Outsourcing: a primer

William M. Lankford
Richards College of Business, State University of West Georgia, Carrollton, Georgia, USA
Faramarz Parsa
Richards College of Business, State University of West Georgia, Carrollton, Georgia, USA

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Abstract
Outsourcing is defined as the procurement of products or services from sources that are external to the organization. Firms should consider outsourcing when it is believed that certain support functions can be completed faster, cheaper, or better by an outside organization. Tasks that are not core competencies of the organization are candidates for being contracted out. However, any skill or knowledge that allows you to serve your customer base better, that deals directly with the product or service you are trying to put out of the door, is one that must remain in-house. Today, the outsourcing of selected organizational activities is an integral part of corporate strategy. For corporations, benefits of outsourcing are substantial: reduced costs, expanded services and expertise. Outsourcing allows companies to refocus their resources on their core business. Corporations can buy technology from a vendor that would be too expensive for them to replicate internally. For outsourcing to be successful the decision needs to be an informed one. Effective management of the outsourcing relationships is an organizational imperative.

Definition of outsourcing

Outsourcing is defined as the procurement of products or services from sources that are external to the organization. For services, this usually involves the transfer of operational control to the suppliers. In the current environment of right-sizing, with a renewed focus on core business activities, companies can no longer assume that all organizational services must be provided and managed internally. Competitive advantage may be gained when products or services are produced more effectively and efficiently by outside suppliers. The advantages in outsourcing can be operational, strategic, or both. Operational advantages usually provide for short-term trouble avoidance, while strategic advantages offer long-term contributions in maximizing opportunities.

It is estimated that every *Fortune* 500 company will consider outsourcing during this decade and that 20 percent of them will enter into a contract by the end of the decade. A variety of firms already exhibit this trend. General Electric Corporation has entered into a five-year, $500 million contract with Electronic Data Systems (EDS) to handle the corporation's desktop computer procurement, service, and maintenance activities (Behara *et al.,* 1995).

Overview of outsourcing

Why do senior managers sometimes prefer to entrust outside firms with critical tasks? The fact is, senior management often finds outside firms to be more cost-effective. While middle managers often claim they can hire a guy for 40 grand a year to do it cheaper, upper management looks at things differently. They know they will typically pay at least $100 per hour to outsource, but they also know the job will be done on time and in a predictable fashion. And if it isn't, they can get somebody else without going through the hassles of hiring and firing employees. It is vision, function, and economics that drive the need for outsourcing (Harkins, 1996).

A recent study indicates that outsourcing operations is the trend of the future and that organizations already outsourcing activities are pleased with the results. A year-long international study by Arthur Andersen and The Economist Intelligence Unit finds that 93 percent of corporations interviewed plan to outsource in the next three years. Of those that already outsource, 91 percent are satisfied with the results (Struebing, 1996).

The study, "New Directions in Finance: Strategic Outsourcing," is based on interviews with 50 global organizations plus a survey of 303 senior executives throughout North America and Europe. Said Dennis E. Torkko, managing partner for Arthur Andersen's Contract Services Practice, "The study documents a clear trend to the use of outsourcing as a competitive tool, rather than just a simple means of cost control. Especially relevant is the outsourcing of key business processes and financial functions" (Struebing, 1996).

The document includes outsourcing case studies with Alcatel Italia, British Petroleum Co., Houghton Mifflin, Mead, Microsoft, Octel Communications, Plastics MFG, Sybase, Talegen Holdings, Tektronix, and Zeneca Group. Of the executives surveyed, 85 percent outsource all or part of at least one business function. The most widely outsourced activity is legal work (59 percent), followed by shipping (41 percent), computer information systems (36 percent), and production and manufacturing (31 percent). Twenty-six percent of the executives interviewed currently outsource at least one financial function; 42 percent expect to outsource at least one financial function in the next three years (Struebing, 1996).

Outsourcing and re-engineering

Re-engineering means "new beginnings." It is the search for a new way of organizing the various elements of work. Re-engineering is

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"the fundamental rethinking and radical redesign of business processes to achieve dramatic improvements in critical, contemporary measures of performance, such as cost, quality, service, and speed." Such change is possible only through innovation that "encompasses the envisioning of new work strategies, the actual process design activity, and the implementation of the change in all its complex technological, human, and organizational dimensions."

