

## Outsourcing versus internal problems

Erschienen: ITJ International Transport Journal, 29. Mai 1998/22

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The term outsourcing stands for the externalisation of a company's internal tasks and processes. This very simple definition, however, does not do justice to the true facts of the matter. Outsourcing is much more than the mere search for a suitable partner.

The outsourcing strategy is not as new as the term used widely today. Externalisation of a company's internal tasks and processes has a much longer tradition in the car industry if we consider for example the external production of whole vehicle modules.

Outsourcing is not one possible solution of a simple task. Neither is the externalisation of tasks and processes about passing the bulk of company internal problems to the outsourcing partner on a one-to-one scale, hoping that the latter will find a cheaper and better solution. Successful implementation of an outsourcing process requires the formation of suitable, logistics-friendly structures at home as well as at the outsourcing partner's company.

### What does get lost?

It goes without saying that the possibilities of control gets lost when a company is willing to outsource. They have to be re-created on a contractual basis. The loss of a company's internal know-how may also have to be compensated. In addition, strategic developments and the resulting increased dependencies have to be taken into consideration.

In this context logistics service providers or outsourcing partners should never forget that every company which decides on outsourcing parts of its activities has to ask itself in the last resort how to manage the balancing act between focussing on its true core competences and ensuring its influence on the outsourced sector without landing flat on its nose (key word: danger of loss of customers).

For their final decision, the range of outsourcing possibilities is of the utmost importance for companies willing to outsource. Procurement has to be named, transport and warehousing. In addition there are other whole areas such as order processing, commissioning, smart distribution, fine distribution, customer service, recycling, EDP, etc. The consequence of this is that outsourcing of processes and tasks is a strategic management decision which absolutely has to be planned strategically as well.

### Company-economic considerations

Outsourcing is not always the only possible solution in the battle against costs and pressure on margins. Previous analyses of the status quo often reveal many company internal weak spots. Two company consulting firms – one in the USA and one in Switzerland – show how far considerations in a company willing to outsource sometimes have to go in order to lead to real cost savings.

According to Marietta GA-based The Colography Group, US companies at the end of 1994 – more recent figures are unfortunately not available – were sitting on USD 950 billion of inventory, up from less than 200 billion in 1970. During this period, the relative costs of carrying inventories – measured as a percentage of total physical distribution expenses – rose by 88.2%, while the cost of maintaining warehouses to store goods rose by 17.6%, the consulting firm said. Transportation costs fell, on a relative basis, by 20.7%.

These numbers challenge the conventional wisdom that shippers have conquered their inventory management problems. If the current trends continue, the study forecasts that inventory and warehousing expenses could account for as much as 71% of a typical company's distribution costs by the year 2010. What are the reasons for this stifling financial burden?

The Colography Group concludes that the culprits that are primarily to blame for this situation are undifferentiated warehousing and distribution. Different inventory and distribution strategies may be required for high-value and low-value products. By calculating the “crossover point” – the point where the costs of carrying inventory exceeds the expenditure of shipping it – companies can shift to a faster mode of transportation that will help to keep expensive goods off the shelves.

Colography applied the bifurcated inventory strategy to a mid-size company with about USD 500 million in annual sales. After analysing the company's inventory flows, it advised a shift towards high-priced, but time-definite air distribution. While the company's transportation costs rose 8%, its inventory carrying costs fell 20%, warehousing costs dropped 9.3% and the value of inventory declined 5.5%. More importantly, the company's net operating profit rose by USD 1.1 billion without a corresponding increase in revenue.

Consulting firm Dr Acel & Partner AG, Zürich/Switzerland, specialised on logistics management, came to a similar conclusion. To solve the cost problems, however, it already starts with the planning and production processes. Dr Peter Acel has found out that by reversing the previous production principles – as a result of the transfer from the push to the pull system – the stock of finished goods will drop considerably, while at the same time production profitability increases and the time needed to react to short-term orders improves. “Instead of changing to flexible control mechanism with short-term planning horizons, production experts show a contrary reaction,” says Acel. Even more is planned, even more frequently and in more detail. This reaction pattern is clearly reflected in the production principles: conventional production companies make A-parts – parts, which produce high turnover or are ordered most frequently – in accordance with the just-in-time principle. B- and C-parts are produced and stocked. In this they do not consider that their range consists of at least 80% of B- and C-parts, while normally A-parts only account for some 20% of all articles. Their production policy thus leads to a large stock of B- and C-articles and at the same time to ups and downs in production, the consulting firm says in criticism of the obsolete planning and production processes that are still widely used.

