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# HR Outsourcing for SMBs

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# The Business Drivers for Outsourcing Human Resources

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## The Early Days of Human Resources Outsourcing—Early to Mid-2000s

Since the late 1990s, companies have leveraged third parties to help with human resources (HR) functions. At that time, these functions were often services such as recruiting (particularly within tight employment markets such as information technology—IT) and payroll. Small and midsize businesses (SMBs) in particular needed services that would supplement the tasks carried out by their overly-taxed employees. Oftentimes, HR functions in small companies were handled by an executive or office manager. For this reason, SMBs leveraged external resources to fulfill HR functions—either because it was believed those functions didn't require a full-time employee or the company was unable to invest in a skilled, full-time employee. Thus, SMBs sought expertise provided by HR outsourcing (HRO) companies.

## Business Drivers for SMB Outsourcing

In the late 90s, unemployment was low, and the demand for technologically savvy employees was booming. Suddenly, experience counted for less, and knowledge of Internet technologies and software drove hiring decisions. This trend continued until the post 9/11 recession, aka DotBomb, which increased the supply of unemployed workers.

Outsourcing, and even offshoring, had been a popular model, but companies faced with a skilled, affordable labor market and the need to tighten the corporate belt began pulling projects in-house. Then came the rise of enterprise resource planning (ERP) software. Demand for ERP consultants, particularly those with strong communications skills, skyrocketed as companies clamored for people to help them roll out their new software and understand how to use the data they were now receiving to make better business decisions: An unexpected benefit of ERP software was that executives were enabled to see how each of their lines of business (LOB) fed into one another, and the practice of finance and accounting outsourcing (FAO) and HRO were a logical next step. Payroll, a function often handled through HRO, ties in closely with financial decision-making, which is often managed via FAO. Once companies had outsourced one service, they became increasingly interested in outsourcing another.

Technology provided faster, data-driven decision-making, and through continued software advances, companies were able to use intelligent software to handle functions previously performed by employees<sup>1</sup>. However, with fierce competition in the US marketplace, companies had to consistently find additional ways of selling better, faster, and cheaper. One of the strategies was to shift costs from fixed to variable—a perfect option was to outsource personnel, which allowed for utilization of human capital when needed. By leveraging outsourcers, companies were able to cut headcount while maintaining acceptable service levels and gaining agility to scale up or down as necessary. Until the economic collapse of 2008, this widely-accepted practice fit well into organizations’ “make or buy” strategy.

### Services Outsourced

Typical HR services outsourced in the beginning were those “most unlikely to incur high costs due to uncertainty, the threat of opportunism, asset specificity, frequency, and ease of measurement” according to Jean Woodall et al. in “Making the Decision to Outsource Human Resources”<sup>2</sup>. In simpler terms, companies outsourced those HR functions that were unlikely to put the company at risk yet were tied to specific company assets, occurred with regularity, and were easy to manage and measure. Woodall also found that companies in the US and Europe most commonly outsourced “outplacement, pre-employment testing, training, payroll administration, employee assistance, [counseling], and pension plans,” while retaining the strategic functions of policy making, succession planning, and employee relations in-house.

HR functions can be categorized into three arenas: transactional, traditional, and transformational. Benefits administration and payroll occur with regularity and are largely administrative functions, thus they have been considered *transactional* HR functions. *Traditional* functions in HR are those of recruiting, staffing, performance management, and training. Strategies for compliance, labor relations, and strategic workforce analysis, as well as overall HR strategy as part of an organization’s overriding business practices are considered *transformational* HR activities because these are the approaches that can change a company’s business. Unfortunately, within HR departments in the 1990s and early 2000s, only a few companies had these “change agents” at the top of the HR hierarchy. Thus, within HR departments at the time, most employees had duties that fit within the transactional or traditional categories.

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<sup>1</sup> James H. Lee, “Hard at Work in the Jobless Future,” *Futurist*. 2012.

<sup>2</sup> Jean Woodall et al., “Making the Decision to Outsource Human Resources,” *Personnel Review*, 2009.