The decision to outsource should address the critical role of information and processes in organizations, including the role that systems play. If an entire function is to be outsourced, sufficient provision should be made in the outsourcing contract to deal with current and future requirements of the organization. Special attention should be given to the potential need for innovative solutions to be provided by the outsourcer, and to the timing of these actions.

In this era of the virtual organization, outsourcing traditional corporate tasks has become popular. And doing so can be cost-effective – provided that the right tasks are contracted out (Behara *et al.,* 1995).

Consultants say that firms should consider outsourcing when it is believed that certain support functions can be completed faster, cheaper, or better by an outside organization. Tasks that are not core competencies of the organization – human resources, payroll and benefits, information systems, even food service in the cafeteria – are ripe for being contracted out.

On the other hand, any skill or knowledge that allows you to serve your customer base better, that deals directly with the product or service you're trying to put out of the door, is one that must remain in-house. Support functions serve your employees better, so you can give those tasks over to a group that treats the employees like customers (Carey, 1995).

Today, the outsourcing of selected organizational activities is an integral part of corporate strategy. Historically, third party participation in a company's business has generally focused on the manufacture of parts and components and the provision of auxiliary services such as legal and travel services. A more recent phenomenon, however, involves third party participation in the management of the information systems (I/S) function. Since information is a principal resource in most businesses today, the consequences of external control of a firm's information system must be considered carefully. The formulation and management of the service contracts with information services suppliers are critical issues (Behara *et al.,* 1995).

Advantages of outsourcing

Cutting costs is often seen as a major benefit of outsourcing. However, this can lead to disappointment. The Freight Transport Association has produced research to show that contracting out does not necessarily save money. A much better reason is the specialized knowledge that the contractor can provide (Davies, 1995). Outsourcing works best when it is an outgrowth of re-engineering. Re-engineering means stepping back to take a fresh look at a whole process with an eye to discovering how it can be reconceived and rebuilt, from the ground up, as something that works better (Gamble, 1995).

In principle, re-engineering is bold, rational and efficiency-seeking. It respects no sacred cows. It does not set out to protect jobs or turf in any function, operation or department, or another outsourcing agency. It sets out to build better mouse traps, whatever the consequences. Tradition resists re-engineering. So does entrenched self-interest. It is not a naturally popular process (Gamble, 1995).

When re-engineering looks at who is best suited to performing a particular task – who can do the task with the greatest efficiency and the highest quality – and then determines that it is not the in-house staff, outsourcing is likely to result. When competitive pressures get strong, truly re-engineered companies will rise to the top because they have built the vital processes that work best (Gamble, 1995).

Outsourcing is not a new fad but a solution with a long, distinguished track record. Using a wholesale lockbox is outsourcing, pure and simple, but it happened before outsourcing became faddish. It has prospered because, for a great many companies, it simply works better to direct the checks straight to the bank, then let the most efficient provider do the key-punching and photocopying. Where management is bent on staff reductions and prejudges outsourcing as a way to keep essential functions operating while deep staff cuts are carried out, then mistakes are likely. The outcome might be a lean, mean internal staff or a dispirited, anorexic one (Gamble, 1995).

"Especially during the recession, there was a tendency to feel that the reason to go for outsourcing was to save money," explains Mark Pope, commercial manager with outsourcing services company CMS. "But if you ask companies two or three years into a contract what the benefits are, they tend to suggest it is the opportunity to concentrate on the business, the predictability of services and the ability to manage the cost stream

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because there are no sudden surprises, such as a demand for new equipment" (Sweet, 1994).

Yet in many corporations today, downsizing has left administrative staffs unable to deal with routine business transactions, let alone the complicated assimilation and management required to successfully relocate a large number of employees. Outsourcing partnerships provide businesses with a viable solution to the productivity problem. Corporations can develop flexible outsourcing partnerships and programs designed to meet their unique needs and culture (Runnion, 1993).

For corporations, benefits are substantial: reduced costs, expanded services and expertise, improved employee productivity and morale, and a more positive corporate image. Indeed, most outsourcing contracts target a minimum 15 percent cost savings, sometimes between 20 to 25 percent. To attain such goals, it is essential to have multi-year agreements so the economies of scale and cost-cutting measures can take effect. Contracts are usually multi-million dollar deals signed for five years or more with performance clauses built in (Manion *et al.*, 1993).

