BUSINESS OUTSOURCING CONTEXT: IMPLICATIONS AND CONSEQUENCES FOR COMPETITIVE ADVANTAGES

Nataša RUPČIĆ,
Faculty of Economics, University of Rijeka
Ivana Filipovića 4, 51000 Rijeka, Croatia
e-mail: natasa.rupcic@efri.hr

Saša ŽIKOVIĆ
Faculty of Economics, University of Rijeka
Ivana Filipovića 4, 51000 Rijeka, Croatia
e-mail: sasa.zikovic@efri.hr

Abstract

Strategic approach to outsourcing should fit the company's need to achieve the balance between vertical integration and the use of outside supply. Traditionally, outsourcing decisions were focused on questions of "core" versus "non-core" activities, with the letter being candidates for outsourcing. Regardless of the type of relationships selected with the outside provider(s), outsourcing context can be seen as a portfolio of relationships. Managers must permanently review the results of outsourcing in the context of the changing technology and market conditions.

Key words: outsourcing, strategic analysis, contracting

1. Introduction

Outsourcing can be viewed as "finding new suppliers and ways to secure the delivery of raw materials, goods, components and services by utilizing knowledge, experience and creativity of outside suppliers not used previously" (Kraker, 1995) or "deciding to obtain selected goods and services from outside the company" (Engelke, 1996, p.1). Outsourcing is a mechanism for reconfiguring a firm's value chain in ways that allows it not only to compete effectively but also to sustain future market dominance.

The downsized companies assume that not all organizational activities have to be performed and managed internally. Competitive advantages can be gained when products or services are produced more efficiently by outside suppliers. The outsourcing of selected organizational activities is an integral part of a corporate strategy. There are a number of the value chain activities that can be performed externally: logistics, maintenance, marketing and sales, service support, technology development, computer information systems, HRM, check processing etc. It is estimated that every *Fortune 500* company will consider outsourcing during this decade and that 20% of them will be involved in the outsourcing arrangements (Lankford, Parsa, 1999, p.310). The study "*New Directions in Finance: Strategic Outsourcing*" based on interviews with 50 global organizations plus a survey of 303 senior executives throughout USA and Europe documents a clear trend towards using outsourcing as a competitive tool, rather than just a simple means of cost control. 85% of the executives surveyed outsource all, or part of at least one business function.

In the times of virtual organizations, outsourcing traditional corporate tasks has become popular and cost-effective provided the right tasks are contracted out. Contracting out refers to work assigned to an outside supplier on a job-by-job basis. Outsourcing on the other hand entails a long-term relationship between supplier and a beneficiary, with a high degree of risk sharing (Anon, 1995, p.30). Outsourcing works best when it is an outgrowth of re-engineering. Re-engineering means rebuilding the entire business process. Outsourcing can be an integral part of re-engineering, as a process of searching a company best suited to perform a particular task with greatest efficiency and highest quality. Re-engineered companies will therefore gain competitive advantages because they have built the processes that work best in terms of cost, quality and customer satisfaction.

2. Outsourcing advantages and disadvantages

Due to the new world economy every business faces unprecedented pressure to be vigilant on all expenditures. Cost reduction is the predominant motive for outsourcing. While outsourcing contracts usually set a target of 15% cost savings the actual outcome may average 9%, although a large portion of outsourcing partners may only break even or find their costs increase (Embleton, Wright, 1998). Ketler and Walstrom (1993) find that initial vendor bills are usually 20% higher than anticipated due to low vendor estimate or misunderstanding of the contract. In is not hard to conclude that the in-house supply can often provide lower costs because suppliers are sometimes unable to match the right economy of scale. Supplier has to have access to the low cost locations and the required know-how in order to make a sourcing deal mutually profitable. Lower operational costs and savings drawn for personnel and asset cuts must be confronted with induced initial costs such as the cost of the partner search, analysis and selection of potential vendors, contract management, negotiations and transaction costs that often exceed the "out of pocket money" amounts.

