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**HR sourcing and shoring: strategies, drivers, success factors  
and implications for HR**

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# HR Sourcing and Shoring: Strategies, Drivers, Success factors and Implications for HR

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**Outsourcing, Offshoring, In-Sourcing, HR Strategy, Centres of Excellence**

## Abstract

This paper identifies the core strategies pursued as firms make choices about sourcing and shoring of HR services. It draws attention to a range of variables that need to be measured to assess the effectiveness of these sourcing and shoring strategies. It presents a review of the business drivers for human resource outsourcing and identifies the strategic outcomes that should be used to determine success in this. A range of readiness factors are identified and included in Appendix 1. In order to help HR practitioners plan for their own approach, the paper also considers how the market for sourcing and shoring options is developing by analysing some data on the volume and scale of contemporary deals. This analysis is used to identify useful avenues of research that might help explain international differences in the HRO market. Finally, some future developments and challenges for HR functions are signalled by analysing both vendor strategies and issues for the retained HR business.

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# **HR Sourcing and Shoring: Strategies, Drivers, Success factors and Implications for HR**

## **INTRODUCTION**

A wide set of business services can now be delivered through a range of new organisational forms. Abramovsky, Griffith and Sako (2006) differentiate these services into direct IT services (for example hardware and software consultancy, data processing, maintenance etc) and IT-enabled services (the much broader range of work including professional services and other diverse activity, of which the various human resource sourcing and shoring strategies examined in this paper are one variant).

Mahoney and Brewster (2002) note that whilst findings from the Cranet survey show that HR service delivery is commonly indicated as one of the key challenges for personnel / HR management, the term "HR outsourcing" still carries its own intellectual 'baggage'. It is often associated with perceptions about the loss of responsibility and control, reduced importance for the function, and a lack of focus from the external service providers. In reality, because HR departments are challenged to be more cost effective whilst improving the quality of their service and the value of their overall business contribution, outsourcing of certain activities under appropriate conditions may be a desirable solution. Finding the right balance and solution remains the challenge for many, and no organisation appears to have yet developed a fully effective way of exploiting the possibilities associated with these recent developments in HR service provision on a global scale (Sparrow, Brewster and Harris, 2004). Indeed, there is still considerable confusion about many of the options faced.

## **CORE STRATEGIC, RATIONALES AND CHOICES**

The first question that we address therefore is: how can we best distinguish between some of the new organisational forms that have emerged such as insourcing, outsourcing, offshoring and global insourcing? Abramovsky, Griffith and Sako (2006) provide a staged model of these organisational forms. They are all seen as different forms of specialisation, whereby activities are moved, under different geographical and sourcing arrangements, to specialised units. For Chakrabarty (2006), there are two strategies at play: "sourcing" (across organisational boundaries between a client entity and non-client entities such as vendors, suppliers and third parties) and "shoring" (across either on-shore – same country – or wider geographical boundaries). Sometimes offshoring may be further differentiated into near-shoring (shared borders or close institutional and cultural regulatory regimes) and offshoring (used specifically to refer to sourcing across a wide geographical and cultural distance). The taxonomy below can be applied to any process, not just HR. Indeed, as a general observation, in order to inform research on HR sourcing and shoring we need to draw upon the general business process outsourcing literature. From this perspective, then, there are four core strategies that might be applied:

1. *In-country insourcing* describes the situation where the supplier-customer relationship is still formalised and contracted, and activities are still sent to an overseas location (generally for reasons of cost efficiency), *but* the activities are still performed in-house, for example in one of the organisations own subsidiaries or a service centre. The responsibility and delegation of tasks to the service provider means that they are still what is called an internalised “client-entity”.
2. *Global insourcing* describes the situation where the re-design and re-configuration of activities and processes to become more efficient and effective allows some geographical flexibility over the location of the activity. For economists, ownership of 10% of offshore operations constitutes direct foreign investment between a parent operation and an affiliate.
3. *Outsourcing* describes situations when a third party provider is used to carry out the activity, with the production of services purchased externally, but still within the same country. It is generally aimed at achieving higher profitability by using fewer in-house resources. It is defined as “... a discontinuation of internal production (whether it be production of goods or services) and an initiation of procurement from outside suppliers” (Gilley and Rasheed (2000, p. 764). Human resource outsourcing (henceforth abbreviated to HRO) involves “...the purchasing by an organisation of ongoing HR services from a third-party provider that it would otherwise normally provide by itself “ (Hesketh, 2006, p.1).
4. *Offshoring* describes a particular type of specialisation in which the production of services or goods is moved overseas. Offshoring involves a broad range of tasks that are executed by a firm in another country, ranging from the establishment of a foreign subsidiary to a relatively arm’s length relationship with another firm (Harrison and McMillan, 2006). More arms length relationships tend to involve a more explicit practice of contracting with individuals or companies in foreign countries to perform work that might reasonably be conducted domestically. Hunter (2006, p.2) therefore defines offshoring as “... the act of transferring some of a company’s recurring internal activities to outside providers, who are located in a different country and market economy, under a formal service contract”. Offshore transactions also typically involve two parts: a transfer of *responsibility* for the operation and management of part of an organisation; and a *guaranteed provision of services* to the client organisation by the vendor for a time period. Given the distances involved in offshoring, the factors of production are rarely transferred to offshore sites, but the services, processes and decision rights are (Hunter, 2006).

The risks associated with each of the above organisational forms of course differ. Offshoring is considered to take the benefits and risks of outsourcing to its extremes (Chakrabarty, 2006). Moreover, even if the best skills can be found at the lowest cost, the challenges of co-ordination, communication and control are tested by the cultural divergences.

Three dominant theoretical perspectives have been used to explain the motivation to outsource: models of core-peripheral activity and the resource-based view of the firm, transactional cost

economics and the decision to make or buy services, and models of HR roles and the shift towards more consultative and strategic activity (Cooke and Budhwar, 2008). But the theoretical bases driving the each choice of organisational form is different. As a strategic tool, Hesketh (2006) argues that outsourcing revolves around decisions about: capability (whether to improve or acquire this); scale (providing well-administered services for populations large enough to justify the return on investment); and technology (the benefits of which may be acquired or leveraged through the development of shared services or outsourcing). Outsourcing is therefore typically analysed from a resource-based view (RBV) of the firm. Espino-Rodriguez and Padrón-Robaina (2006) point out, however, that it is not the capabilities or resources that form the source of competitive advantage, but the *exploitation* of these resources through the efficiency and effectiveness of existing business processes.

Offshoring, in contrast, is often analysed from a transaction cost perspective. Traditional supplier relationships often involve the purchase of new services, but offshoring generally involves the movement of already-existing in-house activities. The issue therefore is the completion of the same task in a different location, where the costs may be significantly cheaper. Hesketh (2006) notes that decisions about this are driven more by economic theories of labour arbitrage rather than the RBV models of organisational capability that drive thinking about shared service, e-enablement, and outsourcing.

Theory, however, rarely aligns with the pragmatic judgements that are made by the strategic actors. One of the challenges that faces all of those working with the decisions that surround the choice of the above four options is neatly summarised by De Vita and Wang (2006, p.4):

*“... The question of the extent to which each (core competence)... is singularly both necessary and sufficient to justify the... choice has never been satisfactorily squared... Ambiguity still reigns on how to establish what, and what not, should be seen as core. Is it what we do best? Is it what creates value? Or is it related to the strategic importance of the activity in relation to changing industry requirements?”.*

Not surprisingly then, Kenney and Florida (2004, p.1) observe that, once we analyse the strategic paths being pursued, we should not over-simplify our assumptions about globalisation:

*“... Globalisation is much more than simply moving employment and activities from developed nations into nations with lower cost forces. Such a simple conclusion obscures the complicated skein of cross-border relationships that have evolved out of firm strategies seeking to balance a kaleidoscope of variables including labor and inventory costs, transportation, quality, concentration of valuable knowledge in clusters and temporal proximity to customers. Understanding firm strategies at a single moment in time is complicated enough, but unfortunately these variables also fluctuate [over time]”.*

## **DETERMINANTS OF THE EFFECTIVENESS OF STRATEGIC CHOICE AND EXECUTION**

The second question to address is: which variables need to be measured to assess the effectiveness of these organisational forms (or assess the strategy used to execute them)? In answering this question, one cannot ignore the role that technology (primarily, through e-enablement) and supporting HR structures (for example in the form of shared services) play in enabling each of the above choices. This is because one of the cornerstones for success in HRO is clarity in terms of desired changes for the future HR operating model. Outsourcing HR activities typically involves moving activities into an outsourced centre of scale (in contrast to an internal Shared Service Centre). In most companies this triggers a restructuring process of the retained HR organisation and organisational design work around the retained organisation, including the establishment of Service Management Organisations (SMO) to manage the client-vendor interface and structural arrangements for the transition and transformation stages. HR outsourcing projects also allow organisations to gain access to cutting-edge HR technology while avoiding ongoing IT investments. In order to maximise the benefits from this access to technology, organisations have to formulate an appropriate IT strategy and architecture approach. This requires a thorough understanding of the vendor's technology, the challenges it creates in terms of appropriate technology interfaces, data compatibility, data security, maximised user buy-in and technology investment for the retained organisation.

