

A brief introduction to outsourcing management



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Introduction Outsourcing is a business trend that has greatly increased in recent years with more and more companies outsourcing part or whole of their functions/activities. Outsourcing can be defined as the transfer of a business function or activity previously produced in-house to an external supplier which then takes prime responsibility for fulfilling the task (Finn, 2007). Although companies may perceive outsourcing as an alternative to reduce costs as a result of access to economies of scale and improve performance as a result of unique expertise that a large outsourcing vendor can deliver (Roodhooft and Warlop 1999 cited by Jiang and Qureshi 2006), outsourcing has many hidden cost and risks that can lead to create various financial and non financial problems. This essay will discuss whether outsourcing achieves economies of scale. More specifically this essay will explore current trends in outsourcing.

Then it will discuss how outsourcing vendors achieve economies of scale and cost reductions. Furthermore it will give an insight of hidden costs and disadvantages in order to give a complete picture of outsourcing benefits and drawbacks. An estimation of the amount spent on outsourcing in 2001 was to be \$3. 7 trillion and it was expected to reach \$5. 1 trillion by the end of the year 2003 (Corbett, 2003 cited by Clott, 2004).

Researchers estimated that by 2015, about 3. 3 million jobs accounting for \$136 billion in wages will move off shore (McCartney 2003). Further outsourcing industry trends are mentioned by a survey conducted in 1997-1998, which indicated that two-thirds of executive manager had outsourced a business process and that the outsourcing market penetration was expected to grow from 6% in 1995 to 10% in 2000. That predicted growth

was surpassed with demand for outsourcing exceeding a global value of \$100 billion in 2006 (Juras 2007). Traditionally outsourcing was associated as tactical move with the main objective to reduce costs, but recently that notion of outsourcing has evolved from a tactical move to a more strategic tool. Strategic outsourcing not only intends to achieve the cost reduction benefit but also to help towards the achievement of strategic goals since companies gain access to external expertise and quality improvement, at the same time companies are able to free up resources which allow them to focus on their core activities and strategic goals (Juras, 2007).

The outsourcing deal between Barclays and consultancy group Accenture in a \$400m contract is an example of strategic outsourcing where Barclays not only expected to reduce costs but as well to attain its strategy goals of “improving the agility, efficiency and capability” of its information technology operations (Cave, 2004). There are many real life examples of companies outsourcing or considering outsourcing in order to reduce costs, improve performance or a combination of the two. Dutch financial services ING is one example of companies turning to outsourcing. The initiative behind this decision was to reduce operating cost of approximately €460m per year and to attain strategic goals of efficiency improvement and achieving a higher operational effectiveness for its retail banking operations (The Daily Telegraph, 2006). A company planning to outsource is Britain’s largest mobile operator Orange (White, 2005) as part of an initiative by its French parent Telecom to reduce costs and improve customer service quality in high demand periods. The initiative involves outsourcing 1500 jobs from UK to Indian call centres.

Kakadbase and Kakadbase (2002) identified the most common functions and activities being outsourced by large international companies in Europe and US. Figure 1 illustrates these findings: Source: Kakabadse and Kakakbadse (2002) Kakadbase and Kakadbase (2002) also identified the most cited motives for outsourcing as described by companies in Europe and US. Figures 2 illustrate this finding. Source: Kakadbase and Kakadbase (2002) Figure 2 identifies cost discipline/control as the main motive for companies in Europe and US to outsource their functions/activities. A research examining the outsourcing practices of more than a 100 western companies, found that the primary rationale to outsource was to save on overheads through short-term costs savings (PriceWaterHouseCoopers, 1999 cited by Kakabadse and Kakabadse 2002). Furthermore in the IS/IT industry companies outsource primarily for financial reasons as stated by (Karyda et al, 2006) where companies are expecting to improve rate of return investments (ROI), reduce costs and achieve economies of scale that would not be achievable internally.

