Reversing Course?

Survey sheds light on pitfalls of outsourcing

by Jerry H. Seibert and William A. Schiemann

In 50 Words Or Less

- In a recent survey, almost all responding organizations indicated they outsource functions, but most have not met or achieved service, quality and productivity goals.
- For outsourced functions, internal service levels were frequently disappointing.
- A more holistic approach with less emphasis on cost savings may lead to fewer outsourcing failures.

THE OUTSOURCING OF FUNCTIONS once performed by organizations' internal departments has been increasing in quantity and scope. What began as an effort to shift low-value activities to outside suppliers has steadily grown to the point at which virtually any function may be subject to outsourcing: from corporate administrative functions (such as IT, finance and HR) to basic production and R&D.

Even activities once thought of as an organization's core strengths, requiring unique expertise and producing competitive advantage, are candidates for external procurement for some.

"Originally, everyone was trying to figure out what's a core competency and what's noncore," John Lutz, general manager at IBM's managed business process services, told *Forbes* magazine. "I don't hear much of that anymore. In some cases, just because of scale or expertise, someone else can do a better job than they can, even if it's essential to their business."[1]

Outsourcing is exceptionally popular. In a recent study conducted by ASQ and the Metrus Group, a research and consulting firm, nearly 94% of the 1,920 participants reported their organization outsourced at least one of 15 important functions. Yet almost one in four described their typical supplier relationship in dysfunctional terms, such as "guard-inmate" (trapped in a contract) or "predator-prey" (always looking for advantage).

Perhaps it shouldn't be surprising that a majority of organizations have not met, or even mostly achieved, their outsourcing goals. Financial goals are the most likely to be met, but service, quality and productivity goals lag behind. Figures 1-4 show how often each type of goal is met or not met.

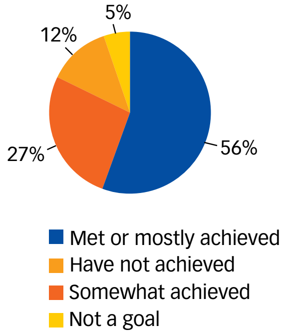
The study examined outsourcing and offshoring, as well as their effects on key organizational outcomes, including costs and benefits, levels of alignment and engagement, implications for capabilities, levels of quality and productivity, and internal service quality.

The study also addressed whether successful implementation of outsourcing—including quality and satisfaction metrics, not just financial targets—is more likely with some types of shared services than others.

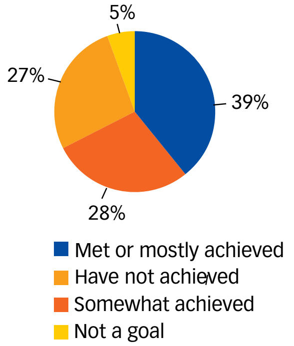
About the survey

A total of 1,920 people responded to the online survey, which was conducted in January and February 2011. Respondents included ASQ members, customers and

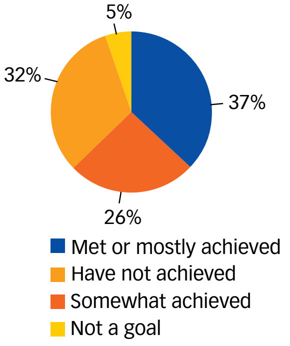
Financial goal achievement / FIGURE 1



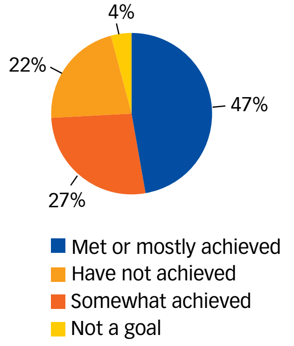
Internal service goal achievement / FIGURE 2



Quality goal achievement / FIGURE 3



Productivity goal achievement / FIGURE 4



Survey participants / TABLE 1

Most frequently represented industries	Respondents
Manufacturing and industrial products	321
Pharmaceuticals, biotech and medical devices	164
Professional services	164
Aerospace	104
High tech	86
Healthcare services	61
Defense	55
Transportation and automotive	47
Oil, petroleum, plastics and chemicals	39
Government	36
Consumer products	33
Utilities and energy	26

Survey participants—organization size / TABLE 2

No. of employees at organization	No. of respondents
100 or fewer	299
101 – 500	353
501 – 5,000	338
More than 5,000	300
Not reported	630
Total	1,920

a sample provided by Metrus Group. More than half the participants (64%) were managers or executives employed by organizations in a wide range of industries. A summary of the most frequently represented industries and a breakdown by organizational size is provided in Tables 1 and 2.