Therefore, although it is beyond the scope of this paper to discuss the more general developments of the role of IT in HR, in practice solutions such as outsourcing are often combined with the e-enablement of many HR processes and an extension of existing Information and Communications Technology (ICT) systems (CIPD, 2005a, 2005b). Indeed, in a study of 64 UK MNCs, Brewster, Sparrow and Harris (2005) found that when HR managers ranked items on HR structures and strategies, high outsourcing of business processes loaded on a factor of efficiency alongside high centralisation and e-enablement of HR.

In practice, when we consider execution of strategy, responses are far more complex even than suggested by the four organisational forms above. This is because each of the four organisational forms – and indeed the hybrid combinations of these forms that are often pursued - offers a different contribution to parts of the value chain (Chakrabarty, 2006). Firms therefore make much more differentiated decisions, which involve choices about:

- sourcing (for example co-sourcing with one or multi-sourcing with multiple vendors);
- different support strategies (for example fix-and-keep in-house, rehabilitate and retain, enable capability building within the client or indeed the vendor operation, outsourcing with a reverse option, through to complete divestment)

- contractual arrangements, which may be benefits based (whereby payments are linked to realised benefits) or may be co-sourced (where vendor revenues are linked to client performance)
- location of resources, which may be distributed (where the vendor has teams both on shore and offshore) or dyadic (independent client and vendor operations).

There are also multiple regulatory regimes (referred to as contract complexity or density) that can be adopted. Attention is therefore now being given to the nature of governance and risk mitigation that accompanies any particular outsourcing solution (Barthélemy and Quélin, 2006). Complexity is required for three reasons:

- to mitigate opportunistic behaviours by the vendor,
- to avoid over-dependence on the vendor, and
- to allow flexible responses to changes in the environment.

In practice governance arrangements are based on two control mechanisms:

1. formal contractual relations in the form of "... a bundle of obligations, incentives, rewards and penalties" where "... it is not clear that the chosen governance will mitigate all contractual hazards".
2. a range of complementary social mechanisms such as trust, reputation, and what has been termed "the shadow of the future" act to ensure self-regulation.

How important a set of variables does contract complexity represent? Barthélemy and Quélin (2006) identified 816 outsourcing agreements from 1992-97 based on searches in ABI/Inform and Reuters. They surveyed 82 of these deals (76% in Europe) in order to assess the link between contract complexity and the aftermath (the impact of hazards on post-deal transaction costs). Denser contracts existed when there were high switching costs, higher strategic centrality of the outsourced activity, and higher uncertainty about future needs. Denser contracts were also associated with higher monitoring and enforcement costs. Whilst adapting human assets, surprisingly, bore no relationship to contract complexity, it was associated with higher switching costs. The study also showed that governance was clearly based on a blend of formal contracts *and* relational norms, and this raises an important research agenda around the design of outsourcing arrangements, the role of relational versus contractual elements (itself likely to differ across countries or national cultures), and the impact on performance outcomes such as service, innovation and productivity.

What messages does the above section contain for researchers? Given the above complexity of sourcing and shoring strategies and contracts, the need to understand how these are combined with other changes (such as centralisation or e-enablement), and the range of variables associated with effective execution, beware the writers who take strong ideological positions for or against HRO.

## **BUSINESS DRIVERS FOR HRO**

How important might the different business drivers for sourcing options be? What does analysis of these drivers tell us about the necessary research base that is needed? In this section we look at the business drivers for one of the sourcing options – HRO – to help address these questions. The most common business drivers for companies to consider HRO are:

- Cost savings
- Improved service quality
- IT investment/ access to technology
- Improved process efficiencies, global process harmonisation
- Strategic reorientation of HR
- Improved business agility

We will review each of these drivers in turn, but first set the broader decision making context. The decision to outsource reflects a complex amalgam of motivations. Greer, Youngblood and Gray (1999) identified a series of competitive and political forces that by the end of the 1990s were driving a significant proportion of firms to outsource some or all of their HR activities as they attempted to refocus their businesses, lower costs, increase service levels and improve the capability to respond to future business challenges. These were:

1. downsising pressures in other functions, moving into the HR function itself as calls for reduced costs of HR services increased;
2. rapid growth through mergers or acquisitions or rapid decline in markets and associated pressure to monitor costs,. The former provided the opportunity to decide whether to hold onto or release selected HR activities, or was associated with exceptional service demands being outsourced because of limited internal capacity. The latter increased pressure to reduce costs
3. globalisation, where the move from being sellers of products or services to managing more complex international movements, harmonisation of policies, or requirements for specialised services lead to the standardisation of in-house activity or outsourcing to specialist providers.
4. increased competition and adoption of balanced scorecard approaches, which increased attention to customer and employee measures of service quality and created pressure for more responsive service provision at lowest cost.
5. mismatches between the demand for more specialised expertise and growing complexity of HR tasks and capabilities of existing specialists, reinforcing pressure to outsource.

6. desire to reduce HR bureaucracy (perceived) to get in the way of operational efficiency, reinforcing pressures for the shape, size and focus of HR departments to be determined on the basis of market forces rather than procedural processes.
7. outsourcing enabling unsatisfactorily performing or troublesome HR operations to be 'hidden' from view or passed onto vendors, reducing personal risk to the decision-makers.

In addition to descriptions of the political and strategic forces at play, there have also been analyses of the actual management motivations to outsource HR.

#### **Management motivations to outsource HR**

Lever (1997) showed that early developments in the outsourcing of HR were not just driven by cost drivers, but by a combination of three factors:

1. *Cost reduction:*

Savings produced by avoiding the need to add new personnel or by reducing existing personnel by hiring experts in specific areas at lower cost.

Higher value created where transactions with external agents are more cost-effective than building and maintaining internal capacity.

Better service demonstrated at lower prices through economies of scale and learning curve efficiencies as work from several clients is combined.

Standardisation of processes, judicious use of services or reduction of bureaucracy extracting additional cost savings that can be shared with the purchaser

2. *Risk reduction:*

Insuring against problematic performance and reducing business risks by transferring productivity and component cost issues to the vendor.

Vendor risk increased because of exposure to client business life cycles and their profits depending on the client maintaining their business.

Client risk reduced because technological and skills obsolescence/ updating issues and day-to-day control/ co-ordination passed onto the vendor.

3. *Competency-building:*

Building organisational capability by focusing on a set of core competences.

Access to highly skilled specialists and opportunity afforded by outsourcing mundane or infrequent activity used to selectively build internal skills.

Commodity-like and esoteric activity replaced by more value-adding activity.

### Cost savings

While buyers are increasingly demanding higher value and incremental business benefits from their HRO engagement, the achievement of significant cost savings is by far the most frequently mentioned reason why companies outsource (Hesketh, 2006; Cook and Gildner, 2006). The capital outlay, for example for continuous HR technology investments, can be immense and for many companies HRO provides a real incentive to move towards a variable cost model.

Cost reduction has proved an enduring motivation. The study by Brewster, Sparrow and Harris (2005) found that 37 per cent of their sample of MNCs were pursuing an efficiency strategy, combining outsourcing with centralisation and e-enablement. Similarly, data from an UNCTAD/ Roland Berger Strategy Consultants study (cited in Hunter, 2006) shows that in practice the decisions by Fortune 500 companies to pursue another of the sourcing option – that of offshoring - are driven (in order of importance) by: lower wage costs; reduction of other costs; improved service quality; focus on core competences; speeding up the process cycle; avoiding capacity constraints; extending the scope of services; strengthening an existing affiliate; and access to technology and infra structure.

