# 1 Introduction

A key issue to have emerged for many organisations has been the growing importance of outsourcing. The drive for greater efficiencies and cost reductions has forced many organisations to increasingly specialise in a limited number of key areas. This has led organisations to outsource activities traditionally carried out in-house. Outsourcing involves re-drawing the boundaries between the organisation and its supply base. Although, the term outsourcing has become in vogue in the last few years, organisations have always made decisions on determining the boundary of the organisation. However, the increasing prevalence of outsourcing has led to the concept receiving a significant amount of attention from both academia and practitioners. Outsourcing has progressed from involving only peripheral business activities towards encompassing more critical business activities that contribute to competitive advantage. On the one hand, outsourcing can involve the transfer of business support functions such as cleaning or security to external suppliers in order to obtain higher levels of performance at a lower cost with relatively little upheaval for the organisation. On the other, it can lead to major organisational change that involves dismantling the traditional structure of the organisation, transferring staff to external suppliers, re-defining staff terms and conditions and altering the expectations of the employees that remain within the outsourcing organisation. As a result, outsourcing has become an increasingly important and complex issue for many organisations.

Outsourcing often provokes contrasting reactions from a range of organisational stakeholders including business leaders, unions, employees, politicians and governments. For example, many business leaders regard outsourcing as a powerful vehicle to achieve performance improvements, whilst unions regard outsourcing as another weapon in the armoury of powerful businesses to further erode the terms and conditions of an already embattled employee. Governments and politicians have also become involved in both the debate and practice of outsourcing. Outsourcing has become an extremely political issue in developed economies such as the US and the UK as organisations increasingly outsource many production- and service-related activities to developing economies in order to avail of lower labour rates and more favourable employment legislation. Many governments in developed economies have also been employing outsourcing as a means of reducing the scale of large public sector organisations and accessing the capabilities of product and service providers in the private sector.

Where outsourcing is evaluated and managed appropriately it can be a very powerful means for achieving performance improvements and contributing to the strategic development of an organisation. Organisations can benefit greatly from accessing the capabilities of suppliers in a range of areas including catering, security, design, manufacture, marketing, logistics and information technology. In fact, the development of supply markets for a range of business services has precipitated the trend towards outsourcing and provided opportunities for organisations to enhance their own competitive position. However, many organisations have failed to achieve the desired benefits associated with outsourcing and experienced the consequences of outsourcing failure. Such a trend has increased the likelihood of outsourcing suffering a similar backlash to those that have followed Total Quality Management and Business Process Re-engineering. Similarly, concepts such as outsourcing tend to be adopted by practitioners under pressure to demonstrate knowledge and expertise but who do not have the time to assess whether the concept is applicable to their particular business situation. Indeed, many outsourcing failure cases have been as a result of the misapplication of the concept by practitioners. Organisations that have experienced poor results with outsourcing often have had limited knowledge and experience of outsourcing. Organisations have often embarked upon extensive outsourcing without fully understanding the concept. For example, organisations have outsourced activities with which they are having problems without diagnosing the causes of poor internal performance. Rather than attempt to effect performance improvements internally, they have rushed into outsourcing with scant consideration of the consequences. Moreover, opportunistic suppliers can be extremely adept at holding organisations to ransom through locking them into long-term contracts and adding supplementary charges as conditions change. Suppliers often exploit the naiveté on the part of the outsourcing organisation to negotiate a sufficiently robust contract.

Initial research for the writing of this book revealed that organisations were experiencing many of these problems. Organisations were encountering difficulties in both the evaluation of the suitability of outsourcing for their organisation and in the management of the outsourcing process. These difficulties stemmed from the lack of a structured approach to the evaluation and management of outsourcing. Furthermore, through extensive research and teaching in this area, I have found that there is no single text that adequately addresses the topic of outsourcing. Many books or individual articles are generally oriented towards a single perspective and do not provide an overall integrative framework necessary to understand outsourcing evaluation and management. The objective of this book is to summarise and integrate the latest research in outsourcing and related disciplines in a way that is accessible to both students and practitioners and in a way that facilitates its application. The book synthesises much of the literature that relates to outsourcing into a comprehensive framework for understanding the process of outsourcing evaluation and management. In particular, the outsourcing framework is influenced by literature from a number of areas including business strategy, economics and inter-organisational relationships. The implications of a number of key influences on the outsourcing process such as organisational capability, supplier capability, competitor actions and supply market risk are examined and a number of alternatives are offered based upon an analysis of these key influences. The book is influenced by empirical research that involved talking directly to practitioners in order to elicit their views on key aspects of the outsourcing process. In-depth case studies were also carried out with a number of companies that had embarked upon extensive outsourcing. The framework has been tested and refined by many presentations and discussions with both academics and practitioners. Much of the structure of the book is influenced by the stages involved in outsourcing evaluation and management. The book is structured as follows:

