OUTSOURCING – A PATH WITHOUT RETURN?

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Abstract

This article deals with outsourcing as a part of strategic decision and strategic management of the company. It discusses the definitions, development, basic characteristics and types as well as reasons that should be considered in decision making. Contributions but also the risks are analyzed. The critical question of this article is whether outsourcing is a path with or without the possibility to return.

Outsourcing

Outsourcing is a made-up word that combines the three terms outside, sourcing and using. The term of outsourcing describes the procurement of resources from external suppliers that were generated within the sourcing organization. In the late 80s outsourcing became a popular buzzword in business and management in America. In 1989 Kodak outsourced their data processing and communication networks to DEC, IBM and Businessland. This was one of the first steps in outsourcing. Shortly after the first outsourcing activities of Kodak in America the term of outsourcing became acquainted in Europe too. Over the years outsourcing evolved. More and more companies thought about outsourcing and today outsourcing is well established in business and management.

For outsourcing a lot of definitions exist and some definitions are more precise than others but the main facts are the same. Gartner for example defines Outsourcing as followed: A contractual relationship with an outside vendor that is usually characterized by the transfer of assets such as facilities, staff or hardware. It can include facilities management (for data centers or networks),

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14 Cf. Franze, F., Outsourcing: begriffliche und kostentheoretische Aspekte, p. 10
16 Cf. Schwarze, L. & Müller, PP., IT-Outsourcing – Erfahrungen, Status und zukünftige Herausforderungen, p. 6
application development and maintenance functions, end-user computing or business process services.\textsuperscript{17}

In general outsourcing is a strategic management model where companies decide farming out. Companies have to decide either to keep on rendering the needed resources by their own or to get it from external supplier. In business studies it is known as the make-or-buy-problem.\textsuperscript{18} Outsourcing can cover many areas, including the outsourcing of manufacturing as well as services. It can involve the transfer of an entire business function to a supplier or alternatively may lead to the transfer of some activities associated with the function whilst some are kept inhouse.\textsuperscript{19}

The first reason for organizations to outsource is the consideration of cost reduction and improvement of cost structure. While outsourcing the customer benefits from the suppliers cost advantages such as economies of scale, economies of scope, experience and location. Supplier may take on investment and development costs while sharing these risks among many customers and thereby reducing supplier costs for all customers.\textsuperscript{20} Through the demand-oriented usage of services the customer can convert fixed costs into variable costs. So the supplier has to deal with the problem of excess capacity in times of adverse business conditions.\textsuperscript{21} Another motive is the concentration on core competencies. Company’s core competencies are things that a firm can do well and that meet the following three conditions specified. First it provides customer benefits, second it is hard for competitors to imitate and third it can be leveraged widely to many products and market.\textsuperscript{22} A core competency can take various forms, including technical/subject matter knowledge, a reliable process, and/or close relationships with customers and suppliers.\textsuperscript{23} Every company has a limited number of talented managers. These managers are responsible for processes that determines high added value for the company. Organizations outsource processes in order to not applying too much of the valuable management capacities for administrative border areas.\textsuperscript{24} A next reason is to get a higher level and quality of services. In certain activities higher levels of performance can be achieved by many specialist suppliers. This advantage is not only based on reduced costs. Specialist suppliers can also provide higher level of service quality to the outsourcing company. The management can leverage the value enhancement that the company may not have inhouse.\textsuperscript{25}

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Due to rapid changes in technology, reduced time-to-market and increasingly sophisticated customers for organizations it is very difficult to control all activities. While in the past companies attempted to control the majority of activities internal, outsourcing can provide greater flexibility for the organizations. So outsourcing provides management with flexible and scalable services to meet customers' changing requirements, and to support the company's strategic plan.\textsuperscript{26}

Also a reason for companies to outsource is to get access to advanced technology and innovation. Outsourcing enables companies to design and implement leading-edge enterprise systems to support the business processes and to manage the technology infrastructure with more efficient capital investments and reduced training costs.\textsuperscript{27}

Classified into the three parts cost, competency focus and revenue the following table summarizes the reasons for outsourcing that were founded out by the research of CAPS Research and AT Kearney.

