Coming to terms with the true costs of outsourcing

Firms need a new approach to developing outsourcing models which takes into account the risks to brand and reputation that hide beneath lower cost production in regions like Asia

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By **Richard Brubaker**

In the run-up to Apple's recent launch of the iPad, the focus of the media, analysts and consumers was on whether the new product would become a replacement for Amazon's kindle; whether consumers would accept the addition of a new device, and what content would be made readily available. Eight thousand miles away the story was very different, as 2,000 workers at Apple's Suzhou-based supplier, Wintek, were on strike and the production lines were idle.

A mix of rumours on the reasons behind the strike action circulated, including that staff had been exposed to toxic substances and that Wintek had failed to pay overtime salaries. The problems at the supplier should not have come as a big surprise to Apple – the company's own 2009 supplier responsibility report revealed that more than half (43 of 81) of their China-based suppliers were not in compliance with company directives.

Economic and moral balance

For many, corporate social responsibility (CSR) has had the look and feel of a fluffy add-on; something to be done when extra money was in the bank or when a little extra brand value needed to be created. It has not been seen as an investment in products, processes and people that create sustainable businesses, or as a strategic counter-balance to the negative externalities that many expose themselves to when outsourcing production to another country. While consumers on the whole may not understand the complexity of a supply chain, or have a direct personal connection to the labourer who assembled their product, they do have a line, and they will increasingly walk away from firms that break the unwritten and written codes. This is a fact that some firms have lost sight of over the past 18 months as the global recession took hold.

For Apple, the strike itself was not all that different from others where workers were expressing their dissatisfaction. But the fact that this strike was not the first one to hit a supplier of the global computer brand should have propelled management to immediate action, not just as a feel good measure of corporate responsibility but because there was a real risk to damaging the Apple brand and global sales.

Yet the conditions did not garner the ‘red alert’ one might have expected, and within six months of the release of the supplier responsibility report, news of a Foxconn employee committing suicide threatened to become a commercial issue for Apple as it highlighted the problems the company was facing with its suppliers.

For those who would suggest that companies should work to find a balance between economic and moral imperatives, what we are finding is that it is the firms who act morally that perform the best economically over the long-term, and those with the least moral imperative are more often the first to exit the market.

Why is this the case? Because a firm that has a core of responsible decisions and practices has a much better understanding of real costs and – unlike firms that act irresponsibly through graft, labour/environmental abuse, and so on – is not relying on anyone to subsidise negative externalities. At some point, firms that ignore CSR will be forced to move into compliance and pay the real price for what they do. The question at that point is whether or not they can continue to compete on the new cost basis.

In the article ‘Why Apple can’t control its Chinese factories’ it was recently reported by Malcom Moore in Britain’s *Daily Telegraph* that the company was powerless to make a change in suppliers when an employee committed suicide at Foxconn’s Suzhou facility because, “it is the triumvirate of big suppliers who are in charge of running the system day-by-day. If Apple tried to take its business elsewhere, it would risk losing its entire supply chain”. If there is indeed something here, it signals the labour woes are symptomatic of a much wider supply chain management issue, and highlights once again why firms need to reassess how their supply chain models are constructed, this time with CSR and sustainability in mind.

The brand carries the risk

It should be abundantly clear that regardless of whether a supplier has produced to spec or failed to produce to spec, it is ultimately the brand that carries the risk. Nike, Mattel, Toyota and many others have all learned this lesson the hard way. It is an expensive lesson to learn, and one that others should take note of. Brands, not suppliers, ultimately carry the risk of CSR failure in supply chains, and it is their responsibility to take the necessary steps to remove the risk of economic, environmental, and social failures.

Once ownership of the risks has been accepted by the brand, the next step is to work out where those risks lie, and where the exposure points exist. Firms needs to ask whether the main threats are found in environmental, labour, product quality, or other areas, and what the relationships are between these issues and stakeholders? They need to ask will it be a government official upholding a regulation; a blogger exposing an environmental failure; a line worker who falls ill, or a consumer who dies that will expose the problem?

Low cost does not always mean full cost

Outsourcing a component, or a process, to a firm may bring immediate economic benefits through economies of scale, by allowing organisations to focus on core activities, or by savings from lower labour costs. But firms should never assume that these reduced costs, as quoted by an external firm, somehow represent the full costs of the move from in-house operations to outsourced operations, and

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should understand that at some point these excluded costs will be incurred.

