

Outsourcing Decisions

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The decision to outsource different business functions is critically impacts company operations. The decision is a factor in determining capacity, resource needs, the type of service or manufacturing process used, and even the kind of information system necessary. Because of its importance, an outsourcing decision is generally strategic and made by top management. The decision involves two main alternatives:

1. Insourcing: provide products and services through internal firm resources;
2. Outsourcing: provide some products and services through external resources.

In general, outsourcing will increase a company's flexibility, provide access to advanced processes and technologies that would otherwise be unavailable, and make available liquidity that would have otherwise been spent on capital resources. While there are many benefits to outsourcing, it is a decision which requires careful attention. Several factors need to be considered beforehand, the first of which is cost effectiveness.

Cost/Benefit Analysis

As part of a company's option to insource or outsource, a company must evaluate the financial obligation it will shoulder when choosing to outsource externally or internally. There is a cost associated with the decision to make a product in-house or not. The total cost of the outsourcing decision can be broken down into two types of costs:

1. direct costs
2. indirect costs

The process of analyzing the company's sourcing options quantitatively based on these two costs is known as a total cost analysis.

Direct costs are directly tied to the company's level of production or amount of service. For example: if a Crow's Country Cabinets was making wooden entertainment centers and the price of wood for the entertainment center was \$1.75 per square foot, and the company needed a total of 60 square feet of wood for one entertainment center, the price of wood for one entertainment center would be

$$\$1.75(60 \text{ feet}) = \$105$$

Indirect costs, such as overhead, are not easily tied to the level of production or activity. Executive's salaries or plant security costs may not easily relate to the direct level of production.

By allocating indirect costs to individual units of production, managers can get a better overall picture of the total cost in the sourcing decision. If project planning would account for an initial overhead of \$50,000 and in the first year the company plans to produce 25,000 units the company could apply the indirect cost on an average bases to the 25,000 units as follows:

$$\$50,000/25,000 \text{ units} = \$2.00 \text{ per unit}$$

Furthermore, for the company to develop a more accurate idea of the total cost of outsourcing the above average unit overhead cost can be updated with additional cost information as it becomes available. Suppliers can assist in collecting additional information such as projected costs at various levels of output. This information can then in turn be used in determining total cost projection.

Another aspect of outsourcing that should be considered in the total cost analysis is the reduction in administration costs. Because the outsourcee is responsible for and producer of the component, it will account for additional costs via the supplier's invoice. Also, the accounting involved in production is the outsourcee's responsibility. The outsourcer can focus on the accounting of expenses rather than the accounting of the production process.

Comparing analyses of insourcing vs. outsourcing side-by-side can present a clear picture of the bottom line. If the benefits outweigh the decision alternative costs, then the conclusion to outsource or insource will be reached.

In making an outsourcing decision a rule of thumb should be remembered: long-term sourcing issues may be better suited to be outsourced, whereas short-run decisions may be better suited as insource decisions. The principle idea behind this rule is the learning curve. As time increases, the efficiency of the outsourcee will most likely also increase, which can leave to more cost saving.

Core Competencies

While cost savings is important to every company, it is no longer the only driving force in an outsourcing decision. Companies today need to take a broader view of outsourcing by isolating their core competencies, and then chipping away at all the functions that do not contribute to them. When a company starts evaluating their activities for outsourcing potential, any products or processes involved in the company's core competencies should automatically be off-limits. Core competencies are the organization's strengths and abilities developed over a long period of time. They provide value to customers and are difficult for competitors to replicate (Bozarth, 298). These core competencies are the most important activities to the firm, so they need to stay inside the firm's control. Rather than outsourcing these core competencies, a company would want to outsource the non-core, but still significant, functions to experts outside the firm (Li, South China Morning Post). By doing so, skilled employees are freed up to focus on the core operations - the activities that add value to the product or service.

For example, if the finance department in a manufacturing company were looking to outsource, they would want to look at activities with high transaction volumes but low values to the customer. These would include basic functions such as billing, account payables, and financial accounting. Then, the personnel usually assigned to these repetitive tasks would be able to work on tasks such as analyzing the feasibility of a new

machine, one that would increase the quality of the end product, improving customer satisfaction.

Capacity

Another factor in the outsourcing decision is the capacity the firm will need to meet customer demand. With each process that is outsourced, the capacity of the firm is increased. The opposite ends of the spectrum are total insourcing, which is the capacity only the firm itself can manage, and total outsourcing, which creates a virtual supply chain with limitless capacity. Each company will need to find someplace in the middle of each extreme that fits their situation and future goals.

Capacity is also a source for flexibility. Firms that outsource for higher capacity can respond quicker to changes in demand and technology (Bozarth 298). Instead of being stuck with out-of-date equipment and tools, a firm can demand the advanced technology from the supplier. If the supplier can't deliver, the company can find someone else who can. If that technology wasn't outsourced, the company would be stuck with obsolete machines and processes, creating a huge cash outflow.

Ethics

There are many ethical issues a firm must when management is considering outsourcing an aspect of the business. Important factors range beyond the financial issues facing the company. Among these issues are two that relate directly to the firm, they are: (1) an employer's responsibility to his/her employees, (2) the cultural impact on the firm and new employees. Each one needs to be considered before making the decision to outsource.

Case:

The phone rang on a Thursday night. It was my boss; he wanted to meet for breakfast before work the next morning.

At breakfast, he explained that our corporate headquarters had decided to close our California manufacturing facilities. The 500+ employees who worked here would either be let go or relocated. The manufacturing operations would be moved to Georgia, South Carolina, and Hong Kong. As a selected member of the relocation team, he gave me the uncomfortable task of traveling to Hong Kong to train our replacements. The assignment: to teach the intricacies of building complex aerospace valves in a foreign language, 7,000 miles away.

A few months later between overseas trips I stopped by the "home" plant. What I saw was overwhelming and depressing. Virtually all that remained in the 100,000-sq-ft facility was my desk, surrounded by a few file boxes. Even my filing cabinets had been surplus. At that moment the loss of

jobs seemed grossly unfair. However, as I look back on that event, I now understand that there are many reasons why companies are deciding to send their manufacturing overseas.

I have heard some people argue that as long as these actions are legal, they are ethical. Others argue back that these actions (by greedy companies that disrupt the economic futures of many people) are purely unethical (Harrison).

Each firm needs to make these decisions. It is sometimes difficult to give appropriate weight to the contrasting aspects, but it is important in the process of making a good decision.

Additional Information

The four factors outlined above—cost/benefit analysis, core competencies, capacity, and ethics—can make the difference between a good and bad outsourcing decision. Each of these evaluation criteria can be used in every business, but some decisions may require a more in depth analysis. For more information on outsourcing decisions, please review the following list, along with the sources included in the bibliography.

Stcak, Martin and Richard Downing. “Another Look at Offshoring.” Business Horizons. Greenwich: Nov/Dec 2005. Vol. 48, Iss 6; p.513

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Harrison, Kenneth. “Is International Outsourcing Ethical?” Machine Design. Cleveland: Aug 19, 2004. Vol. 76, Iss. 16; p. 105, 1 pg

Li, Andrea. South China Morning Post. Hong Kong: Oct 29, 2005. pg. 8