The widely perceived false conception is that outsourcing brings only cost cutting benefits. Lower cost can emerge as a result of terminating the in-house performance of the non-value adding activities and greater economy of scale achieved by vendors. Outsourcing enables the company to focus on core activities that can be neglected due to the dispersed management attention and offer time saving benefits along with the increased productivity leading to the responsiveness to the market change. Through diversification organizations can decide to buy activities and expertise they lack and find no interest in developing. Outsourcing enables managers to reevaluate business processes and eliminate hidden costs, leading to greater expenditure accountability due to agreed contractual terms obligatory to vendors that cannot be imposed on internal departments. The outsourced activity also brings cash infusion through revenues generated by asset selling or renting.

Quality is an issue sometimes underestimated in the decision making process. In the long run such agreements can offer quality improvements achieved through the vendor's focused speciality. Companies cite the access to the best quality of services as one of the most dominant motive that leads to outsourcing.

Technology is one of the capital prerequisites to develop and sustain competitive advantages. The technology that does not hold the key status can be sourced externally considering the cost and the rate of technological change, which often occurs at a faster rate than the company, can sustain internally. The situation when a company is lagging in technology must by all means be avoided, either by investing internally, or through external supply.

Flexibility is an obvious benefit of outsourcing for companies that face seasonal or cyclical patterns of demand representing the option to free company's own productive capabilities. The contracting must ensure that the peak levels of demand are met on time. In such a situation the in-house and vendor's capacity can be combined to meet the requests of customers in the critical situations. Besides the output volume the potential for improved flexibility can be manifested through the ability to change the product range in response to market conditions. Rapid information exchange, rather than ownership of the various stages of production enables companies to respond to the product's short life cycles and abrupt changes in a particular industry (Richardson, 1996).

The practice showes numerous drawbacks attributed to outsourcing. Through outsourcing a company looses control of activities that can be a survival component if the base competition changes. Due to the loss of control of an outsourced activity a company faces monitoring costs because of the fear of diminishing quality of goods or services coming from the vendors' attempts to cut cost. If binded by long-term contracts, vendors are less likely to follow the pace of the technological change and opportunities that arise, depriving the company of better and more efficient services. Through perusing the economies of scale, vendors can have numerous clients and may not dedicate enough time and attention to each one. Once outsourced an activity is extremely difficult and costly to integrate back in house. Cuts in staff due to outsourcing can damage the morale of the remaining employees and create a fearful atmosphere of unmotivated personnel. The most skilled may consider finding a better position. Large employee layoffs can be very damaging for the corporate image.

Depending on the outsourcing motive, advantages in outsourcing can be operational and/or strategic. Operational advantages usually provide short term benefits, mostly attributed to cost cutting, while strategic advantages offer long term contributions in maximizing opportunities. The lack of strategic planning in the outsourcing decision making process is identified as the root of drawbacks in outsourcing especially when conducted with the single goal pursued: cost cutting. It is an imperative that outsourcing is strategically planned and performed systematically, considering all aspects, risks and stakeholders.

3. Strategic analysis: planned approach to outsourcing

Despite the general movement towards the use of the outside supply, a company must use a strategic approach designed to fit its needs due to the fact that the correct balance between vertical integration and the use of outside supply differs between industries (Van Hoek, 1999) and individual firms within an industry (Blumberg D.F., 1998). Complex vertical integration may be a result of a company's strategy but also of a particular industry's development. When an external supply market is undeveloped an organization sources a wide range of activities in-house (Chandler, 1962). As external supply market develops companies are challenged to source parts of their value chain externally. Assuming any part of the value chain can be sourced externally implies that the company has no unique value-adding capabilities, and that the processes are available for replication by competition (Jennings, 2002, p.26). Quinn and Hilmer (1994) emphasize the need for the organization to concentrate its resources on a set of core competencies where they can provide unique value for customers, strategically outsourcing other activities including many traditionally considered integral to the company. A survey done by Lonsdale (1999) indicated that the majority of managers are dissatisfied with the results of outsourcing, indicating that the traditional approach to no longer fulfills company's expectations, causing more drawbacks than benefits.

