Outsourcing vs. Contracting: What Solution Is Best For My Business?

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Is it best to use a staffing based outsourcing model?

The recent decades have seen a rapid rise in the outsourcing of business activities and the use of external parties to provide services to organizations that previously were performed internally. Unfortunately, far too many organizations have not realized the full benefits of such a strategy, and instead have confused outsourcing with a straightforward staffing model that only replaces or adds to the internal employee base with contract resources, likely based offshore, from external vendors.

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Such models limit the savings potential to the organization to only capturing a portion of the labor cost arbitrage while changing the nature of and increasing the risks to the organization. The realization of process improvement and better practice solutions is generally overlooked or constrained in staffing based outsourcing arrangements. Staff augmentation is valuable in certain circumstance; however, it does not always provide the best outsourcing solution for the organization.

Financial and operational risks in staffing based outsourcing arrangements.

The structure of an outsourcing arrangement directly impacts the risk and potential benefits. Some companies rely heavily on a staff augmentation approach. Others are focused on process improvement and productivity. A risk for straightforward staff augmentation / outsourcing approach is the arrangement removes the incentive for the outsourcing vendor to strive for productivity and quality improvements. Labor cost arbitrage can generate strong initial savings but such savings are invariably eroded over time as inflation and labor supply pressures start to exert their influence in the destination country. Productivity and quality improvements are, on the other hand, sustainable permanent reductions in costs and improvements in quality.

This distinction is not always clear since most organizations initially seek to outsource their non-core functions and activities. It is well accepted that companies cannot out-innovate their competitors in all areas of their operations and must focus on innovating around their core strengths and competencies. However, by engaging in a staff augmentation model, management restricts its ability, inadvertently, to tap into a vendor's deep core competencies, processes and tools in the outsourced function. Organizations excel when they recognize that the real benefits of outsourcing extend beyond labor cost arbitrage and move to exploit these benefits. There is a far greater benefit to exploiting innovation by using specialized service vendors thereby maintaining a high level of innovation and competitiveness across all areas of their organization, not just in those that differentiate the organization in the market place.

Further, staff augmentation models pose and perhaps even increase risks to the organization related to quality staff recruitment, increased attrition, ongoing training and individual career progression since the organization continues to bear primary responsibility for these activities. Most major vendors provide support in such resource management activities and indeed, enter into contractual service levels that seek to mitigate these risks. However, penalties associated with non-compliance on these service levels tend to be insignificant and the ultimate financial and operational impact of these risks remain with the organization.

Also, if not actively managed, a staff augmentation model often creates unwelcome dynamics between the contracted workers and internal staff. Contracted workers and internal employees typically work together in teams and are generally responsible for similar metrics of performance. However, contract workers do not have the same opportunities for career advancement and personal development as internal employees. This status, in effect, makes them a separate class of pseudo-employees often perceived as 'inferior' and 'disposable' by both the internal employees and the contract worker. Management needs to actively monitor what motivates this group including exposure to new technologies, building new skills, finding alternative opportunities for advancement, ranging from purely monetary gains through rate or wage increases or other benefits to avoid losing key resources to alternate employment.

Most importantly, studies have shown that outsourcing arrangements focused on labor cost arbitrage account for less than half of the potential savings that are achievable from outsourcing. Staff augmentation models, while simpler and easier to establish, carry significant risk of leaving significant value on the table by not harvesting the full array of process improvement opportunities and the vendor's core competencies.

Are there significant legal risks?

Perhaps one of the most underestimated or under-regarded risks in staff augmentation outsourcing models are the legal risks. Most organizations tend to focus on vendor risks and price considerations in establishing their staff augmentation outsourcing arrangements. While almost all organizations seek the advice of legal counsel on their outsourcing and staff augmentation contracts, such legal considerations are generally limited to the contractual document itself and to ensuring contractual protections and obligations between the client and the outsourcing vendor. Few organizations deliberate on the new or changed risks and exposures to the organization from the chosen outsourcing model.

However, a significant source of legal risk is created internally, often unnoticed, within the organization with limited contractual protection from the vendor. Because a contract worker under a staff augmentation model typically works closely with internal employees in the execution of the activities and under the supervision and direction of an employee, the risk of long term contract workers being considered a 'deemed employee' is high.

Courts have typically focused on the level of operational control that an organization exercises over its contract workers to determine if such a worker would be considered a de facto employee and be eligible for benefits that the organization provides to its employees. Executed vendor contract terms and conditions and signed contract worker agreements that seek to remove this risk from the organization often do not prevail in court if there is clear evidence of operational control being exercised by the organization over its contract workers. As the length of time that an individual contract worker is engaged by the organization increases, this risks increases. This poses a conundrum for the organization since most organizations greatly value the institutional and functional experience and knowledge that individual workers accumulate over time; such experience and knowledge allows the organization to access improved productivity, increasing worker experience, reduce attrition and lower training costs.

Why is this risk significant? Not only is the organization exposed to claims by contract workers (such as that noted in the recent Microsoft Corporation litigation), but various other entities may also lay claim to associated financial and regulatory penalties and remedies. Such entities may include tax authorities seeking payment of payroll and other labor related taxes, worker safety agencies, and immigration authorities that may determine that a worker entered the host country on an inappropriately obtained visa.

Finally, there is a risk that the contract workers may be misrepresented, deliberately or otherwise, to a client of an organization as an employee and agent of the organization. Indeed, there are organizations that provide contract workers with business cards of the organization in order to enable the worker to 'interact smoothly with the client without any disruptive inquiries from the client into the worker's status and authority within the organization'. Any claims made by such misrepresented contract workers bind the organization to the claim and expose the organization to risks associated with fraudulent/misleading claims and misrepresentation. The financial, operational and reputational risk associated with bottom line impact of these types of events is often significant.

Is there a better way?

Many of the risks associated with staff augmentation arrangements can be avoided by careful consideration of the strategic nature of the activities that an organization either outsources or uses external contract workers for and in designing programs that manage these risks.

Staff augmentation models are well suited for short term resource needs such as short duration back fills, to cover the temporary absences of employees or for specific technical skills required for a limited time by the organization. In other cases either a process improvement / technology enabled initiative or full outsourcing arrangements are significantly more valuable alternatives. Staff augmentation and transient workers are often required when the organization has these types of specific project needs. However, such needs end when the project objectives are achieved (or the project is abandoned). Outsourcing is not about the need for workers, it is about the need for a specialized vendor who can provide a set of services better and in most cases cheaper than the organization currently provide for itself.

Conclusion

By meticulously examining the business objectives and goals that is driving the need to consider outsourcing or use external resources, an organization can establish strategically grounded guiding principles and programs that make appropriate and optimal use of external resources in a manner that minimizes the risks associated with both staff augmentation and outsourcing models and improves returns to the business.

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