FITT International Business Guide:

PROS AND CONS OF OUTSOURCING PRODUCT MANUFACTURING AND SERVICES

FITT

Forum for International Trade Training

FITT International Business Guide:
Outsourcing Product Manufacturing and Services – Pros and Cons

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Table of Contents

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Introduction

Almost all manufacturing includes an outsourcing component: buttons and zippers for clothing; hundreds of parts for computers (e.g. keyboards, monitors); automobiles; and, whole subsections of aircraft made in distant places and integrated to form the final product. It's the natural way for humans to accomplish complex tasks. The logical basis for the process is that we focus our own efforts on the jobs that we are skilled at and seek others with complementary skills to complete a project.

This guide is intended to provide a concise review of outsourcing as a possible strategy to consider by any company facing the challenges of increasing costs, shortage of labour needed to expand, or competition from home or abroad. It is based primarily on the Forum for International Trade Training's (FITT) ***FITTskills Global Supply Chain Management*** course. FITT is dedicated to providing international business training, resources, and professional certification to individuals and businesses, and accreditation to educational business programs. FITT's international business courses (FITTskills) provide in-depth, comprehensive training on these issues. For your convenience, the courses are available online through FITT or in-class through numerous educational institutions. For further information, please visit: fittfortrade.com

Vertical Integration and Outsourcing

In business terms, the degree to which a company produces (manufactures, develops) the complete product or service for sale is called the degree of Vertical Integration, being 100% if no other entity participates in the development of the final product.

There are some obvious advantages to vertical integration, such as the following:

- ☑ It enables you to invest in specialized production assets to differentiate your products from the competition and improve your margins; and,
- ☑ It may enable you to lower transactional, operational and labour costs, and improved quality performance.

However, there are also serious potential disadvantages, including the following:

- ☑ You may encounter Balancing Problems;
- ☑ The business may need to establish excess upstream capacity in order to ensure that the downstream operations will have enough supply under any demand conditions; and,
- ☑ Because of the investments necessary to integrate all parts of the production process, the company may encounter decreased flexibility.

Typically only very large companies are capable of complete vertical integration because of the capital investment required. Examples include Apple, *although even Apple outsources the manufacture of iPhones to Shenzhen, China,* Walmart and Exxon. Most of the rest of the world outsources.

So naturally, the opposite of vertical integration is outsourcing, and the key to successful outsourcing is efficient global supply chain management. The decision to outsource or not must be made after a complete analysis of the existing and proposed alternate supply chains. This process will identify the net benefit to the company of various options, which may include dismissing outsourcing altogether (e.g. too expensive, too complex to establish, too demanding of financial and personnel resources), or choosing to outsource domestically (e.g. simpler to implement within a domestic legal and transportation system), or outsourcing offshore. "Offshoring" is more complex but offers higher margins if successful, and as noted above, positions the company closer to existing or potential markets abroad.

Outsourcing allows a company to potentially:

1. Lower operational and labour costs;
2. Focus on core interests and free up assets while delegating secondary processes to third parties;
3. Access world class technologies; and,
4. Move the production processes closer to world markets.

Global Supply Chain Management

Firms are creating truly global supply chains because it enables them to reduce their costs. Companies can take advantage of lower production costs and can outsource to free up capital from non-core activities and generate large-scale efficiencies. In addition, the costs of shipping, communications and tariff-related charges have come down over the years. Going "global" through global supply chains helps facilitate entry into new markets, enable business growth and provide firms with access to new technologies through partnerships with foreign firms.

Case Study in Supply Chain Rationalization

The ***FITTskills Global Supply Chain Management*** course discusses an example of a medical supply manufacturing company that faced a gradually tightening market. To deal with this, the company re-examined their distribution network and developed a new, more efficiently integrated transport system. The result was that they were able to replace sea freight with air freight, providing substantial cost savings while still maintaining delivery times. Cost reductions in manufacturing processes were also identified.

