

## Outsourcing as a specific form of inter-firm cooperation

*The present paper contains an analysis of organizational and economical nature of outsourcing. A classification of outsourcing types based on economic criteria is proposed. It is demonstrated that financial leasing may be considered as a particular case of outsourcing operation. An analysis of terminology used for description of outsourcing is made and amendments to this terminology are proposed. A list of criteria of differentiation between outsourcing and other forms of cooperation is described.*

*Outsourcing, types of outsourcing.*



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### **Introduction**

Despite the widespread adoption of outsourcing in enterprises' economic activity (which is due to the efficiency of outsourcing as a tool to reduce companies' costs and improve profitability), the theoretical understanding of the phenomenon of outsourcing is significantly behind its implementation.

Specialists focus primarily on studying the effectiveness of its use for optimization of various company's functions – it can be easily seen from both the topics of articles devoted to it [1, 2], and from the direction of Ph.D. theses on outsourcing [3, 4, 5]. Such studies are distinctly practical in nature. Even the works applying for a theoretical understanding of the essence of outsourcing, either focus on its practical aspects, or reduce it to labor division, without specifying the differences of outsourcing from other forms of labor division and inter-firm cooperation [6, 7].

Because of this, there is still no unambiguous definition of outsourcing as well as understanding of economic nature of this phenomenon. In this regard, a number of disadvantages appear. In particular, there is no formulated

list of differences between outsourcing and procurement of goods and services for industrial needs and the contract [8 – 12], although there were some attempts to characterize these differences [1]. For this reason, some experts equate outsourcing and production cooperation or contract and refuse to single it out as a distinct economic phenomenon, while other researchers believe that any form of cooperation between enterprises on production of the final product to the consumer can be attributed to outsourcing. It is obvious that such extremes in the study of outsourcing are not acceptable.

The purpose of this article is to clarify the economic substance of outsourcing transaction, to formulate a list of criteria to differentiate outsourcing and other methods of cooperation between firms and analyze the mechanism of companies' financial cooperation in outsourcing.

### **Management and economic content of outsourcing**

As mentioned above, outsourcing is seen primarily as an administrative rather than economic phenomenon [8]. But it is clear that outsourcing contains both managerial and economic [9, 11, 12] component (*tab. 1*).

Table 1. Managerial and economic aspects of outsourcing

<b>The essence of outsourcing</b>	Failure of the independent fulfillment of certain functions and focus on core processes for the purpose of effectiveness enhancing
Managerial aspect	Transfer of tasks or processes to external operators
Economic aspect	The use of external resources to perform the enterprise's functions, that is attraction of factors of production, controlled and organized by other firms in the interests of the client company by an enterprise to conduct its business

From a managerial point of view it is convenient to classify the types of outsourcing by the criterion of processes types sent to contractors.

There are three basic approaches to this classification, presented in *table 2*. Of course, there is more to it than these approaches, but they are most often found in scientific, practical and academic literature.

Table 2. The most common approaches to the classification of outsourcing

Classification criteria	Types of outsourcing
Relation to the core activity of an enterprises	Outsourcing of key processes Outsourcing of support processes
Activities	Outsourcing of information technology (IT outsourcing) Manufacturing outsourcing Logistics outsourcing Outsourcing of personnel Accounting outsourcing, etc.
Contents of transferred functions	Outsourcing of tasks (one-time projects are passed to execution, and the term of their implementation is clearly stated) Example: designing a new product. Sometimes, this type of outsourcing is called "outtasking" (from the English 'task') Business process outsourcing (in this case we are talking about long-term cooperation between enterprises, where the contractor takes the carrying out of any functions entrusted to him by a customer on a regular basis) Example: production outsourcing or factoring

As can be seen from table 2, the natural classification of outsourcing from an economic point of view should be made according to the criterion of the form of resources (factors of productions) needed to perform the corresponding functions. In this case, we can distinguish the following types of outsourcing (the list of factors of production is given in accordance with the classification most common at present):