The typical achievable cost savings through HRO are believed to be in the range of 20-25 per cent (Golas, 2005). Hunter (2006) estimates that a typical offshore deal from the UK to India generates cost savings of between 35-45 per cent once offshore overheads (onsite contract management, schedule delays and rework and transition costs) have been accounted for. We caution that such figures need to be read with great care as the achievable cost savings are evidently dependent on a whole range of factors. Some of the most obvious variables are listed below:

- *Previous HR transformation and current HR efficiency rate:* Efficiency savings are typically lower if a company has already established a Shared Service Centre structure.
- *Complexity of HR processes and the extent of transformation and transition work required by vendor:* The more vendor resources need to be tied up during the transition and transformation stage to baseline and untangle 'as-is' HR processes, the more this will impact cost savings negatively.
- *Transition and transformation approach and degree of process specificity required by the client:* The more a client is willing to move towards the standardised 'best practice' processes of a vendor, the higher the opportunities for cost savings.
- *Type of processes to be outsourced:* The more transactional and standardised the requested HR processes the larger the possible cost savings.
- *HRO market maturity and degree of competitiveness:* In the past years many vendors in the multi-process HRO market have struggled to build a showcase base of clients. As a

consequence, they were willing to guarantee significant cost savings to these clients. The more competitive the market for the requested processes, the bigger the positive impact on cost savings.

- *Cost base to be transferred:* The higher the transferred cost base to a vendor, the higher the possibilities for efficiency savings.
- *The delivery model:* There is a positive association between the degree to which the client is willing to accept an offshore delivery model and the impact on cost savings.
- *Employee transition:* The higher the number of staff which need to be transitioned from client to vendor, the lower the possible cost savings.

There are many hidden costs. Barthélemy and Quélin (2006) draw attention to the problem of escalating commitment. The governance and risk mitigation arrangements mentioned earlier (which themselves bear cost) are necessary because of the switching costs associated with a move to outsourcing, and the extent to which the resources that underlie the activity contribute to competitive advantage. There are additional hidden costs associated with adapting the human assets (changes required in the skills and knowledge of employees to work effectively in the new context, the customisation required to business processes, and so forth) involved in the delivery of services.

The strong focus of companies on cost savings as the main business driver of HRO is therefore intriguing. In addition to hidden costs, it is well known that the costs of the HR function is typically not much higher than 1% of the total operating costs of a company. Efficiency savings achieved through HRO are, therefore, unlikely to influence the overall performance of a company.

What really impacts shareholder value, however, are the assumptions that go with HRO in terms of service quality improvement, enhanced strategic focus of the retained HR function, increased alignment of the HR structure for possible merger and acquisition activities.

### **Improved service quality**

Many HR functions which have not yet gone through a significant HR transformation, are characterised by (Golas, 2005):

- Excessive amounts of time management spends on transactional administrative issues.
- Little standardisation and harmonisation of processes across business units and geographies.
- High degree of exception cases resulting in management acting as 'fire fighters'.
- Limited internal capability to manage change and transformation.

In presenting the arguments in the following sections, therefore, more sceptical observers would argue that the potential benefits presented should be seen as no more than propositions that remain to be tested and evidenced. This is undoubtedly true. More pragmatic observers would argue that strategy

tends to follow action, and the potential benefits presented will act as proxies for strategic logics and as benchmarks that could be up to evaluate inevitable actions in the area.

Unlike internal HR functions, outsourcing providers must prove themselves in the market place (Cook and Gildner, 2006). In order to maintain their competitive position, vendors will strive for maximised process efficiencies and the application of best practices. Vendor specialisation, company size and market position means that they are typically in a good position to attract HR talent, develop and maintain high professional standards. Indeed, 'best in class' vendor companies typically have sophisticated HR metrics systems in place, which they use with client companies. Given the dearth of HR metrics in the average client HR function, the availability of intelligent metrics can drastically improve the way an organisation's retained HR organisation is perceived by top management. This obviously assumes that a client organisation has successfully gone through the appropriate design and implementation of an effective retained HR function which is capable of utilising a vendor's HR metrics.

#### **IT investment/ access to technology**

In many companies continued investment in HR technology has been a low priority. HR information systems (HRIS) are often in desperate need of upgrades or patching. HR functions are frequently highly fragmented and differentiated across geographies or business units. As a consequence their HRIS consists of a patchwork of highly customised and incompatible systems with poor data integration qualities with existing ERP systems and poor analytical and reporting functionalities.

Any internal HR transformation is, therefore, typically linked to immense investments in HR technology. Often a new or updated ERP module is needed and/or investments in adequate ESS/MSS portal technology and CRM systems. Furthermore, ongoing licensing, upgrade and maintenance costs need to be considered. Even after heavy investments, many companies are not using the implemented technology effectively. Experts suggest that most users take advantage of only 10 per cent of what an application provides (Ravi et al., 2006).

Through an outsourced solution, clients can avoid ongoing IT investments. Furthermore, clients gain access to cutting-edge technology. For vendors, continuous investments in their HR technology is a prerequisite to keep up with competition and for many it is a source of competitive differentiation.

#### **Improved process efficiencies and global process harmonisation**

Historically, many MNCs have structured their HR processes on a country-by-country or regional basis. The assumption was, that HR is too idiosyncratic and country-specific in order to allow global harmonisation. Today, MNCs increasingly try to harmonise at least their transactional HR processes (e.g. the administration of payroll, training, performance appraisals) globally. Yet, decades of decentralised HR management have still left redundancies in terms of HR delivery platforms, services

and resources. Internal transformations towards global HR structures are therefore always likely to meet strong and continuing internal resistance.

HRO vendors are still in the “proving” stage of being able to deliver seamless global services, but they are surely developing this capability rapidly (Martorelli, 2006). For this reason we discuss international differences in the pursuit of HRO later in the paper. At this point, however, suffice it to say that for many MNCs, HRO is therefore an option to gain access to consistent global practices which are delivered via highly efficient platforms. The delivery platforms of vendors are already in place, speeding up the implementation of these processes. During the transition and transformation phase, vendors will share the burden of an intensive change management task and will help the company deal with internal resistance. Furthermore, vendors will control legal risks and ensure compliance of global processes with local/ regional laws and regulations (e.g. on issues of data protection).

### **Strategic reorientation of HR**

Increasingly companies want to restructure their HR function so that remaining internal staff are more focused on transformational processes and the delivery of strategic activities, rather than spending the majority of their time on transactional administration. The reasons for this lie in the expressed desire by many senior executives for HR to become more involved in transformational activities such as workforce strategic alignment, the strategic management of workforce costs, the creation of a human capital metrics system which incorporates not only efficiency measures (of the HR function) but also effectiveness and impact measures of HR activities on the workforce (see for example the work of authors such as Lawler, Levenson, Boudreau, Huselid and Becker)

Outsourcing transactional HR activities clearly allows companies to pursue this ambition. Yet, once transactional processes are outsourced, a strategic reorientation of HR is only possible if a company is willing to go through a dramatic change process in designing and implementing a world-class *retained HR function*.

We argue that MNCs need to build an HR business partner structure that is committed to dealing with HR issues impacting business units. Implementation of such a structure is hugely complex, even in a domestic setting, especially as in many companies the boundaries of this role are far from clearly defined and existing HR personnel often not displaying an adequate set of competencies. Making this operate across national boundaries where the role of business partners and line managers varies so much raises its own research agenda.

Parallel to a Business Partner structure, for the continuous development of HR strategy, policies, processes and services, MNCs have been advised to develop a Centres of Excellence (CoEs) structure. The traditional and evolutionary progression of MNCs has been discussed in the context of the trade-off between global integration and local responsiveness, but as MNCs change their organisation design in response to the need to build more international capability, they establish

dedicated balancing mechanisms and organisational forms to facilitate this - one of which is the centre of excellence (CoE). CoEs are organisational units that embody sets of capabilities that are explicitly recognised as an important source of value creation. They need strategic remits, such as the intention to leverage or disseminate these capabilities to other parts of the firm. Whilst the leadership of a CoE might be vested in a physical location, the centre itself may be virtual, spread across networks of teams in different geographies (Sparrow, Brewster and Harris, 2004).

CoEs involve further differentiating the retained HR services into those activities where additional benefits can be obtained if the capability can be leveraged internally. The development and effective use of CoEs therefore demands a clearly defined knowledge management strategy, an understanding of the development stages of CoEs, and the establishment of interfaces which structure the exchange of knowledge between the CoEs, Business Partners and Business Units as well as corporate HR (Sparrow, 2006).

Additionally, companies will need to develop advanced Management Information (MI) and HR metrics system. Vendor companies will be able to provide their clients with sophisticated HR metrics related to the outsourced transactional activities. The effectiveness of such metrics, however, is greatly diminished, unless they are combined with metrics generated within the retained function and unless they reach and can be utilised by their appropriate recipients in the Business Partner roles and the CoEs.