Outsource (Make or Buy) Analysis - Principles

The following section identifies the key issues involved in the process of evaluating whether or not to utilize an outsourcing strategy. In some circumstances, it might make sense for a company to manufacture a product from sourced raw materials or components. In others, companies might find it more profitable to pay another company to perform the manufacturing process and then sell the finished product.

A major component of planning a supply chain strategy depends on a company's decision as to whether it will make a product, purchase the product to sell to customers or supply a service. The core aspect to bear in mind during the analysis is the **quantification** of the criterion at each phase. Without applying numerical values to the criteria, an objective comparison between alternatives simply cannot be made.

Using a global supply chain strategy, decisions must also be made as to **where** and **when** these actions will take place because these directly impact the final price. For example, a company can choose to make a product in the following ways:

- ☑ **Make to stock:** In this production method, companies manufacture a product in anticipation of customer orders.
- ☑ **Make to order:** In this production method, companies only manufacture a product when they have received a firm order from a customer. Companies can pass orders on to a partnering manufacturer in a foreign market or a manufacturer in a domestic market, or produce the goods at a company manufacturing location.
- ☑ **Configure to order:** In this production method, companies partially manufacture the product and complete it after a firm customer order is received.
- ☑ **Engineer to order:** In this production method, companies manufacture a product to unique specifications provided by a customer.

Cost

If the goods or services are to be produced in-house, companies must consider the costs associated with labour and other capital assets. In some cases, the capital assets might be better used in some other way. If the manufacturing will be outsourced to a supplier, companies must factor in the costs of dealing with the supplier and correcting any errors to ensure quality control.

Production Capacity

If the company does not have adequate production capacity, it can choose to subcontract out some or all aspects of production.

Competitive Advantage

If a company does not want its competitors gaining knowledge about a proprietary product or process, it should not use external companies to produce its products.

Primary and Secondary Sourcing

Companies must aim to ensure the supply of goods or services while minimizing the number of suppliers, maintaining quality standards and meeting cost objectives. In some circumstances, a company will be able to, or will have to, use a sole source for their supplies. However, the company should always have a contingency plan in case a sole supplier becomes unreliable, is taken over by a competing company or is affected by external events.

Global Outsourcing Risks

Deloitte's 2014 Global Outsourcing and Insourcing Survey found that "most issues are derived from the service provider being reactive rather than proactive" (49% of respondents) "or from the provider delivering poor service despite achieving service levels" (48% of respondents). The least commonly cited issues are "cost related metrics and culture compatibility." (www2.deloitte.com/content/dam/Deloitte/us/Documents/strategy/us-2014-global-outsourcing-insourcing-survey-report-123114.pdf)

Risk Factors and Due Diligence

The following sections discuss the diverse risks which must be examined in the course of a make or buy decision:

1. Supplier Risk

Any arrangement with suppliers has elements of risk involved with it; however, risks associated with sourcing internationally are often higher.

With sourcing, the company must thoroughly investigate (i.e. carry out due diligence on) potential source markets and suppliers, making an in-depth risk assessment and checking the business practices of potential suppliers to identify any possible problems. Issues to investigate are outlined below.

2. Quality

The implications of a quality failure from an international source are much more severe than a quality failure from a domestic source. With the lead times involved with transporting goods from international sources, serious disruptions can occur and it can take several months to rectify the problem. To help minimize this risk, many companies prepare detailed product specifications for suppliers and insist on independent quality control inspections. See the following Case Study.

Case Study in Quality Control

Some years ago, a small U.S. company obtained a contract to supply character dolls for a famous entertainment conglomerate. The proprietor found a supplier in China that offered excellent pricing and showed pictures of samples they had produced to specifications provided. Because the supply contract was very important for this and future business, the proprietor decided to visit the plant, where he found that the samples were the only suitable models of many the manufacturer had produced. The proprietor decided to stay at the plant to supervise the entire six week production run. The end result was a successful, high margin transaction with a satisfied buyer and many other similar contracts to follow. Summers in Southern China, product ready for Christmas!.

