RELEVANT TO ACCA QUALIFICATION PAPER P3 AND PERFORMANCE OBJECTIVES 7, 8 AND 9

Outsourcing

Outsourcing is when any operation or process that could be – or would usually be – performed in-house by an organisation's employees is sub-contracted to another organisation for a substantial period. The outsourced tasks can be performed on-site or off-site.

Outsourcing is currently relatively popular with both profit-seeking and not-for-profit organisations, and we will see both its potential advantages and disadvantages later in this article. The following table shows the frequency with which outsourcing has been examined in recent sittings of Paper P3:

June 2008	Q2 – Country Car Club
December 2009	Q3(b) – Lowlands Bank
June 2010	Q3(a) – Ergo City Authority
June 2011	Q1(b) – EcoCar

It is important to appreciate that outsourcing will almost certainly continue to be examined as part of a scenario in the Paper P3 exam, so you could be required to, for example, describe the specific advantages that outsourcing could bring to the organisation described in the scenario.

Additionally, outsourcing lends itself very well to financial calculations, as seen in the June 2011 exam. Essentially, a decision to outsource is likely to save some internal costs but incur additional external costs. Revenue could also change if, for example, outsourcing increased capacity. Therefore, the decision to outsource could be heavily influenced by marginal cost and marginal revenue considerations.

Before looking at a specific scenario, we will briefly explain the 'standard' advantages and disadvantages of outsourcing and describe some common outsourcing applications.

Common outsourcing applications

1. It allows the organisation to focus on its core, value-adding activities without the distraction of having to run support services. Support services can soak up both management time and financial resources and these would usually be better spent concentrating on where the business can use its resources and competences to gain competitive advantages.
2. Cost savings. Usually the organisations to which activities are outsourced specialise in those activities and, therefore, are likely to enjoy economies of scale, whether from the use of machinery or the employment of expertise. There can be additional cost savings if a

process is outsourced to a foreign company operating in a cheaper labour area (off-shoring).

3. Cost certainty. An outsourcing contract at a fixed, or closely defined price, shifts much of the financial risk on to the provider. Costs become more predictable.
4. Cost restructuring. For some types of outsourcing such as component manufacturing, there will be lower fixed costs and higher variable costs. If all components are bought in, then these costs are all variable. Had the components been made in-house, there would inevitably have been associated substantial fixed overheads.
5. Access to cutting edge expertise and talent. In technically advanced, fast moving industries, it can be difficult for small companies to develop or make use of new processes. Outsourcing to a specialist company can give access to the latest technologies.
6. Better quality. There can be an immediate improvement in quality if a process is outsourced to a world-class company where the quality is carefully defined in a service level agreement.
7. Risk transference. If a company perceives that one of its processes has high risks, then this can be transferred by outsourcing to another company.
8. Capacity management. For example, it can be difficult for businesses to deal with variable demand: either they run out of capacity (unhappy customers), or have (expensive) unused capacity. Outsourcing to a large company can mitigate this problem.

Potential disadvantages of outsourcing

1. Unexpected costs. Although many costs become more predictable, the supplier will be very careful to define exactly what these costs cover. There are likely to be substantial additional charges for anything extra. Additionally, remember that almost certainly the supplier knows that part of the business better then the outsourcer and will ensure that the contract is carefully (and advantageously) worded.
2. Difficult to reverse. Once an activity is outsourced and internal knowhow gone, it can be very difficult to bring a process in-house again. This is particularly relevant when a contract comes up for renewal: the price increase might be higher than expected but it can be difficult to abandon the supplier.
3. Damage to reputation. If the outsource company does not perform properly – for example, not manufacturing to the required quality standards and not supplying goods on time –great damage can be done to the organisation’s reputation.
4. Non-congruent objectives and loss of managerial control. The supplier company makes money doing things efficiently. The buying company might make money by innovation. To some extent, despite the contract,

there can therefore be a difference in the objectives and core values between the two parties.