- *Chapter 2: The trend towards outsourcing* – this chapter provides an overview of the outsourcing concept. It identifies a number of developments in the business environment that have led to the increasing prominence of outsourcing. The potential benefits and risks associated with outsourcing are outlined along with the inter-organisational relationships that have been adopted as a result of the trend towards outsourcing.
- *Chapter 3: Theoretical influences on outsourcing* – the characteristics and limitations of a number of theoretical influences on outsourcing are outlined. It is argued that there are a number of aspects to each theoretical perspective that can assist in outsourcing evaluation and management.
- *Chapter 4: The outsourcing process: a framework for evaluation and management* – this chapter provides an overview of the practical problems with outsourcing and an overview of the stages involved in the framework for outsourcing evaluation and management. The stages in the framework serve as a structure for the following six chapters in the book.
- *Chapter 5: Determining the current boundary of the organisation* – in this chapter a number of models are presented that can assist in providing an outline of the current scope of an organisation's activities. Outsourcing evaluation and management analysis is carried out at the activity level throughout the book.
- *Chapter 6: Activity importance analysis* – a key element in outsourcing evaluation is assessing the importance level of organisational activities. An analysis of the competitive environment and customer needs can assist in identifying which activities are critical for success in the business environment. A number of

techniques are outlined that can assist in determining the importance level of organisational activities.

- *Chapter 7: Capability analysis* – this chapter provides a structure for assessing the capability of an organisation in activities relative to competitors and potential suppliers for outsourcing evaluation. The relative performance of the sourcing organisation in an activity will have a major influence on whether an activity should be performed internally or outsourced.
- *Chapter 8: An analysis of the strategic sourcing options* – this chapter outlines the implications of each strategic sourcing option based upon the importance level and capability of the organisation in the relevant activity. Issues considered include the performance disparity in the activity relative to competitors or suppliers, technology influences, behavioural considerations and supply market risk.
- *Chapter 9: Developing the relationship strategy* – this stage in the analysis is concerned with outlining the steps involved in developing a relationship strategy that enables the achievement of the outsourcing objectives. A number of potential relationship strategies are discussed that are influenced by both the importance of the activity and the level of supply market risk.
- *Chapter 10: Establish, manage and evaluate the relationship* – in this chapter the stages involved in implementing the outsourcing strategy are outlined. A number of issues are considered including supplier selection, contracting, supplier and relationship evaluation.
- *Chapter 11: Outsourcing experiences at Telco* – this chapter presents a case study documenting the outsourcing experiences of a company in the telecommunications industry. The analysis presented is related to the framework for outsourcing evaluation and management presented in the book.
- *Chapter 12* – this chapter provides a number of practical lessons for outsourcing evaluation and management and also identifies a number of potential future developments.

This book is intended for readers in the academic market, who require an up-to-date understanding of the outsourcing process and a structured framework to evaluate and manage the key issues associated with outsourcing. The book is of interest to students on postgraduate (MBA, MA and MSc) programmes studying the subject of outsourcing. The book can be used as a core text on a stand-alone outsourcing module or on a module such as business strategy, supply chain management, information systems, and operations management where significant attention is given to outsourcing. The book is also of value to students who are researching the area of outsourcing. Chapter 3 provides a detailed and critical evaluation of the key theoretical influences on outsourcing. It is shown that there are a number of inter-dependencies with each of the theoretical influences that can assist in understanding the outsourcing process. In particular, the importance of the business strategy and inter-organisational relationship literature to an understanding of outsourcing is emphasised.

