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# HR Outsourcing for SMBs

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# Risks and Realities of Outsourcing Human Resources

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## Perceived and Actual Risks of HR Outsourcing

Human resources outsourcing (HRO) is still a relatively new concept. As such, there exists some trepidation against outsourcing, with a common fear being a loss of control, particularly when it comes to releasing sensitive employee information to a third party.<sup>1</sup> Based upon research, however, the risks associated with HRO are not loss of confidential employee information or reduction/dilution in intellectual capital from engaging with an outside party for internal resources. In fact, the most common downside of HRO has occurred in terms of failure of the organization's internal, retained HR executives to contribute as "change agents" or strategic business personnel—which was part of the purpose of outsourcing in the first place. This consequence is most commonly realized by midsize businesses that choose to outsource transactional and traditional functions for the purpose of moving key HR personnel further up the value chain.

A second risk of HRO results from a lack of understanding between the outsourcing provider and the client. For example, in "Making the Decision to Outsource Human Resources," Jean Woodall et al. noted, "Very few respondents admitted that they had a good understanding of the cost of delivery of their HR service to the rest of the business, and only [one company] felt confident that they were aware of this prior to outsourcing. Yet, paradoxically, a good understanding of the cost of the HR function was a necessary prerequisite for successful outsourcing, as well as being a desired outcome."<sup>2</sup> Although it seems obvious that a company would understand the cost of and value delivered by its personnel prior to considering outsourcing, findings have shown that typically the cost considered was solely that of employee overhead rather than additional costs savings in terms of in-house HR information system (HRIS), project management, and more.

Finally, as one would expect, some companies have had negative experiences with HROs because the provider selected was unresponsive, did not meet customer expectations, or did not fully understand the organization's culture and needs. Because of this lack of understanding or delivery upon expectations, costs associated with outsourcing were higher than expected, and in some cases, the functions were then brought back in-house (Woodall et al.).

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<sup>1</sup> "Current Benefits Trends: Cost-Saving Practices & Better Employee Communications," *Compensation Benefits for Law Offices*, 2008.

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

### Small Companies

A senior manager from one of the five small companies that had outsourced HR and was surveyed by Woodall et al. remarked, “There have been some instances where employees do not know whom to contact, and some occasions where no one was available to answer the phone.” Particularly within small companies where personnel are used to being able to easily access one another, working with an HRO provider can be tricky. For this reason, it’s critical that expectations are addressed prior to engagement with the HRO provider, metrics are established, and performance reviews occur on a regular basis. Additionally, companies need to closely consider their service level expectations prior to reviewing potential vendors because the most cost-effective providers are not going to be able to provide the highest levels of service.

Of the HROs available, Professional Employment Organizations (PEOs) offer a comprehensive suite of services within the HRO industry. By “contractually assum[ing] certain employer responsibilities and employment-related liabilities,” PEOs are a valuable resource for small and midsize businesses (SMBs).<sup>3</sup> Some of the most common services contracted through PEOs are benefits administration, regulatory compliance, recruiting, and retention—all of which are of particular concern to small business owners. In “Three Million Reasons to Add Payroll Services,” Julie Lubetkin writes that almost 60 percent of surveyed small businesses with less than 20 employees still manually process payroll. They are short on time and resources, so “one in three small businesses incurs [sic] an average of \$1,500 in late tax payment penalties every year.”<sup>4</sup> For this reason, small companies are encouraged to outsource the transactional HR duties to a third-party provider.

### Midsize Companies

The dynamics of midsize companies—being too large to have close interaction with all employees and too small to be able to rely upon extensive financial and personnel resources—mean that companies within this category have unique considerations. Unlike small businesses, midsize companies tend to have individuals whose primary role falls within HR. For this reason, executives look at how they can leverage these individuals in the most cost-effective manner that will help contribute to the company’s continued growth. A standard approach is to outsource transactional and traditional HR functions but retain transformational functions in-house. The goal is to retain key HR executives and move them further up the value chain to become advocates for employees, business strategists with insight into labor relations, and change agents who are able to help C-level executives execute upon corporate strategy.

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<sup>3</sup> “Outsource HR to Achieve Value,” *Accounting Technology*, 2008.

<sup>4</sup> Julie Lubetkin, “Three Million Reasons to Add Payroll Services,” *Accounting Today*, 2008.

Unfortunately, as discovered by Woodall et al., “One unintended consequence was the disappearance of in-house HR expertise. This was due to the effect of the downsizing that appears to have accompanied the outsourcing of HR in many organizations. Predictably, the radical change brought by outsourcing left problems in terms of knowledge management and corporate memory.” For this reason, it is imperative that organizations pursuing HRO partner closely with their outsourcing provider to ensure that there is not a drain on corporate knowledge as well as making sure that retained HR personnel are trained and supported. At a minimum, midsize companies need to closely monitor knowledge transfer through the outsourcing process.

## Realities of HR Outsourcing

In a survey of 129 companies cited by Todd Henneman in “Measuring the True Benefit of Human Resources Outsourcing,” the top three reasons for HRO were to gain outside expertise, improve service quality, and focus on the core business.<sup>5</sup> These findings are echoed by Woodall et al. who found that “[organizations] undertake outsourcing to reduce costs, gain access to HR expertise, achieve workforce flexibility, and to focus managerial resources on strategic matters and also to keep up with workplace regulation.” These findings reflect that companies today are using HRO in much the same way that they were a decade ago. However, Workscape analysts presented interesting observations in their *Annual Benefits Study 2008*:<sup>6</sup>

- “Web-based technologies are the primary means of accessing benefits information, but they are often used in tandem with other traditional personnel communications methodologies.”
- “CEOs are significantly more likely than HR and benefits professionals to see 24/7 access to benefits support as being important.”
- “[Firms having] already invested in internal technology [feel] no current pressure to switch.”
- Although cost savings from outsourcing can be significant, the return isn’t necessarily immediate, especially if a firm looks only at HR labor costs associated with enrollment and does not associate other related expenses, such as IT support.