5. Success depends on another company's performance. Though there is always a dependency between buyers and sellers, outsourcing shifts more responsibility for success to other companies' performance. If an important outsource company goes bankrupt, there can be serious consequences.
6. Confidentiality/security. Outsourcing some processes can give the supplier information that could be valuable or sensitive. Keeping a process in-house should increase security.

Examples of outsourcing

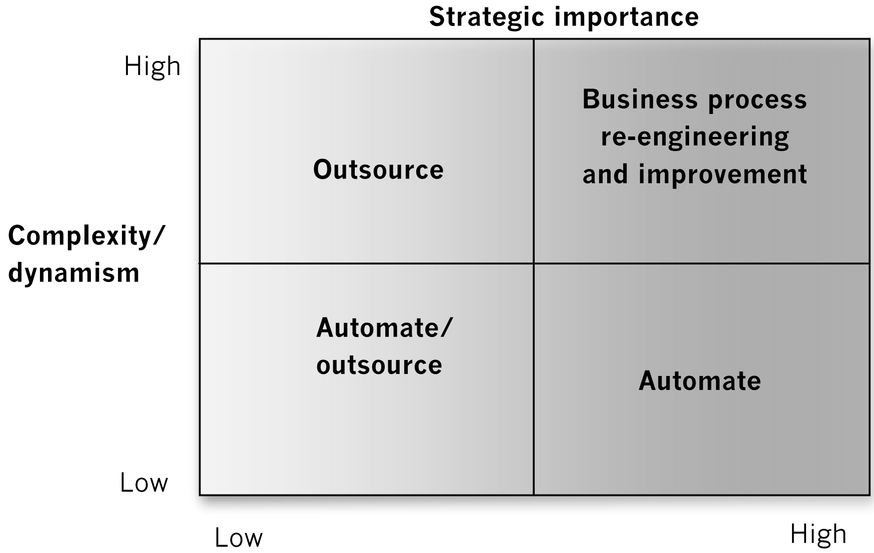
1. Catering facilities. For example, Compass Group UK and Ireland has a turnover of almost $3bn and its main business is providing catering facilities for organisations such as schools, hospitals, client entertainment, businesses, and sports and leisure venues.
2. Document handling. Document handling is a serious problem for many companies and there are often legal requirements to preserve documents for many years. The company Ricoh offers scanning and archiving facilities (both electronic and hard copy), printing (including folding and binding), mail room (receipt, sorting delivery and dispatch). Increasingly, incoming documents are scanned and stored electronically. That way, documents are instantly retrievable and can be used simultaneously by several people.
3. Technology services/IT. Because of the large investment, high specialist expertise needed and rapid technological changes, this one of the most common processes to be outsourced.
4. Accounting services. For example, receivables ledger maintenance or wages and salaries administration.
8. HRM. Recruitment, legal considerations (for example, complying with equal opportunities legislation), appraisals, contracts, disciplinary, grievance.
9. Fleet management. Purchase, maintenance and disposal of vehicles.

What should be outsourced?

Harmon's Process Strategy Matrix provides very useful guidance about which processes can be safely outsourced and which should be kept in-house, but subject to automation or other improvement.

It uses two axes:

- Complexity/dynamism of the process. Dynamism is a measure of how much the process changes.
- Strategic importance of the process



Notice that in the right-hand pair of quadrants, where strategic importance of the process is high, outsourcing is not recommended. If a process is strategically important it is likely to be a source of competitive advantage. If that were to be outsourced, then the company would be telling the supplier about its most valuable secrets and competences. What would then be left for the outsourcer to do? If a process is relatively stable and non-complex, then automation would be feasible and worthwhile. If, however, the process were very complex and subject to many changes, then automation will be difficult to achieve and even more difficult to keep up to date.

Of the examples given in the previous section, with the exception of technology services, all are pretty firmly not of strategic importance to most organisations. Technology services might or might not be of strategic importance. If the organisation used IT for fairly routine accounting and management purposes, it is unlikely to be strategically important. However, some organisations will use IT in a very creative way so that it becomes a source of competitive advantage. Consider Amazon.com, the online supplier of books, DVD, electronic equipment, etc. The company has very advanced customer relationship management software which, for example, recommends books that you might like because of previous purchases you made, allows readers to enter and read reviews, uses targeted emails to market special offers. IT is the mainspring of Amazon and it is unlikely to ever outsource that foundation of its success.

