Outsourcing: What are the real costs?

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Abstract: - This paper focuses on outsourcing as a strategic tool to optimize internal process in a company. Companies which consider outsourcing of their noncore processes and activities face the question of real costs generated by the decision. Different models and calculation formulas have been introduced so far but the main question has remained: What are the real costs? Many authors have discussed the problem of hidden costs of outsourcing which theoretical models do not cover. How to identify the hidden costs and where they come from? This paper looks for the answers and describes the origin of the hidden costs.

Key-Words: - Outsourcing, Outsourcing framework, Costs, Hidden costs, Key factors

1 Introduction

Present business environment is generally described as turbulent. Companies in order to stay competitive and to keep their pace are literally "forced" to pursue every new opportunity if they tend to leap ahead. One of the decision companies has been facing for quite a long period is the decision whether transfer certain activities and processes to a third party company or whether invest time, money and energy and carry out all necessary processes and activities inside on the soil of own company. This problem is so called "make or buy decision" and the company compares transaction costs which are related to buying services, technologies or products in the market and the price of carrying out all processes inside the company. So we find out that the outsourcing decision of the company is influence by transaction costs and production costs.
Snieska, Vasiliauskiene and Asta [10] state that Global trade environment has changed in three major ways in recent decades. "International trade has grown rapidly in value and volume, the composition of trade has altered significantly, and trade flows have been extensively liberalized." Boguslauskas and Kvedaraviciene [1] say that most companies often consider outsourcing as a solution without understanding and evaluation the true strategic rationales for making the final decision.
Outsourcing has become an essential part of companies' strategy and enables managers to stay focused on the key processes and key activities of their business. "A basic premise of outsourcing is that firms should concentrate internally on activities that are strategically important to them, and through which they are capable of generating sustainable competitive advantage." State Midambi and Tallman [8] That means other activities which are not strategically important should be outsourced to precisely chosen business partners that can offer economies of scale, greater focus, and organizational learning benefits, and to whom these activities are core activities says Vanketesan [13].
Whitfield and Joslin [16] point out that most of the potential outsourcers in all industries generally assume that outsourcing would work for them on a "plug and play" basis. That means company will only have to absorb limited costs before large savings can be realized and furthermore, that offshoring of workforce will generates over 60

percent savings. Based on research, reality speaks about 10 to 15 percent savings for highly commoditized services areas and 40 to 50 percent in optimal circumstances. So looking at these numbers one question might rise up immediately. What are the true costs of outsourcing or to be more specific – What are the hidden costs of outsourcing?
This paper describes the key element of outsourcing with the focus on costs generation through different stages of outsourcing partnership and answers for the question: What has been revealed so far about the real costs related to decision to outsource processes and to life cycle of business outsourcing partnership between companies. To conclude the introduction there will be defined the two dimensions of outsourcing:

	Local	**Abroad**
Do it yourself	Locally Integrated	Multi - National
Outsource	Local Outsource	Offshore

Fig. 1 Outsourcing decisions, [Author]

As the chart above defines, companies decide whether to carry out the processes inside company (local or abroad) or they buy products and services in the market (local and abroad). Local outsourcing means that companies look for the partner in their domestic counties (outsourcing of HR or Accounting). As an advantage of this solution it is considered easy control in place and in personal communication. Abroad outsourcing so called off shoring is a typical case of automotive manufactures (Porsche in the Slovak Republic, TPCA in the Czech Republic etc) and the companies enjoy significant cost savings in compare with the manufacture in Germany (German wage policy) and Japan (also Japanese wage policy plus shipping costs etc).

2 Problem description

As it is mentioned above, desired “plug and play” effect of outsourcing followed by 60 percent cost reduction belongs into theoretical outcome of outsourcing. Whitfild and Joslin [16] states that effect of cost reduction reaches 10 to 15 percent in the area of communized services and might reach up to 50 percent in optimal circumstances. Kumar, Holden and Igo [6] point out that there is a certain risk in overrating the value of wage savings and overestimating the inventory, obsolescence, and intellectual property and currency risks associated with outsourcing. Hogan [3] adds the warning of logistical risks incurred when a new business partner responsible for a supply is located further from current customers than existing “in-house” solution.
However, many outsourcing frameworks tend to focus on the cost implications of the outsourcing decision. Early approaches were based on quantitative models to evaluate the decision make or buy say Gambino [2]. Lately, the concept of transactional costs and its minimization influenced some of the approaches proposed in the literature write Vining and Globerman [15]. Syaripah *et al* [11] defines the Transaction cost theory (TCT) as the economic theory used in order to decide whether to outsource a function or not. TCT implies total cost which
consists of production cost and transaction cost.
Holcomb and Hitt [4] have challenged the predominance of cost considerations in the outsourcing decision with the scant attention being given to how the decision impacts the long term capabilities of the organization. Recently, modern outsourcing frameworks argue that a strategic focus should be given to the decision in an operative context, which involves more than an analysis of costs say Wu *et. al.* [17].
Being more specific, some case studies have revealed basic costs groups which should be calculated while considering the outsourcing plan. There are several costs group related to outsourcing which must be covered in decision making process. Kumar, Holden and Igo [6] point out following:

- Cost of lost costumer
- Labour costs
- Material costs
- Trends in prices
- Shipping costs
- Trends in ocean freight prices

A different view on costing the outsourcing is determined by Whitfield and Joslin [16] whom describe outsourcing as life cycle. This cycle consists of following:

- Contracting phase
- Transition phase
- Execution phase

- Other costs

Authors underline the importance of the other costs calculation which is mostly related to monetary risks such as foreign currencies fluctuations, labor rates, inflation index etc. Company should also consider tax implications and finally the sacrifice of owning the process and related risk of dependency on the service provider.
Tadelis [12] state that in a Deloitte Consulting survey of 25 world-class organizations from various fields of business was not concluded encouraging result.

- 25 percent of companies had brought business processes back in-house after realizing they are able to complete more work at lower costs.
- 44 percent companies surveyed reported that outsourcing did not save any money.
- Nearly 50 percent identified hidden costs as the most common problem when managing outsourcing projects.

In 2006 *Information Week* carried out a survey of 420 business technology professionals with similar results as Deloitte Consulting reported. Participants were asked to rate services provided by their outsourced vendors in different categories on a scale 1 to 10. Report stated only reasonable satisfaction with vendors' performance and generally disappointment with the cost – for – value of the service.

- 45% attributed failures were related to poor services and lack of flexibility.
- 39 % pointed to hidden costs as serious problem.

So the question here is: What are the hidden costs of outsourcing? Tadelis [12] says: "The tension between the buyer's wish to buy at a low price and the seller's wish to sell at a high profit margin, at the heart of the problem lays a conflict of interest that is present in any outsourcing relationship." So it indicates that the strategy of outsourcing itself influences the success and satisfaction of outsourcing results. This is where the partnership should begin. Following diagram indicates where the strategy "creation" should begin:

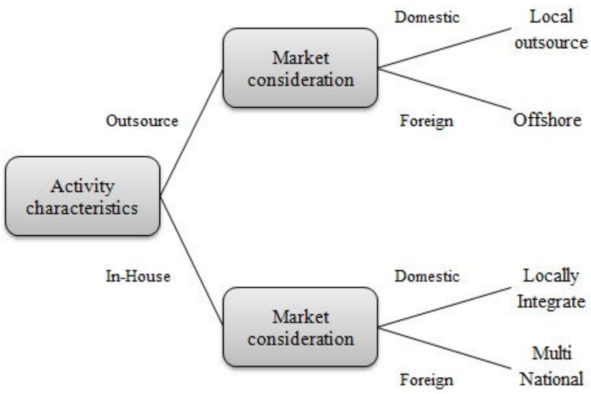

Fig. 2 Process of outsourcing strategy, [12]

3 Problem Solution

Pellicelli and Meo-Colomba [9] define the core phases of the outsourcing strategy which consist of:

1. Allocation of outsourcing as a part of the general strategy.
2. Chose of which activities to outsource.
3. Chose the outsourcer.
4. Negotiation of the contract.
5. Transfer of the outsourced activities to the supplier.
6. Set the appropriate outsourcer – supplier relationship.

The authors distinguish between the partnerships with direct control over the outsourcer in the form of corporate or formal control and the outsourcing of supplies without direct control in the form of partnership. They state that modern tendencies indicate that relationship between the firm that outsources and its supplier exists without formal corporate control.
From another point of view Jennings [5] identifies the following necessary steps:

1. Define the long term strategy for the function to be outsourced.
2. Consider the impact of the decision to outsource on the achievement of the mission and strategies of the organization, including costs, quality, flexibility, and the meeting of deadlines.
3. Consider changes in the environment that require a change in strategy.

Several outsourcing models have been introduced in past few years. Vasiliauskiene, Snieska and Venclauskiene [14] describes following models and their stages:

Welch and Nayak's model from 1994 begins by evaluation of technologies, continues by assess process maturity, assess technological state of competitors and finally makes preliminary decision. The final result of their model is a model of outsourced activity.
Probert's model from 1996 begins by identification of business actualities and continues by definition and evaluation of the structure and production technologies assess technologies, subsystems and selections and ends by preparation of strategic recommendation and implementation plan. The result is a vertical analysis.
McIvor's model form 2000 defines the main activities of the company, assess adequate activities of value chain, analyse the main activities of the company and carries out the analysis of interrelationship. The result is a vertical analysis too.
Fill and Visser's model form 2000 is based on the research of related factors, strategic and structural factors. Researches the cost related to the performance of the eligible function and evaluates the management. The result is a model of outsourcing activity.
Arlbjorn's model from 2004 starts by planning the activities of the process, reviews these activities, evaluates their profitability, carries out the research of possible suppliers and makes the decision. The result is a vertical analysis.
Sink and Langley's model from 1997 identifies the need to use logistics outsourcing, reconsiders all possible alternatives, assesses and chooses a supplier and implements the outsourcing project. At the end assesses performed activity. The result is a model of outsourcing.