Participants were asked:

- What are the most important attributes for internal and external suppliers? What are the top causes of supplier failures?
- What goals have been set for outsourced functions? To what extent have they been met?
- What functions have been outsourced?
- What are the internal customer service levels for key functions—those that are in-house and those that have been outsourced?

While most organizations partially outsource some functions, it's unusual for a function to be completely outsourced. Table 3 displays the rate at which each function was reported as partially or fully outsourced.

Manufacturing/production was most likely to be outsourced (by 61% of the organizations), but it is rarely fully outsourced (only 7%). IT, security, legal and logistics were each partially or fully outsourced by 50% or more of the organizations. Security and legal were the only functions that were actually slightly more likely to be fully outsourced than partially outsourced.

Effect on internal service quality

When evaluating the impact of outsourcing on internal service levels, there are two perspectives to consider.

1. Does the outsourcing effort meet an individual function's goals, including maintaining internal service quality?
2. Does extensive use of outsourcing across numerous functions affect the general level of internal service within an organization?

Ideally, an organization highly experienced in outsourcing could be expected to avoid many of the

Extent of outsourcing for various functions / TABLE 3

Function	Partially outsourced	Fully outsourced
Manufacturing/production	54%	7%
IT	45%	11%
Security	26%	28%
Legal	25%	27%
Logistics/distribution	40%	10%
Facilities management	36%	10%
Marketing/market research	37%	4%
R&D	29%	2%
Finance/accounting services	26%	4%
HR	26%	3%
Communications/public affairs	25%	3%
Customer service	23%	3%
Sales	19%	2%
Procurement/purchasing	18%	2%
Quality	17%	1%

associated pitfalls. Lessons learned from one experience would improve later outsourcing activities and relationships. Because each outsourcing effort might involve a different function, however, organizations with limited collaboration or learning systems among departments would be less likely to benefit from multiple outsourcing experiences.

While a core goal of most outsourcing is cost savings, survey respondents indicated this was only partially achieved. Only 56% of the organizations achieved the financial goals associated with outsourcing. In this context, it is not unreasonable to predict that internal service levels will be less emphasized and thus negatively affected.

For example, an outsourced service will be handled by outside individuals who have less contact with colleagues within the outsourcing organization. Communication issues and a lack of institutional knowledge could easily lead to lower levels of service performance.

While it is true that most outsourcing includes some objective metrics for measuring the performance level of the service provider, these are typically transaction measurements. Excellent performance against such metrics will not capture the interactions between service recipients and service providers.

For example, the chief HR officer for a large global manufacturer that Metrus Group has worked with was dismayed to find managers providing negative feedback regarding the recruiting function, which had been outsourced the previous year. The common recruiting metrics of time-to-fill-positions and number of open positions indicated the service provider was doing at least as well as the former HR staff had done.

Unfortunately, those metrics did not reflect the actual experience of the hiring managers. Those managers found that the recruiters, with less knowledge of the organization and less experience with the technical engineering roles that needed to be filled, required a great deal of handholding. As a result, the managers were spending more hours personally involved in the recruiting process than they had previously.

Furthermore, high rates of turnover within the service provider meant the managers were often retraining their designated recruiter. These issues led to a decreased level of satisfaction with recruitment by the hiring managers, despite the apparently satisfactory transaction metrics.

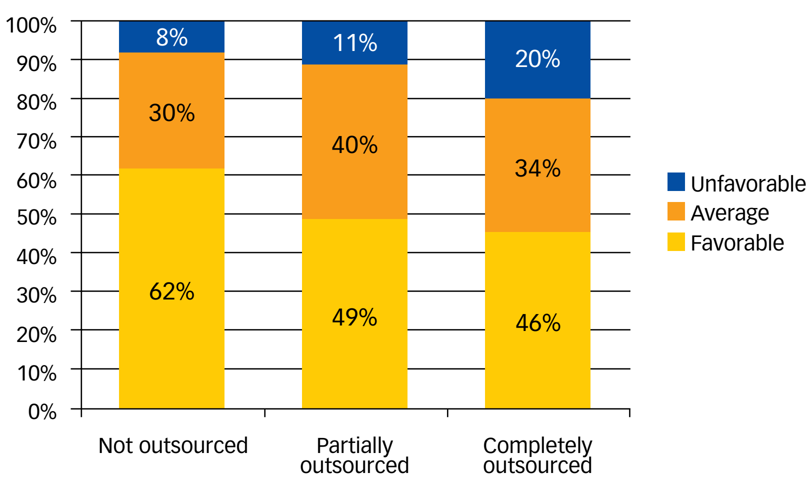
This situation indicated a hidden cost to outsourcing. While the service provider was delivering services at a lower cost than that reflected by the previous recruiting budget, there was no method to account for the labor cost of managers who needed to be more involved in the process. Because this had no effect on the HR budget, it led to an overestimation of the financial benefit of the outsourcing.