1. Outsourcing capital, where the customer enterprise uses capital (physical or monetary), organized by an operator enterprise in its interests, but at its own risk. A classic example of outsourcing capital is manufacturing outsourcing, when a company places orders for the manufacture of products under its brand with a foreign executor. Another example is leasing, where for the production they use equipment owned by another company (lessor). We should note that the interpretation of leasing as a form of outsourcing is not a new one, and some sources say it refers to a manufacturing outsourcing [10]. However, in our view, this approach is incorrect; the function of leasing in its content is radically different from the functions of manufacturing outsourcing. Manufacturing outsourcing represents a transfer to an external operator of the whole technological process of product manufacturing (or any element of this process). Obviously, it does not occur at lease [13]. Lessor is not engaged in production for the lessee, but he performs the tasks of financing and acquisition of fixed assets in the lessee's interest and assumes the function of ownership. Since the implementation of these tasks and responsibilities is associated with raising capital, we believe it is logical to include leasing to capital outsourcing.

2. Outsourcing of land (natural resources). To our knowledge, outsourcing in the field of agriculture and natural resources is not considered in the existing literature (except outsourcing of service extractive industries - but in this case, the operator is a service company, not a nature management company, i.e. it is a fundamentally different phenomenon). The idea

is that an enterprise of agriculture (or nature management) intentionally manufactures products for a customer under the terms of compulsory acquisition. The program “Milk rivers” sold by the company Wimm-Bill-Dann may serve as an example [14].

3. Outsourcing of work – it applies to outsourcing of staff. It is important to note that the usual involvement of non staff employees (when the company itself concludes an employment contract directly with the employee) which the practices often interpret as outsourcing of personnel, in fact, it is not – this is just another form of employment relationship between employer and employee. Only legal entities can be participants of the outsourcing transaction.

4. Outsourcing of information – in this case, the corporate customer requests the information gathering and processing to a third-party company; accounting outsourcing can be referred to this type of outsourcing, in our view.

5. Outsourcing of entrepreneurial skills – corporate customer uses entrepreneurial skills, focused in other companies to conduct its own business. This type of outsourcing includes franchising (in which an independent entrepreneur – franchisee – outsources the management of the brand name under which he or she conducts the business [15]).

6. Expertise outsourcing – corporate customer attracts a company having certain skills and experience (first of all management) to perform some functions. An example could be attracting foreign companies to manage real estate;

7. Mixed outsourcing – when the corporate customer sends to a third party contractor a function that requires multiple types of resources; this form of outsourcing includes factoring, where the company factor, on the one hand, provides vendor resources (capital outsourcing), but on the other – it is engaged in collecting and processing information about current and potential customers of the supplier to determine their ability to pay (outsourcing

of information). Obviously, in real economic activity any enterprise, including outsourcers, uses more than one resource, which, however, does not mean that mixed outsourcing can include all types of outsourcing. The idea is that in mixed outsource all resources mobilized by the operator for the customer are equally important for successful implementation of the functions transferred to him, whereas in the “pure” (“one-resource”) outsourcing (e.g., outsourcing of labor or capital), the emphasis is in primarily on one resource.

In our opinion, the classification proposed above can adequately describe the economic nature of different types of outsourcing.

***Outsourcing and procurement of goods and services: differences analysis***

An important task of outsourcing analysis is to provide a distinction between the business process outsourcing and procurement of goods and services. The solution of the task is complicated by a high degree of similarity between these phenomena. In both cases, the customer purchases from the executive (supplier) a finished product (or service). Very often, outsourcing is described as a special case of a contract under which goods or services are produced in accordance with specific customer requirements. The situation is furthermore complicated by the fact that Russian law does not provide the concept of “outsourcing”.

It should be also noted that the Russian terminology of outsourcing is not standardized yet. A company that provides outsourcing services, may be called an “operator”, an “outsourcer”, and in some cases a “contractor”. A company, which transmits the function to execute to an external operator, has no special designation and is usually called just a “customer”. According to the author, a provider of outsourcing services should be called the outsourcer; the term “operator” is also possible. In turn, a company ordering services outsourcing should be called “outsourcee”. This corresponds to the English terminology and allows using special terms for the parties of the outsourcing transaction (as it occurs, for

example, with the lease transaction where the parties also have special designations, which greatly simplifies the description and analysis of this transaction).