Two major reasons causing failure of the outsourcing arrangement are the fact that the traditional approach is tactical rather than strategic and the relationships between partners are adversarial rather than cooperative. If executives are looking only for ways to cut costs or fix an immediate problem in a non-core area, a traditional vendor relationship is more suitable. If they are targeting a new market or reengineering customer service, the more strategic and integrated arrangement would be advised. The specific outsourcing strategy helps not only make partnerships with right vendors but also develops competitive advantages and the desired business context.

If the outsourcing decision is not based on the strategic approach it can undermine a company's capability leading to a loss of critical skills and the creation of the "hollow corporation" (Bettis, Bradley, Hamel, 1992). Because the cross-functional activities are disabled the innovative process may become impeded especially in the situation when, manufacturing and retailing are separated. Retailers have access to knowledge on customer preferences while manufacturers do not come in touch with the information that would redirect the production. The outsourcing decision therefore requires the analysis of a wide range of contextual factors and their implications on the competitive advantage of a company because the ability to manage and sustain sourcing relationships is increasingly essential to competitive success.

Traditionally, outsourcing decisions were focused on questions of "core" versus "non-core" activities, with the letter being candidates for outsourcing. However, many companies have successfully outsourced activities vital for core functions. There may sometimes be difficulties in defining the core activities. Examples show that capabilities can be entirely intangible and may largely be based on a company's reputation. According to Schoemaker (1992) core capabilities need to be unique, important, controllable, durable and able to generate excess profit, but they ***do not*** necessarily have to be wholly owned. When considering the outsourcing of near to core activities care must be taken to ensure that the essential relationships responsible for the creation of value remain available for development. Relationships with vendors built across the organization should provide information exchange and assure the desired level of control.

Companies can consider two types of relationships connected with the core business (Blumberg L., 2003): sharing core in which a company performs activities vital to core processes in a highly integrated relationship with the outsourcing partner, and expanded core, which involves the creation of new competencies and capabilities through a partnership. These arrangements require, closely integrated operations and a strategic, long-term partnership between the companies involved.

The outsourcing decision should be based upon internal cost/benefit and SWOT analysis, but the decision making process does not stop there. Authors (Lonsdale, 1999) warn of dangers when outsourcing is being executed in a limited supply market where a small number of firms provide a particular good or service and are in the position to exploit and monopolize the market. The service capability of suppliers and their financial strength must be assessed to avoid supplier failure as well as their ability to understand and meet the customer's goals. A good assessment of the vendor's market developments is necessary because an activity can be kept in house despite the higher costs if the supply market is underdeveloped. If the competitive environment is characterized as uncertain it has implications on the outsourcing decision. If a company is facing a volatile product demand it can use the benefits of outsourcing and therefore avoid excessive and risky in-house investment but also minimize exit costs if the declining demand persist.

An outsourcing strategy should be an outgrowth of a company's overall strategic plan. Managers should have a clear understanding of the overall strategy and the outsourcing's role in it. Do to waves of disappointments the initiative must come from the top. Top managers must formulate goals of an outsourcing arrangement and determine how such an arrangements would benefit the organization. Outsourcing should not be used as an excuse to get rid of poorly managed, costly or underestimated activity. Managers should assess the costs of a function and manage it effectively before considering its potential for outsourcing. Not understanding the nature of an activity and outsourcing could have serious effects on a company's future competitive capabilities.

Conditio sine qua non of the successful outsourcing lies in the following analysis:

1. Determine the company's core and peripheral activities and chose among peripheral activities the possible candidates for outsourcing taking into consideration cross functionality.
2. Determine the desired level of quality of service, requiring clear understanding and specification of desired type and level of services with options for future changes in contract specifications.
3. Determine the cost of outsourced activity. Company must have full understanding of the type and level of all costs associated with the outsourced activity.
4. Determine the barriers raised by corporate culture and assess the impact of outsourcing on the corporate culture: a company must take into account the compatibility with the vendor's.
5. Determine short and long-term implications for company's strategic position concerning the value chain in the market perspective.

Managers should also take into account the broader perspective considering all stakeholders involved, such as customers, suppliers, stock holders, employees and the community in general. Outsourcing plans might rise the level of uncertainty in the local community and result in the declining stock prices. For starters, managers should consider the dilemma of total or selective outsourcing. Total outsourcing involves transferring most equipment, personnel, and responsibility for the delivery services transferred to a vendor, while selective outsourcing includes the transfer of only a few selected processes underlying the specific function.