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<sup>5</sup> Todd Henneman, “Measuring the True Benefit of Human Resources Outsourcing,” *Workforce Management*, 2005.

<sup>6</sup> “Current Benefits Trends: Cost-Saving Practices & Better Employee Communications,” *Compensation Benefits for Law Offices*, 2008.

### Small Companies

According to research conducted by Woodall et al., the main difference in outsourcing practices between larger and smaller companies is that smaller companies are much more likely to outsource the whole or the majority of their HR activity, whereas larger companies focus primarily on the more routine 'transactional' work. As previously mentioned, of those interviewed, employees within a benefits or HR role were as much as half as likely as CEOs to see 24/7 benefits access as important to employees. Access to Web-based portals for benefits, performance metrics, or organizational insight is not only costly but risky to build in-house, making this an area where small companies are able to leverage the technologies provided by HROs.

### Midsized Companies

Like most midsized companies, Business Advantage, Inc. came to their comprehensive HRO decision following an initial decision to outsource payroll. After their initial outsourcing foray, Business Advantage began investigating other services to outsource but soon realized that with multiple vendors, integration would be an issue. "Trying to handle some processes ourselves and some through separate outside vendors was like trying to manage a herd of cats," according to Business Advantage CEO Stanley Joseph. After modifying and expanding Business Advantage's outsourcing arrangement five times in 3 months, the company finally decided on a comprehensive HRO/finance and accounting outsourcing (FAO) contract with an estimated savings of 30 to 40 percent annually compared with the in-house cost for similar functions<sup>7</sup>. SMBs can also leverage outsourcing companies during times of growth and transition—like expanding into new markets—in order to adhere to local employment laws and payroll-tax regulations.<sup>8</sup>

Similar to Business Advantage, Inc., Catalina Restaurant Group is a midsized company that has leveraged HRO. Samuel Borgese, CEO of Catalina, made the decision to outsource HR in 2002 (following a spin-off). The decision to outsource was primarily driven by a need for standardization and economies of scale—without having to invest a lot of capital. By utilizing an outsourcing provider, Catalina was able "to keep strategic tasks in-house with tactical support from the outsourcing vendor" while utilizing the vendor's HR platform (qtd. in Hansen). According to Borgese, "It's very hard for a VP of HR to be a strategic player if he or she is managing the HR infrastructure. If they are freed from this, they can concentrate on workforce deployment and strategic issues."

Of additional note, Catalina's executives were concerned about regulatory compliance. Citing tax regulations as a strong factor in the decision to outsource, Borgese noted, "You need to have great confidence in your ability to meet requirements. On the F&A side, we must close our books with complete accuracy within five days." As midsized companies, Business Advantage and Catalina executives both found that, through HRO, they could build in operational flexibility and efficiency without the significant capital investment that would be required to perform the same functions in-house.

<sup>7</sup> Fay Hansen, "Special Report: Midmarket Outsourcing," *Workforce Management*, 2007.

<sup>8</sup> Paul McDougall, "Help with Human Resources," *InformationWeek*, 2005.

## Adjustments to Approach for HR Outsourcing

Outsourcing significant functions is complicated and bears risk. Thus, it's important that firms closely examine what is currently being delivered by internal resources and the full costs associated with those service levels. Organizations can then determine value that can be aligned with their expectations of outsourcing. From this point, executives must set clear objectives with the outsourcing partner and agree upon metrics to reflect performance. From their survey, Woodall et al. determined that many companies had not factored in the full cost and value of their internal resources prior to outsourcing. This situation in turn meant that the cost of reaching previous service levels was more significant than anticipated. In review of their practices, respondents made the following remarks:

- “[a big weakness was] not ‘base-lining’ our own service before we started”
- “No cost evaluation was made against internal or external providers—this would be a weakness”
- “Most HR directors only understand 75 [percent] of their cost base”
- “Don’t outsource what you don’t understand”

### Small Company Models

Although many small company owners dream of the day when their company experiences exponential growth—thus propelling them to a midsize company—such growth carries drawbacks. A company that cannot scale systems and processes to meet the needs of the accelerated growth can find itself just as quickly losing customers and employees. For this reason, small companies that are experiencing rapid growth should consider outsourcing systems and processes that fall outside of their core competencies. By shifting these functions and tasks to an outside vendor, focus can remain on areas that provide competitive advantage without sacrificing quality.

### Midsize Company Models

For companies that have been used to having in-house resources, HRO can require a period of adjustment. In addition to agreeing upon expectations, midsize companies must realize that they are shifting functions outside the company. This shift makes it critical for companies to think of their vendor as a partner and engage strategically with that partner before, during, and after outsourcing in order to realize the full benefits of outsourcing. As stated by Borgese, “If the vendor is truly responsive, it will be like having the functions in-house.” This commitment must be considered long before engaging in negotiations. Although service levels can be negotiated, relationships with a vendor should not be one of those negotiations. Executives will need to spend a lot of time with their provider, so the rapport needs to be strong and mutually beneficial from the beginning.