



A Twin Approach to the Control of Outsourced Activities

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This briefing addresses the question of how firms control outsourced activities. Two findings are discussed: the lack of measurement of transaction costs; and a pragmatic twin pronged approach to control based on contract enforcement and trust based cooperation. The findings then build to a discussion of the social aspects of control.

Background

Over the last two decades there has been a major increase in the scope of activities which firms have been prepared to outsource rather than perform in-house. Although there have been high profile cases of failure, the willingness of firms to outsource critical activities such as the treasury function suggests that they are generally satisfied with the level of control that they achieve over the outsourcing process. The question which this poses and which this study addresses is 'how do firms control outsourced activities?'

In order to provide a basis for investigation a framework of control was proposed from the academic literature. The main propositions of the framework were:

Power is the basis of control. Control is based on power and accordingly a firm's potential for control of outsourced activities depends on the balance of power between the firm and the provider. Sources of power lie in: the relative financial strength (size and liquidity) of the firm and the supplier; market

structure; competencies; property rights; and the outsourcing relationship.

The operational objective of outsourcing is to provide activities which form an integral part of the firm's composite value chain (i.e. value chain comprised of both in-house and outsourced activities).

The problems to be overcome include: suppliers' propensity to behave opportunistically including the possibility of bribery; contracts' inevitable incompleteness because all contingencies can not be anticipated; and the need for certainty for some aspects of delivery but the desirability for flexibility of delivery for other aspects.

The means of achieving control include: formal contract and monitoring of delivery; relational contract based on trust and cooperation; and practices such as multiple sourcing and short contract duration.

Method

A series of interviews was conducted with managers responsible for outsourcing three types of outsourced activity namely site services, manufacture and R&D in order to compare their perceptions with the propositions.

Results

Power as the basis of control

All managers agreed that power is the basis of control. They all agreed that formal contract once transacted is a source of power – to both parties. There was universal agreement that property rights (notably to intellectual property) and a competence in outsourcing management (which all claimed to possess) were sources of power. Other competencies have no relevance to the suppliers of site services but firms outsourcing R&D and manufacture regarded their competencies in these areas as rewarding sources of power over suppliers. As an illustration, a manager in a global pharmaceutical company claimed that its suppliers by dealing with the firm's manufacturing department obtain what amounts to free consultancy. Market structure was not seen as a source of power by any managers as high degrees of concentration did not prevail among buyers or suppliers. There was a mixed response regarding relative financial strength as a source of power.

Objectives of Outsourcing

Managers were aware of the fundamental reasons why their firms outsourced particular activities, but all accepted that once the decision to outsource has been made the operational objective is delivery of the activity to the composite value chain.

Problems of Outsourcing

The extent to which problems were encountered varied according to the type of activity. Managers outsourcing site services claimed that their control of the outsourcing process had developed to a point where they are free of significant problems. This situation is the result of an ongoing process in which controls are put in place to mitigate new problems as they arise. Managers outsourcing manufacture were not quite as problem free but the extent of their problems was relatively low. Two instances of continuing problems were: opportunism in the form of overloading of overheads by suppliers in open book contracts for the manufacture of pharmaceutical intermediate products; and difficulties in handling demand fluctuations for engineering components.

The outsourcing of R&D encountered more problems than the other two activities. Managers attributed this to the unpredictability of outcome of projects, the dynamic portfolio of projects outsourced, and the proportion of suppliers that are relatively new and lacking in established reputation. Whilst managers of other types of outsourced R&D did not see incomplete contract as a critical issue, the manager outsourcing clinical trials on pharmaceutical products sees it as a very real problem because one does not know what will happen regarding patients reactions to new drugs. All managers agreed that absolute certainty is essential for the protection of the firm's IPR when outsourcing R&D. They all recognised that some

operational flexibility was necessary but the pharmaceutical firm was, for the reason indicated, particularly cautious on this score. All managers of outsourced R&D encountered and were on guard against a common form of opportunism namely the propensity of small spin out companies to overstate their capabilities in order to obtain new business.

Controlling Outsourced Activities

The means which managers used to control outsourced activities in all cases fell within a twin pronged approach comprising:

- The establishing and the monitoring of formal contracts covering key issues including the protection of IPR and critical aspects of delivery as defined by key performance indicators (KPIs) and service levels.
- The selection of trustworthy suppliers with which they operated parallel relational contracts based on trust and cooperation, whilst at the same time maintaining safeguards against opportunism and bribery.

Regarding sourcing techniques, no managers used duration restriction as a means of control. Multiple sourcing was used by some

managers of outsourced manufacture and outsourced R&D as a means of control and as a safeguard against supply failure.

Questioned as to whether the selection of trustworthy suppliers resulted in reduced transaction costs because a lower level of monitoring could be applied, managers' ability to respond was limited by the extent to which such costs are measured.