### **Improved business agility**

The argument that HRO produces improved business agility rests on the assumption that a combination of outsourced, centralised and standardised transactional HR processes, combined with a restructured retained HR function and an effective HR metrics system, will greatly improve decision making support within a company and will enhance control and impact measurement of HR activities. Furthermore, outsourced solutions can provide an effective platform for growth, business fluctuation, organisational change and merger and acquisition activities. It is HRO vendors who are in a far better position than an individual company to flexibly adjust to changing patterns in service demand. By operating on a “one-to-many” service delivery platform, vendors are able to spread their resources flexibly across their clients, without a decrease in service quality.

### **Constraints to development**

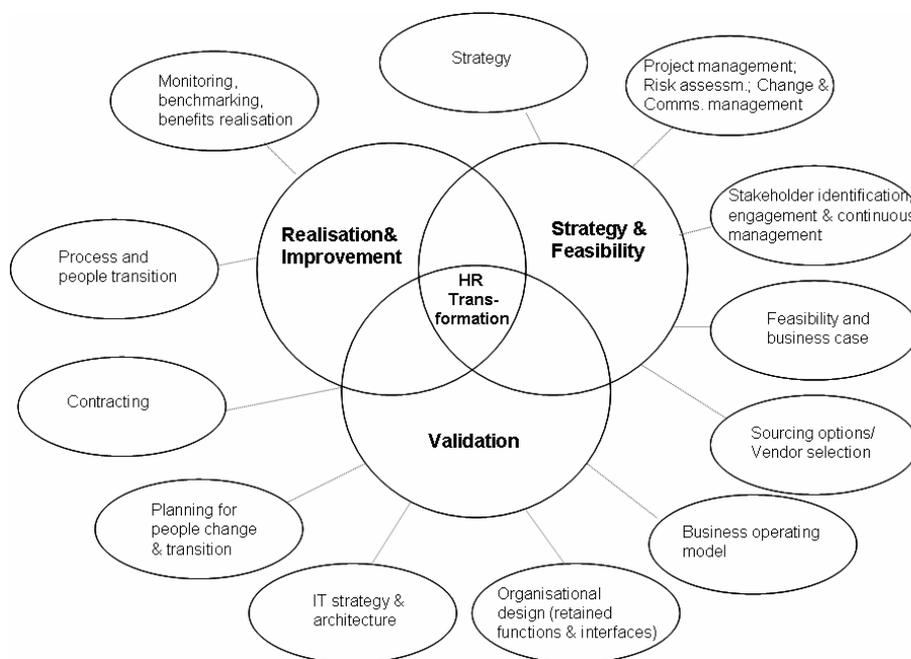
There are, however, some natural constraints to the pace of the sourcing and shoring options discussed in this paper. Constraints to offshoring have been discussed recently. The demand and supply of appropriate talent is one of these constraints. The McKinsey Global Institute has analysed likely demand for offshore talent in service work within the automotive, financial services, software, pharmaceuticals and retailing sectors as well as the likely supply of offshore talent in 28 low-cost countries (Farrell, Laboissière and Rosenfeld (2006). They estimate that 11% of service jobs around

the world have the potential to be carried out remotely, though this varies across sectors, ranging from 49% in packaged software to 3% in retail. In practice only a small proportion of those jobs that could go offshore actually will – total offshore employment will grow from 1.5 million jobs in 2003 to 4.1 million by 2008 – only 1 per cent of service jobs in developed economies. The main deterrents to larger movements are:

1. company-specific considerations such as scale (current fragmentation of work makes it difficult to create sufficient critical mass of activity, and therefore insufficient scale of activity to justify the costs of offshoring),
2. structure (large organisations have complex business processes that would require root and branch reorganisation in order to globalise service delivery; international growth through mergers and acquisitions creates complex interactions, and separating out those portions of an operation that could be performed offshore is very difficult)
3. management attitudes (senior managers are wary of overseeing operations that are geographically remote, travel and co-ordination costs and availability of talent).

From this, there are a range of important success and readiness factors. These are summarised below in Figure 1 and detailed in Appendix 1.

**Figure 2:** Crucial elements in the HR transformation process



## SO HOW WILL THE HRO MARKET CONTINUE TO DEVELOP?

Given such constraints, clearly automation or organisational restructuring of existing activity may be a more attractive option than offshoring. Such a comment requires that we enter into a penultimate discussion. In order to identify relevant and sustainable research agendas, we need to consider how the market for sourcing and shoring options is developing. To do this, in this section we review the evidence on developments in the HRO market, by looking at the volume and scale of deals, international differences, and the current developments and challenges.

Hesketh (2006) cited research by the Everest Research group showing spending on HRO increasing from \$75 million in 1998 to \$1562 million by 2004. Golas (2005) estimates that the HRO market is worth approximately \$3.6bn. Much higher estimates are also to be found. According to strategy consultants McKinsey, the *potential* global market for HR offshoring could be worth £27 billion by 2008, up from £0.6 billion in 2001. Despite their observations about constraints on growth, the amount of 'offshoring' is expected to have shown a rise by an average of 71 per cent each year between 2001 and 2008 – twice the rate of most other business activities. Currently, the USA and UK together generate almost three-quarters of global offshoring activity. However, whilst legal and cultural differences are still considered to inhibit the transfer of more advisory roles, it has become feasible to move HR administration overseas. Prime candidates for HR 'offshoring' have included payroll, as well as pensions and benefits administration (see Table 1).

However, predictions about future growth have to be read very carefully. After much hype in recent years, growth in the HRO market actually slowed somewhat in 2006, although this was believed to be only a temporary slow down. The most positive estimates by research institutes claim that over the next 3-5 years, the total HRO market will grow by a compound annual growth rate (CAGR) of between 8-10% (Golas, 2005; Cook and Gildner, 2006). However, within this "multi-process HRO" will show a higher CAGR of 10-20% (Rowan, 2006).

**Table 1:** HRO market volume

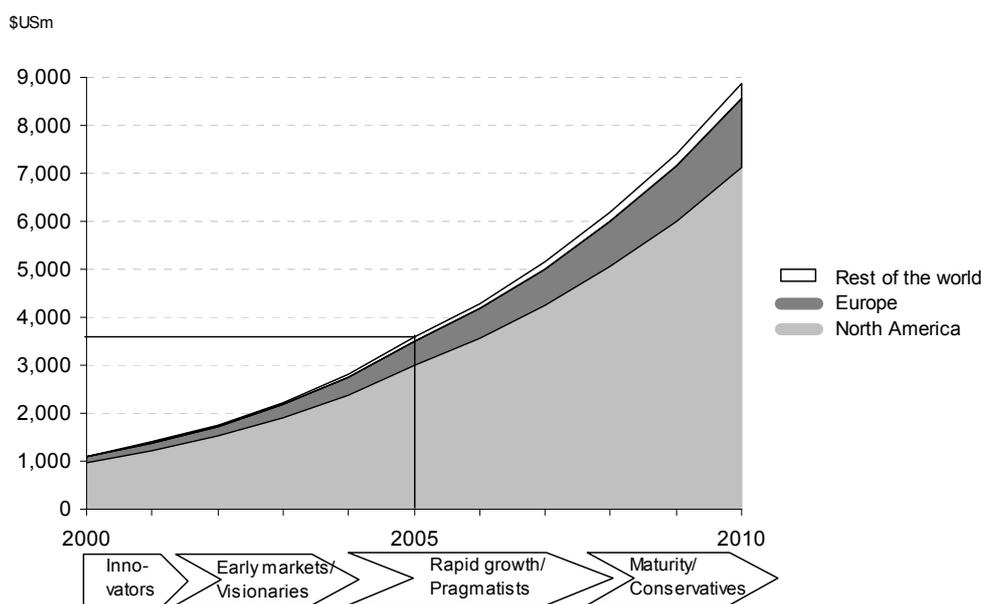
HRO categories	2005 Estimated Global Market (\$m)	2009 Estimated Global Market (\$m)	Estimated CAGR (%)
Multi-process HRO	3,600	7,400	20
Payroll Administration	8,700	9,800	3
Benefits Administration	10,600	15,400	10
Recruiting and staffing	26,100	38,000	10
Workforce development	24,100	29,400	5
Mobility Services	10,200	13,300	7
Total	83,300	113,300	8

Adapted from Golas (2005)

Significant progress in globalising HR service delivery has been made through the inter-related developments of sourcing, technology and process streamlining. We have outlined the different sourcing options in the introduction, but in addition there have been developments in technology and in the nature of process streamlining. Arrangements have evolved rapidly and become more complex. Many current multi-process HRO contracts developed out of more traditional single process outsourcing deals for payroll and benefits administration (Martorielli, 2006). Although CAGRs for these market segments are estimated to be significantly lower than for multi-process HRO, currently these single process HRO market segments still outweigh the multi-process HRO market. Payroll administration is estimated to have a global market volume of \$9.8bn, whereas benefits administration is believed to represent \$15.4bn. When all the single process service areas are included, the global HRO market is estimated to have reached a volume of more than \$80bn in 2005 and is expected to rise to well over \$100bn by 2009/10 (Golas, 2005; Cook and Gildner, 2006).