Significant characteristics of outsourcing, frequently cited in the literature are [8 – 12]:

1. Goods and services (which are the end product of performance functions transferred to the outsourcer) are intended solely for outsourcing, i.e., they are not standardized, manufactured in accordance with the requirements of the outsourcee, and should not be sold on the open market;

2. Goods and services delivered by the outsourcer are produced in terms of their guaranteed payment by the outsourcee (of course, if they fully comply with specifications). This minimizes outsourcer's risks.

According to the author, is also rightfully to assume that only legal entities can be the parties in the outsourcing transaction and the goods and services supplied by outsourcer and being the end result of the execution function passed to it can be used only for commercial purposes (i.e. for later resale, for the production of final products or for business activities). Previously, to our knowledge, it was not mentioned about the necessity of compliance with these conditions in studies on outsourcing.

In our view, taking into account the above, outsourcing can be defined as a form of cooperation between enterprises, in which independent external executive (outsourcer) attracts, organizes and uses on his behalf and on his own responsibility, but in the interest of the client (outsourcee), the factors of production for execution of task or function in accordance with the outsourcee's requirements on the risk-free cost-recovery basis.

This definition, as can be easily seen, takes into account all the distinctive features of outsourcing identified above and means that the outsourcer serves as a legally independent external unit of the outsourcee for the period of cooperation.

It is important to note that the attempts to interpret outsourcing theoretically faced with

an important task – the complexity of the formalization of the submission that the outsourcer is an external unit of the outsourcee, being independent (a contradiction between these attributes is obvious, because it does not fit the traditional approach to enterprise). As a rule, the authors have to say this, as givens, trying to clarify the content and specificity of this phenomenon. Below we will attempt to solve this problem.

Based on the analysis of the literature and our own research it seems legitimate to assume that the main differences between the procurement and outsourcing are in different values of the five basic and four secondary attributes. These signs and their meanings are listed in *table 3*. Secondary requirements can be fulfilled not always; the more secondary criteria are satisfied, the more closely the outsourcer and the outsourcee are integrated.

The author believes that right-hand column of *table 3* can serve as a formal description of a situation in which a legally independent company (outsourcer) serves as an external unit of another independent company (outsourcee). In other words, we can talk about the solving of the above problem of formalization of outsourcing signs.

#### ***Mechanisms of outsourcer's services payment***

Above it was shown that an important characteristic of outsourcing is its risk-free for the operator – it is guaranteed to receive payment for services rendered for the implementation of the process or task transferred to it (assuming that the quality of performance meets the customer requirements). However, this condition, at first glance, is not always met.

Factoring can be considered as an example. According to a number of sources factoring is a receivables management outsourcing (in our opinion, it would be more correct to speak about outsourcing of management of financial relationships with the buyer, however, in any case we are talking about outsourcing). Formally, in the case of factoring the requirement of guaranteed payment factor is satisfied because

Table 3. Comparative characteristics of the procurement of goods and services and business process outsourcing

Compared signs	Procurement of goods (services)	Business process (tasks) outsourcing
<i>Basic signs</i>		
The essence of the supplier's (operator's) activity	The provider produces goods for sale on the open market on own initiative without a firm order on it	The operator produces a product (provides a service) having an order from the outsourcee
Guarantee of proceeds receipt by the supplier (operator)	No guarantee of goods and receiving sale and proceeds receipt (as determined by market conditions and customer requirements)	The outsourcee guarantees repayment of manufactured goods (services rendered) and its timely payment
Type of goods (services)	Goods (services) are made in accordance with the specifications of the supplier and are standardized for all customers	Goods (services) are made according to customer's technical specifications
Designation of goods (services)	Goods (services) can be used for personal needs or for commercial purposes	Goods (services) are designed for outsourcee's use for commercial purposes
Participants in the transaction	The participants of the transaction may be physical or juridical persons	The participants of the transaction can be only legal entities. If an enterprise transfers a task to an individual, then it is not about outsourcing, but labor relations
<i>Secondary signs</i>		
Pricing mechanism	The seller sets the price for the goods (services), and, if necessary, gives the buyer a discount	The operator discloses to the customer the structure and size of the costs, then the customer and the operator set the normative value of markups on operator's goods (services)
Nature of the production capacities of the supplier (operator)	Manufacturer (supplier) independently forms the production capacities based on the specifics of the produced (supplied) goods	The operator forms production capacities (number, structure, nomenclature, geographic location), based on customer requirements
The mechanism of the buyer's (customer's) work	The buyer uses a purchased goods (services) according to the set internal regulations	In order to ensure optimum quality of services the outsourcer makes changes to those procedures of the customer, which are associated with the process referred for execution
Getting authorities from the customer	No	If necessary the outsourcee transmits to the operator the core authorities needed to perform the process or task (technologies, equipment, etc.)

