# Assessment of outsourcing criteria

## Vorlesungsvortrag ITTM, Outsourcing, WS 2003

# 1 Introduction

In this presentation, **the most important criteria** for an outsourcing-decision will be explained, **followed by methods for assessment**. We will show, that there are different kinds of criteria, which have to be dealt with differently. The list of criteria mentioned in this presentation should be seen as examples, that have to be further developed in an outsourcing process.

For terms:

In this presentation we will use the word **outsourcing company** for the company that is outsourcing, and **servicing company** for the company, that is providing the outsourcing company with the product.

The literature and sources used for this presentation:


- Mueller, Outsourcing Management, Bund 1997
- Macha, Grundlagen der Kosten und Leistungsrechnung, Campus 1999
- Nagengast, Outsourcing von Dienstleistungen industrielle Unternehmen, Dr. Kovac 1997
- Studie des Europaeischen Forschungszentrum fuer Einkauf und Logistik, Wien, Outsourcing – Sourcing Agencies, Internet 2003,
- Tempobrain AG, Kosten sparen mit Inhouse Consulting, Internet 2002
- Smalla, Vertikale Integration oder Outsourcing
- Meldearbeit, Internet 1998

# 2 Finding of criteria

Criteria for an outsourcing decision have to be **found and assessed by people involved in or with the results of an outsourcing process**. This chapter will describe by whom and how the criteria could be set.

## 2.1 People involved

With respect to the outsourcing-process, there are four main "stakeholders" in the company.

- The **internal customer** as receiver of the product (or anybody else, responsible for the quality of the product);
- the **subjected department** that is outsourced (being the control authority of the outsourcing process; maybe people who are likely to lose their job afterward should be excluded);
- **Personnel department** as a responsible place for possible staff measures;
- **Works committee**, dto.;
- at least **one member of the general board**, depending on the importance of the decision.

## 2.2 Methods

There are different Methodologies for the finding of criteria. The first is likely to be a kind of **brainstorming**, followed by **comprehensible quantitative methods of valuation**. Some possible valuation methods will be described later in the text.

# 3 Outsourcing barriers

In these chapter, criteria will, be described, which should be positively fulfilled. Otherwise an outsourcing is impossible in practice.

## *3.1 Technical criteria*

Technical criteria are related to the process itself. Of course there is always a possibility to make an outsourcing, however complicated the situation is going to be. But here an economic view has be in mind.

- The process to be outsourced should to be in an more ore less isolated field, **the process should be relatively closed**. If not, the defining and controlling of **interfaces** could take to much effort.
- The **know how** within the company with respect to the outsourcing products should be sufficient **to control** the process and **to reintegrate the product** into the company processes.

## *3.2 Legal criteria*

Legal criteria are often given from outside and without influence of the company. Especially rules for human rights and safety are provided and controlled by government and can hinder an outsourcing-decision.

- **Secrecy regulations** set by the governmental law (personal data, client or banking secret) or company policy (R&D data) must be fulfilled all the time. If not, outsourcing can do massive **harm with respect to damage compensation or company know-how**.
- **Safety regulations**, esp. medicine, food, environmental protection must be fulfilled also. In this case, the **government will also at least observe** the outsourcing process.

### 3.3 Strategic criteria

A business-strategy should be developed by the company. Only if the strategy is clear, strengths and targets can be found and decisions made.

- **Core competencies** (competencies, in that the company is able to compete on the market or even has a kind of leadership) **must not be outsourced**. Core Competencies can be found out by benchmarking techniques (comparing of key figures like productivity).
- For future development the **processes in growing markets** should be developed on site.

### 3.4 Suitable enterprises

Of course outsourcing only can take place if there are **suitable companies existing** on the market. They not only have to **be able**, but **willing to take the processes**.

# 4 Cost criteria

Costs and cost assessment are the main factors for an outsourcing-decision. This chapter will give examples of costs and an outsourcing-valuation method. Of course these depend heavily on the quality of accounting methods and the availability of cost-figures in the Company.