Not only is service provision of HRO moving from single to multi-process, it is changing from the mere provision of bureau, processing and managed services in the more traditional process areas, towards the provision of multiple, fully outsourced end-to-end processes. The market for services has now become quite differentiated.

With the service offerings of vendors evolving, an increasing number of companies are evaluating the feasibility of outsourcing either parts of, or entire end-to-end processes. These developments have been linked in particular to three HR processes: recruitment, training and development and talent management (Hesketh, 2006; Ravi et al., 2006) with a particularly strong and rapidly growing single process HRO segment in this regard being recruitment and staffing. Golas (2006) estimates the total market for this segment - Recruitment Process Outsourcing (RPO) - to have a volume of \$26bn with significant growth potential. Although few vendors in the RPO sector are capable of providing a complete end-to-end recruitment and staffing solution (certainly not without entering into other partnerships), they are quickly building their technological and service capabilities and are active in every stage of the recruitment process i.e. strategic consulting, sourcing, screening, on-boarding and benchmarking and surveying (Teng, 2006a).

**Figure 1: Multi-process HRO market growth**

Based on data from Golas (2005)

What does this analysis of the HRO market show us? There was an initial 'innovator' phase, seen for example in the early deals by BP and Bank of America with Exult in 1999/2000, followed by the recent 'early market phase', in which firms have moved down the learning curve. In this early market phase some firms that signed HRO deals in the innovator phase re-evaluated their contracts and in some cases re-contracted (this happened at firms such as Bank of America and BASF). However, the multi-process HRO industry has now entered a new rapid growth.

#### **The characteristics of the multi process HRO industry.**

The industry can now be characterised by two developments:

1. After a relative lull in so called 'mega-deals' (i.e. deals exceeding total contract value of \$1bn) in this period, recently there has been an increase in such deals, involving firms such as DuPont, Unilever, and CVS (Rowan, 2006). For example, the Unilever contract signed in June 2006 was the largest multi-process HRO contract to date, on the basis of total contract value, number of employees served and geographic scope. The Unilever contract also suggests that there is a new pattern of activity developing. A number of companies are now following their innovator competitors (in the case of Unilever this is Proctor & Gamble) in entering multi-process HRO contracts.
2. In 2005 and 2006, the industry also saw a significant increase in the activity in the multi-process HRO mid-market, serving companies outside the Global & Fortune 500 and FTSE 100 MNC

categories (Mortland, 2006). Evidence for this second development can be seen in recent vendor moves. For example, Accenture acquired Savista (a provider of HR and payroll services to the small and mid-market), Aon aligned with Ultimate Software for mid-market platform delivery. In 2005 Gevity, originally focusing on small businesses, announced a mid-market initiative moving upmarket (Ravi et al., 2006; Rowan, 2006).

### **ARE THERE INTERNATIONAL DIFFERENCES IN THE HRO MARKET?**

The practitioner literature on market differentiation and volume increasingly suggests then that the world of outsourcing is at an important juncture. The outsourcing penetration in the MNC market is believed to be about 4 per cent (Teng, 2006b). However, in pointing to evidence that many outsourcing deals collapse before the contract ends, PriceWaterhouseCoopers (2007) highlight contrasting prognoses whereby “some industry analysts and media pundits ... translate the findings into painful trade-offs: cost savings vs. growth, speed vs. quality, and organisational cohesion vs. knowledge and innovation. Others suggest outsourcing is in a death spiral... a decline fuelled by structural risks, questionable cost savings, and multiple complexities” whilst others point to “lucrative outsourcing deals, impressive benefits and uncapped growth projections” and “level[s] of strategic and operational flexibility unattainable through other means” (PriceWaterhouseCoopers, 2007, p.2). Their survey of 226 customers and 66 service providers across nine countries confirmed the growing complexity of options, maturing strategies and innovative partnering. However “... outsourcing is now as diverse as business itself, differing by country, sector, and company strategy” (p.3).

In this section we consider the nature of international differences in HRO through by asking (and briefly addressing) five questions:

- Is there geographical differentiation in HRO expenditure and market volume?
- Are there different preferences for in-sourcing versus outsourcing across geographies?
- What factors likely determine international differences in adoption?
- Are there cultural differences in service perception (and so different pull factors with regards to use of services)?
- What is the institutional context that surrounds the attractiveness of sourcing and shoring options?

The picture in relation to international differences in the attractiveness of HRO remains a little confused, depending on whether one examines practice at the level of organisations or the size of the market for services. From the former perspective, Mahoney and Brewster (2002) found that approximately one quarter of European organisations involved in the 1999 Cranet survey used external suppliers for multiple services (3 or more HR processes). Whilst the use of suppliers was

increasing significantly, 55% of organisations had not changed their use of suppliers in the three years prior to 1999. The trend in outsourcing was clearly up but was not yet fundamentally changing the basis on the way in which the HR function was organised. There were important country variations in the outsourcing of HR even though overall the use of outsourcing is widespread across Europe. The results showed that for a majority of countries in Europe, more than 60% of organisations outsourced. Countries outsourcing the most included Sweden, the Czech republic, Poland, the Netherlands and Finland (92%, 86%, 78% and 77% respectively) and countries outsourcing the least included Turkey Greece and Italy (32%, 46% and 49% respectively). The United Kingdom was just above the average, with 71% of organisations outsourcing. There was also wide variation in the resource levels and cost structures of HR functions throughout Europe and the research evidence did not support the assumption that organisations with a low HR staff to employee ratio used suppliers more, nor that by using suppliers the headcount in the HR department was lower.

However, when market volume data are analysed, then there are clear international differences in the market for HRO. There is a geographically differentiated HRO market which reflects the pattern seen in the broader business services market. North America is clearly dominating the HRO market. In the multi-process HRO segment, North America is estimated to represent a market volume of \$3bn. In contrast, Europe and the rest of the world have significantly lower market volumes with \$500m and \$80m respectively. On the other hand, growth expectations in Europe and the rest of the world are higher than in North America with 23% and 32% annual respective growth.

Region	005 Estimated Market Size (\$ million)	009 Estimated Market Size (\$ million)	Estimated GAGR (percentage)
<b>NORTH AMERICA</b>	3,000	6,000	19
<b>U.S.A.</b>	2,500	4,900	18
<b>Canada</b>	500	1,100	22
<b>EUROPE</b>	500	1,150	23
<b>UK</b>	220	410	17
<b>Continental Europe</b>	280	750	28
<b>REST OF THE WORLD</b>	80	250	32
<b>TOTAL</b>	3,600	7,400	20

Table 2: Multi-process HRO market by geographies  
Adapted from Golas (2005)

Within Europe the majority of HRO spending goes to single-process payroll outsourcing (Takahashi, 2006) and the total market value in Europe, inclusive of all single and multi-process HRO, is estimated to be approximately \$4.8bn. However, the UK is clearly the most established European HRO market, accounting for approximately 40% of Europe's HRO spending. Germany and France account for approximately 16% and 14% of HRO spending (Takahashi, 2006). The relatively lower HRO market penetration in these two core EU economies has been linked to stronger trade union influence and the legislative complexities associated with HR (Golas, 2005). The majority of the remaining European HRO spend is distributed across the Netherlands, Italy and the four Nordic countries. Forrester predicts rapid future growth in the Baltic and Eastern European countries (Takahashi, 2006). Indeed, 2006 witnessed an increasingly buoyant European multi-process HRO market, evidenced by the signing of a number of significant deals in firms such as Unilever, BBC, Nestle, Lloyds, and Centrica (McEwen, 2006).

However, there is still evidence that suggests that continental European firms continue to favour captive (in-sourcing) arrangements rather than pure outsourcing scenarios (Golas, 2005). Hesketh (2006) argues that HR directors in Europe may see an in-sourced shared services route as the best stepping-stone to future HRO. His research across 28 organisations, such as Credit Suisse, Deutsche Bank, Royal Bank of Scotland, IBM, Shell, and Royal Mail Group showed increased outsourcing of higher value HR processes such as recruitment, use of shared service models and evolution of e-HR activities.

