Choose the Right Outsourcing Model for Organisation

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ABSTRACT

Organisations today find themselves at major crossroads with the need to choose strategic long term decision with regard to choosing their outsourcing model for various business needs. This article is a guide to the working managers to understand their outsourcing needs and also plan for the same.

Introduction

Outsourcing contracts having been part and parcel of human civilization since time immemorial. Today we frequently turn to professionals for major plumbing, air conditioner or car repairs, domestic chores, education for children, transport etc. While it has been practiced at family and social level for a long time, for business organizations too it is the one of long standing practices continuing till date. A very good example of the same is piece-rated compensation for products and services manufactured or sold.

Simply speaking outsourcing is a contract between two persons or organizations where one provides and the other receives some product or service at a contracted price. Economists refer to this process of turning to those who can produce a product or service at a lower marginal cost as “comparative advantage,” and consider it a key ingredient to an efficient and productive economy.

There have been a number of attempts in the past to put a restraint on outsourcing in the name of fair labour practices, social justice and equity in India and also protecting jobs in most advanced countries, but, outsourcing has managed to survive all such attempts.

Today not only private but even governmental agencies and departments have almost completely outsourced their administrative activities such as cleaning, maintenance, transport, surveillance, security, legal services etc. with a view to eliminate unnecessary administrative cost in extending welfare measures and retaining focus on planning and rolling out schemes alone. Businesses have long understood the futility of getting itself tied to routine non value adding activities such as bookkeeping, payroll processing or janitorial services which does nothing but keep on adding flab which becomes difficult to shed. Outsourcing also helps business organisations to tide over difficult organizational challenges and also for extending timely response for increasing business commitments where their own resources fall short.

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In a nutshell we can thus conclude that outsourcing practices are here to stay with us in different avatars.

Outsourcing Enablers

For long organization have been outsourcing one of their key functions, sales and distribution to distributors/dealers/C&F agents, the same has not been considered as outsourcing, though that is what it essentially is. Organizations in the past, have thought of outsourcing only for their non-core administrative functions but of late increasingly we come across examples where businesses have acquired operational leverage by successfully outsourcing even their core functions. This has led to a significant spurt in outsourcing contracts in our domestic business environment particularly in the services sector. The central philosophy which has been behind growth in outsourcing of core functions has been the realization that even core processes are made of large number of discrete subsystems, most of which are low value adding processes and hence can be outsourced to be executed at lowest possible cost without much value destruction.

There have been two major enablers for this spurt in outsourcing contracts in the present century. One is the complicated legal instruments and mechanism for their enforcement and the second is the development of sophisticated IT systems and ERP packages. This has made it possible for the organizations to monitor and control the performance of their contracts on real time basis and also take corrective action for deviations as quickly as they would have done for themselves.

Evolution of Long Term Outsourcing Contracts

Coupled with the above enabling factors is the ever growing need of the businesses to remain ahead of the competition and focus on their customer deliverables and relationships alone. As opposed to short term and medium term outsourcing perspective practiced earlier, today businesses and organization are known to take a long term view on outsourcing with a view to keep itself nimble & agile, and also, increase its focus on evolving product and service deliverables to maintain its lead over the competition.

An automobile company thus need not focus on critical and core activities such as manufacture of gear boxes, body parts, engine components etc. if there are others ready to take care of these activities at a much lesser cost without compromising on delivery schedule and quality. With variety of management processes and tools being available to control quality and delivery schedule from a vendor companies, the justification of retaining manufacturing processes in the name of critical activities is fast eroding.

Mapping Outsourcing Need

There are a number of reasons why an organization may need to outsource. For managers planning outsourcing of their business process it is very important to map out these needs otherwise there are chances that the outsourcing model the organization will adopt will be either sub-optimal or more than what is required.

Outsourcing needs can be grouped into following basic categories –

a) Augmentation of Human Resource for cyclic fluctuations

This represents one of the basic purposes of outsourcing. All organisations, other than military, functions with a set of manpower for which it has regular round the year job. However, to tackle the seasonal and temporary variation in requirement of either skilled or unskilled category of workmen necessitating short term engagement the organization has to enter into short duration contract for hiring of services of other organisations which may be having such labour force.

