5.4 Location – Outsourcing Summary Notes

REORGANISING PRODUCTION

OUTSOURCING

A practice used by different companies to reduce costs by transferring portions of work to outside suppliers rather than completing it internally.

Outsourcing is an effective cost-saving strategy when used properly. It is sometimes more affordable to purchase a good from companies with comparative advantages than it is to produce the good internally. An example of a manufacturing company outsourcing would be Dell buying some of its computer components from another manufacturer in order to save on production costs. Alternatively, businesses may decide to outsource book-keeping and accounting duties to independent accounting firms, as it may be cheaper than retaining an in-house accountant.

Business operations that are commonly outsourced include:

- Cleaning
- Accounting and book keeping
- IT support and ICT maintenance
- Manufacturing, either component parts or complete products

Generally, business functions and processes outsourced to an external company bring cost savings and/or productivity gains. For example, a specialist accountancy firm may be contracted to prepare tax returns and investor reports at a cost far less than having to employ an accountant to do this internally. Likewise, specialist manufacturers will be able to supply components and products far more cost effectively and efficiently than a firm who does not have that area of expertise.

The best arguments made for outsourcing are that:

- The quality of goods and services being provided can be exceptional, much better than a non-specialist firm lacking specific software, hardware, capital equipment or the required human capital (skills and knowledge).
- Organisations can concentrate on their core operations and functions, allowing them to focus on what they are best at doing and reap productive and efficiency gains. It makes sense for Apple Inc. to run brilliant research and development divisions, design great products and superb software, and employ clever marketing to sell massive numbers of

iPhones. There is no business case for it to also design and manufacture the computer chips used in the phone.

- Often the subcontracting firms are able to achieve economies of scale, have much higher productivity and thus have lower production costs by providing their services to multiple companies. For example, one very little known fact is that the Nike, Reebok and Adidas while being locked into intense competition, outsource their manufacturing to the same mega-factory in China. Their trainers are made in the same factory!

Not all companies engage in outsourcing, and if they are it will not necessarily be to the same extent. Outsourcing comes with problems of its own, which need to be weighed strategically by management. **The limitations of outsourcing include:**

- **Loss of Managerial Control**

Whether a firm signs a contract to have another company perform the function of an entire department or single task, it is turning the management and control of that function over to another company. Yes, there will be a contract, but the managerial control will belong to another company. It is likely the outsourcing company will not be driven by the same standards and mission that drives the contracting company. They are driven to make a profit from the services that they are providing to the firms contracting them.

- **Hidden Costs**

Anything not covered in the contract details of the service that they will be providing will be the basis for a firm to pay additional charges. Additionally, firms will experience legal fees to retain a lawyer to review the contacts signed. Remember, this is the outsourcing company's business. They have done this before and they are the ones that write the contract and often firms will be at a disadvantage when negotiations start.

- **Threat to Security and Confidentiality**

The life-blood of any business is the information that keeps it running. If a firm has payroll, medical records or any other confidential information that will be transmitted to the outsourcing company, there is a risk that the confidentiality may be compromised. If the outsourced function involves sharing proprietary company data or knowledge (e.g. product drawings, formulas, etc.), this must be taken into account. The outsourcing company must be evaluated carefully to make sure data is protected and contracts have penalty clauses if an incident occurs.

- **Quality Problems**

The outsourcing company will be motivated by profit. Since the contract will fix the price, the only way for them to increase profit will be to decrease expenses. As long as they meet the conditions of the contract, you will pay. In addition, you will lose the ability to rapidly respond to changes in the business environment. The contract will be very specific and you will pay extra for changes.

- **Tied to the Financial Well-Being of another Company**

Since you will be turning over part of the operations of your business to another company, you will now be tied to the financial well-being of that company. It wouldn't be the first time that an outsourcing company could go bankrupt and leave you holding-the-bag.

- **Bad Publicity and Ill-Will**

The word "outsourcing" brings to mind different things to different people. If you live in a community that has an outsourcing company and they employ your friends and neighbors, outsourcing is good. If your friends and neighbors lost their jobs because they were shipped across the state, across the country or across the world, outsourcing will bring bad publicity. If you outsource part of your operations, morale may suffer in the remaining work force.