Outsourcing and the commoditisation of business processes

When a process is going to be outsourced it is important that both parties know what is expected otherwise there will probably be misunderstanding and trouble. However, often there is no clear mechanism for comparing the capabilities and services provided by third party organisations and those that are provided in-house. If processes are not standardised, then it will be difficult for companies to decide whether outsourcing will provide value for money and to compare different potential suppliers.

There are three processing standards to consider:

- Process activity and flow standards: exactly what are the processes, the information flows and the movement of materials?
- Process performance standards: once there is agreement about what a process consists of, this step establishes the level of performance required. This can be built into outsourcing contracts.
- Process management standards: how is the process monitored, documented, controlled and improved?

Once processes have been standardised this will lead to commoditisation of outsourcing, leading to more competition and lower prices. Commoditisation means that buyers can largely buy on price (just as is often done nowadays when buying a laptop computer) because the services provided will be essentially the same. Some suppliers will no doubt try to escape this price competition by trying to differentiate what they do. For example, in addition to providing the basic, commoditised outsourced process they might also begin to make suggestions about how the process could be improved.

Example: June 2011 – Question 1b

The EcoCar company was formed six years ago to commercially exploit the pioneering work of Professor Jacques of Midshire University, a university in the country of Erewhon. Over a number of years he had patented processes that allowed him to use Lithiumion batteries to power an electric car, which could travel up to 160 kilometres before it needed recharging. Together with two colleagues from the university, he set up EcoCar to put the car into commercial production. The company now manufactures three car models: the original Eco, the EcoPlus, and the EcoLite.

Although EcoCar was established in an area where there already existed a pool of skilled car workers, the subsequent retirement of many of these workers has left a skills gap. Although unemployment remains high in the area, applicants for jobs appear to lack the skills and motivation of the older workers. EcoCar is finding it difficult to recruit skilled labour and this shortage is being reflected in increased wages and staff costs at the Lags Lane site. The urban location of the Lags Lane site also causes a problem. Inbound logistics are made expensive by the relative inaccessibility of the site and the general congestion on Midshire's main roads.

Finally, there is insufficient production capacity at the Lags Lane site to meet the current demand for EcoCar's products. EcoCar attempts to produce the most profitable combination of its products within this constraint. However, it is unable to completely satisfy market demand. To address the first internal weakness, Universal Motors is considering outsourcing the manufacture of the EcoLite model to an overseas company. Information relevant to this decision is presented in Figure 2. The potential manufacturer has quoted a production price to Universal Motors of $3,500 per car. The manufacturing plant is approximately 300 miles from Erewhon, which includes crossing the 40-mile wide Gulf of Berang.

There are 112 production hours available in total per week at the Lags Lane site (seven days per week, two eight hour shifts) that can be used for a combination of the three product lines.

The weekly overhead costs are $35,000 per week at Lags Lane. If the production of the EcoLite model is outsourced, it is forecast that overhead costs will fall by $1,250 per week. The transportation cost is estimated at $250 for each outsourced EcoLite produced.

	Eco	**EcoPlus**	**EcoLite**
Selling price per car ($)	9,999	12,999	6,999
Variable cost per car ($)	7,000	10,000	4,500
Weekly demand (cars)	6	5	6
Production time per car (hrs)	9	10	8

Universal Motors is considering outsourcing the EcoLite model to an overseas manufacturer, while retaining in-house production of the Eco and EcoPlus models.