Cooke and Budhwar (2008) concur with this. The complexity of HR operations still makes single process outsourcing an attractive option and many of the solutions that have been adopted are not as radical as some of the practitioner literature suggests. They also draw attention to the persistence of wide international differences in the pursuit of HRO. Asian organisations are not adopting outsourcing to the same extent as found in US and European organisations. They link the current (limited) use of outsourcing by indigenous MNCs or small firms to the size of domestic businesses, the sophistication of HR functions, the extent to which there is a developed local HR outsourcing market, cultural norms and other institutional factors. They examined the specific challenges associated with the offshoring of HR work to India and China., noting that currently the motivation to offshore to each is different. They argue that, unlike IT outsourcing and offshoring, the same decisions in relation to HR work tend to be tied far more closely to the internationalisation strategy of the firm, and driven by motivations to reduce levels of uncertainty and to gain insight into local market conditions.

IHRM functions clearly face complex decisions, and the outcome is clearly likely to vary across national ownership. In a global context, local country managers argue that much of the corporate HR armoury requires deep tacit understanding of the national culture and therefore should not be a

candidate either for operation through shared services or indeed for any subsequent outsourcing. Organisations must make sensible assessments of this tacit knowledge constraint.

It is also likely that other national factors will influence the effectiveness that might be achieved in outsourcing (and associated automation) of HR activity. Although not directly looking at HR outsourcing, there is some work that should be of interest to HR researchers. It comes from the international and services marketing literatures and has been carried out looking at international differences in service perceptions. This draws attention to the role of ethics in explaining cultural differences in service perception and could be used to explore the implications of offshore outsourcing for consumer (employee) behaviour and the way in which perceptions, attitudes and behaviours to the new organisational forms may differ internationally:

*“... within e-business environment, while there is evidence that the processes of engineering and implementation of... systems are being successfully exported... as a consequence of globalisation, the adoption of western social and ethical values... is another matter”.* (Ruzic, 2006, p.99)

The work of Ruzic (2006) shows that employee engagement with and usage of e-enabled services is influenced by a series of ethical judgements made about the provision of such services, namely: perceived personal benefit; social benefit; societal consequences; level of benevolence (help to those in need); paternalism (assistance to others to pursue their best interests when they cannot do it themselves); honesty (lack of deceit); lawfulness; autonomy (freedom over action); justice (due process); and rights (to information, privacy and free expression). It would be interesting to see if such factors have any utility in explaining international differences in the attractiveness (or not) of e-enabled HR services that are associated with the organisational solutions that accompany outsourcing (such as shared service centres, centres of excellence and self-service intranets).

Finally, there are also very real problems faced in the calculation of the cost-benefit of these decisions, and the cost-benefit varies across countries in subtle ways. For example, Pyndt and Pedersen (2006) found that whilst the direct benefits of offshoring may be easy to understand (and are derived from savings in labour costs, foreign suppliers import of products or services and repatriation of profits), the indirect benefits of offshoring (which include the value of re-employing the employees in the home country affected by the offshoring) make the calculation of true costs and benefits much more difficult. They point out that in principle, capital savings associated with offshoring can be reinvested in higher value jobs. Achieving these benefits is dependent upon the home country's ability to train, upgrade and re-employ the home workers. It immediately becomes clear that the institutional context that surrounds the employment relationship both in the country from which work is outsourced and the new location determines the attractiveness (or not) of offshoring. In Denmark the return on every unit of currency invested in offshoring was 1.15, but in Germany the equivalent return was only 0.8. In part

this figure also reflects the fact that German firms tend to offshore to East European countries, which have higher labour costs.

The pursuit of these processes across countries is a relatively under-theorised one, although recent advances in institutional theory have focused on the causes and nature of the diversity in organisational practices, and differing degrees of receptiveness to new technologies (Streeck and Thelen, 2005).

## WHAT ARE THE FUTURE DEVELOPMENTS AND CHALLENGES?

Having noted the challenges of executing sourcing and shoring strategies on a global scale, we return to a generic discussion of the future developments and challenges for HR functions. It is clear there are performance issues surrounding HRO deals and continuing debates over the shape of HR functions and the focus of HRO measurement and evaluation. In order to address these latter concerns, attention should be focused on five issues:

1. Efficiency focus in the delivery of HR services
2. Developments in the HRO vendor landscape
3. The need for improved understanding of the outsourcing process
4. The need to see HRO as part of multi-functional outsourcing arrangements
5. Understanding the issues involved in the management of multiple vendor relationships

Continued attention to the first element – that of efficiency - will result because of the idiosyncratic nature of many HR processes and frequent resistance by client companies to offshore (this resistance applies particularly to voice-related HR processes). As a consequence the HRO business model cannot take full advantage of the cost benefits of offshore labour arbitrage. The real test for HRO providers is their ability to create the necessary economies of scale without jeopardising service quality (Ravi et al., 2006). Providers are currently relying on streamlining service delivery and processes to create cost savings. But in contrast to experience in finance and accounting outsourcing, where delivery can be judged on a standardised basis, for HR services the delivery challenge is highly complex. Many HRO providers are struggling to deliver immediate cost savings as well as promised service quality improvements (Fersht, 2006). Moreover, despite the fact that vendors have built impressive delivery centres and capabilities spanning the globe, their ability to truly optimise HR processes on a global scale remains to be proven (Martorelli, 2006).

One way of predicting future developments in HRO, therefore, is to consider a second element. How will vendor HRO strategies develop in response to these challenges? After all, it is their survival that is most at stake. An analysis of their strategies is informative. They have a vital interest in focusing on those HR processes that can be easily adapted to an outsourced model and that eventually allow them to reduce costs through a 'one-to-many' service delivery platform. To create the necessary economies of scale:

1. To reduce costs, they will focus on clients who have large transferable cost bases, by offering improved and increased offshore capabilities (including their capabilities for voice related processes)
2. To improve their multi-shore delivery arrangements, vendors will need to combine on-, near- and offshore delivery in the most cost-efficient way.

3. To increase acceptance among future clients for off-shore delivery, they will develop their communication strategies.

Apart from the classic offshore locations in India, new locations are continuously developing, for example in Mexico and Jamaica in the Americas, or Philippines and Malaysia in South East Asia. However, a geographically differentiated HRO market segment should be expected to continue. The country specific nature of HR means that geographies vary with regards to their client requirements and their current HRO penetration. Vendors currently have, and will continue to develop, differentiated strategies serving particular geographic regions. For example, providers like Fidelity and Hewitt have appealed to US-based clientele with their strong payroll and benefits solution focus (Rowan, 2006; Martorelli, 2006). providing continued opportunities for new suppliers to enter the market entry, with for example new providers developing out of the current Indian offshore providers.

On the other hand, given that a crucial requirement for many MNCs is the need to optimise and harmonise their processes on a global scale (Sparrow, Brewster and Harris, 2004), there is a strong demand for a pan-regional and global capabilities (payroll is one example of this). Vendors in the multi-process space (such as Accenture, ACS, Convergys, IBM, Hewitt) as well as those in the single-process market (such as ADP and Arinso for international payroll) have responded by crafting HRO strategies that appeal to this MNC market.

A third element is the need to improve understanding of the outsourcing process. HRO clients now understand that many outsourcing agreements have run into difficulties because of lack of up-front investment into the development of a valid business case. HRO clients increasingly understand that the initial base-lining of processes and costs and the development of a solid business case is an absolute prerequisite to track future benefits and to monitor an outsourcing arrangement with a vendor. In future, HRO clients will become more advanced in the development of Service Level Agreements, Price and Performance mechanisms, and the benefits realisation process. Understanding and articulating these data and mechanisms on a global scale represents a significant challenge for researchers and practitioners alike.

A fourth element concerns the need to view these processes across functions. As observed by Sparrow, Brewster and Harris (2004), the pursuit of global strategies is leading to increasing convergence of workstreams across HR, IT, marketing and supply chain functions. As Business Process Outsourcing becomes increasingly established in multiple business functions, clients will start integrating HRO as part of what are called “multi-tower arrangements” i.e. arrangements that also include F&A and IT. As a result, companies will look for ways to capitalise on the synergies of cross-functional outsourcing contracts.

A fifth and final element is that with an increase in outsourcing activity, the need to manage multiple vendors (either as part of a multi-tower deal or existing vendor relationships) will become an increasingly complex task for organisations. This will further increase pressure for converged

organisational capabilities (and structures) that sit across HR, IT and F&A functions in side globalising firms.