"There are several primary reasons why a firm considers outsourcing," according to Kevin Moran, senior vice president with Fidelity Institutional Retirement Services' Benefits Center. He describes them as follows (McCarthy, 1996):

- Outsourcing allows companies to refocus their resources on their core business.
- Corporations can buy technology from a vendor that would be too expensive for them to replicate internally.
- Outsourcing lets companies re-examine their benefit plans, make them more efficient, and save time and money while improving efficiencies.
- Companies outsource to improve the benefit plan service level to their employees by making the information more consistent and more available.
- A final possible reason is to reduce costs, certainly over the longer term.

Fears that allowing someone else to run a support function somehow means that the company is no longer in control of its own destiny have evaporated. Many organizations tacitly admit they have little enough control over their in-house support departments, and see a legally enforceable contract with an external supplier as a way of keeping the lid on costs and improving the quality of the service they get (Sweet, 1994).

Disadvantages of outsourcing

Unfortunately, determining core competencies can sometimes be tricky, and a wrong guess deadly. For instance, contracting out training programs is common today, but mismanagement there could wreak long-term havoc. In another example, Darcy Hitchcock, president of Axis Performance Advisors, in Battle Ground, Washington, contends that "IBM guessed wrong around 1980 when they went into the PC market. They thought their core competency was marketing, and not creating an operating system or microchips." Microsoft was commissioned to write the operating system, while Intel took on the task of building the chips. Today, those two firms are more vital to the computer industry than IBM, whose outsourcing decisions helped launch Microsoft and Intel (Carey, 1995).

When it comes to signing the contract, some companies are in danger of signing a blank check, they often feel it is too difficult to sort out exactly what should be provided in detail, and it is too easy for the suppliers to simply say trust the other side (Sweet, 1994).

Despite the sound financial appeal, outsourcing is a topic that is still fraught with emotional overtones. The fear of losing control is a major emotional stumbling block to outsourcing. Such sentiments are somewhat understandable. But outsourcing can be more a partnership than a vendor/supplier relationship. Some questions that should be asked are (Manion *et al.*, 1993):

- *What are the proposed savings measured against?* The dollar saving is probably calculated against your current budget. Is that the right basis for comparison? The budget almost certainly has "funny-money" corporate allocations in it, or costs that won't go away with outsourcing. Shouldn't the comparison be made against the actual cost of running the department? No, that's still not good enough. It should be made against what your actual outlay would be if you were operating at "best-of-breed" unit costs. That's the price tag you'd like the outsourcer to beat; otherwise you'll be paying a higher price for the service than it is really worth.
- *Does the outsourcer have economies of scale not available to you?* Don't assume he does. A 1991 study of information systems providers failed to reveal any obvious economies of scale across a large number of data centers. If the in-house operation understood exactly what you could achieve yourself, it is very likely you could save your company more than the outsourcer can. You should have an edge,

of course, because you don't pay yourself a profit.

- *Is the guaranteed price a good deal?* Is your incremental cost of additional workload equal to today's unit cost? In many cases the marginal cost of adding workload to the current base is considerably lower. That could be critical to an accurate evaluation. A wrong move here could result in your outsourcing decision costing a lot more than you expected. Even the best deals reported in the recent press seem to pass on only about half the potential benefit of decreasing unit costs.
- *Can the outsourcer buy equipment and hardware cheaper?* It is commonly held that, because of the outsourcer's size and diversity, he enjoys an appreciable edge in buying power and flexibility. It is argued that this coupled with greater "granularity", allows him to keep the cost of hardware additions below what smaller operations can achieve. When you buy capacity before it is really needed, you've spent too much for it. Not only is the time value of money important, but buying hardware tomorrow is always cheaper than buying it today. Adopting a "just-in-time capacity" strategy may pay bigger dividends than is generally recognized.
- *Tend your own knitting and leave support operations to the specialists.* These are often heard cries, but be careful here too. It doesn't follow that you should outsource your support operations at any cost. It still holds, though, that your support operations should only be outsourced if it is cost effective to do so. Outsourcing is often touted as a way to handle thorny problems like a large book value that is hard to swallow, an inflexible leasing arrangement, staff relation difficulties, and so on. Ask yourself whether outsourcing is really the right way to deal with such issues, or whether it just shifts and disguises them. In any case, you should understand what price you're paying to avoid dealing with them directly (Manion *et al*., 1993).