### Transactional

In “The Influence of Business Strategy on the Decision to Outsource Human Resources Activities,” Hasliza Abdul-Halim and Norbani Che-Ha cite “non-core functions are transactional activities that are administrative and routine that can easily be replicated and duplicated.”<sup>3</sup> In transactional functions, small-scale, repeated functions are fulfilled by the individuals acting as HR agents. These functions are necessary to the organization; however, they are not considered value-adding activities. Typically, benefits administration and recordkeeping are considered transactional because they are necessary and happen on a timely basis, but, being more of an administrative function, they add little value to the company itself. For this reason, transactional functions have a history of being outsourced, particularly within small companies, which, as they grow, find they must leverage additional third-party resources to meet internal needs and objectives.

### Traditional

Similar to the way they have handled transactional functions, SMBs have historically used third parties to fulfill the traditional HR role: recruiting/staffing and training. Small companies in particular had budgetary challenges and were mindful of building a tight organization of like-minded individuals who would have longevity with the company. Thus, outsourcing the recruiting and staffing function to a third-party provider was a wise move. By leveraging consultants for either short-term projects on an as-needed basis or by using contract-to-hire employees, SMBs could spend their limited budgets wisely and build relationships with their provider that leveraged the provider’s knowledge and expertise, particularly within employment law.

### Transformational

Although most SMBs were familiar with the concept of outsourcing transactional or traditional functions, many had not considered utilizing a third-party provider to realize their organizational goals because it was not considered an internal function of HR at the time. Until late in 2007, when HRO became popularized, few SMBs had considered the possibility that HR could be a strategic player (as evidenced by the lack of HR staff appointed to board positions). For this reason, most HR functions that were outsourced were transactional or traditional.

The period from the 1990s to the mid-2000s saw the rise and growth of outsourcing from IT to HR, finance, and other departments. This growth developed as companies sought ways of leveraging outside expertise, mitigating risk, maintaining compliance, and embracing a flexible staffing model that allowed for scaling up or down—all while shifting labor costs from fixed to flexible, thereby increasing shareholder value.

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<sup>3</sup> Hasliza Abdul-Halim and Norbani Che-Ha, “Exploring the Effect of Business Strategy on Human Resource Activities: A Study of Malaysian Manufacturing Organisations,” *Singapore Management Review*, 2011.

## HRO in a Struggling Economy

Through the summer months of 2008, some SMB executives discussed possible increases in corporate taxes and how their organizations would deal with such rises in cost. At the time, I was working 120 hours each week to provide hundreds of candidates to a well-known global consulting firm for their college recruiting and ERP training initiative. Through this initiative, they would roll out ERP consultants throughout the US to meet the increasing demand. Within one week of the students beginning their new lives as ERP trainees, they watched, as did the rest of the world, as in late September, the US stock market crashed. And crashed in October. Then continued to crash for eight consecutive trading days<sup>4</sup>.

According to Lakshman Achuthan, managing director of Economic Cycle Research Institute (ECRI), 7.9 million jobs have been lost since 2008, and that number is factoring in nearly 600,000 private sector jobs that have been created since that time<sup>5</sup>. As a result of the economic instability, capital crunch, mass layoffs, and sheer lack of experience in running a company through such difficult economic times, executives have had to find ways to get the greatest performance out of the smallest number of employees. Although the National Bureau of Economic Research report declared that the recession ended in June 2009, SMBs, in particular, are still struggling to do more with less. From this situation comes the rise of HRO.

## Changes to Business Drivers for SMB Outsourcing

The cost-consciousness of companies in a struggling economy has made the move to HRO not only desirable but necessary. Of primary importance to small companies is the flexibility to staff up or down as necessary without affecting service levels. However, both small and midsize companies benefit from the variable—versus fixed—cost of outsourcing.

Within their research, Woodall et al. found that HRO enabled a small finance company to avoid training employees in employment law and a telecom company to cut risks around contractor recruitment. In addition to reduced employment costs and risk, “a desire to achieve ‘best practice,’ to improve service quality, to focus upon the ‘core competences’ of an [organization], and to [utilize] new technology are also prominent reasons offered by [organizations]” for utilizing HRO. Authors Abdul-Halim and Che-Ha found that in considering outsourcing, companies also are looking at operational efficiency, which ties into their strategies for either “[providing] a service in-house or [buying] it from the market.”

