INSOURCING: A WORLD OF DIFFERENCE

Rather than outsourcing a corporate department or function, it sometimes makes sense to bring in specialists to do the job.

by Ward C. Naughton

CAREFUL READERS MAY HAVE NOTICED THAT, in his 2006 best-seller *The World Is Flat*, Thomas Friedman makes note that UPS provides an insourcing solution for its customers.

Insourcing? For busy executives, it would be easy to skim over the word as a new term for a now-familiar concept. After all, North American companies have been inundated with proposals from the likes of EDS, IBM, and Accenture to outsource their operations. There is even an Outsourcing Institute, whose membership includes organizations such as Citigroup, Gartner, Marsh & McLennan, MetLife and Verizon.

On the other hand, insourcing has a lower profile. It is in fact a different approach to operations, which may provide small and mid-sized companies (SMCs) with an especially practical solution for their operational and financial needs.

To understand the difference between outsourcing and insourcing, it helps to measure the value that each delivers. Consulting firms such as McKinsey, Booz Allen Hamilton and Bain & Company gauge value in part as the return that a company or practice generates in excess of the return on equity required by shareholders. In other words, a company creates value when it exceeds expectations.

Outsourcing often is undertaken for cost savings. Lower personnel costs help boost the bottom line, a measure of value. Another way for companies to deliver value is to take advantage of the intellectual capital and resources of their business partners as well as their own employees. Indeed, access to others' intellectual capital is the definitive difference between outsourcing and insourcing. Here's why.

By convention, outsourcing repositions a client's internal resources via a contractual relationship with a third-party provider, who assumes responsibility for the daily management of these outsourced resources.

Outsourcing brings employees of one company under the management services of another. Fully loaded personnel costs are immediately transferred to a new category of expense, namely professional service fees. In the case of information-systems management, fixed costs can be converted into activity or unit-based costs, as capital investments in hardware and software are also often transferred to the vendor of the outsourced services. tailored The company that is outsourcing its personnel can then tailor these fees to its financial-reporting objectives. This might entail a blend of monthly fees plus a per-transaction fee or combining up-front management fees with later, tiered fees and tailored escalation provisions. How one tailors these payments can affect reported accounting statements. But what about real value creation?

Insourcing uses a vendor's expertise to meet an internal business requirement.

For example, in many outsourcing situations, a company's intellectual-capital base often remains relatively constant, as the composition of the employee base tends to change little after the transition. Executives may find peace of mind in the knowledge that their IT centres are still being managed by individuals familiar with their business. But there's no assurance that the company's intellectual capital will produce IT innovation or make IT run more efficiently or effectively.

The actual impact of outsourcing on improving shareholder value is subject to much debate. The company undertaking the outsourcing typically removes both assets (such as fixed assets) and liabilities (such as future employee payroll accruals). But the client also incurs a new payable to the third-party service provider. In return, it gets the contractual commitment of the third-party service provider and perhaps some form of credit for selected assets that are transferred.

What's most important to note is that the client ends up tying part of its future financial results to the third-party service provider. A third-party provider competing aggressively for a new client relationship might underbid or underestimate its true cost on a contract, then seek to recover the shortfall in future contract negotiations. At that point, the client company has little choice but to pay at least part of the increase; the cost of switching to another provider may be prohibitive. The size of the contract and the complexity of the service arrangement often put the client in a weaker negotiating position.

It's hard to make the case, unequivocally, that outsourcing is entirely beneficial to the aggregate shareholder-value equation. For example, when a certain large outsourcing firm was forced to write down $559 million in deferred costs related to one of its contracts, it quite likely renegotiated adjustments in subsequent contracts with the same client. That could have meant higher fees for the customer, not to mention the considerable opportunity cost of the time spent by executives in renegotiations.

Insourcing uses a vendor's expertise to meet an internal business requirement, when internal resources don't

exist or are limited. (See "Part-time executive, full-time value", p. 13.) The client company turns to an independent firm that specializes in the function required, tapping the vendor's intellectual capital. But the client retains more control over the project, including specific rights to terminate the services of the specialist provider.