In contrast to many other books on outsourcing, considerable attention is given to evaluating whether outsourcing is appropriate for organisational activities. This is reflected in the title, which emphasises both the evaluation and management aspects of the outsourcing process. Referring to the chapter structure of the book it can be seen that particular emphasis is given to understanding the implications of outsourcing before implementation. Furthermore, in contrast to many other books on outsourcing that focus solely on information technology and outsourcing, this book is generic and applicable to evaluating outsourcing for a range of organisation activities. I have attempted to make the book as interesting as possible to both students and researchers in the area through the use of illustrations and empirical research. The illustrations in each chapter are intended to enrich the analysis and provide support for the strategies proposed. The book is strengthened through reference to contemporary research in the area of outsourcing in a range of leading international journals including the *Strategic Management Journal, Academy of Management Executive, Journal of Management, Administrative Science Quarterly, Long Range Planning, Sloan Management Review, Harvard Business Review*, etc.

Although much of the book is oriented towards the academic community, it is also of value to practitioners who are involved in or considering outsourcing. The book proposes new ways of looking at the outsourcing process, and employing outsourcing as a vehicle to obtain performance improvements and achieve competitive advantage. A framework is provided which employs a number of tools and techniques that many practitioners are already familiar with applying, including competitor analysis, benchmarking, cost analysis and buyer-supplier relationship management. Although the analysis presented employs a number of the theoretical models, these can make a valuable contribution to strategic decision-making. The approach in the book builds in substantial parts of contemporary research and theory. Research and theory can assist in stimulating a deeper understanding of the key issues associated with outsourcing. The book provides guidelines on deciding whether outsourcing is appropriate and if so, how the outsourcing process should be managed. Chapter 12 provides some lessons on the outsourcing process that have been drawn from the analysis presented in the book. It alerts practitioners to the key issues that should be addressed if they are approaching the problem themselves. It will also be useful to companies that are considering employing consultants to undertake both the evaluation and management of outsourcing.

# 2 The trend towards outsourcing

## 2.1 Introduction

The increasing prevalence of outsourcing has led to it being considered central to the strategic development of many organisations. Outsourcing is increasingly being employed to achieve performance improvements across the entire business. For example, one particular growth area has been the externalisation of Information Technology (IT) with a recent report showing companies outsourcing 38% of their IT functions to external providers (Barthelemy, 2001). Another area of the business that is also increasingly being outsourced is the human resource function. An American Management Association survey found that 77% of firms surveyed in the US had outsourced a number of human resource activities including training and development, executive recruitment and payroll management (Anonymous, 1997). The outsourcing decision can often be a major influence on the profitability and competitive position of the organisation. However, many organisations possess a limited understanding of outsourcing and in particular the potential benefits and risks and how they should be managed. This chapter provides an overview of the outsourcing concept. It outlines a number of key developments in the business environment that have occurred including globalisation, advances in information technology, reforms in the public sector and more demanding consumers. These changes have forced organisations to be more flexible and responsive to customer needs. As a result, many hierarchically controlled organisations that have previously performed the majority of business activities internally have been forced to create more network-oriented organisational structures, which involves outsourcing activities to specialist suppliers. A number of the key dimensions of outsourcing are identified including the potential advantages of outsourcing, the potential risks, and inter-organisational relationship configurations that have been adopted as a result of the trend towards outsourcing. These issues will be dealt with in more depth in the context of outsourcing evaluation and management in the following chapters.

## 2.2 An overview of the outsourcing concept

Outsourcing involves the sourcing of goods and services previously produced internally within the sourcing organisation from external suppliers. The term outsourcing can cover many areas, including the outsourcing of manufacturing as well as services. The term 'outsourcing' is most commonly used in relation to the switching of the supply of product or service activities to external suppliers. Outsourcing can involve the transfer of an entire business function to a supplier. Alternatively, outsourcing may lead to the transfer of some activities associated with the function whilst some are kept in-house. Outsourcing can also involve the transfer of both people and physical assets to the supplier. Outsourcing is not just a straightforward financial or purchasing decision. In many cases, outsourcing is a major strategic decision that has implications for the entire organisation. The evaluation and management of the outsourcing process involves a number of important elements. A starting point in the evaluation process involves analysing whether outsourcing an activity is appropriate for the organisation. This involves considering issues such as the capability of the organisation in the activity relative to competitors, the importance of the activity to competitive advantage, the capability of suppliers to provide the activity, the level of risk in the supply market, potential workforce resistance and the impact upon employee morale. Where the decision to outsource has been made, a number of important issues have to be considered including supplier selection, contract negotiation and the transitioning of assets to the supplier. Significant attention should also be given to managing the relationship with the supplier to ensure that outsourcing meets its intended objectives.