For 14 of the 15 functions assessed in this study, results indicated that the more a function was outsourced, the lower the level of internal service ratings. In other words, the average partially outsourced function received fewer favorable and more unfavorable ratings than one that was not outsourced at all.

When the function was fully outsourced, it received the lowest levels of favorable ratings and highest levels of unfavorable ratings. Frequently, fully outsourced functions received twice as many unfavorable ratings of those that were not outsourced at all. Figure 5 illustrates this pattern, using the average across the 15 functions.

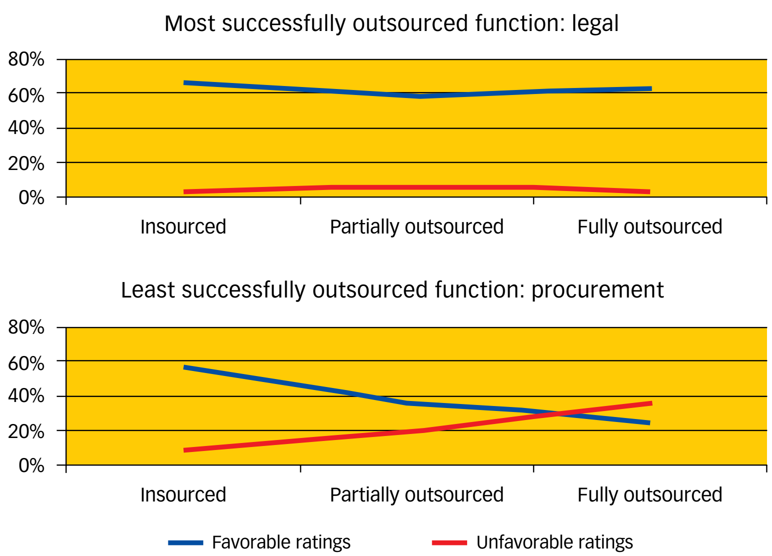
These results indicated that on a case-by-case basis, the outsourced functions have failed to maintain appropriate levels of internal service quality. The only function that did not display this pattern was legal. There, fully outsourcing the function produced service levels comparable to in-house departments. Figure 6 contrasts legal and procurement, re-

Outsourcing vs. internal service / FIGURE 5

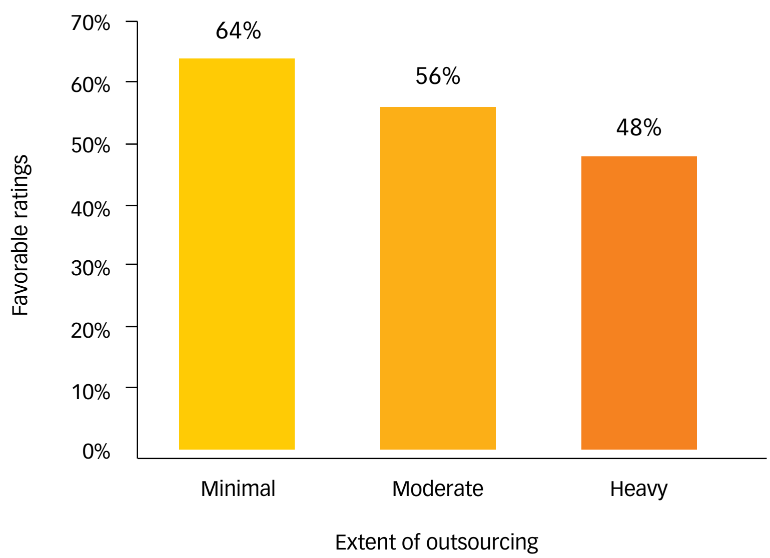


spectively the most and least successfully outsourced functions in terms of internal service quality.

Outsourcing highs and lows / FIGURE 6



Outsourcing and internal service quality / FIGURE 7



Broad outsourcing: boost or barrier?

Let's examine organizations that do a considerable degree of outsourcing: Do the organizations that outsource broadly see more success with their efforts? The survey analyzed organizations that were heavy outsourcers (those outsourcing eight or more of the 15 functions), those with moderate levels of outsourcing (three to seven functions) and those that did little or no outsourcing (two or fewer functions).