Process to determine if outsourcing is the correct strategy

While outsourcing can often help control costs, simplify operations, and keep a company focused on its core competencies, it won't work unless it is properly implemented. Here are some guidelines (Kelley, 1995):

- *Determine what business you're in.* Quickly jot down the company's core competencies and primary sources of revenue. Obviously, these functions and processes are areas that you don't want to outsource. Whatever isn't on this list, however, may be outsourced.
- *Look for outsourcing opportunities.* Similarly, find the functions or processes within the company that don't make the company unique or offer a clear competitive advantage over other businesses. Such non-strategic areas can often be outsourced.
- *Evaluate costs.* Try to determine just how much is being spent on a function and whether or not it can be done more cheaply by an outside company. Set objectives. Realistically decide what an outsource partner can do for the company. Whether it is to cut costs, improve focus, or free up resources, make certain the goals are attainable.
- *Be cautious.* Don't select an outsource partner without careful examination. After all, that business will be your company's representative to both employees and customers.
- *Monitor.* If you decide to outsource, set up regular performance reviews or similar criteria to measure the provider's performance. Outsourcing isn't an excuse to overlook an aspect of your business.
- *Be flexible.* Even after deciding to outsource, look at ways it can be improved. Don't be afraid to make changes in the ways a process is being handled.
- *Don't jump on the bandwagon.* Just because outsourcing is a growing trend doesn't mean it should be automatically embraced. If a change isn't needed, don't make one just for the sake of it.

It also can be dangerous to focus too narrowly on a single, isolated process when making an outsourcing decision. Such choices should be made only after four questions have been answered (Gamble, 1995):

1. What will be the net gain or loss in efficiency and cost-effectiveness of using outsourcing?
2. What will be the net gain or loss in performance quality of using outsourcing?
3. What will be the net effect on the strength, versatility and resourcefulness of the treasury department if the duties in question are outsourced?
4. What dependence on a third party will be created by outsourcing, and how vulnerable would the organization be if that third party somehow became unable to perform as expected?

The outsourcing decision

A number of issues are involved in the decision to outsource an organization's resources. To summarize, key items to analyze are scale economy, outsourcer expertise, short- and long-term financial advantage from the sale of resources, inability to manage the function, strategic realignment, and a need to focus on the core business. Additional issues that typically are involved and need to be considered in the context of a specific firm's situation include (Behara *et al.*, 1995):

- impact on company competitiveness;
- identifying services to be outsourced;
- the number of suppliers to be used;
- ability to return to in-house operations if required;
- supplier reliability;
- supplier service quality;
- coordinating with the supplier and evaluating performance;
- flexibility in the products offered by the supplier;
- providing the latest/advanced technology and expertise.

Steps that need to be completed to implement the transition from an in-house service to an outsourced service

The purchasing function must be involved in the negotiations and contract development when outsourced services are purchased. This procedure will have a positive impact on the quality and value the organization receives because of purchasing's expertise in procurement issues related to service contracts. Corporate risk management, legal, and strategic planning groups should also be involved. This will ensure that the strategic impact of the outsourcing contract is adequately evaluated (Behara *et al.,* 1995).

As in the case of all other procurement, purchasers of outsourced services should not be willing to accept the standard contract offered by most suppliers. The following factors should be an integral part of the planning and conduct of the acquisition process:

- Purchasing representation on the supplier selection team.
- Competence factors to use in evaluating suppliers (e.g. flexibility, understanding the company's business, technology leadership).
- Bid evaluation procedures, including the specific evaluation of low bids.
- A precisely defined scope of work, detailing the nature and extent of collaboration between buyer and supplier.
- Safeguards for performance and cost control.
- Methods and procedures for measuring supplier performance.

The specific needs of the organization should be matched with the supplier's capabilities during negotiations so as to develop a contract around a shared vision. A cross-functional team with members from a variety of decision-making levels is required to assess the company's needs. Such a team is also required to manage the contract after its execution. Outsourcers should have the financial and technological incentive to help the company migrate to technology that is suitable to the organization. Suppliers that have a good understanding and an interest in the outsourcing firm's business will be better positioned to help define mutually beneficial goals.