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<sup>4</sup> Money-zine, “Stock Market Crash of 2008”.

<sup>5</sup> Qtd. in Chris Isidore, “7.9 Million Jobs Lost—Some Forever,” *Cable News Network*, 2010.

## Services Outsourced

According to Amy Pena in “Contracting a Third Party to Cut Costs,” some of the key reasons for current outsourcing have been to cut or control costs, focus on core competencies, access additional capabilities, and mitigate risk<sup>6</sup>. Abdul-Halim and Che-Ha found that after surveying 113 companies, they were able to match the business strategies of companies to their HRO practices. Of the four business strategy categories—proactive, reactive, breadth, and quality-based, the strategy that most closely correlates to SMBs is that of a proactive strategy in which the company focuses on using “innovation and the differentiation of its products through unique designs and features.” Such was particularly the case of SMBs engaged in technology.

The findings of Abdul-Halim and Che-Ha were that companies using a proactive strategy tend to outsource payroll, HR information system (HRIS), and benefits” because it is critical that the company maintain a strategic focus and “concentrate on innovative and differentiated products that will positively impact [organizational] performance.” Proactive companies also had a tendency to outsource traditional functions, such as training, that require significant investment to tailor to the needs of the organization, which would take the focus from the companies’ core competencies. Finally, outsourcing traditional functions for these companies was beneficial for the purpose of maintaining flexibility during times of change by allowing them to “monitor the frequent modifications of the functions” and reduce capital investment.

## Transactional

Transactional HR functions are often outsourced because “maximizing flexibility and focusing on strategic practices are much more significant than monitoring day-to-day operations” (Abdul-Halim and Che-Ha). Particularly in the case of small businesses, the use of their limited employee resources to complete repetitive, low-value tasks such as payroll is wasteful for a company that needs to focus on delivering innovative products and services to the marketplace. At a minimum, SMBs should outsource payroll and benefits administration to a third party; doing so frees up employees for activities that will add value to the organization.

The Kaiser Family Foundation and the Health Research Education Trust conducted a study in 2007 that “concluded that health care premiums [have been] outpacing both inflation and employee wage increases” which has forced companies to introduce “various tactics for controlling both the costs of benefits and the costs of administering those benefits programs.”<sup>7</sup> As mentioned earlier, small companies often have HR functions completed by someone other than a HR expert who is handling HR management in addition to other tasks that fall within their line of expertise. It is critical that these companies shift those tasks outside the organization to allow that person, be it the CFO or CEO, to focus on activities that will strengthen the company’s competitive position.

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<sup>6</sup> Amy Pena, “Contracting a Third Party to Cut Costs,” *Hispanic*, 2001.

<sup>7</sup> “Current Benefits Trends: Cost-Saving Practices & Better Employee Communications,” *Compensation Benefits for Law Offices*, 2008.



### Traditional

Although Abdul-Halim and Che-Ha found that proactive companies consistently outsourced transactional activities, the same companies hesitated to outsource traditional HR functions. These companies feared that by outsourcing training and recruiting, they might drain intellectual capital, which is of particular importance to proactive companies. They also feared that it would take a significant upfront investment to “enable outside suppliers to understand the [company’s] particular requirements.” Although such might be the case within midsize companies, which typically have some specialized HR personnel, smaller companies simply don’t have the internal resources to provide necessary recruiting and staffing efforts, and training is relegated to a luxury item. Unfortunately, these companies are ill-prepared to address external influences such as legislation changes, particularly with labor laws. For these reasons, outsourcing traditional HR functions is a necessary, astute practice.