The results provide little support for the theory that organizations that make heavy use of outsourcing are effectively learning from their experiences. Figure 7 reveals a lower level of internal service quality found as organizations increase the amount of outsourcing.

How do these results affect overall business performance? Prior research has indicated that high levels of internal customer service are associated with better business performance on a number of metrics.[2, 3] If organizations that rely heavily on outsourcing are trading some direct cost savings for generally lower levels of internal service, their overall business performance may suffer.

To verify this, the study examined financial performance, productivity, external customer satisfaction and quality outcomes, and found a consistent pattern. The more likely the organization was to outsource multiple functions, the less likely it was to be among the leaders in its industry for business performance metrics. In fact, heavy outsourcers were 10% less likely to be among the top performers in quality, customer satisfaction, productivity and financial performance.

The study also addressed whether there was an impact on people equity[4]—the degree of workforce alignment, capabilities and engagement among the organization's employees. No correlation was found between these factors and the extent of outsourcing by an organization.

Supplier failures

The results of the study indicated that from a service quality perspective, outsourcing fails to meet its objectives. This failure may translate into hidden or indirect costs. Furthermore, organizations that heavily outsource are less likely to be leaders within their industry on key business metrics.

Finally, while a slight majority of organizations reported meeting or at least mostly achieving their financial goals for outsourcing, less than half claimed to have met service, productivity or quality goals. What are the reasons for these failures? Respondents were asked to indicate from experience what they believe are the top three reasons for supplier failure.

Regardless of how much outsourcing the organization was involved in, the No. 1 reason cited for failure was supplier capability issues—insufficient skills, knowledge or resources. This finding begs the question of what criteria were used to select the supplier.

Perhaps organizations are placing too much emphasis on cost without developing enough knowledge of their suppliers' capabilities to be able to make an informed decision as to who should earn the contract or whether it should be outsourced at all. A more balanced or holistic evaluation might reduce this source of failure.

The second most common reason for failure was communication issues. Communication breakdowns and inadequate buyer-supplier collaboration make it difficult to align a supplier with the main organization. Each of these problems was cited by 40 to 50% of the respondents as a top reason for supplier failure.

There were two reasons for supplier failure that differed notably by the level of outsourcing: performance standards and supplier management. Only 26% of minimal outsourcers cited unclear performance standards as a top reason for failure, while 38% of heavy outsourcers mentioned this reason. Similarly, supplier management issues were cited by 22% of minimal outsourcers and 32% of heavy outsourcers.

These two issues point to internal capability problems. Setting performance standards and communicating them is the responsibility of the outsourcing organization and should be addressed as part of the vendor selection process.

Supplier management is clearly the responsibility of the outsourcing organization. Planning and ensuring adequate resources for supplier management is a surprising failure point, even more so because it was more often an issue with heavy outsourcers.

There was a distinct pattern when examining how often outsourcing goals were met (on average) compared to how the respondents described the typical supplier relationship at their organization (Figure 8).

To the extent that organizational culture influences the relationship with suppliers, this may indicate the pattern of failure is partly related to organizational culture. Future studies should further examine this possibility.

Insourcing more?

How often do supplier failures lead to insourcing a function that had previously been outsourced? This is an important question considering the resources invested in preparing to outsource, selecting a supplier and managing the transition.

More than one-third of respondents said their organization had reversed course on at least one outsourced function—a significant failure rate. Another one-third of respondents said they were uncertain, meaning the true rate could be even higher.

The implications from a cost and lost productivity perspective are enormous. Participants were invited to explain the reasons for bringing a function back in-house, and the most common themes focused on having more control of service, quality and cost. Many respondents reported costs were not what they expected; there were surprises from suppliers, and internal costs arose that simply had not been anticipated.

In the end, many organizations (36% of the survey sample) determined insourcing was actually the more efficient alternative—after significant transaction costs associated with the failed effort were incurred.

