Outsourcing, Part 2: Uncovering the Hidden Costs

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Security risks, higher-than-expected costs and productivity losses -- as well as management, communications and coordination problems -- have led some outsourcers to reconsider their decisions and even pull some processes back in-house. Moreover, as the outsourcing market matures, cost inflation has pushed executives to take a harder look at outsourcing, offshoring and near-shoring.

Outsourcing continues to grow at a healthy rate. As the market expands to include a wider range of business processes, competitive cost opportunities in emerging markets are pressuring management decision-making.

Currents counter to this trend are in evidence, however, as Part 1 of this two-part series observes. Part 2 delves a bit further into the challenges associated with outsourcing, identifying some of the business processes that -- for a variety of reasons -- are proving resistant to being farmed out.

Outsourcing Takes Root and Spreads

Outsourcing has come a long way. Initially, the practice made a well-publicized mark when U.S. manufacturers began sending their operations to developing-market countries and laying off blue collar employees back home.

Blue collar and customer service call center jobs are not the only ones at risk, however. Competition in emerging markets has been leading companies in almost every economic vertical to outsource a broader range of processes, including almost every business support service -- from IT to human resources, finance, accounting and even R&D.

Multinational corporations are looking at near-shoring, offshoring and outsourcing as a means of restructuring themselves strategically in order to better compete in an increasingly global economy.

An October 2005 report from Everest Research Institute reported that the finance and accounting outsourcing market grew at a 40 percent rate in 2005 to reach the US$2 billion mark.

Initially, energy and utility firms drove growth in the sector. However, a more recent surge was driven by demand from manufacturing and consumer goods companies. The retail and financial services sectors are underpenetrated and have high untapped demand, according to the report.

Resistant to Outsourcing

That said, there are processes that businesses do not want to outsource. "Companies are generally reluctant to outsource conceptual and front-end design work," said Ben Rissing, a research scholar and member of a team conducting ongoing research into the outsourcing phenomenon at Duke University's Pratt School of Engineering.

"While R&D outsourcing is gaining momentum, the initial planning and design work requires extensive and timely communication with key stakeholders," he told CRM Buyer. "Moreover, to remain competitive, this work must be completed with a minimal number of development cycles."

Furthermore, "every division or project will encounter unique problems based on the type of outsourcing work being completed and the model that is employed," Rissing added.

Underestimating Costs and Risks

No company wants to outsource its core competencies, noted Bill Puso of the Insight Group. "Most people don't realize how much executives agonize over the outsourcing decision," he told CRM Buyer. "The economic decision is the easiest. The agony comes over the perceived loss of control and a significant concern for the welfare of their displaced workers. This latter point is often a key advantage for onshore outsourcing firms. While the financial benefits would be less than offshoring, the transition of a workforce can offset a large enough portion to make the deal viable."

Most companies do a very good job estimating the direct financial costs of outsourcing, said Puso, indirect costs are often underestimated.

"First is the cost of selecting the right outsourcing partner ... which can reach six figures. Second is the time and cost to [make the] transition," Puso said. "It can easily take six months or more for an offshore supplier to completely understand the requirements at a detailed-enough level to replicate an operation. This includes all the lead time required for any equipment they would need to purchase, facility upgrades, etc."

The challenges of working in different cultures are also frequently underestimated. "Executives that we have spoken with continue to stress that language and cultural issues are key barriers that can limit the success of an outsourced operation," Duke's Rissing added.

Security and Regulatory Barriers

When considering outsourcing, executives say their top worry may be maintaining data security and integrity. The potential for information theft figures prominently among those concerns, according to James W. Wilson III, vice president of direct sales for DOW Networks.

"When a company thinks of outsourcing anywhere, security of the company's customer database is paramount. The customer's private personal information is of equal concern," Wilson told CRM Buyer. "Both ... can possibly outweigh potential savings."

Regulatory compliance is another significant barrier to outsourcing, he continued. Specifically, outsourcers in some economic sectors need to show government regulators that they are in compliance with HIPAA (Health Insurance Portability and Accountability Act), SOX (Sarbanes-Oxley) and GLBA (Gramm-Leach-Bliley Act) -- and that ample information security policies are in place.

Confusion over HIPAA, SOX or GLBA may slow an organization's compliance efforts and unnecessarily influence the decisions to limit, postpone or cancel outsourcing, Wilson noted.

Hidden Costs

Two other costs that are usually underestimated in the outsourcing equation, according to the Insight Group's Puso, are compensating displaced workers and managing the outsourcing relationship.

The latter "will require ongoing project management and should be performed by a dedicated individual or individuals," he advised.

Of all costs associated with the decision to outsource, the largest is lost productivity. "In most cases, there will be a 5 percent to 10 percent loss in productivity in the offshored operations," Puso said.

"Most of this is due to communications," he explained. "An example is having software design engineers in the U.S. and the coders in an offshore operation. The ongoing communications that must take place and the numerous opportunities for gaps in understanding will affect the productivity. The cost benefit will still support the offshore operation as a wise move, but the efficiency will be slightly less than originally anticipated."

Currency risk is another cost that is often underestimated -- even overlooked -- when considering outsourcing, according to DOW Networks' Wilson. "The biggest hidden cost I have seen in the last five years is currency risk. I have personally seen the U.S. dollar slip against the South African rand from 13-to-1 USD to as low as 6-to-1 USD," he commented.

Wilson has also watched the U.S. dollar depreciate against Eastern European currencies, the euro, Asian currencies, and -- to a lesser extent -- Latin America and Canadian currencies.

"The weakened USD has helped my USD-based minutes, products and services sell better against other international competitors in other currencies," he commented. "Conversely, call centers with contracts in [dollars] have seen profits erode in the same period. South Africa is almost too expensive to outsource U.S. business, because Canada is now the same price."

Outsourcing Inflation

Security risks, higher-than-expected costs and productivity losses -- as well as management, communications and coordination problems -- have led some outsourcers to reconsider their decisions and even pull some processes back in-house.

"In some cases, internal IT employees will be asked to shift gears and retake ownership of functions that they previously helped transition to an outsourcer," said Brian Tumpowsky, a senior member of Diamond Technology and Management Consultant's global sourcing practice.

"We think the trend we've seen in past studies, where companies are outsourcing commodity activities to redirect IT staff toward more strategic work, will continue," he said.

Moreover, as the outsourcing market matures, cost inflation -- rising wages and overall compensation -- has pushed executives to take a closer, harder look at outsourcing, offshoring and near-shoring.

"Wage inflation and intellectual property theft continue to be real concerns in many rising technology centers in the developing world," Duke's Rissing noted.

A.T. Kearney's Global Services Location Index puts these issues in perspective: Although total compensation costs for positions such as IT programmers and call center staff increased 5 percent to 10 percent in developed countries, they rose from 20 percent to 40 percent in emerging-market outsourcing centers such as India, China, the Philippines, parts of Eastern Europe, and Latin America.

Overall, literacy, educational levels, and quality of products and services are improving in these countries. However, other business expenses -- such as telecom services -- have dropped by as much as 25 percent or more in many nations, according to the report.

"The interesting topic recently is the rapid growth of salaries in India and the impact that might have on their outsourcing industry," opined the Insight Group's Puso.

"I believe the continuation of that growth in salaries will at some point begin to have an effect on [a country's] ability to deliver the necessary cost benefit to their clients. This will most likely simply move the focal point to another arena but not stop the continued movement to offshore," he added.