“Production principles which adapt to consumers and modern organisation on the other hand work the other way round and are simpler,” Acel further said. A-parts are produced from stock. This increases turnover figures for the warehouse. Simultaneously, time spent inside the warehouse decreases. C-parts are produced just-in-time. B-parts are split up into A- and C-parts where possible. D-parts, which might have a negative impact on the offsetting contribution, are eliminated completely. Simplification to two groups of parts and just-in-time production of those parts that are not so much in demand produced good results. Production is more or less working to capacity, and peak demand can be absorbed. Planning becomes simpler and more reliable. The efforts involved in post-planning decrease clearly.

Conclusion: If you entrust your warehousing to a logistics service provider without taking care of pre- and post-processes internally and externally, you could be in for a bad surprise. Are these the reasons for the misjudgments sometimes found about «superweapon» outsourcing? In each outsourcing project every part of the logistics chain has to be investigated for its strong and its weak points painstakingly, as well as for the use for your own company. If you work with undifferentiated tools, do not be surprised if the desired result does not materialise.

### Contract law-related considerations

In those cases in which outsourcing processes and tasks are commercially feasible, the company willing to outsource has to ask itself what the legal side is and how the agreements entered can best be turned into contracts with the outsourcing partner.

In answer to the first question: outsourcing contracts are often mixed-type agreements which combine the services of different types of legal contracts. “For legal considerations the name of the contract as such does not have any significance,” says Martin Schweinoch, lawyer with the firm Schlawien, Habel, Helming, which has offices in Germany, Italy and Switzerland. “The service duties defined are decisive,” he points out. “They also determine the legal warranty and liability regulations for each type of service, in so far as there are no contractual agreements.”

The lawyer answers the second question as follows: «In order to create the flexibility needed for changes of service and implement them without any unnecessary effort, an agreement structure has to be recommended which consists of a firm frame or main contract on the one hand and individual orders on the other hand. When services are changed, they can be rewritten or amended relatively easily.

“The frame or main contract should regulate the procedure of changes and the continued documentation of contracts,” the lawyer further recommends. “Agreements on the inventories, work strategies and competences of the joint managing and controlling teams should also be covered by the main contract. The same is true for agreements on quality assurance and control. For default of service, for example, a defined escalation procedure can be agreed upon with the involvement of the joint steering committee in order to show the way to problem solving.”

Further important main contract items are the exclusion of retention rights by the outsourcing partner or service provider and the mention of a court venue. In addition, the contract has to define the procedures for terminating the cooperation. A simple agreement on a period for giving notice as a rule does not even come close to covering the interests of the outsourcing contractors (the key words here are step-by-step termination of services provided, transfer of know-how, real estate, investments, etc).

### Summary

As far as organisation is concerned, successful outsourcing needs long-term targets on both sides. In addition it needs a precise definition of tasks, competences and responsibilities, the separation between process and performance responsibility and the formation of an outsourcing team. The logistics service provider should already be part of this team at a very early stage. This is because the moment of involvement determines to a large extent his contribution of know-how and to a substantial degree also his amount of responsibility. Finally, the activities that belong together in the sectors of supply, warehousing and distribution logistics

should grow together in an outsourcing project, but in view of infrastructures and performance profiles of many logistics service providers they are not always compatible. He is successful who best knows how to find real improvements and cost cutting potential, how to implement them internally and to design the processes in a way an external logistics service provider can imitate.

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### **What is the etymology of the term outsourcing?**

The term “outsourcing” stems from the word combination “outside resource using”. This means the use of third-party resources. Today the term is used in connection with the externalisation of company-internal processes and tasks without any real added value to third-party companies.