A term often used in the context of outsourcing is vertical integration. Vertical integration refers to the level of ownership of activities either *backward* (for example, component manufacture or inbound logistics) into the supply chain or *forward* (for example, distribution or after-sales service) towards the customer or end user of the product or service. This is illustrated on Figure 2.1.

Vertical integration is similar to the outsourcing concept in that it is concerned with the decision on whether to perform an activity internally or source it from an external supplier. Another term that is often used in a manufacturing context is 'make-or-buy', which has been around for many years. The term 'make-or-buy' is associated with the decision on whether to manufacture a component internally or buy it from an external supplier. In fact, it could be argued that make-or-buy is a more appropriate term as it implies that there should be an evaluation of the suitability of either internal or external supply whereas the term outsourcing implies that the decision to use an external supplier has already been made without any consideration of whether it is appropriate for the organisation. Successful

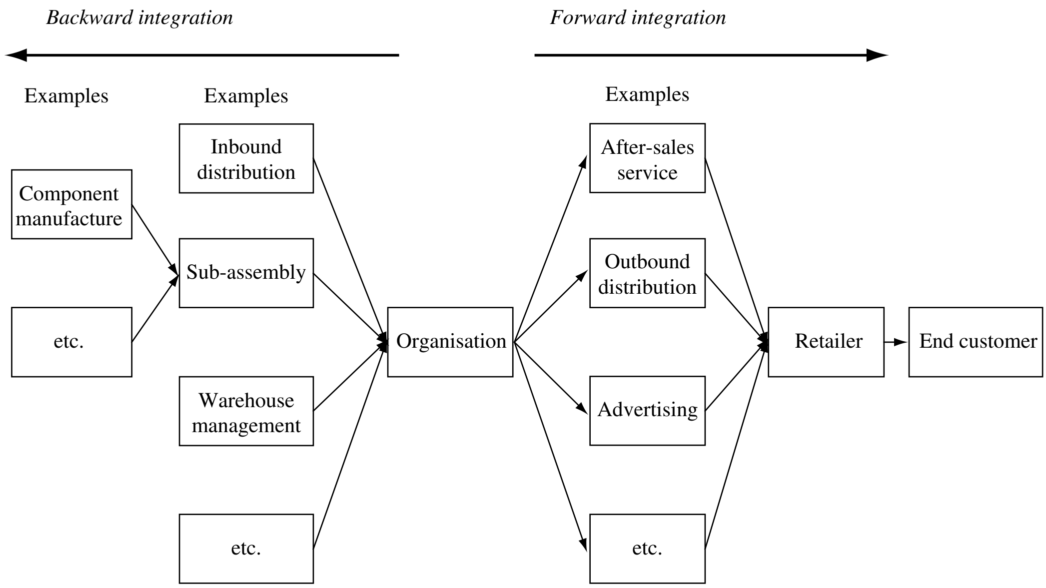


**Figure 2.1** Backward and forward integration

application of the outsourcing concept involves an analysis of whether outsourcing is appropriate for the organisation and, if so, how the outsourcing process should be managed.

Organisations have always employed external product and service providers to carry out a range of business activities such as catering, security, distribution, accounting and information technology. However, many organisations are increasingly outsourcing a wider range of activities and a greater level of the value associated with these activities. In effect, organisations are no longer outsourcing peripheral activities alone but extending the scope of outsourcing to encompass more critical activities that contribute to their competitive position. Consequently, the evaluation and management of the outsourcing process has become increasingly complex. For example, contracts are more complex as agreements become more sophisticated in terms of measurement procedures, the financial management of transferred assets and the inclusion of clauses associated with bringing the activity back in-house (Quelin and Duhamel, 2003). Furthermore, the presence of political influences on the decision-making process, such as the vested interests of the functions under scrutiny to keep the relevant activities in-house, can prevent the choice of the most appropriate sourcing option for the organisation. The strategic nature of the decision means that it not only involves input from operational management, but also from top management. Considerable care and effort has to be given to evaluating and managing the outsourcing process. Outsourcing decisions are extremely costly and difficult to reverse. For example, in a study of outsourcing, Barthelemy and Geyer (2000) found that in the event of outsourcing not meeting its intended objectives, it can take an average of 8 to 9 months to switch to another service provider or bring the activity back in-house at the end of the contract.