Perhaps it will come in the form of the complete loss of control over one's supply chain, or through the erasure of brand equity that a firm has worked years to develop through a labour scandal or a weakened quality control process that results in product failures. Either way, it is imperative that firms begin to understand that low cost does not equal full cost and that costs need to be incurred to protect the integrity of the supply chain.

Risk and responsibility are not mutually exclusive

"We abide by all local standards" is something that one can commonly hear when firms are defending themselves. How often can you remember when a firm said: "We have a global standard in place, a standard that did not meet the local conditions"?

For many firms, outsourcing the production of a product or process – all or part – is in some ways liberation. Not only are cost savings gained through the process, but someone else also owns risk of a failure – supply chain failures become the product of China's poor quality control systems.

The shift in responsibility here is of course an illusion, as the aftermath of cases such as the Mattel recall have conclusively proven. The risk of supply chain failure rests squarely with the brand and firms that disregard the arbitrage between the standards at home and those in another location will run into issues going forward.

Mitigating negative externalities will cost the brand much less in the long-term

Mattel's original recall of product was initially estimated to cost $20m in product and logistics costs, a figure that inflated into the hundreds of millions of dollars as fines were levied, class action suits settled, and market competitiveness lost. Why Mattel didn't make the decision to invest $20m into supply chain integrity is a simple function of not properly understanding and planning for the risks of the outsourced supply chain, and an unwillingness to invest in a system upfront to mitigate those risks. In hindsight, it was a bad calculation. Many firms fail to invest in mitigation of negative externalities related to their outsourced supply chains and do not account for the risks of when intangible negative externalities turn into very real economic costs.

Building a sustainable supply chain model

While the process of developing a sustainable supply chain model may for some begin with a CSR or sustainability programme, or may simply require a firm to add those lenses, at the end of the day the issue for firms is ensuring economic and market sustainability. Like any other sustainable competitive advantage, it is a process that engages the entire organisation through a change in core values and drives decisions that will return favourably internally and externally to the firm.

Unlike a traditional model, where immediate gains are logged without a full understanding or recognition of how those savings may require a top-up investment of unknown proportions, a sustainable model is one that anticipates early and plans around the unexpected. It is a process that removes long-term risk to the system, develops strength in supply chain and distribution channels, and maintains brand equity. It is a process that ultimately returns higher profit margins and satisfies consumers and investors.

Building a sustainable outsourcing model requires development of a supply chain that incorporates the value and risks of negative externalities that may return in the future. For some that will mean understanding the costs and risks associated with working with a country or company that does not have the same level of environmental or labour controls in place, which has created temporary arbitrages that will be removed over time.

The next step is to understand how quickly and in what manner those arbitrages will be removed. Will it come through a new regulation and/or increased enforcement of current regulations that will force the supplier to invest in new equipment? Will it come in the form of a news report highlighting the abuse of workers in the same factory you have outsourced to, and the potential for consumer actions that have been proven to cost firms billions in lost revenue and brand value?

After that the assessment begins.

"We abide by all local standards" is something that one can commonly hear when firms are defending themselves, but how often can you remember when a firm said: "We have a global standard in place, a standard that did not meet the local conditions"?"

Knowing the risks of outsourcing and off shoring, do the benefits still outweigh the costs? Are there ways to reduce those risks upfront so as to ensure the long-term economic viability of the model and process?

Mature approach

Moving beyond the standard moral reasons for developing a new approach to outsourcing that is compliant with the wider needs of the economy, environment, and society, there is a very strong business motive for doing so. Firms are no longer simply outsourcing their products, they are trusting partners to safeguard their brand and the availability and safety of the product.

While developing the case for an offshore or outsourced production model, firms traditionally only looked at bottom line cost savings and will have to take a much more mature approach to making these decisions going forward so as to ensure their place and success in the market.

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Additional resources:

International Labor Organization (http://www.ilo.org) – Works between NGOs, corporations, and government agencies to promote best practices in labour standards

Ethical Corporation (www.ethicalcorp.com) – Monthly magazine promoting responsible business decision making

Business for Social Responsibility – (www.bsr.org)