### Transformational

A common struggle of SMBs is to decide which functions to retain in-house and which to outsource. Activities that are considered “transformational” present the opportunity to change the business. Unfortunately, when it comes to small companies, HR functions are oftentimes not performed by an individual who specializes in strategic workforce planning, labor relations, or human capital management. Thus, for small businesses, keeping the HR function in-house is not an option. There is no one who can internally address these sophisticated employment measures, so the company can either make the decision to outsource these functions to experts or choose to ignore these strategies and hope for the best.

With midsize companies, there is typically an individual whose function is HR, and if the individual is an expert in human capital management, labor relations, and strategic workforce planning and analysis, it makes sense that the individual (if not overcommitted with other duties) provide that expertise. If such an employee does not exist (or if the employee has expertise in only one of the core strategic areas), the company must outsource these functions in order to maximize employee engagement and performance, maintain regulatory compliance, and refrain from charging an employee with duties for which he/she lacks the know-how.

## HR Outsourcing Future Strategies

After reviewing the rise of HRO over the past two decades, it is easy to see how outsourcing has grown in response to the need for outside expertise in HR. However, what strategies can be enacted by calculating companies for competitive advantage? By spreading risk to the outsourcing company and by leveraging information systems and human capital expertise offered by the HRO provider (who presents not only actionable intelligence but an expert to explain trends), SMBs can leverage HRO providers as a strategic partner for employment decision-making and become a best-in-class employer with the operational flexibility to meet market demands.

### SMB Planning for the Future

Although SMBs have started getting on the HRO bandwagon by shifting more of their transactional and traditional activities to a third party, HRO providers have been largely untapped for transformative HR activities. Once executives of SMBs realize the impact of leveraging human capital experts to help grow their companies while increasing productivity, efficiency, and transparency, reliance upon transformational HRO will increase.

Although research firm Gartner notes that comprehensive HRO accounts for only 15 to 20 percent of all HRO deals, the trend is growing from a need to have a unified view of the company for operational decision-making.<sup>8</sup> By having a “standardized platform and delivery model,” and by bringing multiple processes under a contract, Gartner notes that employers can then realize the full benefits of HRO in terms of cost reduction and process improvement (qtd. in Hansen).

According to “Outsourcing the HR Function: Possibilities and Pitfalls,” the Corporate Research Forum found that “HR [has failed] to engage with a strategic vision to transform itself.”<sup>9</sup> This finding is concurrent with the conclusions drawn by Woodall et al.: Once functions had been outsourced, the key personnel retained to achieve higher order were often unable to transition from traditional and transactional duties to those of a change agent, strategist, and “business partner” because they lacked the necessary skills. One respondent to the survey conducted by Woodall et al. stated, “The remaining HR staff are more generalist and tend to get involved at a level down from previously.” A second respondent remarked, “We would like to think that [HRO] frees up internal staff for higher value activities, but in reality, staff reductions are the most common outcome.” Because of this tendency, in the future, SMBs will have an even greater reliance upon HROs, as they focus further on their core competencies and leave HR activities and strategies to the human capital management experts.

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<sup>8</sup> Fay Hansen, “Special Report: Midmarket Outsourcing,” *Workforce Management*, 2007.

<sup>9</sup> Corporate Research Forum, “Outsourcing the HR Function: Possibilities and Pitfalls, 2006.

### Creating Flexible Technological and Operational Strategies

Unlike enterprise organizations, SMBs have to be able to cope with rapid market changes that could require that they scale up or down within a short timeframe. In response to the survey by Woodall et al., a respondent from a professional services firm remarked that their decision to outsource was driven by a need to “[cope] with growth,” as its staff expanded from 69 to 160 within a single year, which created significant capacity issues with the HR staff. Another respondent remarked that, “The decision to outsource was driven by the collapse of the old payroll system due to overload. Our initial thoughts were just around outsourcing payroll, then as we looked at it, we saw the other bits fit around this and decided to outsource administration. We then thought if we are outsourcing most of it, we might as well outsource it all.” For this company, outsourcing all services helped to scale its systems and processes to meet the challenges of exponential growth.

Although outsourcing all HR activities under a single, comprehensive contract was a sensible move for this particular company, other companies engage a staggered approach. Through this method, they outsource a few functions at a time, carefully reviewing metrics for delivery upon expectations.