

Corporate Outsourcing Evaluation Financial Mechanisms

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Abstract: The subject matter of the article is the outsourcing efficiency evaluation mechanisms. The purpose of the article is to suggest the outsourcing efficiency evaluation mechanism accounting for the interests of all participants of a corporation restructuring and for the risks of company transformation.

Research methodology is based on the application of systemic and institutional approaches, induction and analysis, comparison and generalization.

The outsourcing efficiency evaluation methods have been analyzed. The known evaluation methods are found to have industrial focus, which determines selection of such efficiency criteria as seasonal personnel optimization, logistics improvement, and reduction of information system failures. Such standard efficiency criteria as production costs reduction, improvement of rendered services quality, and higher production processes balance are widely applied. Methods based on financial indicators of a company transformation are rarely applied. The mechanisms of outsourcing efficiency evaluation have little concern for the key commercial activity task of company value increase. A major drawback of the known approaches is the methods' focus on the companies ordering outsourcing. The impact of risks related to switching to outsourcing is nearly never accounted. Suggestions are made on generation of an outsourcing efficiency evaluation mechanism based on @Risk indicator, which accounts for changes of indicators of all participants of a restructuring process. Any criterion relevant for a certain company may be used as an efficiency indicator. However, free cash flow at risk (FCF@Risk) is suggested to be used as the main efficiency evaluation indicator. An outsourcing project is deemed efficient if $\Delta FCF@Risk$ is positive after switching to outsourcing.

Keywords: Outsourcing, efficiency, efficiency criteria, indicator @ Risk - "at risk", risk.

INTRODUCTION

In Russia, outsourcing is recognized as an advanced and efficient technology of organizations development but it is not applied as wide as it should be. Outsourcing mechanisms development is restricted by many factors including lack of proper regulatory and legal framework, weak methodological substantiation of outsourcing efficiency, and owners' strong distrust to such technology. There is no harmonized opinion on who may render outsourcing services. Not all of the advantages gained by the companies participating in outsourcing are identified. Generally, they recognize such standard benefits of outsourcing as (Aksenov E. and Altshuler I. G. (2009), Anikin B. A. and Rudaya I. L. (2013), Vyzhitovich A. M. (2015) costs reduction, higher quality of services rendered by an outsourcer, possibility to focus completely on the core business, eliminate multiple tasks arising in the work process and

the resulting increase of business processes' efficiency (Fedorenko (2014)). The company using outsourcing services becomes able to develop new business lines or strengthen previously weak position. Rarer, the companies turn to outsourcing because they do not want to waste their time solving such issues, which may be solved by the professionals (Fedorenko (2007)). Outsourcing advantages are seen single-mindedly, from the position of the company ordering the outsourcing services. Owners' strong distrust to such form of the company restructuring, fear of losing control of the key business functions combined with imperfect legal framework result in outsourcing of supplementary functions (accounting, information technology, clearing, office security and safety, and other non-core functions of the company) most often (Anikin B. A. (2003), Jean-Louis Bravard and Robert Morgan (2007)). The known methods of outsourcing efficiency evaluation are related to certain industries but not of a universal nature, which determines the choice of evaluation criteria.

Currently, many types of activities require high competence of employees and their extensive training,

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availability of specific tangible and intangible assets such as special corporate culture, high level of buyers' and suppliers' trust, and expertise. Such resources are hard to be copied by the competitors, the companies accumulate them for many years, and they require significant financial investments and concentrated efforts. Performing such types of activities using own resources may become rather unprofitable for a company. There are some actual situations when a company ordering outsourcing services is not able to perform certain works and has to find an efficient provider of such services.

DISCUSSION

International and Russian experience suggests many methods for identification of outsourcing efficiency. However, the majority of the known methods only reflect the situation in a certain industry or a company using outsourcing services. It is believed that the services may be rendered only by those companies and organizations, which are charged to perform a certain task for a long time (Vyshitovich (2015).

Substantiation of outsourcing efficiency evaluation method accounting for the interests of all participants of the process will create preconditions for expansion of modern technology application, in-depth substantiation of advisability of functions delegation, complete accounting for advantages and disadvantages of a corporate restructuring.

Transfer of functions to a third-party organization for their fulfillment is a project of company restructuring. Pursuant to the Russian legislation, a decision on company restructuring is made by the general shareholders' meeting. Hence, the ultimate beneficiaries of outsourcing deliverables will be the company owners. The company shareholders have significant financial resources but they may have poor understanding of industry peculiarities and corporate transformation processes. The suggested criteria of efficiency evaluation should be comprehensible and interesting to the shareholders, which leaves us with the restructuring project cost indicators and their effect on the dividends size. The organization shareholders should understand and accept the method of outsourcing efficiency substantiation.