ADVANTAGES AND DISADVANATAGES OF OUTSOURCING

Reasons for outsourcing	Drawbacks to outsourcing
▪ **Reduction and control of operating costs.** Instead of employing expensive specialists that might not be kept busy at all times it could be cheaper to 'buy in' specialist services or products as and when needed. Outsourcing firms may be cheaper because they benefit from economies of scale, as they may provide similar services to a large number of other businesses. Much outsourcing involves offshoring – buying in services, components or completed products from low-wage economies.	▪ **Loss of jobs within the business**. Workers who remain directly employed by the organisation may experience a loss of job security, reducing motivation. Bad publicity may result from redundancies, especially if the business is accused of employing very low-wage employees in other countries to replace the jobs lost. The firm's ethical standards could be questioned.
▪ **Increased flexibility.** By removing departments from the staff payroll and buying in services when needed, fixed costs are converted into variable costs. Additional capacity can be obtained from outsourcing only when needed and contracts can be cancelled if demand falls much more quickly than closing down whole factories owned by the business.	▪ **Quality issues**. Internal processes will be monitored by the firm's own quality assurance system. This will not be so easy when outside contractors are performing important functions. A clear contract with minimum service-level agreements will be needed. The company contracting out the functions may have to send quality assurance staff out to the business undertaking the tasks to ensure that product quality and customer service standards are being met.
▪ **Improved company focus.** By outsourcing 'peripheral' activities the management of a business can concentrate on the main aims and tasks of the business. These are called the 'core' parts of the business. So, a small hotel might use management time to	▪ **Customer resistance**. This could take several forms. Overseas telephone call centres have led to criticism about inability to understand foreign operators. Customers may object to dealing with overseas outsourced operations. Bought-in components and

improve customer service and outsource the accounting function completely.	functions may raise doubts in customers' minds over quality and reliability.
▪ **Access to quality service or resources that are not available internally.** Many outsourcing firms employ quality specialists that small to medium-sized businesses could not afford to employ directly.	▪ **Ethical concerns**. If outsourcing is undertaken by firms in countries with poor human rights or employment rights records, it may be cheaper for the business that has outsourced – but how will the media and consumers view this potentially unethical decision?
▪ **Free up internal resources for use in other areas.** If the human resources department of an insurance company is closed and the functions bought in, then the resulting office space and computer facilities could be made available to improve customer service.	▪ **Security**. Using outside businesses to perform important IT functions may be a security risk – if important data were lost by the business, who would take responsibility

OFFSHORING

The practice of basing some of a company's business functions (account and book-keeping), processes (manufacturing) or services (IT solutions) overseas, usually so as to take advantage of lower costs. Offshored functions can remain within the functional control and ownership of the business or they can be entirely outsourced to a separate offshore organisation – this is termed **offshore outsourcing**. Offshoring is outsourcing to a firm in a different country. The same advantages apply, and these advantages can likely be boosted. Costs can be further reduced (a Philippine-based call centre is likely less expensive than one based in the US. This could be from additional economies of scale being achieved, lower operating costs (especially labour costs) and lower tax rates.

Manufacturing (production) and **services** are the two categories of offshoring. Call centres, IT and accountancy services are common examples of business functions that are offshored. Factories producing entire products or component products account for a much larger share of the world's offshored business processes than services do.

Offshoring often gains negative publicity. Jobs in the home country are lost and environmental controls and labour regulations may be lax in some countries – there has been a backlash over the exploitation of workers in general and women and children specifically in many developing economies such as Bangladesh.

Offshoring also comes with additional risks over outsourcing, especially political risks, increasing supply chain complexity and fast-rising wages in developing countries. In China wages are growing at double digit rates whereas in many European countries average workers have not seen a real wage increase in years. Venezuela and Argentina were perceived as being business friendly, in the last five years the governments of this country have seized business operations of large firms with token compensation (if any) being paid.

Offshoring brings jobs, increased incomes and human capital investment to host countries. Both developing and developed economies compete to attract foreign direct investment because of the advantages it brings. There are relatively few disadvantages to a host country as long as there is good industry regulation, oversight and enforcement. Unfortunately, in many poor and corrupt countries this regulatory framework is inadequate or entirely absent. Environmental and labour exploitation may then occur.

INSOURCING

Assigning a project to a person or department within the company instead of hiring an outside person or company to do the work. While outsourcing is commonly thought of as a way for companies to save money, it is sometimes more cost effective to have the work done in-house. Another reason for insourcing is that a firm may not be happy with the quality of the service or manufacturing they have outsourced. Bringing that process back 'in house' provides better control of the process at all levels as long as the company has the resources and knowledge to re-establish these effectively.

In the United States, insourcing can also refer to the use of U.S.-based subsidiaries by foreign multinational corporations. These insourcing companies contribute to research and development, capital investment, exports and job creation. So, while outsourcing is often looked upon as a negative effect of globalisation that sends U.S. jobs abroad to countries with cheaper labor, outsourcing actually works both ways because it also sends jobs to the United States from foreign countries.

When previously offshored business functions or processes are insourced back to the country of domicile, then this is termed **re-shoring**. As the relocation decision is likely to be costly, insourcing will not be entered into likely. In fact, **industrial inertia** (geographical) describes a stage at which an industry prefers to run in its former location although the main alluring factors are gone.