The cost reduction achieved by outsourcing providers is mainly due to specialisation and achievement of economies of scale, since providers are often servicing a large number of clients; they often achieve lower unit costs than any single company can, what is more outsourcing providers are more likely to be able to invest in new technologies and innovative practises than any company not specialising in that activity are (Alexander and Young, 1996 cited by Bryce and Useem, 1998). Further factors contributing to the ability of outsourcing providers to offer cost reduction to its customers are globalisation and new technology which have allowed outsource providers to

move business processes to areas where labour costs are substantially lower (Finn, 2007). Example By moving business processes to countries with lower costs such as China where labour costs for manufacturing jobs in are just 60 cents for unskilled labour (Wonnacot, 2002 cited by Clott 2004); in the services industry particularly call centres, wage rates for graduate Philippine and Indian people is \$1. 0 to \$2. 00 compared to \$10 to\$18 for similar positions in the United States (Kirkpatrick, 2003 cited by Clott, 2004); and in the IT industry up to 65% of labour costs could be reduced by sending work to India (Khirallah, 2002 cited by Clott, 2004). Access to economies of scale and lower labour costs as a result of outsourcing have helped to reduce operating cost of real life companies like BP (British Petroleum) which contracted Exhul to carry out administrative and business processes of its HR function.

The deal resulted in a reduction of \$15 million a year in operating costs and the avoidance to fund \$30 million in capital cost for technology (Belcourt, 2006). A further example that illustrates cost-saving through outsourcing is UK company British Telecom (BT) which incurred over ? 50m a year to run an in-house HR function and by transferring this function in a five year deal to outsourcing provider Accenture, BT saved ? 30m from that contract. Real cost reduction experienced by British Petroleum and British Telecom demonstrates that there can be significant cost saving as a result of outsourcing. Some companies have had to exploit the opportunity to reduce costs in order to survive as a result of fierce competitive prices, pressure from shareholders to increase company's value and customer pressure to reduce costs. A company that had to outsource in order to survive and

remain competitive in the market was American company Wayne Youngers, Youngers & Sons because Chinese competitors were offering the same product for \$2. 0 or less in comparison to \$6.

00 charged by the company, and customers where terminating contracts with the company as a result (Collins, 2007). Although many companies have experienced cost reductions and improvement in their operations and activities as a result of outsourcing there are many hidden costs and non financial problems that are not anticipated and might adversely affect these results and can cause problems such as not real savings and non-finacial problems to companies which fail to identify them. In a recent Deloitte consulting survey of 25 world-class organizations covering various industries, the conclusions about outsourcing were not encouraging. One quarter of the companies had brought business functions back in-house after realizing that they could do the work themselves more successfully at lower cost. Forty four percent of the companies surveyed reported that outsourcing didn't save any money, and nearly half identified hidden costs as the most common problem when managing outsourcing projects" (Tadelis, 2007 pp 261).

Hidden costs are those that are not directly linked or obvious to the project such as cost of selecting and supervising the project, quality, customer dissatisfaction etc; these costs are often ignored by the accounting department when coming to estimate the cost of an outsourcing deal (Purdum, 2007). Related contract-costs with overseas provider can reach a 2% of the contract value; this would mean that for a \$1m contract \$20, 000 would be associated with the cost of the contract, further hidden costs are <https://assignbuster.com/a-brief-introduction-to-outsourcing-management/>

cost overruns, legal fees, insufficient legal protection for intellectual property (Lucas, 2004). Global outsourcing can represent risks to intellectual property, particularly when dealing with China and countries in the Asian Pacific area in general. Copying, reverse engineering and counterfeiting products are not unusual practices in these countries. Hayward Pool Products of USA found that a Chinese company had copied their products and were selling them under their logo to one of their clients at 25% discount which affected more than \$20 million sale to that customer (Collins, 2007).