the supplier pays it a commission. But this commission is negligible compared to the amount provided by factoring financing, and the factor assumes the risk of the buyer's default, and is able to fully get its money back only when (and if) the buyer transfers it the payments for goods supplied by the seller. If the buyer behaves improperly and it is impossible to recover the amount due to him, then the factor would be at a loss, although it will receive a commission from the seller (it is often paid when the factor transfers the first payment). Thus, if there is a formal fact of payment for services, the risk-free for the factor is out of the question (which, incidentally, is evident from the contents of factoring: we should repeat once again that the factor assumes the risk of default).

It would be possible to resolve this contradiction (factoring refers to outsourcing, but it is not risk-free for the operator), assuming that factoring in fact cannot be considered a kind of outsourcing. However, the actual content of the factor's activity shows that it still goes on outsourcing [16]. Thus, it is necessary to carefully analyze the mechanism of factor's services payment and determine whether there are guarantees for the factor from the supplier (except, of course, the recourse which will not be explored in this article). In other words, it is necessary to determine whether the factor's services payment can be considered as risk-free.

Let us consider the similar moments in other forms of business in detail.

In the case of franchising the franchisee, executing the trade of goods and services for the benefit of franchisor under its brand name (that is why, in author's opinion, franchising for the franchisor should be considered as outsourcing services for conducting sales activities), receives income only from the actual sale the above-mentioned goods and services to end consumers. However, when opening a new franchise outlet the franchisor and the prospective franchisee make up business plan together, which records the expected sales volumes. These amounts are established based on the capacity of the local market and an analysis of previous experience of other franchisees, which the franchisor has. Franchisee's using a well-known brand is a guarantee that local consumers may wish to use its services, and the planned sales will be made (and, accordingly, the franchisee will receive the planned revenue and profit). In other words, unlike the beginning independent entrepreneurs who are trying to operate under their own brand name, and do not have any guarantee that they will reach the planned level of sales, the franchisee possesses an effective tool to attract consumers – it is a well-known brand.

Thus, in case of franchising, the franchiser does not pay to the franchisee for goods distribution services, but the demand for riskless is met through the two following conditions:

- adequate assessment of market potential, where the franchisee will operate;
- providing the franchisee with an important asset in use – the brand (i.e., essentially giving him a guaranteed source of income by the franchisor).

In case of factoring the situation is largely similar – the supplier gives the factor the rights of requirements recognized by the buyer (i.e., payment of which the buyer agrees to receive in the future). This means that the supplier gives the factor a guaranteed source of future cash flows.

Thus, in all forms of business considered above the customer does not make direct payments to the outsourcer, but provides him with tools for guaranteed income.

All the above suggests that the risk-free of outsourcing is provided by one of the following mechanisms:

- full payment for outsourcer's services by the customer;
- providing the customer a guaranteed source of income by the outsourcer (or an instrument to attract a guaranteed number of consumers or the obligations of third parties on the commission payment, of course, within the statistical error).

We should note that the second point should not be interpreted broadly and, for example, retailers cannot be regarded as outsourcers for their suppliers, because they do not give the commercial networks any guarantees in terms of sales.

### **Conclusion**

The classification proposed in this paper allowed us to refer certain activities that previously were not included, but were considered as independent to outsourcing. In author's opinion, it was possible, on the one hand, due to a better understanding of both the economic nature of the outsourcing phenomenon and the mechanisms of interaction between enterprises in the framework of outsourcing, but on the other hand it allowed to consider a number of today's popular business forms (such as leasing and franchising) as special case of a more general phenomenon of external companies resource use (i.e., outsourcing).

In addition, the author believes that the proposed refinement of the concept of "outsourcing" and the formalization of the criteria which should be met by outsourcing interaction between enterprises, can serve as a basis for further theoretical understanding of the phenomenon of outsourcing.

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