The known methods of outsourcing efficiency evaluation also depend on the position of individual researchers. O. V. Lobanov (Lobanov (2005) notes that the efficiency of functions assignment to a third-party contractor depends on costs of commercial activity and

costs of non-core assets management. At the same time, the customer's and the outsourcer's costs are not differentiated. We may assume that the author talks about the costs of the services consumer. Outsourcing promotion is supported by growth of global economies, increase of production volumes, and national companies' turnover. The demand for time and resources required for ensuring of the core activities, as well as for third-party/external assistance in fulfilment of supplementary and yet important functions, grows (Heywood (2004). Therefore, outsourcing efficiency will be determined by increase of the company's competencies and resources deficit replenishment.

A special mechanism for outsourcing efficiency determination is suggested for the bank IT departments (Kvasnitsky and Grischenko (2012). It is based on identification of key performance indicators (KPIs) of outsourcing, which allow calculating the index of the rendered service level. The suggested KPIs may not be used in other industries: they are rather peculiar and focused on outsourcing of information technology services.

Reduction of the ordering company's manufacturing costs of products to be outsourced; costs of production facilities; costs of the fixed and supplementary means of production; payroll costs, including seasonal personnel costs, may be used as outsourcing efficiency criterion (Petrova (2014). It is suggested to use a ratio of costs of own production of goods or services to costs of the same products purchase from an outsourcer as a summarizing criterion of outsourcing efficiency. If this ratio is more than one, the outsourcing is expedient. This method of outsourcing efficiency identification reflects the industrial peculiarity of a clothing industry company, which determines the criteria selected for evaluation.

For a logistic company, a method determining that the outsourcing effect will comprise direct and indirect components has been suggested (Moiseeva *et al.* (2010). The direct effect includes product cost reduction, restricted current capital size reduction, logistic expenses reduction, liquidity increase, etc. Indirect effect is achieved through focusing on the core business, faster response to changes in the environment, company headcount reduction, and professional liability warranty.

There are some universal methods of outsourcing efficiency identification that are not related to a certain

industry. For instance, it is suggested to use the following criteria for outsourcing relations evaluation: (a) correspondence of the scope of services rendered and quality of consumers servicing; (b) cost efficiency of services rendering; (c) achieved level of actualization of consumer service system potential; (d) promptness of services rendering under the outsourcing agreement (Kurbanov and Plotnikov (2016)). The final decision is made based on the “Complex criterion of the customer servicing organization efficiency”, which is determined by multiplication of these four indicators. The same authors suggest another approach to outsourcing evaluation from the point of view of the processes disintegration mechanism. According to the method of disintegration effect evaluation, the additional effect received from an outsourcing project implementation is compared to the costs of its implementation. A project is deemed successful if the difference between the added value and costs is positive.

Some methods of outsourcing efficiency identification are based on financial indicators. For instance, a positive net present value for the projection period from incremental revenue generation and a change of OPEX and CAPEX, which arises in the process of switching to a new technology, is suggested to be used as a criterion of economic outsourcing efficiency (Dolzhenko (2013)). However, the main component of incremental revenue is deemed a reduction of personnel costs of a company ordering the services, including insurance and social benefits. At the same time, the author prefers not to discuss the effect of outsourcing risks on the change of financial indicators.

The authors of another method also suggest evaluating outsourcing efficiency by financial indicators achievable through functions delegation to a third party (M. Yu. Savelieva, Yu. V. Saveleva (2015)). The final decision is to be made based on the integral indicator of “Outsourcing Comparative Effect” (OCE), accounting for the change of a company value. This method also fails to account for the impact of outsourcing risks on the change of financial indicators and determines the efficiency for the company ordering the services.

Hence, the outsourcing efficiency evaluation may adopt any indicators, both technical and financial-economic, that are interesting for a company ordering restructuring for the purpose of a certain project implementation. Many outsourcing researchers only provide the lists of criteria, based on which one can directly evaluate economic efficiency of outsourcing,

but they do not provide the evaluation mechanism. In such cases, the criteria include changes of standard technical and economic indicators of a company activity. Depending on peculiarities of the company and business environment, the switching to outsourcing efficiency criteria may include logistics improvement, company headcount optimization, supply balance improvement, strengthening of market positions, costs reduction, and increase of product quality (Figure 1).