Vasiliauskiene, Snieska and Venclauskiene [14] state that models of outsourcing based on transaction cost are not comprehensive enough. The reason of their statement is hidden behind the focus only on superficial analysis of outsourcing strategy which depends on different external and internal environmental factors without presenting any integral attitudes to the establishment factors. So it has been revealed that the analysis of outsourcing transaction cost should include following:

- Macroeconomic factors of the host country
- Factors that are regulated and influenced by the government of the host country
- International factors of global market
- Company factors and the factors influenced by the company

So it gets back to the basic question: What are the hidden costs of outsourcing and how to calculate these costs? Tadelis [12] would answer that these additional or hidden costs exist between buyer's wish to buy at low price and the seller's wish to sell at high profit margin. In addition, there are several issues that might root into other hidden costs:

- Geographical distance – transportation costs can cause significant lost if they are not calculated properly. These costs might consider market development, especially the oil price.
- Languages and cultural distance – quantification of these costs might we pretty tough and they are often underestimated. A company must consider and analyse the impact of language and cultural barriers.
- Regulatory and policy distance – Foreign policy in most cases differs from domestic. This fact might be beneficial for a company as well as may cause additional costs which are not covered in calculations.
- Legal distance - A company should not forget to analyze the legal system of foreign country, the jurisdiction and foreign laws specified in the contract.

What is the role of a company? Recent findings indicate that the role has transformed from "Production management" into "Integration management" as it is described on following figure:

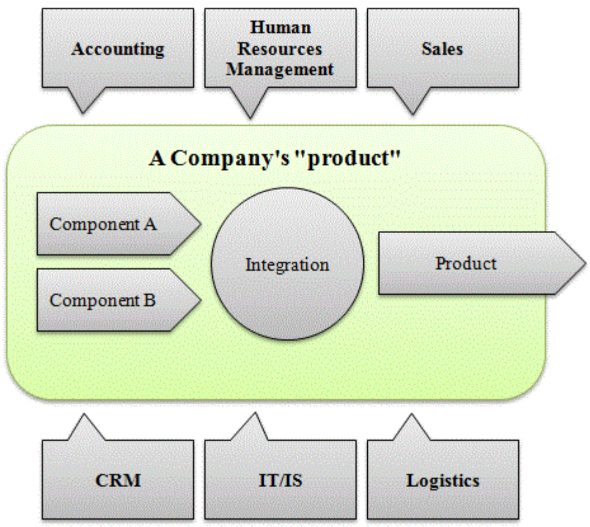

Fig. 3 Evolution of integration management, [12]

Whitfield and Joslin [16] underline the importance of the monetary risks calculations such as foreign currency fluctuation, interest rates, inflation index

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etc, in the other word – the calculations of macroeconomic factors. Based on the previous findings it is possible to define the key factors of outsourcing:

1. Processes identification

Flow of the process, its constraints and dependences must be described into perfection. When outsourcing certain process (activity), complete description of that process must be explain to our business partner in order to ensure quality and time.

2. Costs analysis and costs nature

To distinguish between fixed, variable and semi-variable costs it is necessary to carry out in-depth analysis. The analysis should be used as the background in decision making process of which activities can be outsourced.

3. Quality of suppliers' services

This factor is one o the most important in "outsourcing" partnership. The company has to consider experiences of the outsourcer.

4. Analysis of macroeconomic environment

Certain factors such as tax policy, foreign trade policy, volatility of markets (foreign exchange, price of oil, price etc.) must be considered as a drop in (for ex.) EUR/USD currency rate might cause unexpected extra costs.

4 Conclusion

Findings in this paper indicate on the importance of creating the proper outsourcing strategy and the plan as well as the certain limits of current outsourcing models and frameworks based on transaction costs calculations. The independent results carried out by Deloitte Consulting and Information week reported that 30 to 40 percent of companies were unsatisfied with their outsourcing results in the term of price, quality and flexibility and barely 50 percent companies interviewed described the hidden costs as a serious problem.

How do company avoid the hidden costs? Although there are several outsourcing models available and key stages and factors are defined, the optimal formula for outsourcing evaluation is far from reach as there are many unknown factor to be properly evaluate.

After all, there are many advantages of outsourcing such as:

- Production efficiency (focus on What, not How)
- Using market mechanism
- Focus on core business and efficiency incensement

However, there are several disadvantages too:

- Cost of describing and enforcing performance
- Costly changes adaptation
- Exposing yourself to opportunistic bidding
- Losing expertise that might be valuable in future

One of the advantages of outsourcing which has not been discussed yet is the costs behaviour impact. In many cases the company might transform its fixed cost of a certain service or process into variable cost simply by outsourcing it. The company can buy precise amount of "work hour" instead of employing own worker. A typical case might be IT services department [7].

Based on the theoretical knowledge of the topic and practical results and experiences, the new frameworks and models using qualitative indicators along with probabilistic calculations (focused on macroeconomics indicators) should be introduced.

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