The Outsourcing Advantage:
How to Leverage the Value of Your Organization's Human, Financial, and Technological Capital

Larry R. Heckathorn and Elizabeth Petro

The new human capital movement – which views people as the primary asset of any organization – has thrust human resources managers into a new, more strategic role. The increasing importance of traditional HR functions – such as recruiting, managing, and retaining employees – has made the HR director an indispensable part of the senior management team. In leading-edge organizations today, HR directors communicate regularly with chief executives and senior executives in the areas of finance and technology. HR directors seek assurance that the organization's employees will be supported adequately by financial and technological capital. At the same time, HR directors want to assure other senior executives that the organization's human capital is supporting the organization's long-term operational, financial and technological goals.

This new, more strategic role for HR directors has increased their need to understand the strategic advantages of outsourcing – not just in traditional administrative areas, but also in other areas, both within and beyond the HR function.

Outsourcing – a company's decision to use external companies to provide products or services that it used to provide itself – is an effective strategy used throughout the world by companies of all sizes and in all industries. By judicious use of outsourcing, a company can bring world-class skills, flexibility and best practices to each of its functions to achieve strategic focus and quantum performance and to enhance competitive advantage.

Outsourcing of HR Administrative Functions

The Hr director's first experience with outsourcing came when the HR function began outsourcing certain administrative functions, such as benefits administration. The marketplace of outsourcing firms available to handle benefits administration has grown dramatically. Some have product expertise, specializing in one or two types of benefits, such as pensions or 401(k) plans. Others have process expertise, specializing in one or more functions, such as data processing.

Yet others have a phase expertise, specializing in a specific phase of benefits, such as the preparing and mailing of benefits statements. Some organizations combine process, product and phase expertise in a turnkey operation. And, finally, some organizations handle not only benefits administration but other HR functions, such as payroll. To derive the maximum benefits from outsourcing an administrative function such as benefits management, the HR director must take a view that is not only operational but also strategic. A strategic view requires a fundamental review of the organization's core business and an appreciation of how outsourcing certain administrative functions, such as benefits outsourcing, might help the organization achieve its long-term goals.

Beyond Administrative Functions: The "Virtual Company"

The strategic view, however, need not be restricted to administrative functions. Once an organization's leaders (including the HR director) identify the company's core business, then they can consider outsourcing any function that is outside that core.

A truly strategic view requires that senior managers study all of their functions to decide which ones should be outsourced. For companies that are considering outsourcing for the first time, however, embracing this innovation may require stepping "out of the box" because close precedents in a particular area may be difficult to find.

Taken to the extreme, the outsourcing advantage can create a kind of "virtual company." The virtual company is the polar opposite of the traditional company with its expensive headquarters, seniority system, pyramidal hierarchy and command-and-control culture. Instead, it is a group of peers – often connected only via the internet – responding to opportunity. But outsourcing does not have to lead an organization to this degree of "virtuality." As attractive as the "virtual company" may be in our entrepreneurial era, large corporations need structure as well as restructuring; and they need policies as well as panoramas. When outsourcing any function, managers must exercise extreme caution – to prevent an "insourcing" backlash.

Furthermore, managers need to keep an open mind about insourcing some functions that may have been previously outsourced. Outsourcing is not an "all or nothing" decision. Some functions are better candidates for outsourcing than others, and different business units or functions will have different requirements.

Finally, some services that have previously been outsourced – if they are part of the organization's core competencies – may be good prospects for insourcing. In short, any consideration of outsourcing should also include an analysis of potential insourcing as well.

Identifying Core Competencies

Whether an organization is looking to outsource or insource, the process of strategic sourcing begins with the identification of core competencies – those vital few business processes at which your organization excels and which are the source of your competitive advantage.

In other words, what do your customers pay you for? A shoe manufacturer's core competencies, for example, may be the product design and marketing. A hospital's core competencies may be patient care and a specific medical specialty or procedure, while a credit union's may be customer service. All other business processes are non-core, and companies must determine whether they are essential to the business. Those that are not essential should be shut down or divested. Processes that are essential but non-core are candidates for outsourcing.