4. Implementation: methodological approach

Companies should adopt a systematic approach, which includes planning of resources, personnel and time. It must consider how outsourcing will affect the organization's ability to acquire best practice and build core competencies. A team must be selected to take leadership responsibility and perform the analysis. The team needs to combine managerial and technical talent. It should also include representatives from user areas that would directly be affected by the outsourcing. Their views may be critical for the risk assessment. Outside consultants are recommended in the situation when outsourcing threatens the status quo of poorly managed activities, which would make it difficult to rely on internal sources for accurate estimates of internal costs and effectiveness. The outsourcing team should evaluate the potential impact of the outsourced activities on the company's value chain, competitive capabilities and stakeholders.

The outsourcing team should perform the ***financial analysis*** and identify as carefully as possible which costs can be saved if the activity is outsourced and estimate hidden costs concerning the outsourcing procedure. Care should be taken to distinguish one - time and recurrent costs when making cost comparisons.

The team should also engage in the ***risk analysis*** and differentiate the major sources of risk and set the acceptable level of risk for the organization. Such risks include: environmental risks, legal exposure, process risks, capital availability… The team also needs to assess ongoing ownership of key assets and the potential risks of their transfer to outside provider (Flannery, Heckathorn, 2003, p.10).

After risk and financial analysis the outsourcing team recommends either beginning with the process of selecting a provider or retaining the activity and making improvements.

5. Selection of vendor(s)

In the vendor selection process, it is essential to engage in the following activities (Embleton, P; Wright, 1998, p.101):

- Determine the supplier profile and search the market to identify those who may be able to meet the specified requirements. The supplier performance should be evaluated viewing the technical and functional quality (Lankeford, Parsa, 1999, p.314). Technical quality includes maintaining the required response time, minimizing system down time and providing error-free service. Functional quality is the quality of customer service
- Assess the corporate culture compatibility with vendors
- Conduct site visits, to ensure that an organization looking good on paper is reliable in reality. The company should investigate if the vendor can accommodate any additional requests that may arise
- Negotiate a mutually beneficial deal, to ensure that both management teams have a suitable agreement

Regardless of the type of the relationship selected with the outside provider(s), the outsourcing context can be seen as a portfolio of relationships that contribute to the development of the "extended enterprise" and enable the company to exploit market opportunities it could not address on its own (Blumberg L., 2003). In some cases, companies using two vendors try to maintain a degree of competitiveness in the arrangement by giving each vendor a portion of work, with the remainder being left open for either vendor. That part can be shifted annually to the vendor who has shown the greatest cost and productivity improvements. This approach forces the vendors to sustain the competitive edge, but also has limitations in terms that the vendors are not truly working together in the best interest of the company keeping their focus on cost rather than on innovation.

6. Contracting

An outsourcing contract is a vehicle by which all parties involved agree on the *modus operandi* to deliver contracted services. The only way a contract can be successful in the long run is when it benefits both sides. In order to make an outsourcing arrangement a mutual success it is essential to specify every aspect of the outsourcing relationship and provide guidance (Yallof, 2003, p.20). There are several vital considerations to be taken into account when negotiating an outsourcing agreement:

1. ***Scope and objectives of the agreement*** should specify the relationship's objectives, definition of the character of the desired services, and the possibility for contract alternations.
2. ***Required service levels*** should set the criteria for the desired level for performance of each activity with special attention to areas that have influence on the customer satisfaction. The future performance will show whether the agreed criteria were realistically planned for mutual satisfaction or suited only for the benefit of a single contractual party. The problem may arise from the fact that standards are often set before full implications of an agreement are known.
3. Required ***service levels*** include quantification of qualitative properties of services such as: financial control, punctuality of services, customer satisfaction, accessibility of services, accuracy, dependability, and confidentiality.
4. ***Demand scalability***: partners should pursue an open dialog to ensure that the vendor anticipates rather than reacts to spikes in demand. So, high quality level of services is ensured despite the higher demand. Unpredictable and seasonal spikes in demand should be covered in the contract and include exceptions from performance penalties valid in a situation of unpredictable increase in demand.
5. ***Performance metrics***: contract must include performance measures as objective criteria for managing and evaluating the outsourcing relationship, which also serves as an effective tool to stimulate performance. Performance criteria must be objective, measurable and comparable against pre-established standards but flexible to evolve over time. They should differ depending upon the type of service being provided and customer requirements in the service level and easily benchmarked against performance of other vendors.