Example: Typically organisation engaged in project executions have such outsourcing models well entrenched in their system.
b) Cost and Efficiency Savings

There are a number of functions which do not directly touch upon or affect a company’s final service or product but are mostly required to keep in place the processes required for the final product or services meant for the customer. The cost of maintenance of these functions often are very costly to the company in the long run. Also there are business processes which a third party is in a position to do at a much lesser cost than the organization itself. In such cases it is wise to enter into outsourcing contracts.

Example: A hospital needs to carry out a lot of tests before arriving at a final diagnosis. With specialized diagnostic services readily being available a hospital may choose to outsource completely its diagnostic services. Canteen & pantry services is another example where an organization can achieve both cost saving and improved quality with outsourcing. Payroll processing and IT functions are another area where significant cost saving can be brought about through outsourcing.

c) Capability building

There are a number of processes required to give shape to the final product or service. An organization may lack capability of competency for one or other process within this chain. In such a case the organization will need to enter into an outsourcing contract with an organization which may possess such competencies or capabilities. Normally for such situations cost is not the only criteria on which outsourcing decisions are based. Rather at times acquisition of capability within a short time is the main criteria.

Example: A bank may choose to use other bank ATM for a fee instead of building its own network of ATM. Similarly in airline industry wet-leasing may take care of expansion need within a short time. Steel Industry of late has been getting into service contracts for adding value and customizing its products for the customer. Earlier all the processes related to the product were handled directly by the company itself. However, under pressure from customers to continuously customize the product steel industry is increasingly getting into outsourcing contracts for servicing customer needs.

d) Need for agility and nimbleness

The definition of core activity is under constant evolution nowadays. What core activity was till yesterday is non-core today. Manufacturing had always been considered a core activity for any business organization. However, in recent times there are a number of examples where organizations are increasingly offering even core manufacturing process to outsourced partners. The reason for this is that organisations today need to be very quick in adapting to the new business challenges and continuously evolve to retain its market leadership. What is liked and required by the customer today may not be so after a few years. So an organization too needs to quickly change its products and services. If the organization gets into processes which have taken long time to build, it is equally difficult to get rid of them within a short time. However if an organization does not own the manufacturing facility itself it can quickly get into new outsourced contracts to service new and emerging needs.

Example: There are companies in service sector today, especially in IT and telecom, which has outsourced almost all its functions and activities and retain only skeleton staff for monitoring these contracts. The residual core function for these companies are anticipating future technology trends and customer preferences. This type of business approach has been facilitated by an environment where a number of organisations have developed expertise to take care of operations needed for carrying out the business.

Choosing an Outsourcing Structure

Three basic outsourcing structures are predominantly used by organisations to cut operational costs, maintain operational efficiency and enhance the quality of business deliverable. These are augmenting workforce, out-tasking, project-based outsourcing.

The decision to follow one or more of the above depends on the following two basic considerations -

- **Strategic needs**: Each organization needs to know what is the strategic need of its individual processes and how much of it can be outsourced to strategic partners. There are instances where an organization is not secretive of its business processes and indicators and will not like to share
it with an outsourcing partner. For example in the cut-throat competition within the technology industry (gadgets, IT hardware, software etc) even though most of the manufacturing process is outsourced the company exclusively handles most of the activities leading to development of new products and technologies as there is a distinct advantage in being the first to launch a new technology or a product.

- **Risk Tolerance:** What is the risk involved in outsourcing decision and to what extent the same can be safely tolerated by the organisation is another very important determinant of any outsourcing decision. Typically in an environment where an organisation cannot afford any disruption in any of its basic processes outsourcing is avoided. The cost of disruption to the company is much higher cost than what one could gain as damages from the outsourced partner. For example a steel industry can today easily think of outsourcing its rolling and value adding processes downstream but, planning for outsourcing its input on the upstream is much difficult due to strong linkages on account of 24x7 operations and difficulties inherent in controlling chemistry for desired metallic properties. Further the managing agency in this type of contract models are very costly which in competitive market can become prohibitive.

![Fig. 2]

Workforce Augmentation

This is the most basic of all outsourcing models. One simply adds labour contracts to increase the job output while retaining full control on all resources. In addition to being the most basic setup, this has the least risk among all the outsourcing models. One may use this to expand current capacity to serve short-term immediate business needs.

**Out-Tasking**

If one can identify skill or capability gaps within the company's various processes, one may consider out-tasking. This setup transfers jobs to the contractor to execute jobs that could be done in-house. In this type of outsourcing model the outsourced partner shares higher degree of responsibility for maintaining the job output and quality of service. The Examples of out-tasking contracts are software deployment and integration, transportation, Stock Keeping Units, value-adding process in steel industry etc.