## *4.1 Costs*

The easiest way for finding costs is to have a look in the **profit and loss tableau** of the company. Many of them can be find here. **Accounting/Controlling** is also an good address, even when internal calculation figures are available.

The following arrangement first mentions the company costs, that **might** be reduced after an outsourcing, after this the costs for the servicing company and also additional costs, that have to be taken into account.

### 4.1.1 Prologue: Fixed and variable costs

**Variable costs** are costs which increase or fall with the production. **Fixed costs** are independent of this. Fix- and variable costs can **change their character with the time period** looked at (e.g. personnel: fixed in a quarter year period (employees cant be thrown out easily, at least not in Germany), variable in a five years period (figures can be changed by not replacing leaving persons).

### 4.1.2 Saved Costs in the company

Again, these costs may, however, must not get effective (in some cases they will even rise!). Only costs with a maybe fixed, maybe variable character will be discussed.

#### 4.1.2.1 Material (current assets)

Example: Raw materials, tools (variable)

The most variable costs of all. Be aware of the material on stock (may be sold to the servicing company).

#### 4.1.2.2 Running costs

Example: water, current, pressure air (variable)

As above. But they may be related to provisions (pressure air system).

#### 4.1.2.3 Workforce

Example: Blue collar workers, master (?)

As mentioned it depends on the time schedule. In a short outsourcing process it may be complicated to get rid of the workforce, there may be even additional costs.

#### 4.1.2.4 Overhead

Example: Management, purchase, staff, quality, logistics, IE (normally fixed)

Even it would be logical to reduce heads in overhead after an outsourcing, it is very difficult in practice. To much Know How would leave the company and because many of overhead staff is specialised, vital functions are not longer provided in-house. And for the management...(Ever Know someone that killed his own job? ☺ ) These costs can be a severe danger for an outsourcing process. A solution can be found in a management buy out situation, where the overhead is part of the outsource.

#### 4.1.2.5 Provisions

Depending on assets (fixed)

Depends on how is dealt with the property. If the building, machinery etc. can be sold, they are gone. Otherwise the provisions stay.

Example: Building (property)

Easy to calculate if the building is rented and if there is the possibility to cancel the contract. Then these costs will go zero. A problem may occur if the contract has a duration longer than the building will be needed (and there is no other purpose for the object), then the contract has to be cancelled by paying a compensation. Otherwise rental costs stay how they are. If the building is own property, then it has to be sold or rented to a third party (if possible). Provisions may further occur.

Example: production machines (property)

Also depending on what is done. Can be sold to the servicing Company. Otherwise there will be a one time loss.

#### 4.1.2.6 Capital

Interests for short and long term credits (?)

Normally Credits are not related to the investment (Beware if not: e.g. governmental credits). So the money can be used elsewhere. Short term credits can normally easily changed. Credits are used for assets and current assets, both may be reduced (look above).

### 4.1.3 Costs for the provided product

#### 4.1.3.1 Product costs

The cost of the product provided by the servicing company. Normally variable, but may be fixed by contract.

#### 4.1.3.2 Costs for Logistics

Costs for the delivery to and back from the servicing company.