Supplier performance should be evaluated on the twin dimensions of technical and functional quality. Technical quality includes maintaining the required response time, minimizing system down time, providing error-free service, and utilizing leading edge technology. Functional quality, in essence, is the quality of customer service.

Outsourcing contracts can be all-inclusive, modular (focusing on specific operations), or turnkey (specific jobs). While turnkey contracts historically have represented the typical arrangement between buying firms and outsourcing suppliers, the modular and all-inclusive approaches characterize today's outsourcing relationships. In identifying potential outsourcing suppliers, the firm's own division might well be considered as a possible alternative. Internal audits indicate that a division that rationalizes its operations can generally outbid the outsourcing supplier (Behara *et al.,* 1995).

If the decision to investigate the benefits of outsourcing is made, be prepared for a lengthy evaluation and implementation process. Don't focus solely on short-term needs; this is a major event that one wants to avoid repeating. Firms need to take a long-term view of the move to outsourcing. Ask, "Are they dedicated to the business? Will they stay with the outsourcing business?" The second thing to ask is, "If I outsource with a vendor, am I locked into that vendor? Can I make a change in corporate direction and decide to in-source at some point in the future, or change to a second vendor?" (McCarthy, 1996)

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Example of outsourcing

The outsourcing of the Southwire Company trucking fleet

Southwire Company grew to be the largest producer of electrical wire and cable in the USA. One of the competitive advantages developed by Southwire was its customer service with the ability to deliver products directly to the customer with its own fleet of trucks. Southwire acquired its own fleet of trucks since they were located in a rural area of Georgia when the company was founded and lacked access to commercial transportation. Southwire turned this disadvantage, the lack of commercial transportation, to a competitive advantage by using its own fleet of trucks to deliver product directly to the customer, reducing the order lead time for the customer, and then using the return trip, the back haul, to pick up materials and supplies from vendors, thus reducing the shipping cost of these items. For these and other reasons the Southwire truck fleet was a high profile part of the company culture, and a source of company pride.

By the mid-1990s Southwire began to consider the outsourcing of its fleet operation. There were several reasons for considering outsourcing of the fleet. The fleet operation was not a part of its core business, yet it represented a fair amount of the asset base of the company and the number of employees of the company. Increased cost and time was required for overseeing and compliance with increasing government regulations, i.e. DOT, ICC, drug testing, and various federal and state agencies. The fleet of approximately 100 tractor trailers was becoming old, obsolete, and lacked the safety features found on the newer model trucks. To replace and upgrade the fleet would require a considerable investment. The potential liability cost of operating one's own fleet became a major issue. Southwire is self-insured, and had experienced some unfortunate road accidents involving its trucks. This liability exposure plus the negative press in having an accident with the company's name on the side of the truck involved was deemed a cost that could be avoided with an outsourced fleet. The cost of payroll, medical and other benefits for the mechanics, drivers, and other fleet personnel was a growing part of the payroll expense of the company.

The down side of outsourcing was identified as the cost of perception by the customers. Having the product delivered by a third party – would the customer notice, or really care, so long as the product was delivered on time and to the customers' expectation and satisfaction? Not having the Southwire name on the truck and the resulting advertising from having rolling billboards. And perhaps the most important, the losing of control to a third party of the fleet and delivery of the product to the customer.

For these and other reasons Southwire phased out its own fleet operation in the Fall of 1996 and outsourced the fleet operation to Schneider National Dedicated Operation of Green Bay, Wisconsin. Schneider was chosen because they combine leading-edge technology with a full list of transportation services to engineer solutions for customers. Southwire has stated "With Schneider, Southwire is able to benefit from the advanced technology and take advantage of the efficiency of using a large business like Schneider devoted solely to transportation. This means Southwire can concentrate on what we do best – manufacture wire and cable products" (Dennis, 1997).

Conclusion

The decision to outsource can lead to competitive advantages for businesses. For outsourcing to be successful the decision needs to be an informed one. Good, hard, detailed information in the hands of strong management can help avoid a costly step, one that is not easily reversed. Ultimately, for outsourcing in any form to be successful, quick response times to strategic opportunities and threats are essential. Effective management of the outsourcing relationships is an organizational imperative.

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Application questions

1 Is there a trade-off between the cost savings and flexibility achieved by outsourcing and the level of service which can be expected?

2 Can a firm have its functions completely outsourced? What would happen if it did?