There are also many non-financial problems that a company outsourcing can encounter when outsourcing whole or part of their functions. One of these problems is customer dissatisfaction. “ A 2005 Gartner study predicts that 60 percent of organizations that outsource customer-facing processes will see significant numbers of frustrated customers switching to competitors” (Pfeffer 2006, p 66). A further survey conducted in the UK to pension policy holders, found that 75% of those people surveyed would switch current provider if they experienced bad customer service (Pfeffer, 2006). Customer dissatisfaction comes as a result of the quality level being reduced as a result of outsourcing (Kelley and Jude, 2005), this lower quality service or product can arise as a result of different interests between the provider and the company outsourcing, Tadelis (2007) highlights the conflict of this relationship as a result of “ buyer’s wish to buy at low price and the seller’s wish to sell at high profit margins” (Tadelis, 2007 pp 262). Risk of dependence on the vendor is yet another problem that companies outsourcing face Quelin & Duhamel (2003).

The company outsourcing is transferring all the responsibility to the vendor, might the vendor have internal or external problems and they may fail to deliver on time and with the expected quality. Clott (2004) argues that an outside provider might not be able to respond quickly to problems and change in consumer needs. What is more outsourcing implies transferring functions or activities to an outside provider, as a result there is also a transfer of knowledge and skills to the provider. This transfer of knowledge might expose a company since the provider of the outsourcing services might enter the market and become a competitor (Belcourt, 2006). This situation was faced by US bicycle manufacturer Schwinn, which outsourced the manufacture of its bicycle frames to Taiwanese company Giant Manufacturing.

A few years later Giant entered the market and damaged business (Belcourt, 2006). Loss of critical skills and knowledge as a result of outsourcing is another problem that the company outsourcing might experience. When the company transfers all function responsibility to an external provider the company loses understanding of the service over time. Although the provider has all the knowledge to perform the activities related to the outsourced function, this knowledge will remain with the provider and can not be tranfered back to the organization (Quelin & Duhamel, 2003), this would be a particular great problem if the company decides to bring back a previously outsourced function. Competitive advantage could be affected as a result of transfer of knowledge and skills to an outside provider. Since the provider will often be servicing other clients within that industry (Alexander and

Young, 1996 cited by Bryce and Useem, 1998), the vendor may even sell the acquired know-how and company secrets to a competitor Belcourt (2006).

This transfer of knowledge to the outside provider is risky as the IT/IS industry illustrates, where loss of data confidentiality was ranked first of five risk factors in IT/IS outsourcing (Karyda et al, 2006). Information security is a big risk for companies outsourcing, a report from a British newspaper illustrates this point (Biswas, 2005). The newspaper claimed that one of its journalist bought personal details from a Delhi IT worker for ? 4. 25 each.

Customers of the organisation outsourcing might not feel secure dealing with companies that outsource overseas as a result. Conclusion Outsourcing is a major potential strategy that managers will come across in large and medium-sized international companies; it is associated with major cost reductions as a result of vendor's access to experience economies of scale and major labour cost and overheads reduction by moving activities to areas where labour and overall cost are cheaper such as China, India, Western Europe, Latin America etc.

Literature also highlights that there are further benefits when outsourcing like improving performance, being able to focus on core activities, access to expert skills and knowledge among others, which makes outsourcing an even more appealing strategy for companies to adopt. However cost reduction through outsourcing is not always a fact as there are hidden costs that are often not anticipated or ignored before opting to go ahead with an outsourcing project and can significantly increase the overall cost/reduce the total cost saving achieved. Furthermore companies outsourcing in search for lower costs can be exposed to many non-financial problems that can greatly

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affect long term stability, performance, service demand etc, of the company especially when outsourcing to global vendors or offshoring as there are many cultural, legal, socio-cultural differences that can have a negative effect to the outsourcing experience. As with all major business decisions, the initiative to outsource activities or functions must be appraised and reviewed carefully to identify hidden costs, risks and potential problems that can affect the decision, as well it must be decided what to outsource and to whom, for companies to be able to benefit from cost real reductions.

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