6. ***Billing and fees clauses***: contract should set a basis for fees resulting from regular services based either on per employee and/or per transaction charges. It should specify any additional (level of) services and the methodology enabling their evaluation and pricing.
7. ***Penalties and incentives***: while certain levels of performance are achieved through a price increase (for example: an increase in the speed and capacity of call centers requires bigger staff and thus a higher cost), others are a matter of employee training or quality of processes (dependability and accuracy). Incentives must be provided for managers from both sides to ensure the synchronous action. Penalty clauses are tied to overall client satisfaction and participants' expectations.
8. ***Situation management***: process of documenting, reporting and resolving issues, which arise as a result of the interrelationships with vendor, should be categorized by severity level. The contract should also include guidelines for dealing with unresolved issues.
9. ***Performance improvements:*** usually some performance aspects of services are set lower at the early stage of the arrangement so flexibility should be allowed for improvements. Partners can have distinct opinion of what is achievable in the future business perspective.
10. ***Vis maior***: vendor is excused from liabilities if certain conditions arise that are beyond its control.
11. ***Bankruptcy provision:*** the situation when one of the parties goes bankrupt changes the contract obligations entirely.
12. ***Exit strategy***: a contingency plan is essential considering the fact that even the best-structured relationships can fail. When essential services are outsourced, the dependability and continuity must be guaranteed. Under the contingency plan it is crucial to ensure the integration of the key staff members that provide the services in order to continue current operations.

Outsourcing contract can take three major forms: all-inclusive contracts, modular contracts (focusing on specific operations) and turnkey contracts (specific jobs). In the past turnkey contracts were typical arrangements between partners while modular and all-inclusive contracts characterize outsourcing relationships of today.

7. Vendor relationships management

Companies realize the need to establish a monitoring team to oversee tasks and provide guidelines for vendor activities that can prove critical for outsourced operations. Flexibility should be built into obligations of both contractual parties with the full understanding of the vendor's limitations in changing conditions to ensure adjustments to market developments (Bierce, 2003). If performance results required by the company fail to anticipate changes in the level of market demand, the contract will result in the mismatch of expectations.

Communication between partners should reflect the nature of the contract and the complexity of services being delivered. As the complexity of services increases more dynamic communication is required. This may include joint problem solving and planning of service delivery, discussions on innovations and marketing strategies. Daily reports required for simple arrangements are supplemented at higher stages by monthly reports showing performance measured against predetermined criteria indicating potential problems. Senior management must stay involved during the implementation of the contract at the operational level to address the outcomes and potential problems of the contract.

8. Human Resources Management in the Outsourcing Context

The outsourcing process implies insecurity, misunderstandings and fear of the unknown. If the outsourcing decision is not communicated to all levels of the company it could be perceived as a mysterious scheme by top managers, whose only purpose is job reduction. With such an atmosphere and the employee *a priori* negative attitude even the best-planned outsourcing arrangements are destined to failure. A research (Anfuso, 2003) showed that less than a half of the surveyed companies that undertook outsourcing endeavor achieved a reduction in overall costs and less than one quarter showed increased productivity. Besides ensuring that the outsourcer-vendor relationship runs smoothly, the manager's job should be to address the misconceptions attributed to employee reduction, affecting the working atmosphere.

Outsourcing of an existing activity affects employees in three possible ways (Embleton, Wright, 1998, p.102). Employees whose job is not affected by the outsourcing are usually referred to as "survivors". Managers need to develop training programs for them in order to ensure the desired level of productivity. Partners can arrange that the employees join the vendor and continue to perform the same or similar activities. There are two ways to make such arrangement. Under the clean break approach the company does not negotiate conditions of employment. This approach is likely to be more cost effective and time efficient. In the phased approach, conditions and terms of employment are negotiated with the vendor. Despite the fact that this approach is time and resource intensive, it is desirable when the outsourced activity is dependent on experience and knowledge.