### 4.1.4 Additional costs

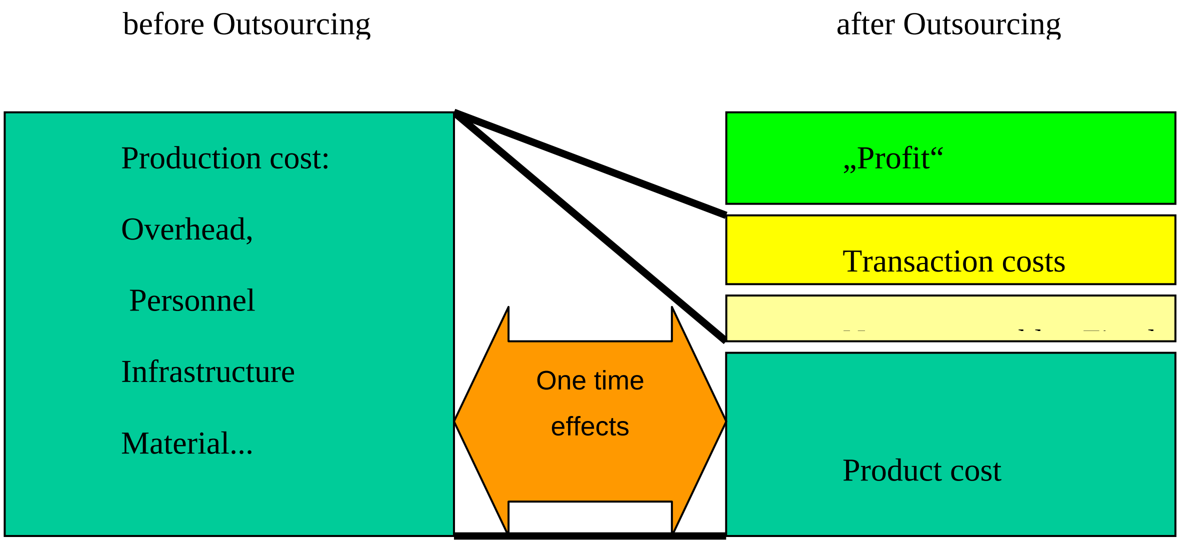
#### 4.1.4.1 Transaction costs

Transaction costs inherit the afford for a divided organisation. The include for example costs for the initiation (search for a servicing company), agreement (especially costs for lawyers), control (quality and delivery control) and customisation (fitting different processes and products in two companies). Transaction costs will rise with the uncertainty and complexity of a project, also with the specifics and frequency of change with respect to the product.

#### 4.1.4.2 Risk-management costs

These costs summarise One time effects (e.g. costs for extra stock, costs for quality or delivering problems in the first time etc. Also the costs to provide the company with a “Plan B” can occur.

### 4.1.5 Graph




## *4.2 Assessment of costs*

The quality of the assessment is directly related to the quality of the cost accounting in the company. Often costs are only estimated by management, which can be right due to the experience and afford avoided, that normally is necessary for a correct calculation. The more vital the outsourcing for the company will be, the less should costs be estimated during decision.

### 4.2.1 Prologue: Direct and overhead costs:

Direct costs are directly caused by somebody or something (direct relation), overhead costs are costs that appear in connection with direct costs, but are distributed by keys (sales volume, value of materials, pieces etc.) E.g. Material costs for the production not only inherit costs of the supplier, but also costs for the stock-workforce, interests for the stock, warehouse...

### 4.2.2 Calculation Scheme

This is a possible calculation scheme for a cost related outsourcing decision. Here additionally opportunity costs are taken into account – costs that appear by NOT doing something (e.g. a trade not made: the lost profit is an opportunity cost).

| Make or buy? | | | |
|---|---|---|---|
| | variable costs | reduction of fix costs | Opportunity costs |
| Material | | | |
| Indirect material costs | | | |
| Production personnel costs | | | |
| Costs of machinery | | | |
| Production overhead costs | | | |
| Special direct costs Production | | | |
| R&D | | | |
| Administration overhead costs | | | |
| Sales overhead costs | | | |
| Special direct costs Sale | | | |
| Production overhead costs | | | |
| Cost of production | | | |
| **Sum** | | | |
| It follows an obtaining calculation according to unit price (invoice) | | | |
| + Allocation amounts (packaging, loading, weighing, fees) | | | |
| + freight-, transport- and storage c | | | |
| - Discount and Compensation | | | |
| + Storage and Quality Assurance | | | |
| Prices expected by partner for product | | | |
| Result | Savings due to outsourcing: | | |
| | Additional costs due to outsourcing: | | |

Compare to:
Safed costs in the company

Compare to:
Costs for the product

Compare to:
Additional Costs

### 4.2.3 Dynamic investment invoice

If the outsourcing process takes a long time to amortise, a simple cost/savings-calculation is insufficient. Outsourcing then should be understood as an independent investment decision. In this case methods like the dynamic profit/loss calculations should be used. Here the costs and savings are discounted to the actual date (this is to take future interests into account).