Reasons for outsourcing an activity\textsuperscript{28}:

\textit{Cost}

- Reduce operating costs
- Reduce capital investments
- Turn fixed costs into variable costs
- Meet downsizing requirements
- Reduce development costs
- Obtain intelligence of competitiveness

\textit{Competency Focus}

- Focus on core business
- Gain access to technology not in company
- Gain access to needed skills
- Provide alternative to building capability
- Create additional capacity
- Provide backup capabilities
- Align with policy/philosophy/culture

\textit{Revenue}

- Increase flexibility and responsiveness
- Increase speed to market

\textsuperscript{28} Source: AT Kearney, Outsourcing Strategically for Sustainable, 2004
- Improve quality
- Reduce customer response time
- Grow revenue

Besides the advantages that outsourcing can offer, a lot of risks exist too. One of the main motives for outsourcing is the reduction of costs. But many organizations under-estimate the future costs and the managing resources and time that have to be invested after outsourcing a process to an external provider. It is erroneous to assume that once the activity is outsourced no costs and operating expenses for this process exist.\(^29\) Another drawback is while outsourcing companies lose direct control over the process and become dependent on the supplier.\(^30\) Organizations have to maintain innovative capacity to stay competitive but through outsourcing they can loss critical skills and intellectual property. As a result supplier can become competitors in the future. Therefore companies should never outsource their core activities.\(^31\) Disadvantages that can occur because of the location were described in the “Outsourcing models” section. The table below presents reasons not to outsource corresponding to the CAPS Research and AT Kearney study.

Reasons for not outsourcing\(^32\):
- Loss of control
- Activities not outsourced are core
- Protection of intellectual property
- Company policy/philosophy
- Inadequate business case
- Concern – dependency on supplier
- Concern – labor/community reaction
- Loss of critical capability
- Difficulty reversing decision later
- Lack of supplier base
- Labor union restrictions
- Physical distance
- Possibility supplier becomes competitor
- Activities not outsourced are highly profitable
- Maintain internal morale

\(^{30}\) Cf. Bauknecht, K., Outsourcing, 2002, p. 18
\(^{32}\) Source: AT Kearney, Outsourcing Strategically for Sustainable, 2004
- Previous lack of success with outsourcing
- Legal restrictions on workforce change
- Other legal restrictions

Outsourcing is divided into 2 types. The two basic forms are information technology outsourcing (ITO) and business process outsourcing (BPO).\textsuperscript{33} The two areas describe that either information technology or business processes were outsourced. ITO and BPO can be realized by different outsourcing models. The typical three approaches are to build up a shared service center, having a joint venture with other corporations or to outsource to an external provider.\textsuperscript{34} These outsourcing models can be executed either in onshore, nearshore or offshore locations.\textsuperscript{35} The chart below gives an overview about the coherence of the different types of outsourcing, the outsourcing models and the sourcing terminology. It includes what can be outsourced, how the activity can be outsourced and where.

![Outsourcing diagram]

**Figure 1:** Outsourcing overview\textsuperscript{36}

What the two types of outsourcing mean exactly? What does each outsourcing model include and what the differences in choosing the location are? These questions will be answered in the next pages.

\textsuperscript{33} Cf. Köhler-Frost, W., Outsourcing: Schlüsselfaktoren der Kundenzufriedenheit, 2005, p. 39
\textsuperscript{34} Cf. Cagemini, Build or Buy, 2004, p. 2
\textsuperscript{35} Cf. Gartner, Offshore Services in Europe, 2002, p. 169
\textsuperscript{36} Source: AT Kearney, Outsourcing Strategically for Sustainable, 2004
Outsourcing is a generic term that has to be subdivided into the two parts information technology outsourcing (ITO) and business process outsourcing (BPO). The following two sections explain what both terms mean and what they do include.

The first type of outsourcing is the concept of IT-Outsourcing. Gartner defines IT-Outsourcing as followed:

“*The contractual vehicle through which enterprises use external sources to provide life cycle service and support operations for their IT infrastructure. Outsourcing can be partial (i.e., modular or selective) or total, and can involve not only operations but also the acquisition of customer assets and personnel. IT outsourcing is divided into five primary market segments: data center operations, network operations, client/server operations, application management and desktop management.*”\(^{37}\)

In general IT-outsourcing is divided into the two parts IT-infrastructure and IT-process outsourcing. Whereas the first one means outsourcing of hardware and software IT-process outsourcing covers the topic of outsourcing IT-workflows. An example for outsourcing IT-processes is outsourcing of service desks. A typical form of farming out IT-infrastructure is to run a data center by third party.\(^{38}\)

Business Process Outsourcing (BPO) is outsourcing of business functions to achieve various benefits such as cost savings, better quality and ability to focus on core competence. BPO involves outsourcing processes that are not core to a company, however, are essential for smooth operation of the company. It is a strategy by which an organization contracts functions to service providers who specialize in these areas. The service provider is responsible for the execution of the business process and if required making recommendations to improve the system.\(^{39}\) The customer transfers the complete responsibility of these functions to the vendor who guarantees certain service quality standards. Such processes include customer service, payroll processing, inventory management, etc.