Action implications

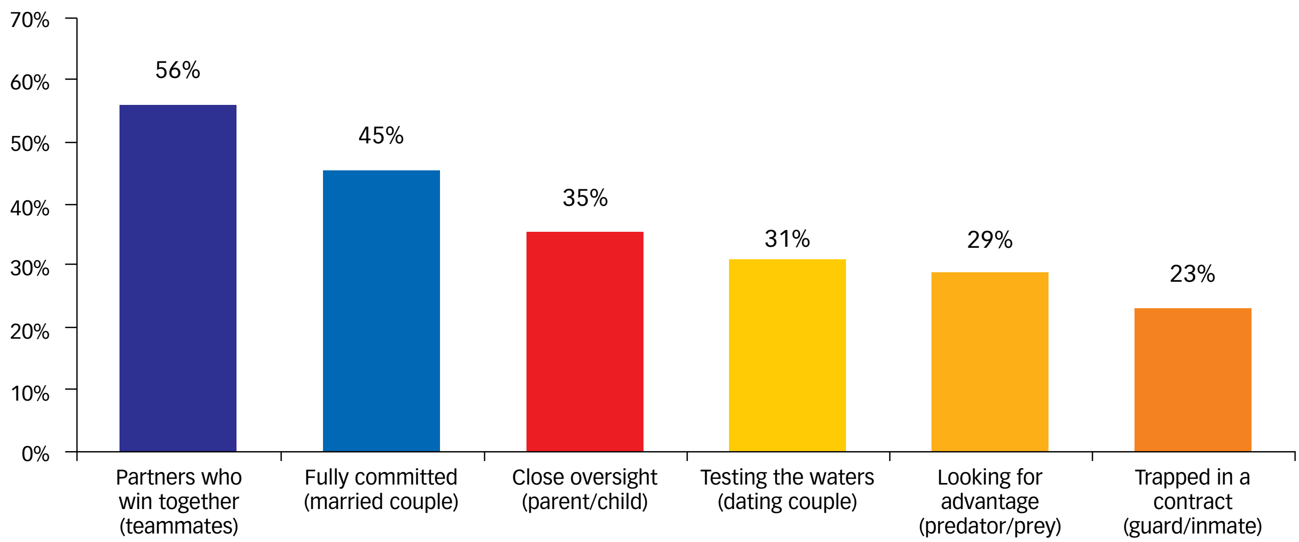
The overall findings of this study are alarming, given the transaction costs and displacement of talent that accompany outsourcing initiatives. When hidden or indirect costs and service quality are considered, the arguments for outsourcing appear much less compelling than the results that may be shown by a narrow cost and benefit analysis.

Less than half of the organizations in the study described their typical supplier relationship as one of partners who win together—teammates. Many described dysfunctional relationships or situations closer to a parent-child relationship in which constant, close oversight is needed. The further from a true partnership the relationship was described, the less likely the goals for the initiative would be met.

From the survey results and analysis, here are some recommendations for organizations that are considering outsourcing:

1. Clearly define and prioritize the goals. Beyond financial goals, spell out what you wish to accomplish. What are the quality objectives, customer targets or productivity goals?

Goal achievement by typical supplier relationship / FIGURE 8



2. Do not measure narrowly. Develop and use measurements that are more holistic, thereby enabling you to identify problems more quickly. For example, besides financial cost metrics, include metrics relating to quality, risk, productivity, customer outcomes, capabilities and engagement.

Expand your focus from efficiency-centered transactional measures to assessments of effectiveness, impact and internal customer perceptions. Measurements of partnering would be highly useful as an adjunct to direct performance measurements.

3. Evaluate your success and learning curve with each outsourced activity, and find ways to share that across functions. Instead of functions hiding their skeletons, make the skeletons visible—even revered—so others can learn and not repeat the same mistakes.

The study indicates many organizations take a narrow, cost-focused approach to outsourcing that can easily lead to wasted resources and, ultimately, to the re-insourcing of functions.

But outsourcing can be successful. Recall the example of the chief HR officer who was surprised to hear managers were unhappy with the outsourced recruiting function. That same organization took the internal stakeholder feedback and was determined to improve the situation.

Twelve months later, the internal service ratings by managers had improved significantly, and within two years, the issue was almost nonexistent. Using internal customer feedback in conjunction with more traditional metrics, they achieved their financial goals and maintained a high level of internal service quality. QP

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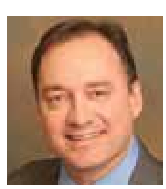
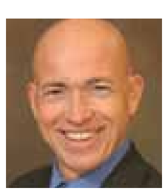


JERRY H. SEIBERT leads the survey and research practice for Metrus Group, a research and consulting firm based in Somerville, NJ. He earned a master's degree in industrial/organizational psychology from Western Kentucky University in Bowling Green.



WILLIAM A. SCHIEMANN is CEO and founder of the Metrus Group. He earned a doctorate in social psychology from the University of Illinois, Champaign-Urbana. His books include Bullseye! Hitting Your Strategic Targets Through High Impact Measurement *and* Reinventing Talent Management.