## **CONCLUSIONS**

The paper has argued that there are two strategies are at play, involving options of both sourcing and shoring of HR services. Different theoretical perspectives tend to have been used to analyse each option but this theory tends not to align with the pragmatic judgements made by strategic actors. A complex range of variables can be identified that need to be controlled for when analysing the effective execution of sourcing and shoring strategies. Moreover, such strategies cannot be analysed without understanding parallel developments in the strategic re-orientation of the HR function. There are continued and substantial international differences in the pursuit and preference for HRO. Despite the fact that HRO vendors are building impressive delivery centres and capabilities spanning the globe, their ability to truly optimise HR processes on a global scale remains to be proven. However, the service offerings of vendors are evolving rapidly to address such concerns.

A number of conclusions can also be drawn with regard to HR functions should be drawn from the analysis of contemporary developments in sourcing and shoring options in this paper. Within IHRM functions there will be some immediate tactical and reactive challenges. For example, Cooke and Budhwar (2008) have drawn attention to some specific challenges created for corporate IHRM functions, including issues such as problems with the recruitment and retention of local talent, differences in career advancement behaviour, potential for hidden discrimination, a heightened importance of boundary spanning and co-ordination roles and the fragmentation of HR careers.

In terms of more strategic considerations, HR functions will have to determine whether the desire (of the organisation or their internal stakeholders) to outsource an HR activity is driven by its low contribution to core competencies, is influenced by the external environment, or reflects poor management of the activity. They will therefore need to demonstrate that performance is more important than low HR department headcounts or lower costs. They will have to consider the trade off between different ways in which they may be evaluated. Many of these trade offs will be very political in nature. For example, might the need to retain and 'pamper' world-class talented employees through personalised service and with error-free administration outweigh potential cost savings of offshoring? As researchers, how would we help demonstrate the consequences of such trade offs?

They will need to avoid excessive deskilling and reliance on single vendors. This means that they will need to assess what the impact might be of learning accruing to the vendor, and not to themselves. In turn, this will require that they must decide how much control and organisational learning is needed for various HR activities and whether such control can be retained with outsourcing.

HR functions will therefore have to treat vendor selection with the same due diligence exercised during a planned acquisition. Managing vendor relationships will be as important as joint venture relationships, requiring the development of long-term relationships where continuity of service, learning of corporate culture and development of employee-organisation fit will be critical. Such (global) assessments are usual for actuarial or search firms, but will likely be extended to more outsourced activities.

These are all implications for the management of those activities that may be handled through different sourcing and shoring options. But, perhaps the most important question that still needs to be understood in the field of HRO is what is the best way to organise the (surviving) HR operations? We believe that there is an important research agenda around the current roles for international HR professionals in the development of centres of excellence (CoE) and structures for the retained HR business. HR functions need to understand what CoEs can be created within their own activities, and how they can build networks of HR experts within these areas of competence on a global basis (Sparrow, Brewster and Harris, 2004)

The IHR function now has to understand how to link developments in new forms of international working and the international mobility of staff in relation to either geographically remote CoEs or globally in-sourced service operations. They need to reconfigure their core competencies on a global scale by adjusting talent management strategies. They need to the best HR strategies to co-ordinate and control such activities. There are a number of likely future avenues for research. What activities, processes and capabilities best constitute a CoE and how should such units be mandated? What has to happen in terms of the “capability building investments” that are needed to develop the retained HR business? In addition to specifying these capabilities, what are the levels of decision-making autonomy, the requisite levels of connectivity to other sources of competence inside the organisation, the leadership roles and processes of knowledge management that will ensure effective operation? What are the indicators of success and under what contingencies? Finally, to what extent do institutional factors preclude or support the long term survival and contribution of CoEs and retained HR structures?

## **Appendix 1**

### **HRO Success and readiness factors**

In identifying readiness and success factors for a HRO project, it makes sense to look at the crucial elements which need to be dealt with during a HR transformation process.

Well managed HR transformation projects go through a strategy and feasibility, a validation and a realisation and improvement phase. Each of these phases is linked to a range of activities. Awareness and adequate resourcing of these activities will maximise the chances of success and will minimise the risks associated with a HRO project.

#### **Strategy**

For any successful HRO project, it is essential that there is a high level of senior management sponsorship and a willingness to formulate a clear sourcing strategy. This entails a roadmap detailing an appropriate sourcing process, the development of a compelling case for change and an understanding of the significant organisational changes which need to be driven in order for a HRO project to succeed.

An effective management team will have a clear understanding of the resources needed for a HRO project, e.g. continuous change and project management skills, communications and relevant legal competencies, base-lining and business case development skills, organisational design and HRIS insights, and will carry out a gap analysis up front in order to draw up an adequate resourcing plan. It is essential to understand that skills required in each phase of the HRO process will vary.

As a part of a sourcing strategy, management will also have to come to a high-level determination of which HR processes and activities should be in scope or out of scope. This includes a plan for a notional future service delivery split for in-house versus outsourced delivery. Furthermore, at this stage, management will review any specific project requirements and challenges, e.g. geographic delivery issues and the viability of global, regional or multi-domestic sourcing options, ERP technology investments etc.

#### **Project management, risk assessment, change and communications management**

Strong project management skills with a focus of continuous risk assessment and planning for risk mitigation is another essential success factor of a HRO project. Risk assessment and the continuous capture of emerging risks and planning for mitigation is an on-going exercise in every step of the HRO process.

Furthermore, throughout the sourcing process an emphasis needs to be placed on continuous change and communications management. HRO projects are obviously likely to have a significant impact on employees within the HR function. However, unlike outsourcing projects in other functions, e.g. a typical FAO project, HRO is likely to impact a far wider employee group (very often *all* employees within an organisation). Any service delivery change resulting from the HRO project which is perceived as a worsening to the old state can, therefore, have an adverse effect on employees' morale, and subsequently on the employer's brand.

Strong project management, a timely delivery of promised changes and effective communications of all changes to affected employee groups are seen as prerequisites to minimise the risk of a HRO project failing.

### **Stakeholder identification and engagement**

A core element feeding into project management and the communications activities is a stakeholder review. HRO projects will affect various stakeholders internal as well as external to the organisation.

Key stakeholder groups internal to the organisation may be:

- Management functions outside HR, especially those with a direct operations interface with HR, e.g. Finance and IT;
- Divisional management;
- All HR employees, but particularly those which are affected by the project;
- All employees affected by the HRO initiative.

Key stakeholder groups external to the organisation may be:

- Owners/ Shareholders;
- Suppliers and vendors. HRO contracts frequently impact already existing contractual relationships with other vendor companies. It is often possible to exit these previous relationships before the end of the contract, by paying an agreed penalty. Quite frequently, however, existing relationships get absorbed into a new HRO contract;
- Retired employees, in particular in the case of a contract involving pensions administration outsourcing;
- Trade unions, in particular with regards to employees transferred to a HRO vendor company;
- Local, national and regional government agencies, with regards to the tendering and bidding process, employee transfers, data protection issues etc.

- Clients and general public with regards to service delivery issues and treatment of employees affected by the project. It needs to be recognised that even after an outsourcing contract has been signed, bad press created by the vendor company can have a negative impact on the client company.

It is important to carry out an analysis on the requirements of each stakeholder group with regards to its change management and communications requirements. For example, different employee groups will be affected in different ways and will need to be addressed with a differentiated set of change management and communications activities.

### **Feasibility and business case**

The importance of a sound business case cannot be emphasised enough. It is the essential tool to decide for or against outsourcing. Furthermore, it is the basis for any future validation and benefits realisation exercise. In conjunction with the business case, in-scope processes need to be mapped, transactional volumes determined, the use of technologies and their interfaces documented. Furthermore, it needs to be clarified to which extent particular HR roles are involved in the in-scope HR processes.

A business case involves the base-lining of current 'as-is' HR activities and the associated service delivery costs. It also involves the modelling of several scenarios: Typically a 'do-nothing' option, (several) outsourced scenarios and a set of in-house options. The number of scenarios which are considered in the business case are usually linked to a sensitivity analysis. A well conducted sensitivity analysis again reflects a thorough understanding of the possible risks and contingencies associated with a HRO project.

Furthermore, a business case is always the basis for any comparative analysis between 'old state' versus 'new state' and the assessment of vendor performance. Without a valid business case, it is impossible to determine e.g. achieved cost savings of a HRO project and to calculate any Return on Investment (ROI). The business case, therefore, also becomes a crucial element in vendor management and the design of vendor performance management systems.