**Intelligent Sourcing**

Sourcing is the procurement of resources - whether from internal or external sources - to accomplish business objectives.\(^{40}\) The intelligent sourcing location terminology covers the topic of what the best location is to get the resources needed. In regard to the location the terms offshoring,

\(^{39}\) Cf. Compass Connections, *What is BPO?*, 2005
\(^{40}\) Cf. Capgemini, *Build or Buy*, 2004
nearshoring and onshoring describe different possible ways of sourcing. All shoring models include the relocation of business processes or business units into other regions or countries with the aim of saving costs, especially personnel costs. But decisions for outsourcing business processes or business units into other regions or countries cannot only be based on a comparison of the labor costs.\(^4^1\) A lot of other criteria have to be taken into account. Criteria for choosing locations are language skills, government support, labor pool, existing infrastructure, educational system, costs, political stability, cultural compatibility and data security.\(^4^2\) The following chart shows a lot of inhibitors and accelerators that have to be taken into account.

![Figure 2: Offshore accelerators and inhibitors](image)

What an offshore, nearshore or onshore location is depends on the location of the outsourcing company. Arbittive is the geographical distance between the outsourcing company and the outsourcing location.

According to ICG Commerce, a market leader in procurement BPO, for outsourcing procurement functions companies should operates a nearshore policy because the business requires extreme interaction at a local evel with suppliers. To be most effective in supporting the organization, a procurement function needs to be tightly connected to the organization as well as the

\(^{42}\) Cf. Gartner, Offshore Outsourcing – The big new wave, 2002, p.15
\(^{43}\) Cf. Gartner, Offshore Outsourcing – The big new wave, 2002, p.15
supply market. Even in today’s global economy, supply markets are still very regional for indirect materials requiring a local or regional procurement presence. Developing a strong end-user to provider relationship is a critical success factor for procurement outsourcing. The most successful outsourcing relationships provide users with easy access to individuals who work in the supplier’s market, can speak the end-user and supplier languages, and are knowledgeable about the category, supplier and products or services being sourced.44

Choosing the right outsourcing destination has to be done very carefully. While issues like relative cost advantage, infrastructure, and political stability are likely to be major points of evaluation for any enterprise, the weight given to each of these criteria may vary from company to company and from one set of requirements to another.45 Each country has its own special characteristics and attributes. Thus companies that are looking for an appropriate outsourcing location have to take into account each criteria and must evaluate what criteria is important for the business processes that should be outsourced. India is a popular outsourcing location because of its low labor costs, high quality, language skills, expert knowledge and quality of service. Challengers for example are Canada, Mexico and Ireland, up and comers are Brazil, Singapore and the Ukraine and beginners are Thailand, Vietnam and Cuba. China will remain the preferred sourcing location for Japanese firms as the Czech Republic, Poland and Hungary will remain favorite nearshore destinations for Western European firms.46

The Ability to Innovate

The service sector forms a significant portion of the economic strength of modern industrial nations. This is accompanied by increasing competition in this sector. In order to survive in this market, it is more important than ever to be able to develop marketable products in the shortest time possible. This means the ability to innovate is taking on an increasingly important role for companies.

It is clearly becoming more difficult for companies to gain a competitive advantage with material goods, meaning that increased differentiation from competitors can only be achieved with the aid of services. In addition, advancing globalisation and deregulation of markets means that foreign providers are seeking to claim market share for themselves. The rapid development of information and communication technologies, producing further potential for rationalisation, is another reason for the increase in competitive pressure.47 Last but not least there is an increased

44 Cf. ICG Commerce, Frequently Used Procurement Terms and Definitions, 2006
45 Gartner, Offshore Services in Europe, 2006, p. 15
46 Bitkom, Business Process Outsourcing Leitfaden – BPO als Chance für den Standort Deutschland, 2005
blurring of the borders between businesses, leading to a situation where companies from different lines of business are offering identical services.

Further problems leading to an increase in the pressure to innovate are caused by the shortening of the product life cycle (PLC). Also proving to be problematic is the fact that, owing to their intangibility, services cannot be protected by patents, posing the danger of imitation and a loss of profit.

