the value of their employees, and therefore they also underestimate the impact of this human element on their overall outsourcing success. It is the people, after all, who actually get the job done not processes, not tools, not specific sites or locations, just people. Successful outsourcing initiatives require seasoned professionals and dedicated workers in-house and off-site, and organizations are more likely to find those valuable candidates in their own back- yard. Once you have excellent resources, keep them, invest in them, and value them, using communication as your platform.
• Communication

One thing is certain: The world changes quickly, and most people change slowly. This slow-to-change tendency is aggravated when modifications are made to people’s work processes, workplaces, or employment without their having awareness, understanding, or input. A fearful and risk-averse employee base can be a very real danger to an organization, resulting in anything from turnover of key personnel to stress claims. To avoid and dispel fear, inform. To shift from risk aversion to support, inform. To let your employees know that you value them, inform.

• People

Whether you outsource on or offshore, you must strategize the process by which you will hire, train, reward, and maintain staff. In any outsourcing situation, there will be some level of attrition. If you do your homework, you will know what to expect; then you can create a process to manage it. If you do not want to risk losing all of the experience in your organization, you must make a plan to retain those you wish to keep.

When P&G planned to move from an internal solution to an outsourcing solution, approximately 7,000 employees were affected. At contract start-up, these P&G employees became employees of the outsourcing vendor. As the employees were informed on an on-going basis, they were employees aware of the process in front of them, as well as their value to the new organization; morale was high, and turnover was low.

If you must reduce staff to implement your outsourcing initiative, you must be aware of the potential for employee bitterness as demoralized employees do not feel valued and do not perform well. A well-rounded human resource strategy includes assisting your displaced employees to obtain additional training so that they can stay current in their field and providing some level of assistance in outplacement.

Key point: Retention of your best assets is critical - do not risk losing anyone because of a weak human resource strategy.

Additional risks considering

In addition to the risks of quality, customer service, delivery, privacy and security, human resources, and compliance, outsourcing provides opportunities for additional and very real risks that you may not have considered.

Disaster Recovery

What happens if, for example, you outsource your call centre to India, and it experiences a devastating earthquake? If you have an intelligent strategy to spread the risk, along with a sturdy disaster recovery plan, you will maintain a high customer satisfaction level while you dig out. If not, you risk losing just about everything.

In 2004, the U.S. government ordered flu vaccine from a source in the United Kingdom; that source found that the majority of its material was defective. The resulting shortage of flu vaccine was both tragic and avoidable; it is hard to ignore the fact that there was no alternative or backup plan and no additional resources from which to draw additional material. The government response to the shortage was to call on the public to “wash your hands more often.” A much more reliable and sensible process would have been to order vaccine from several sources, so that if a single source proved defective, the remaining sources could take up the slack.

Circle back now to the call centre example in India. You must ask yourself: If my call centre halfway around the world must close down because of some disaster, what is my plan? How long can we operate without a call centre? How can we avoid the “wash your hands” reaction?

Political Concerns

There are additional geographical concerns when outsourcing offshore. A solid strategy must address the political stability of the location chosen, the possibility of civil strife, and potential political strains that might undermine your outsourcing project.

Legal Concerns

To ensure the success of your offshore initiative, you must visit the offshore site, and you must visit it often. How easy is it to travel to your offshore site, how often will you visit, and how difficult will it be to obtain visas? Labour laws, import and export licenses, tax implications, and customs issues all must be addressed and resolved.

Ethical Concerns

Running a domestic ethics program supported by employee training and a 1 - 800 hotline for reporting misconduct is thorny. Offshore, there are certain countries where there is an even higher risk for ethical breach because the pressure to pay bribes is greater. Global compliance with ethics programs is considerably more complex, and is hindered by cultural differences. On or offshore, ethics must be addressed.

Key point: Your due-diligence process must involve expertise beyond that of your outsourcing vendor.

THE REWARDS

Now for the good news, the rewards - and there are many.

Improved business focus

Outsourcing allows companies to focus on their core skills and products as well as on more expansive business issues such as branding, strategy, and planning while having specific operational details handled by outside specialists. A company engaged in a well calculated outsourcing initiative will benefit by focusing its resources on meeting the customer’s needs, having been released from dedicating resources to areas outside of its business expertise. In addition to shifting the focus from peripheral activities toward work that is customer - facing, outsourcing can help managers set more specific priorities, and since their time and attention are not divided, they are able to deliver results.

Reduced or controlled operating cost

Perhaps the single, most important tactical reason for outsourcing is the benefit of reducing and controlling operating costs. Gaining access to a vendor’s lower cost structure is one of the most compelling short-term benefits of outsourcing. Organizations that try to do everything themselves may actually experience elevated costs for research, development, marketing, and deployment expenses, and more; and all of these direct and indirect expenses are passed on to the consumer. Your outsourcing provider’s reduced cost structure may be the result of greater economies of scale or other advantages based on specialization, and that reduced cost structure may increase your competitive advantage.

Cost cutting may not be, and should not be, the only reason
to outsource, but it is undoubtedly a significant consideration. For most organizations, employee-related costs and the associated overhead expenses are relatively fixed, regardless of the demand for the organization’s products or services, and during slow times this can be very expensive. Outsourcing allows you to convert fixed costs into variable costs, and your outsourcing provider can offer special pricing for this variable demand.

A recent study conducted by Accenture provides an overview of the fixed/variable-cost situation as it relates to airline companies. We know that airlines are in trouble around the globe, and we also know that they can use outsourcing to optimize their cost structures and achieve high performance.

With airline revenues down, with an over-supply of competitors, and with the vulnerabilities and uncertainties created by an unstable global economic and political landscape, it is no wonder that airlines all over the world are struggling to survive.