3. Intellectual Property Protection

When companies share information with suppliers in countries that have less stringent regulations about intellectual property rights, proprietary information is often leaked. For some products this may constitute an insurmountable obstacle to outsourcing. In others, where the product is constantly evolving, the company may decide to dispense with patent protection, confident it can develop new products faster than the market can reverse engineer them.

4. Reputational Risk

To avoid negative impact on the brand name, supplier human rights issues (e.g. hiring underage workers, poor treatment, and environmental violations) must be carefully investigated to ensure compliance with the company's code of conduct.

Other important considerations with global sourcing include the following:

- ☑ Transport time, costs and risks are usually higher than with domestic sourcing as a consequence of the longer routes;
- ☑ Cultural differences may complicate business communications or cause shipping delays;
- ☑ Documentation for international sourcing is complicated and may require research, consulting costs or in many cases outsourcing to a brokerage;
- ☑ Supplies might be interrupted by political instability, requiring identification of alternative sources; and,
- ☑ Weather could be a factor, creating shipping delays.

Ideally, to minimize their risk exposure to the above factors, companies should investigate a balanced sourcing strategy in which a mixture of global and domestic sources are used.

How to Outsource – The Process

The following sections discuss critical steps in the outsourcing analysis:

Conduct an Internal Needs Analysis

The process of deciding whether to outsource or not begins with a detailed evaluation of every cost element (also referred to as "factor input") necessary to produce a product and deliver it to the buyer. This would involve labour costs, every physical component (e.g. raw materials, parts, fasteners), every transformation required (e.g. casting, welding, shaping, quality assurance testing), every aspect of packaging and labelling, and the whole process of logistics analysis. All these costs must be compared between current and alternative models. Also to be considered are potential benefits of high technology components available offshore, and the impact of greater proximity to markets.

Conduct Market Assessment of Suppliers

In this step, the purchasing team identifies countries from which they can purchase the required products or services. A decision must then be made as to which market will provide the most cost-effective supply and lowest risk based on its proximity to raw materials, labour costs, exchange rates and financial conditions, and transportation costs.

Companies can conduct basic research into markets by:

- ☑ Checking websites about conditions in the country;
- ☑ Contacting foreign governments directly;
- ☑ Requesting information from foreign chambers of commerce; contacting foreign trade associations;
- ☑ Obtaining information from foreign banks or domestic law companies that have offices in the target market;
- ☑ Reading publications such as the International Trade Statistics Yearbook, published annually by the United Nations; and,
- ☑ Contacting the trade commissioner at the foreign embassy located in the company's home country.

Note: Detailed information about how to research international market conditions is described in the ***FITTskills International Trade Research*** course.

Collect Supplier Information

When one or more supplier markets have been identified, the purchasing team prepares a survey for potential suppliers that will help them evaluate each supplier's capabilities, quality level, costs and associated risks. Sample supplier survey forms are widely available on the Internet. If possible, the company should arrange to inspect the supplier site and talk to other customers about their experiences with the supplier. Companies will usually want to select more than one supplier to avoid potential supply chain interruptions.

Develop a Sourcing Strategy

Based on the information gathered in the first three steps, a company can develop a sourcing strategy, such as making direct purchases, making an acquisition or forming a strategic partnership.

Solicit and Evaluate Bids

If a decision is made to make a direct purchase, the company should prepare a request for proposal (RFP), also known as a request for quote (RFQ), and solicit bids from identified potential suppliers. Note that typically the issuance of an RFQ is a one-shot deal based on price and delivery. Therefore, when a company wants to receive bids from several suppliers, online bid-based sourcing can be used to streamline the process. Importers can put an RFQ on an online notice board and potential suppliers can post their response confidentially. This system reduces paperwork and speeds up the process, especially when bidders are located overseas.