The reasons for the increase in pressure to innovate summarised in Fig. 3 shows that there is an enormous need to take action, which can only be realised with the appropriate innovation management.

![Diagram showing reasons for increased pressure to innovate](image)

**Figure 3:** Reasons for the increased pressure to innovate

**Growth and Trends**

Reliable estimates and growth projections of the total market for outsourcing and the respective market segments are difficult to obtain. On a country basis the market researchers mostly infer the national market value from the money contract value of known deals and from the turnover growth of suppliers. In the domain of ITO this method is comparably accurate because most of the information about contract values and duration is publicly available. Concerning BAO and Business Process Outsourcing the methodological assumptions and the accuracy of input data vary enormously; this leads to significant discrepancies in the forecasted market sizes and – to a minor

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extent – the forecasted growth rates. There are three major problems associated with the calculations:

- **Market and market segment definition.** Some analysts do not include business application management in their outsourcing definition\(^{49}\). Since BAO is a significant spending category, and most of the contracts do not neatly fit the project services or outsourcing description, market assessment differ. The same holds for segments in the respective BPO definitions.

- **Market demarcation.** There is a continuum between outsourcing and simple sourcing. At some point in time services recently transferred outside the firms’ boundaries such as logistics management may justifiably be regarded as outsourcing while others – such as contract manufacturing – might better be viewed as sub-contracting. Given that contract manufacturing accounts for nearly half of the BPO market there is large room for error\(^{50}\).

- **Market transparency.** According to projections between 30 and 50 percent of all outsourcing agreements are captive\(^{51}\). Depending on the degree of monopoly power the captive supplier can exercise over the parent company it can be problematic to use the term outsourcing for these relationships\(^{52}\).

According to estimates currently about 5 percent of total spending in Europe on corporate functions can be identified as BPO spending and this percentage is forecast to grow to 7 percent by 2010 and to 11 percent in 2025\(^{53}\). Not only will a growing portion of services be provided via long-term business process outsourcing engagements, significant effort within initiatives will go into supplier induced performance improvements. In ITO, for instance, typical cost savings are in the region of 5 to a maximum of 15 percent. Business Process Outsourcing in conjunction with a re-engineering component offers buyer organisation opportunities to cut between 40 and 60 percent of their costs of running the process\(^{54}\).

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\(^{49}\) Some of the aforementioned analysts, for instance PAC, treat application management as a project service.

\(^{50}\) The transfer criterion does not solve the ambiguity: If an activity is brought outside the firms’ boundaries it is per definition outsourcing. After the contract expires – and the company does not explicitly address the make-or-buy option – the activity is simply sourced from the incumbent or a new supplier.

\(^{51}\) PAC (2003) reckons that currently 33 percent of IT related outsourcing contracts in Germany are captive. The proportion of captive suppliers is decreasing since most of these large company subsidiaries did not succeed in the external market.

\(^{52}\) Consider the example of Germany’s largest public transportation provider Deutsche Bahn AG. Catering, food services and logistics are exclusively provided by the fully-owned subsidiary Mitropa AG. The relationship is budget-based and the subsidiary charges monopoly prices within the captive market. It is questionable whether such relationships provide access to sustainable strategic benefits be they efficiency gains, performance improvements or business innovations.

\(^{53}\) IDC (2002). These projections don’t incl. cross-selling revenues of providers which offer IT or project services in conjunction with BPO.

\(^{54}\) Gartner (2003).
Advantages and Goals when Outsourcing

A multitude of academic and news media literature on the topic of outsourcing can be found (and screened). But only little empirical work has been done to distinguish the beneficial facts or threats in outsourcing from exaggerated claims. Therefore, the author are aiming to examine in the chapters before the facts in outsourcing and whether it really means job losses, crisis or just a part of modern economic structures.

Outsourcing can reduce costs in companies, increase efficiency, flexibility and adaptability and result in other improvements. Offshore outsourcing requires free trade and free capital mobility. Furthermore, offshore outsourcing, as well as trade and competition in general are beneficial for the country of origin and the country of a new source.

Furthermore, outsourcing is a welcome opportunity for private corporations to escape governmental regulations, for example taxation, environmental restrictions, and hours and wage laws. Furthermore, it reduces incentives for raising productivity. When jobs in one sector (like the service sector) are outsourced, other sectors can be affected and gain from that. As practicing firms of outsourcing become more efficient, they produce more cheaply, and hence can provide inputs to other sectors at lower prices. This in return lowers the costs of other firms, reduces their prices and leads to higher demand, which leads to higher consumption for their goods.