It is important to distinguish between two different types of outsourcing. Outsourcing can be used to either maintain the competitive position of the organisation or act as a source of competitive advantage. Normally, when organisations approach outsourcing for the first time they are using it to reduce costs and improve performance in a particular activity. Clearly, outsourcing to reduce costs can deliver benefits for the organisation and impact directly upon the bottom line. However, outsourcing employed primarily at this level is only likely to maintain the competitive position of the organisation. In many cases, it is likely that the organisation is accessing the capabilities of a supplier that are also accessible to its competitors. Indeed, many organisations outsource as a result of following the lead of a competitor. Outsourcing for the sake of outsourcing or responding to competitor actions is not a basis for creating competitive advantage. However, organisations can employ outsourcing as a vehicle to achieve competitive advantage. Studies have shown that organisations are becoming more ambitious and sophisticated in both their objectives and approach to the outsourcing process. For example, Saunders *et al.* (1997) found that in many cases the major motives for outsourcing were technological and strategic and not cost reduction. It was found that outsourcing allowed organisations to achieve a number of strategic benefits ranging from the more rapid adoption of new technologies to being more responsive to customer needs by better coping with variations in product demand. PriceWaterhouseCoopers (1999) have found that outsourcing has moved from searching for efficiencies and improvements in a single process or activity, to reconfiguring entire processes in order to obtain greater value across the organisation.

In effect, these organisations are reacting to changes in the external business environment. Increasingly, the ability of organisations to reduce costs is regarded as a pre-requisite for participation in many industries whereas innovation and responsiveness to customer needs are regarded as potential sources of competitive advantage. Outsourcing strategies are becoming more ambitious in order to meet these challenges. A key element of using outsourcing as a source of competitive advantage is the management of suppliers. Accessing the capabilities of suppliers offers organisations the opportunity to improve their own performance. However, a key aspect of unlocking this potential is the way in which the customer organisation manages the relationship with the supplier. Studies have shown that some organisations can obtain higher levels of performance from their suppliers than their competitors. For example, Liker and Wu (2000) found in a comparison of supplier plants with product lines serving both US car makers and Japanese transplants that the actions of the suppliers' customers significantly affected the ability of suppliers to pursue lean manufacturing principles. Suppliers had much leaner operations within their plants and in logistics processes when dealing with Japanese customers. In order to improve supplier performance, the Japanese companies employed a number of mechanisms including more level production schedules, a disciplined system of delivery time periods, assisting suppliers in developing lean capabilities and the development of a transportation system to handle mixed-load and small-lot deliveries. In fact, astute relationship management in the value chain has become a competitive imperative. As a result, many vertically integrated organisations have been increasingly outsourcing to create a more virtual configuration that relies on a range of business partners to undertake the major parts of the value chain (Kutnick, 1999).

## 2.3 Changes in the business environment driving outsourcing

The trend towards the increased use of outsourcing has been driven by a number of inter-related factors in the external business environment.

### 2.3.1 Globalisation

Over the last few years the external business environment has become increasingly global for many industries. Many organisations are now competing on a global basis. Regional agreements such as the North American Free Trade Agreement (NAFTA) between the US, Canada, and Mexico and the development of the European market with a single currency have facilitated the development of trade on a global basis. Increasingly, there has been a shift away from national markets as distinct entities, protected from each other by trade barriers and distance and time barriers, towards a system in which national markets are merging into a single global market (Hill and Jones, 2001). This trend has led organisations to expand the geographical scope of their business operations in terms of the markets they serve and the production locations for the creation of their products and services. These changes have presented organisations with significant opportunities. For example, companies have been in a position to achieve greater economies of scale, share investments in research and development and marketing across their various markets, and access lower cost labour sources for both the manufacture of their products and delivery of their services. Futhermore, many organisations, such as Microsoft and Sony, have been able to establish internationally recognised brands for their product and service offerings. Throughout the developed nations of the world including the US, Europe and Japan there has been a growing prevalence of standardised consumer