Functions delegation to a third party is a project, and projects efficiency evaluation methods may be used for its efficiency evaluation. A company transformation is deemed efficient, if the project purpose is achieved. Functions delegation aims may be operative (short-term), tactic (mid-term) and strategic (long-term) (Figure 1). The aims determine project implementation tasks and efficiency criteria. Short-term aims are focused on operations improvement in the nearest future. They are not typical for outsourcing, since delegation of certain functions to a contractor implies establishment of long-term mutually beneficial relations.

Liquidation of temporary components shortage, conveyance of accumulated goods, etc. may be used as short-term efficiency criteria. In this situation, entering outsourcing contract is not mandatory, standard contract terms apply. No consent from the general shareholders meeting is required to bring in sub-contractors. Mid-term aims imply company performance improvement in the nearest 1.5-3 years. We include financial indicators of company activity in such aims mostly. Long-term aims cover the period of more than 3 years, although this period may be shorter for a certain company. We recognize as strategic a group of political aims, achievement of which in the longer term may give a company significant advantages: improvement of relations with the governmental authorities, increase of the customers’ loyalty, development of competitive ability, etc. Implementation of a project for some functions delegation to a third party contractor may arise counteraction of the governmental authorities and society if it results in loss of jobs in the region or even in the country (when some functions are outsourced to foreign companies), it may break the social stability in the region.

Dividing outsourcing aims into three categories is quite arbitrary: the same aims may be seen both as tactic and as strategic (Figure 1), or as operative/tactic. For instance, company value growth is both tactic and strategic aim.

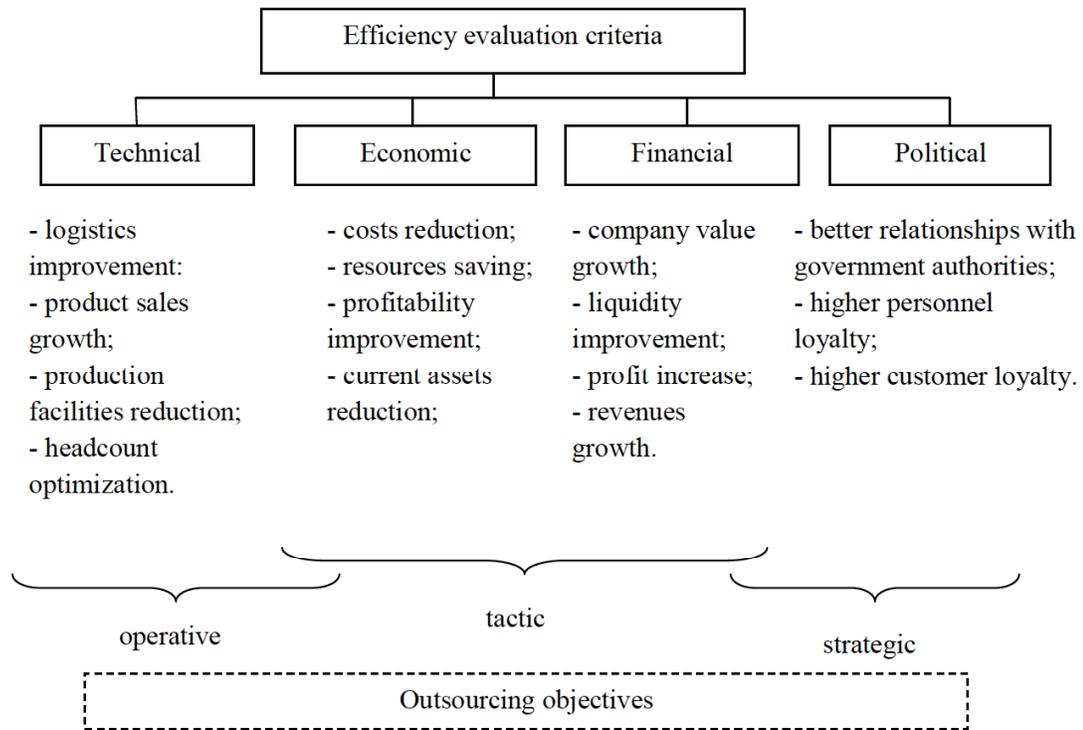


Figure 1: Possible outsourcing evaluation criteria and objectives аутсорсинга.