An RFP on the other hand, frequently is open to minor revisions, picking the best few bidders and receiving Best & Final offers. Both types should include detailed product or service specifications, delivery and service requirements, evaluation criteria, pricing structure and financial terms.

In some cases the solicitation may be in the form of a functional specification, with performance parameters to be met and a detailed scoring system attached showing the weightings assigned to each parameter. The RFP is sent out to suppliers with a deadline for response. The purchasing team will want to ensure that a disclaimer is included to declare that no financial responsibilities lie with their company for soliciting information and any costs associated with the participation in the RFP.

Picking the winning bid may be as simple as selecting the lowest cost and best delivery time. For example, when multiple repeat suppliers are used – this is called a spend-driven approach.

For complex procurements where concept development and design are a part of the solicitation, visits by the evaluation team to each bidder may be necessary and benchmarking of each design carried out to confirm that functional specifications are met or exceeded. This might be the case for example in evaluating large computer systems.

Another situation that would trigger a risk-driven approach could be when the company is sourcing new supplies or working with new suppliers.

Initial Supply Chain Evaluation

While obtaining initial bids it may be useful to utilize web tools to estimate transportation and brokerage fees for a rough cost workup. Sites of the major logistics companies provide a range of options to choose from for this purpose. See the Sources section at the end of the brochure for further details. Sourcing strategies that a risk-driven company will adopt often include:

- ☑ Placing an initial trial order from more than one supplier;
- ☑ Avoiding suppliers in countries where the risk is known to be higher; and,
- ☑ Negotiating payment terms that enable a company to pay a supplier only when certain conditions have been met. For example, this may require the inclusion of a performance bond or inspection certificate.

Negotiating with Suppliers

When a company has selected a new international supplier, the negotiation process must be handled carefully and the terms of the deal finalized. When the company is intending to resell manufactured products, contractual terms will involve details such as the number of units required, warranty conditions, product availability and technical documentation, as well as promotional or advertising support. However, when the deal revolves around services, raw materials, components, machinery or equipment, the terms will be adjusted to the specifics of the transaction. The following sections address the negotiated considerations that are essential in this type of transaction.

Priority Negotiating Elements

Price is obviously a vital area of the deal to negotiate. When negotiating a price, the company should address the following questions:

- ☑ What volume is being purchased?
- ☑ Are discounts available as volumes increase?
- ☑ What logistics costs related to imports and transportation are covered in the price?
- ☑ Does the price include packing, cargo insurance and customs duties? Note that each of these items will be borne by either the exporter or the importer and will be included or excluded from the quoted price of the goods.
- ☑ When do the supplier's responsibilities end and those of the importer begin, as determined by the contracted Incoterm?
- ☑ What are the expected payment terms and how will they affect company cash flow?
- ☑ Are there discounts for accelerated payments?

The answers to these questions will not only determine the final price, they may later have consequences for defining and calculating the value of the goods for any applicable customs duties and taxes. Before signing an agreement, the supplier and the purchasing company must define who is responsible for carrying out the different parts of the agreement. For example, who will arrange for transport, insurance, export and import permits, and customs clearance and inspection? All these responsibilities may fall to one of the parties to the transaction, or they may be apportioned in some other way.

Case Study on Negotiation

A negotiating team from a Canadian high tech company had completed two weeks of discussions with a Chinese buyer. All the details had been agreed to and both sides sat down to initial each page of the agreement while the other participants were waiting in an adjoining room decorated with flags of both countries and featuring champagne for celebratory toasts. As the Canadians began initialing their copies, one of the Chinese negotiators interrupted the proceedings to explain apologetically, that they needed an additional 25% discount to the agreed price. The Canadian team looked at each other, smiled at the group, and stood up, telling their hosts that they would be returning to the hotel and leaving in the morning, since they had offered their best prices. On arriving at the hotel they received an urgent call from the Chinese side agreeing to the settled terms and inviting them back to the negotiating hall, where they enjoyed champagne and received the fully initialled contract.