Companies have leveraged the value of their human, financial and technological capital through outsourcing in a variety of ways. In the HR area, outsourcing is possible in a wide variety of areas, including:

- *Benefits (e.g., group health and life insurance, company car)*
- *Payroll*
- *Recruitment*
- *Employee relocation*
- *Training*
- *Workforce management*
- *Outplacement*

In the financial arena, organizations are outsourcing:

- *Internal control/auditing*
- *Pension fund management*

- *Pension fund proxy voting*

In the technology/logistics arena, organizations have outsourced:

- *Computer programming*
- *Document imaging*
- *Fleet management*
- *Information technology*

This list is only the beginning. When we consider that virtually any company function may be successfully outsourced, the list of potential areas to be outsourced is long indeed.

Benefits of Outsourcing

Outsourcing – if properly managed – can yield a number of benefits, including improved:

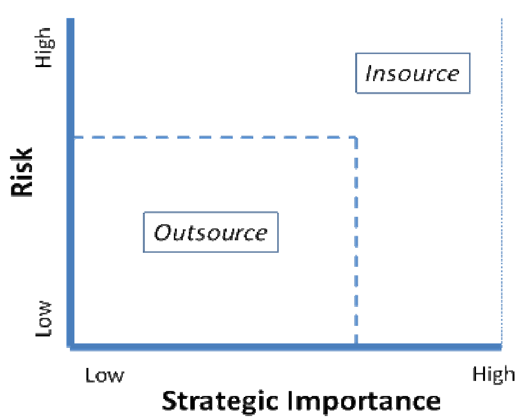
- *Employment flexibility (by giving companies an option to traditional full-time, permanent employment)*
- *Information management (by improving objectivity of information)*
- *Management effectiveness (by increasing management focus on core processes)*
- *Profitability (by reducing current operating costs, controlling long-term costs, increasing investment in and therefore potential returns from core competencies)*

Forming the Outsourcing Project Team

So how can senior managers – not only in HR but also in finance and technology – decide what functions to outsource and what functions to keep in house? One useful way to begin this process is to form an outsourcing project team to create and implement a process for considering outsourcing opportunities. Like any effective team, it should include people who will be affected by the decision to outsource. It should also represent a wide range of skills, from project management to risk analysis.

figure one: strategy/risk matrix

This figure illustrates how the strategic importance and level of risk of business activities can be classified for outsourcing consideration.



Identifying Opportunities

The first work of this team will be to draw up a "Strategy/Risk Matrix" (see Figure One). By plotting the organization's functions in this matrix, senior managers can see which functions may be safely outsourced and which functions would be best left within the company. After identifying opportunities in this way, the outsourcing project team can proceed to evaluate opportunities, select suppliers, implement the outsourcing arrangement/s, and monitor and evaluate performance.

Evaluating Opportunities

After identifying outsourcing opportunities, it is time to evaluate them. The objectives in this phase are to:

- *Specifically define the processes involved in each activity*
- *Determine quantitative reasons for outsourcing, assessing the cost of continuing the activity in-house vs. likely outsourcing costs including start-up expense*
- *Determine qualitative issues on outsourcing, such as risk factors and the loss of control*
- *Prepare a standard "request for proposal" for potential suppliers*
- *Prepare a business case for outsourcing each activity*

The business case should present a balanced picture of both quantitative and qualitative factors, current and anticipated, involved in the outsource/insource decision. Will a continued improvement effort underway in-house significantly lower costs in the future or during the life of the contract? What are the costs and risks of transferring facilities, equipment or people to an outside provider? In the end, what would be the net present value of outsourcing based on net cash flows?

Selecting Suppliers

This far into the process the focus has been inward, looking at the business itself. The objectives of the team have been to determine "whether" to outsource, not the "who" or "how" of outsourcing partnerships. At this phase, managers look outward to the marketplace, asking themselves, who provides the best product or service for the best price.