### **Sourcing options and vendor selection**

Success in a HRO project can only be achieved if there is a compelling business case which justifies outsourcing. Having an impartial view towards several sourcing options, therefore, becomes critical in the starting phase of a HRO project.

Clearly, HRO cannot be recommended to every organisation. Outsourcing is only justified if cost savings and service quality improvements outweigh or are at least in balance with a worsening risk profile the company faces.

Unless there is a solid business case suggesting that a company should outsource, it is essential that management does not close its eyes to the available in-house scenarios or even a 'do-nothing' option.

In case outsourcing is recommended, companies often go through a prolonged vendor selection process, involving vendor meetings, workshops, site-visits, and a process of down-selecting to the most suitable and capable vendors. Typically vendors are invited to submit a response to a Request for Proposal (RFP) which details the potential client's requirements. In the case of public sector organisations (above a certain contract threshold value), companies need to follow the OJEU notice process. This involves placing an invitation for RFP responses in the Official Journal of the European Union (OJEU), to ensure a fair tendering process.

### **Business operating model**

Clarity in terms of desired changes for the future operating model again is one of the cornerstones for success in HRO. Outsourcing HR activities typically involves moving activities into an outsourced centre of scale (in contrast to an internal Shared Service Centre). One of the drivers for outsourcing is that it allows remaining internal staff to focus on transformational processes and the delivery of strategic activities, rather than spending the majority of their time on transactional administration.

In most companies this triggers a restructuring process of the retained HR organisation. For the majority of companies this means moving to the now almost classic 'three box' model, pioneered by Ulrich, combining centres of scale and a tiered service delivery approach (emphasising on 'tier 0' Employee Self Service and Management Self Service), with a structure of Business Partners and Centres of Expertise/ Excellence.

Clarity on the operating model is also a key step in preparation for necessary organisational design work around the retained organisation including a Service Management Organisation (SMO) and the transition and transformation stage.

### **Organisational design (retained functions and interfaces)**

As mentioned before, the outsourcing of HR activities in most cases triggers a restructuring process among the retained HR organisation. Apart from a move towards a structure around Business Partners and Centres of Expertise, appropriate governance processes need to be put in place to regulate the client-vendor relationship (both for stages of transition and 'steady-state').

To manage the client-vendor interface, the client is best advised to build a dedicated organisational entity, the Service Management Organisation (SMO). A SMO ensures that the client acts in an educated and intelligent way. Designing a successful SMO is integrally linked to the development of an adequate set of Key Performance Indicators (KPIs), which in association with appropriate target and benchmark levels and Service Level Agreements (SLAs) lead to a performance management system for the vendor company. Monitoring, measurement and reporting frameworks need to be implemented, often including balanced scorecards. Furthermore, change control procedures need to be defined and agreement reached on the escalation process for important issues.

Below are a number of objectives an effective SMO fulfills:

- *Business relationship management*: Presenting a consistent interface to the vendor company, providing advice to vendor on client requirements, ensuring that new services are developed effectively;
- *Contract management*: Ensure contract compliance, changes control, risk management, vendor performance monitoring and feedback, vendor development, dispute resolution;
- *Financial planning*: Ensuring financial procedures are observed, invoices paid, contract optimized;
- *Strategic and operational planning*: Ensure the interlinkage of plans of vendor and client;
- *Technical architecture coordination*: Ensures that the infrastructure architecture and standards are consistent between vendor and client;
- *Service delivery*: Manages day-to-day service delivery to required level of performance and quality, develops and reviews adequacy of service delivery.

## **IT strategy and architecture**

As previously mentioned, HR outsourcing projects allow companies to gain access to cutting-edge HR technology while avoiding ongoing IT investments.

In order to maximise the benefits from this access to technology, companies need to formulate an appropriate IT strategy and architecture approach. This requires a thorough understanding of the vendor's technology, the challenges it creates in terms of appropriate technology interfaces, data compatibility, data security, maximised user buy-in and technology investment for the retained organisation.

Data security is critical and companies need to ensure that they are compliant with their jurisdiction's data protection regulations (e.g. the EU's directive on data protection, or the 'Safe Harbor' framework in the US).

IT is an important enabler of HRO. An inadequate focus on this topic can have serious adverse effects on the entire HRO process: E.g.

- Incompatibility can lead to connectivity failures and service degradation;
- Lack of security planning can cause firewall changes that delays a successful transition of processes to a vendor;
- Ongoing IT outages will frustrate and annoy customers, causing the organisation to blame the vendor company;
- Poor data will result in a poor HR service.

### **Planning for people change and transition**

As mentioned before a HRO project often impacts all employees within an organisation. It seriously impacts those individuals that are providing the service which is to be outsourced. Planning for transition is a critical stage for companies as it is this point where errors and omissions will eventually create negative perceptions among end-users.

The transitioning of staff and their treatment can have adverse motivational effects on employees which are going to be retained. Companies need to ensure that they can adequately resource the communication and consultation requirements they are bound to have during the transition phase. It is essential that companies devise appropriate retention strategies and factor costs associated with the transition phase (e.g. severance payments and counseling costs etc.). Also, any transitioning of employees to a vendor is typically regulated by a jurisdiction's employee legislation frameworks (e.g. TUPE in the the UK and within the EU by the European Acquired Rights Directive). Companies will, therefore, require the necessary legal know-how to prevent claims of unlawful dismissals.

### **Contracting**

During the contracting phase of a HRO project, vendor and client go through a due diligent process as well as the actual contract negotiations. Due diligence is an information discovery process for both companies to establish an accurate picture each others' processes and service levels. Typically this process involves service reviews, site visits, review of client testimonials etc. It is necessary for both parties to create an environment of co-operation and trust with open communication and a willingness

to share information. The process also needs to be underpinned by a rigorous methodology which needs to guarantee the highest level of data validity and reliability.

Successful contract negotiations start with a negotiation strategy and a plan for contingencies. Client companies need to be aware that negotiation styles have to be adaptable according to different negotiation phases. E.g. It might be necessary to have hard-hitting commercial negotiators up-front, but these will need to be swiftly followed by people who understand service delivery, business processes and the implications of the proposed changes on the whole business.

Due to the level of vendor investments in HRO projects, contractual relationships tend to be longer than contracts for commodity based services. This creates the risk of unplanned change requests to the vendor which needs to be addressed through an appropriate contract design.

### **Transition and transformation**

The successful transition and transformation of processes is absolutely critical in terms of benefits realisation, ensuring a high level of service quality for the end-user and a long-term successful relationship between client and vendor.

Hogg (2006) claims that fault lines in the transition phase usually arises where clients have failed to understand a vendor's transition and transformation approach as well as the scale of input, effort and investment required from them.

Essentially vendors' approaches to transition and transformation can be broadly categorised into three styles (Hogg, 2006):

- 1) *Lift and shift*: A vendor essentially takes ownership of the client's existing function and delivers back the same service for a lower cost. This approach is chosen where speed of transition and maintaining business as usual are more important than service transformation and technology improvements. The approach is common in outsourcing contracts for local governments and smaller, domestic companies. Evidently the approach does not address the issue of service quality improvement and often only warrants modest cost savings.
- 2) *Transform and transition*: This approach is typically the preferred choice of companies comfortable with change (e.g. large MNEs). It usually involves a period of 12-18 months, during which HR processes, the operating model, service levels, technology will be transformed. It will be combined with a transformation of the retained HR function to ensure an effective interplay between the outsourced services and the client organisation. The aim is to

achieve not only a more efficient operation but to realise dramatic improvements in service quality, capability, capacity and flexibility. The associated risks of course are linked to a greater business disruption as well as potential loss of key staff and knowledge.

- 3) *Transition and transform*: This approach represents a 'hybrid' between the first two styles. HR processes are relatively swiftly transitioned to the vendor and then transformed over time.

Neither approach is inherently better than the other. As pointed out, however, approaches are more or less suited depending on specific requirements of the client company. Any transition and transformation approach chosen needs to be complemented with the transformation of the retained HR function.

### **Monitoring, benchmarking, benefits realisation**

A crucial and continuous activity of the SMO function is to monitor and benchmark vendor service delivery. This is a core activity for the vendor performance management. It is also the basis on which to plan and discuss any service changes and improvements for the future.

Clearly, client companies need to establish whether the entire HRO project is producing a positive Return on Investment (ROI). It is, therefore, essential to monitor to which degree the desired benefits from the HRO project are being achieved, e.g. in terms of cost savings, service improvement, end-user satisfaction, business agility etc.

As mentioned previously, this activity re-emphasizes the importance of a thorough base-lining of processes and cost of service delivery at the beginning of the HRO process.

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