**Project-Based Outsourcing**

These types of contract models are adopted for turn-key projects where one cannot comprehensively define, design and execute the tasks. As such, the best solution for your company is to outsource the whole project. In this setup, the outsourced partner has all the necessary competencies and capabilities to complete a project. Mostly day to day monitoring may not necessitated but the focus of the contract is on handling over final deliverable once the contract project is over. This can be as short as a one-time engagement. Examples of this type of outsourcing models are small and big project contracts.

**Limitations of Outsourcing**

As one evaluates the outsourcing choices, one should keep in mind both advantages and disadvantages of outsourcing. One should look at each one of the outsourcing disadvantages listed below and decide what impact it would have on the business. If the outsourcing disadvantages outweigh the advantages of outsourcing then one should avoid outsourcing those operations.

- **Loss of Managerial Control:** Whether one decides to outsource an entire business process or a small part of it, one has to relinquish some amount of management control. The outsourcing partner will have its own priorities which at times will not always match with the priorities, standards and mission that drives the company. They will...
be driven to make a profit from the services that they are providing to an organisation or Business.

* **Hidden Costs**: All aspects of contract is normally not envisaged at the time of execution of a contract. Very typically and outsourcing contract covers only basic terms & conditions and details of the products and services that the outsourcing partner needs to deliver. Many a times organisations have encountered situations where they end up paying substantially for additional items not mentioned in contract. Many organisations also entail high legal fees to review the contracts and also to resolve disputes pertaining to the contract. Remember, this is the outsourced company's core business and in many situations the outsourced partners are protective of their interests fully aware of the business implications of various terms and conditions whereas the company outsourcing are playing on unknown turf and are thus in disadvantageous position when the negotiations start.

* **Security & Confidentiality Risks**: The life-blood of any business is the information that keeps it running. If one has payroll, medical records or any other confidential information that is to be transmitted to the outsourcing partners, there is a risk that the confidentiality of these data may be compromised. Thus whether the outsourced function involves sharing proprietary company data or knowledge (e.g. product drawings, formulas, etc.), needs to be taken into account while taking outsourcing decision. It is very important therefore to evaluate the outsourcing contract carefully to make sure that the data is protected and that the contract has a penalty clause if a leak occurs.

* **Quality Problems**: In case of short term outsourcing models the outsourcing company is largely motivated by quick profit. Most of the time the price is determined by the contract and the only way for outsourcing partner to increase profit is to decrease expenses at the cost of quality.

* **Getting Tied to the Financial Well-Being of Another Company**: Since one is handing over part of the business process to another company, one gets tied up to the financial well-being of that company. It is for this reason advised that outsourcing contracts shall be drafted with win-win philosophy rather than win-lose one.

* **Bad Publicity and Ill-Will**: This is a typical concern in western countries and European countries in particular. Any bad public relation on part of the outsourced partner has very bad effect on long term business prospects of the principal in terms of its business. Further there are risks of the the outsourced partner misrepresenting or misusing the brand of the principal. For example there have instances of outsourced partners passing off spurious material by misrepresenting it to be product of reputed producers.

**Developing an Outsourcing Plan**

The goal of outsourcing is to provide the company with more profitable margins. One should first look at one's cost structures, study the available outsourcing options, and decide which to apply based on one's strategic priority and risk tolerance. It is very important to develop a comprehensive understanding of one's comforts and areas of difficulties for deciding what to perform in house and what tasks, processes or projects to outsource. In case one is planning to outsource a task or process previously performed in house it is advisable to begin with staff augmentation and gradually move towards more complex outsourcing models to minimize the risk of major disruption in business deliverables. A major challenge in such situations is development of the competencies of outsourced manpower which is easier said than done. Further it is very important to work on the desired relationship with the outsourced partner and steer it towards the direction one is comfortable with. If one perceives them as a long term business partner, then it is more meaningful to enter into a mature outsourcing models giving them too a long term strategic focus. It is quite natural that the outsourcing partner will not like to make major investments unless assured of long term business.

Business strategies change over a period of time as the company grows. It is therefore very important not to have outsourcing strategy for a very long period as it may impede rather than furthering the growth of business. One should always be on the lookout for a business process that is suited for present need and provide necessary cost and efficiency leverages for business development.
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