Discussion

The dominant feature of the results is the twin pronged approach to control based on formal and relational contracts. This is illustrated in Figure 1 (below). This use of relational contract, with its dependence on trust and cooperation to achieve control, chimes well with the concept of social capital which has developed in the field of sociology. Social capital is created when relations among persons change in ways that facilitate action. It is capital which exists within the relationship but is not owned by anyone. It can be appropriated by anyone capable of so doing and can be used for purposes other than that for which the relationship was established.

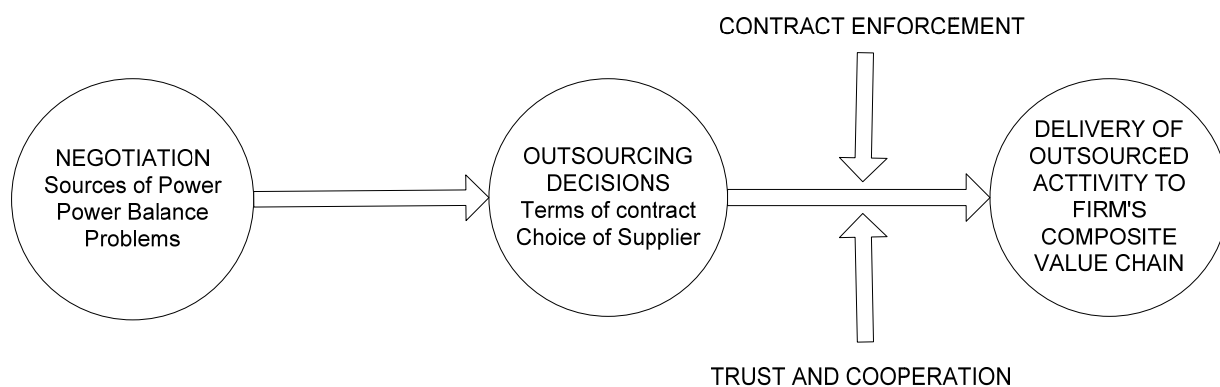


Figure 1: Control of Outsourced Activity

Social capital in a relationship can be analysed in terms of three dimensions. The relational dimension, which is based on trust and other factors, is the dimension that facilitates action. Structural and cognitive dimensions enable the relational dimension to come into play.

Trust is the key element in the relational dimension of social capital: it stimulates the development of other elements of this dimension such as the idea of 'give and take' and in turn is reinforced by such development. Thus social capital sets trust in an interactive context. It is therefore proposed that understanding of the relational contract element of control could be enhanced by a model embracing the wider concept of social capital rather than simply trust. It is suggested that further empirical work be undertaken to test this proposition.

Firms frequently justify outsourcing on grounds of expected cost reductions. A full comparison of costs requires the respective organisational costs to be considered as well as purchase price and internal production cost. Thus the comparison is:

$$\begin{array}{c} \textit{contract price} \\ + \textit{transaction costs} \\ \vee \\ \textit{internal production cost} \\ + \textit{internal governance costs} \end{array}$$

The only firm applying a total cost system covering this comparison in full was a pharmaceutical company which uses it to

decide whether to perform clinical trials internally or to outsource them. In contrast the firms outsourcing manufacture and site services did not produce the data on transaction costs needed to make this comparison. They justified this on the following grounds: they are highly successful in eliminating untrustworthy suppliers; transaction costs show little variation between suppliers and generally transaction costs are negligibly small compared with contract prices. Between these ends of the spectrum other firms outsourcing R&D recognised that transaction costs were important but only measured them to a partial extent.

Thus the evidence suggests that firms measure transaction costs to an extent determined by their perceived relative importance to total costs. Common sense would support such a proposition but in view of the importance of cost in outsourcing decisions it is suggested that empirical research to test it (involving management accountants) is justified. Such work could also address the related topic of the variables which give rise to differences in the level of transaction costs attached to various types of outsourced activity.

Recommendations

It is recommended that supply managers and other managers responsible for outsourced activities compare these findings with their own approach to the control of outsourced activities. In particular:

- *Do you share the twin pronged approach to control?* If so, are you happy with your balance between contract enforcement and trust-based cooperation?
- *Are you clear as to your firm's position in the transaction cost measurement debate?* What assumptions were made when an activity was outsourced as to the level of transaction costs and the question of whether or not they should be routinely measured? Are these assumptions periodically reviewed?

** Briefing based on PhD research by Harry Thompson.

The Supply Chain Management Research Group (SCMRG) was launched in January 2006. It aims to be an internationally recognised centre of excellence for scholarly and relevant research in Supply Chain Management. Further information about SCMRG including its research projects, industry briefings and scholarly publications can be found at: www.scmrg.com

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Harry Thompson spent a career in marketing and overseas business management in a multinational company. The wide experience that he gained in inter-firm and intra-firm relationships provides a relevant background to the research in outsourcing that he is conducting under the supervision of Professor Paul Cousins and Dr. Brian Squire. The focus of that research is now on the role of social capital in outsourcing relationships.