Outsourcing has an undeniable affect on the morale. More than a half of the surveyed companies reported decreased morale and job commitment among “survivors” (Navram Ass, 1996, p.3). Morale is an intangible feeling transmitted among employees and to the customer (Noer, 1996, p.16). According to the Yankee Group (1996) 80% of the employees initially view outsourcing extremely negatively. Their acceptance level improves if management communicates its rationale and possible career paths. By the time the deal is finalized 50% of employees should be accepting the arrangement and further 30% acclimatizing to the situation within the first 6 months. These statistics describe “best case scenario” that is achievable only by open communication channels.

9. Changing Context of Outsourcing

In the business environment technology changes rapidly, unexpected events shock the market, customer preferences changes and the basis of competition shifts. Accurate planning and tighter relationship between partners enable prompter identification and implementation of the required changes in the service levels. Well-structured process for change implementation minimizes the risk of disillusions between partners and consists of the following actions to be taken before the revision of a contract begins and any costs are incurred:

- Prompt and open communication on market and technology developments
- Scanning for potential threats and opportunities in the environment
- Joint problem solving and staff meetings concerning the development of scenarios and models of trends based on requirements imposed on every party
- Documentation of required changes along with accompanying fees and determination of plan time frame
- Schedule of plan implementation
- Assessment of implemented changes
- Monitoring of performance and prompt corrective actions and criteria developments

These actions enable joint problem solving and synergy effects that can arise from company’s and vendor specialization in their own fields and result in innovative and progressive solutions that would otherwise be overlooked.

10. Conclusion

Considering numerous benefits and potential drawbacks the outsourcing decision must be strategically determined i.e. made considering long-term strategic implications rather than concentrating on temporary cost reductions. Operational advantages usually provide short term benefits, mostly attributed to cost cutting, while strategic advantages offer long term contributions in maximizing opportunities.

Outsourcing should not be used as an excuse to get rid of the poorly managed, costly or underestimated activity. Outsourcing enables the company to focus on core activities that can be neglected due to the dispersed management attention and offer time saving benefits along with the increased productivity leading to the responsiveness to market change. Traditionally, outsourcing decisions were focused on questions of “core” versus “non-core” activities, with the letter being candidates for outsourcing. Companies can consider two types of relationships connected with the core business: sharing core and expanded core. Two major reasons causing failure of the outsourcing arrangement are the fact that the traditional approach is tactical rather than strategic and the relationships between partners are adversarial rather than cooperative. The strategic approach should be designed to fit the company’s need to achieve the correct balance between vertical integration and the use of outside supply, which differs between industries and individual firms within an industry. If the outsourcing decision is not based on the strategic approach it can undermine a company’s capability leading to a loss of critical skills and the creation of the “hollow corporation”. An outsourcing strategy should be an outgrowth of a company’s overall strategic plan. The outsourcing decision therefore requires the analysis of a wide range of contextual factors and their implications on the competitive advantage of a company because the ability to manage and sustain sourcing relationships is increasingly essential to competitive success. Managers should also take into account the broader perspective considering all stakeholders involved.

Regardless of the type of relationships selected with the outside provider(s), the outsourcing context can be seen as a portfolio of relationships that contribute to the development of the "extended enterprise" and enable the company to exploit market opportunities it could not address on its own.

In order to make an outsourcing arrangement a mutual success it is essential to specify every aspect of the outsourcing relationship and provide guidelines. Flexibility should be built into obligations of both contractual parties with the full understanding of the vendor's limitations in changing conditions to ensure adjustments to market developments. If performance results required by the company fail to anticipate changes in the level of market demand, the contract will result in the mismatch of expectations. Communication between partners should reflect the nature of the contract and the complexity of services being delivered.

Accurate planning and tighter relationship between partners enable prompter identification and implementation of the required changes in the service levels. Well-structured process for change implementation minimizes the risk of disillusions between partners. Managers must permanently review the overall results and benefits of the outsourcing decision and arrangements in the context of the changing technology and market conditions.

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