Required:
Evaluate the financial and non-financial case for and against the outsourcing option. (15 marks)

The financial case
There is a key/restricted resource problem here because to produce the total weekly demand, 152 (= 6 x 9 + 5 x 10 + 6 x 8) hours of production time would be needed but only 112 hours are available. Before outsourcing any production, Ecocar can maximise its profits by calculating the contribution per unit of key factor for each vehicle:

	Eco	**EcoPlus**	**EcoLite**
Selling price	9,999	12,999	6,999
Variable cost	7,000	10,000	4,500
Contribution	2,999	2,999	2,499
Contribution per hour of production time	2999/9 = 333	2,999/10 = 300	2,499/8 = 312
Ranking	**1**	**3**	**2**

Production plan:

	Number of units	Number of hours	Contribution/ unit	Total contribution
1 Eco	6 (total weekly demand)	6 x 9 = 54	2,999	17,994
2 EcoLite	6 (total weekly demand)	6 x 10 = 48	2,499	14,994
3 EcoPlus	1 (based on hours available)	Balance =10	2,999	2,999
		Total 112		35,978
		Less fixed costs		(35,000)
		Profit/month		987

If the production of EcoLite is all subcontracted, then there is no capacity constraint because hours needed for the Eco and EcoPlus will amount to 104 (54 + 50) and 112 are available. The surplus eight hours would allow one EcoLite model to be produced in-house, but it is assumed that all production will have to be subcontracted to achieve the lower fixed overheads.

Production plan:

	Number of units	Contribution/unit	Total contribution
Eco	6 (total weekly demand)	2,999	17,994
EcoPlus	5 (total weekly demand)	2,999	14,995
EcoLite	6 (total weekly demand)	6,999 – 3500 – 250 = 3,249	19,494
			52,593
		Less fixed costs (35,000 – 1,250)	(33,750)
		Profit/month	18,733

Therefore, the financial case for outsourcing EcoLite production is very strong indeed, producing an improvement in monthly profits of $17,746. The improvement is principally due to the very much lower cost per unit of EcoLite ($4,500 – $3,500), somewhat offset by the increased transport cost per unit of $250.

It is hard to see any financial case for not outsourcing production of the EcoLite. Indeed, the cost benefit arising from outsourcing the EcoLite is so marked that it implies EcoCar is an inefficient, high-cost manufacturer and that production of all models could be advantageously outsourced and the effects of outsourcing the production of the other models should be investigated. Presumably if all production were outsourced, then this would also allow all production fixed costs ($35,000/week) to be saved. In effect, then, all production costs become variable.

Non-financial considerations (note that every paragraph below mentions points specific to EcoCar)

Advantages include:
1. Allowing the company to focus on its core skills, which would appear to be the development of efficient battery technology and not manufacturing. Manufacturing is not of strategic importance to EcoCar: its technology and patents are. In terms of the Harmon grid, manufacturing is likely to be in the top left quadrant.
2. Capacity management. It is likely that the foreign manufacturer will have greater manufacturing capacity (already restricted in EcoCar) that will allow the company to expand easily.
3. Cost certainty. There are labour, transport and motivational problems at the Lags Lane site, all of which add to cost uncertainty. Sub-contracting using fixed price contracts will reduce this – though care will be needed to deal with currency fluctuations because the proposed sub-contractor is a foreign company.
4. Expertise, quality and capacity. EcoCar is a new, small, inexperienced manufacturing company. Success in manufacturing often depends on large, skilled and efficient operations that could be better obtained by outsourcing.

Potential disadvantages include:
1. Damage to reputation – but there is no evidence here that the outsourcer would produce lower quality goods than EcoCar. However, the outsourcer is 300 miles (about 500 km) away and across the Gulf of Berang. The purchase of a car is not an event that is likely to be very dependent on instant supply, and certainly will not incur idle labour costs, so 300 miles of itself is unlikely to be a problem. The Gulf of Berang is somewhat enigmatic and it would be worthwhile investigating if there were, for example, political problems in the area that could interfere with supplies.
2. Non-congruent objectives. However, here it is difficult to see how these could arise. The manufacture of physical products such as EcoCar's vehicles is easy to define and monitor.
3. Success depends on the other company's performance. As above, contractual arrangements and careful monitoring of the quality of cars produced should reduce this risk.
4. Although EcoCar makes use of the patents of Professor Jaques, patents (by definition) are filed publically and the technology is open for all to see. No additional confidential information will be disclosed by outsourcing.

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