Airlines realize that they need cost management and efficiency strategies to improve their bottom lines and to compete with the successful business models of the low-cost/low-complexity airlines. The fundamental point of difference between the low-cost airlines and traditional airlines is the higher percentage of variable costs in their cost structure. Fixed costs make up 60 to 70% of the traditional network airline’s costs; that is reduced to 50 to 60% at low-cost airlines.

Accenture recommends that airlines convert as many of their fixed costs as possible into variable costs, while lowering overall operating costs. This will allow them to be both flexible and efficient enough to prosper in slow or growing economies.

Accenture, using an outsourcing program designed to help airlines enhance the effectiveness of their cost structures and realign themselves for high performance, required an up-close concentration on outsourcing of non-core, rules-based, back-office functions and processes under a term contract to a specialist third party. Forward thinking airlines are already outsourcing a wide range of noncore services such as finance and administration, information technology, and human resources, delivering significant cost savings to their organizations.

The airline industry is only one example of reducing costs through an outsourcing strategy. To save costs in any organization through outsourcing, make sure that the business model supports the need to outsource, investigate, test, and reap the rewards.

Increased access to world-class capabilities

By the very nature of their specialization, outsourcing providers bring extensive world-class resources to meet the needs of their customers. Partnering with an organization with outstanding capabilities can offer access to new technology, tools, and techniques that the organization may not currently possess. World-class providers make extensive investments in technology, methodologies, and people; they gain expertise by working with many clients who are facing similar challenges. This combination of specialization and expertise gives their customers a competitive advantage through these expanded skills, and helps them avoid the cost of chasing technology and training.

A level playing field

Most small companies simply cannot afford to match the in-house support services that larger companies maintain. Outsourcing can help smaller firms act “big” by giving them access to the same economies of scale, efficiency, and expertise that large companies enjoy.

According to the research group Gartner Inc. in Stamford, Connecticut, the small and midsize outsourcing market is growing 12% a year, and outsourcing vendors are rushing to grab a piece of this fast-growing market. Midsize organizations in particular stand to gain a lot from outsourcing; if it is done correctly, midsize organizations can maintain a smaller staff; and, as is the case with any size company, outsourcing noncore activities (for example, HR administration) can free up resources to focus on more strategic efforts.

Resources redirected to more strategic activities

Every organization has limits on its available resources. Outsourcing allows resources to be redirected from non-core activities toward customer-facing activities that provide a greater return. Through a well-planned outsourcing initiative, the organization can redirect displaced employees (or their head count) to greater value-adding activities.

Cash infusion

Outsourcing may involve the transfer of assets from the organization to the vendor or service provider. Equipment, facilities, vehicles, and licenses used in the current operations have value and are sold to the vendor. The vendor then uses these assets to provide services to the organization. Depending on the value of the assets involved, the sale may result in a significant cash payment to the organization. When these assets are sold to the vendor, they are typically sold at book value, which is often higher than market value. In these cases, the difference between the book value and market value may represent a loan from the vendor to the organization that is repaid in the price of the services over the life of the contract. In either event, the benefit of the potential cash infusion is undeniable, and the organization can use this cash infusion to redouble its customer facing efforts, invest in retraining of displaced or transferred employees, or otherwise improve its business.

Availability of capital funds

In most organizations, there is enormous competition for capital funds. Deciding where to invest these funds is one of the most crucial decisions for senior management; it is difficult for a senior manager to justify noncore capital investments over investments that are more directly related to the product, service, or customer. Outsourcing reduces the need to invest capital funds in noncore business functions by contracting for these investments on an “as used” operational basis instead of acquiring the resources through capital expenditures. Outsourcing can also improve certain financial measures of the firm by eliminating the need to show a return on equity from capital investments in noncore areas.

CONCLUSIONS

The trend among firms that have higher outsourcing success rates indicates that organizations that take the time to do their homework and to build a business model for outsourcing that works are the most successful. Successful outsourcing engagements also require organizations that simply refuse to move a broken process or function,
organizations that inform and include their teams and staff, organizations that realize that an outsourcing initiative takes time, and organizations that refused to be pushed into signing a contract. Organizations that are willing to take the time to complete a robust due-diligence process and assign a full-time team to consider all options, including demographics, politics, and best sourcing (regardless of location), always come up on top. Finally, the most successful outsourcing engagements are created and implemented by organizations whose executives accept complete responsibility for the success or failure of the process. So, given all of this failure information, why would anyone consider an outsourcing initiative? It is all due to the potential rewards experienced when it is done right.

The majority of problems with outsourcing deals are rooted in a deficient due-diligence process and poor communication. Executives who are considering an outsourcing program must clearly identify why they want to outsource and what they want to achieve through outsourcing, and they must carefully plan and execute a strong and extensive strategy in order to achieve a significant return on investment. Then, before commencing work with an outsourcing provider, executives must remember that making this process work requires building a relationship with the outsourcing provider; as in any relationship, communication and understanding of mutual expectations is critical to its development. There’s a delicate balance between trusting your outsourcing provider and controlling your outsourcing provider, and striking that balance will help develop and maintain a strong and long-term relationship. Negotiating an outsourcing contract is never easy and can take years. While designing and developing a relationship that will last for five or more years, you are attempting to intuitively build in protections for both sides, while also attempting to predict any changes and mitigating any risks in an effort to benefit from the abundant rewards that can come about during that five-year time frame.

With strong leadership, proper planning, due diligence, and a well-built strategy, the benefits of an outsourcing program are plentiful. Risks are abundant (and certain) without these elements.

REFERENCES