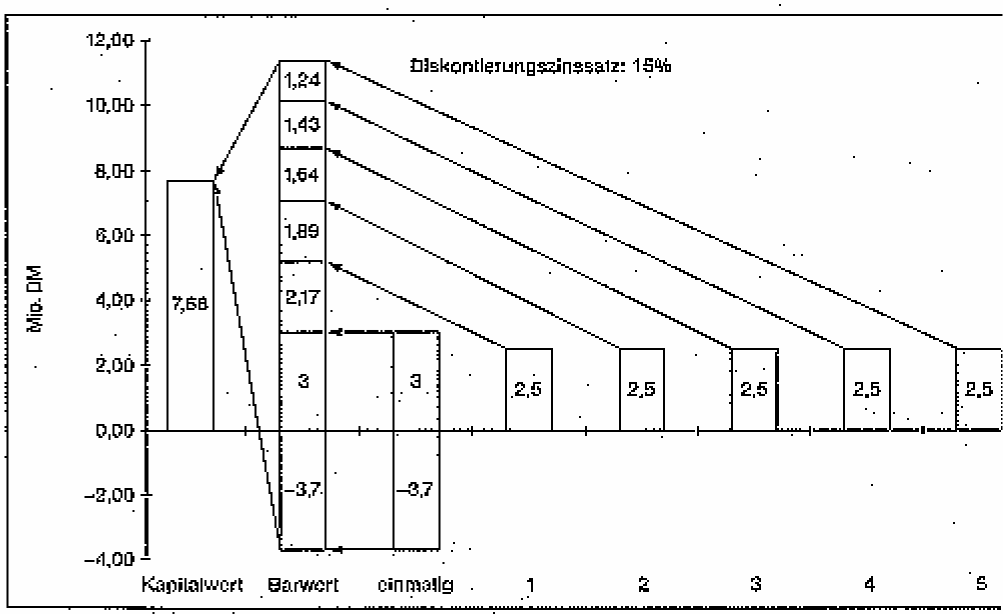



Abbildung 6: Kapitalwertberechnung

# 5 Qualitative criteria

In this chapter some important of these criteria are shown, and in addition a method for assessment.

## *5.1 Criteria*

Cost criteria often are giving the impulse for an outsourcing decision. However, as important are qualitative criteria (compare to Outsourcing barriers).

### 5.1.1 Liquidity

This is perfectly performed by big automotive companies. Before outsourcing, they had to buy material, put it on stock (capital costs!) getting their money back when the car was paid.

This often was a three-month delay, that had to be financed by banks. Today the suppliers have to buy the products, and are often paid with a three month delay. So the pre-financing and interests are the problem of the suppliers, their invoices are stated when the cars are paid. No liquidity problem at all for the Big companies.

### 5.1.2 Tax Control

Outsourcing to another company within the same concern or group is a very interesting part of the taxation law. The prices paid between companies in the same concern but in different tax areas are often political prices to make sure that a minimum amount of tax is paid.

### 5.1.3 Transparency

It is easier to do expense budgeting with external costs than with internal costs (due to the simplified cost accounting – compare overhead costs). Staff is more likely to be cost conscious, if it could be given reliable cost figures.

#### 5.1.4 Flexibility

In case there are many suppliers available, capacity, time and place can be easily adapted to the needing of the company. But often there will be specialised suppliers, which are bound by contract in order to assure a continuos product flow.

#### 5.1.5 Organisation

It is expected, that servicing companies due to their specialisation have better reaction times. However, there are also more interfaces to be handled, so it depends on the very case. The company stuff is relieved of responsibilities other than belonging to the core process.