The lesson to be taken here is that first, there are schools of negotiating techniques abroad that train their teams well, and second, walking away is one of the options a company should always be prepared to implement.

Note also that this is a case of supplier leverage, where there was limited competition and the product quality had been previously established in the market ("the Mercedes effect").

Incoterms

Incoterms are standard trade terms that clearly define different ways of apportioning responsibilities, risks and actual ownership of goods between the exporter and the importer. They should be referred to in the contract as a way of specifying what arrangement is intended. Despite the fact that Incoterms are universally accepted, local usage and trade terminology varies. It is therefore wise for an importer to confirm the agreed-upon meaning and usage of specific Incoterms with the supplier. Incoterms are discussed in detail in the ***FITTskills Global Supply Chain Management*** course.

Method of Payment and Documentation

The method of payment must also be specified and agreed upon in advance. The documents that should accompany supplied goods form a critical part of any global purchasing agreement. Without proper documentation, the goods might be held up or seized at customs, costing the importer both time and money. The goods might even be returned to the point of origin. To avoid these possible situations, it is best to investigate all domestic regulations pertaining to importation and exportation of the goods.

Payment Terms

When and how payment must be made for goods is a matter of negotiation and part of the terms and conditions of the contract. The purchasing company will normally want to defer payment and secure the longest possible time between the date when products are received and the date funds are transferred. During this time, the importer can verify the quality of the shipment, evaluate product performance and minimize the risk of fraud. The importer might even wish to save on financing costs by selling the goods before paying for them. On the other hand, the supplier will want to be paid as quickly as possible, even to the extent of receiving payment before shipping the ordered goods.

Because the payment objectives of the importer and exporter pull in opposite directions, the payment terms actually agreed upon in a contract often reflect the relative strengths of the two parties.

Several alternative methods of arranging payment are available to an exporter. How payment is made will parallel the time when payment is made. The following are the usual options:

- ☑ Cash in advance or prepayment
- ☑ Documentary (letter of) credit
- ☑ Documentary collection
- ☑ Open account

Each method of payment carries a degree of risk and advantages for both the exporter and importer. Cash in advance, in total or in part, is the safest method for the supplier, and it provides financing for the transaction. At the other end, open account is the safest method for the importer, and the most convenient in terms of financing. These methods of payment are detailed in the ***FITTskills International Trade Finance*** course.

An importing company can protect itself against non-fulfillment of obligations by an exporter through performance bonds and guarantees issued by an insurance company or a bank. In the event of a default by the exporter, the importer has recourse against the issuer of the guarantee. However, when a claim has been paid, the company or bank issuing the guarantee will seek reimbursement from the exporter.

The location at which the importing firm will receive its goods and assume its responsibilities will depend on the terms of sale negotiated with the supplier and on the Incoterms that the partners agreed to. To receive the goods from the carrier, the importing firm will have to present a copy of the bill of lading or another cargo-control document to customs clearance officials for clearance or transfer of goods in bond. The exporter or carrier responsible for transporting the goods sends the cargo control documents to the importer. Once goods have cleared customs and are received on site, the importer will verify that the goods are those agreed to and in proper condition.

Compliance with International Law

Before entering into an international supply agreement, companies should ensure that they are aware of all international regulations that might affect the purchase. This aspect of international trade is discussed in detail in the FITTskills Legal Aspects of International Trade course.

Importer's Liability

It is essential that companies investigate legal requirements and payments for importing goods before entering into a purchase agreement, because liability for all customs duties, penalties and charges falls to the importer. The exception to this is when a shipment is negotiated with a delivery duty paid (DDP) Incoterm.

Tariff Classification

Importers must provide customs with a Harmonized System Classification Code on the formal customs accounting document for the products they are importing. This classification will have a direct effect on the duties that are paid to the government of an importing country.