In some areas, the marketplace may feature a wide array of specialized organizations with a range of characteristics that can affect their ability to meet specific business needs. In other areas, only a few suppliers may fill the bill. The job of the outsourcing team is to:

- *Define needs*
- *Set forth proposal requirements*
- *Request proposals*
- *Assess proposals*
- *Interview suppliers*
- *Negotiate/write contracts, and*
- *Award contracts*

In this phase, the supplier selection process, the work becomes more technical, requiring more involvement from specialists. While assessing proposals, for example, it would be good to have the services of someone who has had purchasing experience in the focus industry. This may be a current employee (who may have had such experience at a former employer who also outsourced), or it may be an external consultant specializing in the industry. The processes of proposal analysis, supplier interviews and contract negotiations might be done by the same key individuals, or they may be split up by competency. A veteran attorney may make the best contract negotiator for example.

As the project team and their technical advisors move toward supplier selection, they should focus on the needs of their organization, not the capabilities of the supplier. Clearly, no organization should solicit vendors' and suppliers' "solutions" without a firm, unambiguous "need" that the solution will address. Service features that have no relevance to your business needs, such as a supplier's geographic proximity to one location when you have multiple locations, only divert attention from the issues that need to be addressed.

One important factor will be a willingness to go beyond merely being a supplier to being a co-venturer willing to help organizations make the difficult transition between insourcing and outsourcing. In assessing proposals, the team should go through several levels of analysis, including:

- *Capability assessment, which evaluates the experience and expertise of the supplier, as well as "due diligence" issues such as financial capability*
- *Technical assessment, to assume that specifications have been met and that any modifications or "improvements" are technically acceptable*
- *Contractual assessment, to ensure a match between contract provisions and outsourcing goals regarding key factors such as costs, delivery schedules, quality standards, and incentives for suppliers to ensure top performance*
- *Financial assessment, including identification of all relevant costs, inflows and outflows over time (such as the costs of any layoffs, relocations or consulting work that may be required)*

Implementing Outsourcing Arrangements

Moving any function from an in-house to outsourced activity requires a clear plan and schedule with deadlines, responsibilities and a detailed list of tasks. The schedule – whether organized on a simple calendar or displayed as a "critical path method" diagram – should include:

- *Selection of a "point person" to oversee implementation*
- *Initial announcement to affected employees and suppliers*
- *Pilot phase (if any) of outsourcing program – which may run before or parallel with the program*
- *Redeployment of people who may be moving to the supplier's payroll, to other positions in the organization or to outplacement*
- *Procedural monitoring during the transition*
- *Employee training in new processes*
- *Installation and/or removal of equipment*
- *Disposal or redeployment of assets or facilities no longer needed*
- *Deadlines for each stage of the transition process*
- *Full and timely communications throughout the process*
- *Cost management and oversight*

Communications should begin face-to-face and then move toward other formats. Managers should meet with their employees and key external contacts personally, so that they can answer any questions or concerns on the spot. All explanations should make a strong business case for outsourcing, explaining why it will improve quality as well as save money – and how the money saved may be redeployed. These front-line communications can build the teamwork and trust needed for a successful transition.

Monitoring: Locking in the Advantage

Outsourcing is not magic; it is a complex, long-term process that must be managed carefully from beginning to end and most importantly – beyond implementation. To "lock in" the outsourcing advantage after implementation, organizations must monitor the supplier's performance against agreed-upon performance criteria. Effective monitoring ensures that both the supplier and the customer organization spot and resolve problems as they occur.

Effective monitoring requires input from all parties – including all users of the newly outsourced function. Users should be informed of the organization's expectations and should give regular feedback. At least quarterly, management should meet with the outsourcing supplier to analyze and act on this feedback.

The Outsourcing Advantage

Improved service levels and long-term cost control will likely be an outcome when outsourcing any function to qualified suppliers. However, we caution companies not to use cost reduction as the sole outsourcing objective because short-term cost objectives limit the benefits outsourcing can bring to your organization. Some of the most meaningful benefits of outsourcing are intangible but still can create great value. Such benefits include increased strategic focus, flexibility, and responsiveness within the outsourced function. These benefits – far more than cost – can create a true outsourcing advantage.