All methods of outsourcing efficiency evaluation are focused on a single company ordering services. The situation will become much more complex, if we evaluate outsourcing in a group of companies, in an integrated corporate structure. A large corporation has enough resources to create an outsourcing company servicing the group members, or to hire a third-party company to service a group of companies. In the Russian corporations, such approach is observed when the common corporate service centers are created, which perform repair, IT services, accounting, and a number of other functions. At the same time, the common service centers are situated in the regions with cheap workforce and low property lease fares. It allows saving resources (staff salaries and wages, premises leasing, large centralized deliveries of spare parts, etc.) and maintaining confidentiality, although creates the situation, in which a market of services provided to the corporation members may be monopolized. That is why A. Yu. Zhdanov (2008) warns that functions delegation will not result in a market monopolization if the region hosts a market of outsourced services. Corporate outsourcing may be unprofitable for certain group members, but for the parent company, it ensures significant saving of financial resources and competitive ability growth (Mezinova I. A. (2010). A parent company is able to regulate the group's ultimate results through internal pricing mechanisms. Therefore, we should evaluate

efficiency of certain functions allocation and concentration in an affiliate/subsidiary in its entirety, accounting for changes in performance of all participants of outsourcing project. When evaluating corporate outsourcing, we should also evaluate risks of functions delegation to a third-party contractor, even if this contractor is a member of the corporation.

The main task of the integrated corporate structure is to increase corporation value for the shareholders. Therefore, the change in financial indicators should be used as the corporate outsourcing efficiency criteria, and political criteria should be used rarer.

Shareholders' dividends will depend on the financial indicators, which should include operational and non-operational free cash flow (FCF) and its behavior. The most efficient indicator showing whether it is advisable to use the outsourcing is the company value change indicator – ΔFCF . This indicator is a key criterion for financial and economic evaluation of outsourcing and usually it is of a complex nature. A company value change indicator contains full information about many characteristics of its development (equity size, its structure, size of profit, etc.), and it may be determined by the discounted cash flow method as a FCF (free cash flow) amount.

The known outsourcing efficiency evaluation mechanisms cannot be deemed complete, since they

do not account for the risks and uncertainties, actualization of which may change the resulting evaluation drastically. The full determination of outsourcing risks and financial consequences of their actualization is a long, extensive and quite complicated process, and the results are complicated for the owners understanding. Therefore, we suggest an approach accounting for the changes of “at risk” indicator – indicator @Risk. This criterion allows determining financially any indicator of a company’s activity: profit@Risk, profitability@Risk, FCF@Risk, revenue@Risk, etc., both before restructuring and after transformation and taking actions mitigating risks. $\Delta FCF@Risk$ – the expected company value increase in the long term – should be recognized as the summarizing indicator. However, it has low accuracy and it is of probabilistic nature. In fact, it evaluates volatility of benefits or alternative revenues. Obviously, maximum increase of a company value is achieved at the maximum possible mitigation of outsourcing risks impacts. The advantage of @Risk method is that the evaluation accounts for the effects of all main risks affecting company value during outsourcing. Outsourcing efficiency is defined as:

$$\text{Efficiency} = \text{Changes}\{\text{Profit margins; Risk}\}$$

Accounting for risks impact, the efficiency may be determined as the sum of indicators of the corporation members.

$$\text{Efficiency@Risk} = \text{PM1 efficiency@Risk} + \text{PM2 efficiency@Risk} + \dots + \text{PMn efficiency@Risk},$$

or:

$$\Delta FCF@Risk = \text{PM1 FCF@Risk} + \text{PM2 FCF@Risk} + \dots + \text{PMn FCF@Risk},$$

where “PM” means a project member, and “n” means a number of outsourcing members.

FCF@risk evaluation allows evaluating outsourcing project effect accounting for the risks and project profitability, making informed decisions on project implementation or refusal therefrom. Potential negative consequences of outsourcing for a single company will be compensated by positive results of other members of the integrated group. If general efficiency@Risk is positive, then it is advisable to implement such project.

CONCLUSION

To expand the sphere of outsourcing application in Russia, it is necessary to develop evaluation

mechanisms for identification of benefits and advantages for the parties to companies restructuring. The known evaluation methods are based on technical and economic, and sometimes on financial indicators reflecting peculiarities of the industry and outsourcing customer. The known methods account for the interests of only one party to the process and do not account for the change of indicators when the risks of functions delegation are actualized. A universal mechanism is project efficiency evaluation based on the change of the value of all companies participating in outsourcing. Efficiency evaluation is suggested to be based on indicator@Risk (“at risk”), which may be determined for any indicator adopted by a certain company for outsourcing evaluation. The evaluation procedure becomes more complicated when corporate outsourcing evaluation is performed. In the integrated corporate structure, functions delegation to a third-party contractor may be deemed disadvantageous for certain members but may provide significant effect for the group of companies. For the corporate outsourcing project efficiency evaluation, an indicator@Risk should be determined common for all members. For a corporation, the optimal outsourcing efficiency indicator is change of organization value. The project of functions delegation should be deemed feasible, if the sum of value@Risk indicators of all members of the integrated group of companies is positive.

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