#### 5.1.6 Know how

Outsourcing often means an access to Know How not available in the company (IT is the most important business line). Smaller and medium sized companies have no recourses outside their core competencies, so tax, accounting, IT or law are given to external specialists. As for know-how outsourcing can give access to specialised technology or technique.

If the company is aware of know-how needed, there is also an **insuring** process possible. (think tanks of big companies)

### *5.2 Method of valuation (example)*

The big problem with respect to qualitative criteria is a fair method of valuation, so that the decision process can be understood afterwards. Due to the lack of figures (of course, the criteria is quantitative) there is no ranking possible at first hand. We will show a method, that tries to quantify the decision.

#### 5.2.1 Point value table

This method tries at first hand to give a weight to the criteria. The weight depends on the strategy of the company and of course a technical department will have other interests than sales. But an agreement within the decision party is the perquisite factor for the method. (Therefor a Member of the General board should be member of the party.)

| Feature | weight | Version 1 | Version 2 | Result 1 | Result 2 |
|---|---|---|---|---|---|
| | | Points | Points | Weighted | Weighted |
| **Tax** | 35% | 2 | 5 | 0,7 | 1,75 |
| **Flexibility** | 20% | 3 | 2 | 0,6 | 0,4 |
| **Transparency** | 5% | 5 | 1 | 0,25 | 0,05 |
| **...** | ... | | | | |
| **Sum** | 100% | | | **1,55** | **2,2** |

Following this weighting, the alternative Versions are evaluated by giving them numbers in a certain range (e.g. 1 = non fulfilled, 6 = extra fulfilled). After multiplying the weight and the evaluation number, we get the weighted evaluation. By adding these figures, we get a result, that shows the better alternative (that with the highest number).Cost criteria can of cause also included.

# 6 Assessment of outsourcing criteria

## *6.1 Empirical view*

Asked for the criteria in the outsourcing decision, there were as many answers as companies asked. Nevertheless, there are some main criteria groups for and again outsourcing.

### 6.1.1 Pro outsourcing

As expected, cost criteria are the most mentioned, together with related criteria like flexibility. For special business lines, the access to knowledge (IT) is also a reason, and the concentration on core competencies (facility Management).

### 6.1.2 Against outsourcing

Against outsourcing the criteria varies even more. But many can be summarised with fear for co-ordination problems and the loss or limited control in the process.

## *6.2 Decision-making*

How a decision is to be made? There is no ultimate answer. Many things have to be thought of, every company differs with respect to available figures interest an Organization.

### 6.2.1 Strategy

One important thing to consider before the outsourcing (and every other) decision process takes place is the Strategy of the company. For those with cost leadership targets costs criteria are the most crucial and therefore a decision is a little bit easier to make. But for those with distinction strategies dependencies have to be considered as well as image and marketing (what does the customer say – e.g. made in Germany...).

### 6.2.2 Assessment process

As always, there is no black and white. If the alternatives thought over do not differ much, perhaps there is a way between. There are different kinds of outsourcing (in-house (in the building), on site (near plant), on-shore (in the country), off shore (another continent) and stages of alliances within a concern or with other companies, that there might be a solution that takes the advantages without the disadvantages.

More important is a consequent risk management, starting with things that can go wrong (personnel unwillingness due to possible work abolition followed by loss in quality) to a “plan B” scenario taking place when the outsourcing process fails.

# 7 Summary

The assessment of outsourcing criteria is the most important step in an outsourcing process. The decision should be made by all stakeholders and with at least one leading member of the general board. It should take all necessary criteria into account, calculate or evaluate them, making the decision as transparent as possible. There is seldom a “best” decision, so risk management should be included from the beginning.

The finding of criteria should individually done for different companies or business lines. Even if there are no “standard” criteria, companies mainly mentioned costs and knowledge access for and the loss of control against an outsourcing decision.