In practice, outsourcing has produced mixed results. Some companies who were required to hire off-shore talent by investors, reported communication barriers and high foreign personnel turnover rates. They would often ask for one thing, but be delivered a different item. Communication between domestic and offshore teams, as already mentioned, is a must. Attrition in the offshore company is another issue.

Foreign outsourcing can also help to accelerate the formation of innovative products and services. This is an effect that has thus far been left unmeasured, but may be important. Some firms, especially those that rely on information technology, are using highly trained foreign technicians (for example in China, India) to build prototypes of new products or services. It might be possible to bring those new products and services to market more quickly and at far lower costs than developing them in the home country.

On the other hand, a variety of negative experiences with outsourcing. Peter Bars, Outsourcing Advisory Services Partner, said,

"Often, outsourcing for large companies has not been adding value. Service outsourcing has often failed to deliver on its promises in three key areas – standardisation, cost savings and

complexity. There are fundamental differences between product outsourcing and the outsourcing of service functions, differences that were sometimes overlooked but have now come to the fore."

Bars continued:

"Often outsourcing vendors and companies may have conflicting objectives, putting at risk clients’ desire for innovation, cost savings and quality. Moreover, the advantages envisioned do not always translate into cheaper, better or faster services. As a result, larger companies are scrutinising new outsourcing deals more closely, re-negotiating existing agreements, and bringing functions back in-house with increasing frequency. Looking to the future, outsourcing needs to be driven by the strategic needs of the business, not simply as a cost solution."

Therefore, it is crucial for successful outsourcing that companies ensure that outsourcing is undertaken for strong strategic reasons (not just for cost reasons). In-house capability must exist to manage the process from inception to execution. Furthermore the company should retain strong outsourcing advisory expertise that provides strong technical, financial and commercial skills but also fully addresses the necessary organisational and governance issues arising from outsourcing.

However, instead of simplifying operations, many companies have found that outsourcing activities can introduce unexpected complexity, add cost and friction into the value chain. Many companies substantially underestimate the extent of senior management attention and the expertise required to successfully manage outsourcing. Nevertheless, besides looking at the winners and losers in the outsourcing process, there are also sectors which are likely to be more “immune” against any outsourcing activities, which are hotels and restaurants or media, sports and health organisations.

Conclusion

To answer the critical question of the headline of this work if service outsourcing will be a way without a return, weather outsourcing is a path with or without the possibility to return, the author came to the following conclusion:

Outsourcing may and may not be a one – way scenario.

Every corporation is embedded in a different environment, works in different areas or branches and aims to reach different goals. Not one single company is like any other one. Therefore, a simple yes or no is not enough.

Different circumstances may occur that make a manager consider to re-insource the relevant areas or functions, he outsourced once. For example:

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56 Cf. Bars, P., Brown, J. (Deloitte), Calling for change in the Outsourcing Process, 2005, pp. 2-9
• The contract with the service provider is expired
• The quality of goods or services provided is not satisfying
• Other experiences in the outsourcing process lead to this decision (for example a corporation realises that the outsourced functions belong to their critical parts of the value chain and re-integrate the function)
• Any other reason (change of top management executive, ethical reasons, image, etc)

If once the decision to outsource has been made and the relevant steps have been executed, it is hard to reverse it, because:

• Outsourcing, the complex challenge, oftentimes involves huge amounts of additional capital for re-investments (human resources and/or capacities or infrastructure).
• The stronger the dependency on the external provider, the more difficult it is to re-integrate the relevant processes.
• It may be easier to obtain the relevant capital for financially strong corporations (e.g. multinationals).
• Insecurity in terms of usage of capacities occurs. It is hard for corporations to plan the workload of new capacities in the long term run. If capacities remain unused in future, the fix costs occur anyway.
• It is easier to re-integrate services than the manufacturing of components or products. An example: call-center services in the airline industry. Lufthansa outsourced their miles & more service-center to a call-center in Ireland. The provider was not able to come up with the service standards required (service level agreement). Therefore Lufthansa decided to re-integrate those services in-house. In order to make up possible image losses. This example confirms the statement, that it is easier for financially strong corporations to re-integrate areas.

The author of this article says: Yes, it is possible bringing it all back home, but it is hard to execute and conjoined with extensive cost investments. Again, the decision must be carefully elaborated. The critical factors for the decision will vary from corporation to corporation and its individual circumstances and situation.
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