Because of the complexity involved with importing and exporting goods, many companies use customs brokers to act as their agents. Customs brokers' clear shipments of imported goods, prepare required documentation for export shipments and collect duties and taxes. The selection of a customs broker must be carefully managed to ensure the possession of the specialized knowledge required for the management of such issues as preparation of customs documents, appeals and dispute settlements, etc. This evaluation process is addressed in detail in the ***FITTskills Global Supply Chain Management*** course.

Standard Import Documentation

DOCUMENT	DESCRIPTION
COMMERCIAL INVOICE	This document is issued by the exporter.
BILL OF LADING	This document is issued by the carrier of the goods. The carrier may be a shipping line, airline, transport company or freight forwarder.
IMPORT DECLARATION	This document must be created by the importing company, a customs broker working for the importer or exporter using a DDP Incoterm. It clearly describes the goods being imported; the exporter, vendor, importer and consignee details; the date shipped; and, the country of origin. It must also state the price paid including currency of sale for the goods. Customs use this document to assess duties and/or taxes payable on the shipment.
PACKING LIST	This document is provided by the exporter.
INSURANCE DOCUMENT	This document is issued by the insurance company or freight forwarder.
CERTIFICATE OF ORIGIN	This document is provided by the exporter. Note a **Special Certificate of Origin** is issued by the exporter or an exporting authority stating that the country of origin was a country in a regional trade agreement with the importing country (such as NAFTA).
PHYTOSANITARY CERTIFICATE	This document states that a shipment of plants or plant products is free from pests and diseases. It is usually issued by an agricultural authority in the exporting country.
FUMIGATION CERTIFICATE	This certifies that used clothing, cloth packaging and wood-based packing materials have been sterilized to remove pests.
CERTIFIED CONSULAR INVOICE	This document is issued by a consulate of the importing country that is located in the exporting country. It confirms country of origin and the value of the goods being shipped.
INSPECTION CERTIFICATE	This document certifies product quality or adherence to certain specifications.
QUALITY CERTIFICATE	This certificate states that the products in the shipment meet the standards required for the product by the importing company. This is often provided by the exporter.
VETERINARY CERTIFICATE	This certificate accompanies shipments of animals or meats and states that they have been inspected and shown to be absent of disease.
PUBLIC HEALTH CERTIFICATE	This certificate states that a shipment has been inspected and shown to be absent of pathogenic (disease-causing) organisms.

Conclusion

In the globalizing trade world of today there is a constant trend towards reduction of tariffs through such agreements as the existing North American Free Trade Agreement (NAFTA), the Transpacific Trade Partnership (TTP), the Transatlantic Trade Partnership (TATP) and many others. These have allowed companies worldwide to gain access to lower cost manufacturing areas and to specialized high technology sources as well. When the necessity arises for a company to expand production or lower costs, this accessibility combined with decreased shipping costs through supply chain optimization has added a viable option to consider, namely outsourcing. The analysis undertaken by a company must be rigorous and quantified. It should take advantage of online tools and be reviewed ("reality check") with experienced logistics experts prior to an investment decision being made.

This guide has aimed at introducing the key steps to be taken in making the decision. The subject is treated in more detail in the various FITTskills courses, particularly ***Global Supply Chain Management***, which are offered by the Forum for International Trade Training. Please see fittfortrade.com for further information.

Sources & Additional Resources

Forum for International Trade Training
fittfortrade.com

- ☑ FITTskills textbooks: fittfortrade.com/textbooks-ebooks
  - ☐ Content from the following FITTskills textbooks were used for the development of this guide:
    - ✓ FITT. *FITTskills: Global Supply Chain Management, Sixth Edition*, Ottawa, ON: FITT, 2013.
    - ✓ FITT. *FITTskills: Legal Aspects of International Trade, Sixth Edition*, Ottawa, ON: FITT, 2013.
    - ✓ FITT. *FITTskills: International Trade Research, Sixth Edition*, Ottawa, ON: FITT, 2013.
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UPS Fee Calculator and Tools
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Vertical Integration
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