Since the client typically does not possess the resources it needs, negotiation of insourcing contracts tends not to be as complex as they are for outsourcing, particularly with regard to termination. Terms may require as little as 30 or 60 days notice, although 12 months is more typical for unwinding an insourcing contract. While the client company must identify alternative resources to fill the void, other third-party providers can likely step in.

Certainly, termination in the midst of a project is troublesome. Nevertheless, it is still less risky to the client company's financial performance than an outsourcing arrangement, in which delivery resources are managed by the very party with which the client company, possibly under acrimonious circumstances, is trying to terminate its relationship or engage under different terms. At the end of an insourcing arrangement, the client company simply returns to its status prior to the contract, removing little or no economic value from its balance sheet.

With properly executed insourcing from the right providers, SMCs can enhance shareholder value in a number of ways, including:

1. Access to intellectual capital: otherwise found only at larger companies. Insourcing providers focus on a discrete set of core competencies, rather than the broader set of financial matters that most CFOs must deal with every day. For example, firms such as HiFX, I.C. System and Iron Mountain provide foreign-exchange management, accounts receivables and records management, respectively, and offer expertise accumulated from a wide range of client situations. They invest in staff, operations, and information systems specific to the function they provide. The SMCs that use their services reap the benefits of such specialized investment.

An insourcing partner with global reach provides beneficial insight into commonly accepted international practices.

2. Avoiding up-front capital investments: in systems and people. The access to resources that they gain through insourcing lets SMCs invest in hardware and software crucial to managing their business, instead.

3. Right-sizing expenses: to business requirements. Insourcing provides access to professional resources as needed, without requiring justification of a full-time expense and with assurance that those resources are always well-versed in their function. For example, market rates of currency exchange are highly volatile and subject to wide swings that can negatively affect financial results, particularly when such swings occur on or around key dates such as a quarter end or the date of repatriation of funds. A third-party monitoring service can provide insight into such marketplace movements for planning ahead, when it's needed.

4. Global reach: without building it internally. As smaller companies expand internationally, an insourcing partner with global reach provides beneficial insight into commonly accepted international practices, the nuance of foreign markets and best financial practices. Some insourcing providers also at times permit their clients to connect with and learn from other financial executives through sponsored roundtable forums, advisory councils, or formal networking channels.

5. Operational flexibility: to adjust with changes in business. With changing fortunes, the SMC has the opportunity to adjust the level of service required from the insourcing provider. A change, either positive or negative, of business volumes might prompt a client to alter its contract with its service provider for a modified level of service on an interim basis. As business conditions change, so can the contractual relationship.

Insourcing has been expanding quietly in the world of finance. In fact, corporate treasurers have been engaged in insourcing for some time, although many probably simply viewed it as retaining a specialist. Many of these insourcing providers are involved in daily dialogue and discussion of long-term operating strategies. These firms operate under a greater sense of urgency, given their clients' limitations on internal resources, and quite possibly are more attuned to delivery of immediate value.

As Friedman suggests, the world is becoming increasingly interconnected. And as the impact of insourcing suggests, companies that take advantage of intellectual resources outside their corporate boundaries stand a good chance of flourishing in this new landscape. It stands to reason that insourcing is clearly one way to remain well-rounded in such a flat world.

Ward C. Naughton is a member of the advisory council of HiFX (www.hifx.com), a professional services firm focused on foreign-currency risk management. He can be reached at ward.naughton@hifx.com.

Fixed vs. floating: The Bank speaks

Large currency movements, such as the roughly 35% appreciation in the Canadian dollar since early 2003, can be hard for businesses to deal with. A floating currency does entail somewhat larger transaction costs and, in the short run, additional risks for business. In this regard, the development of deep and well-functioning forward foreign-exchange markets is extraordinarily important in assisting businesses to hedge their foreign-exchange risk. Such well-developed markets, along with financial institutions geared to providing business – especially small business – with the opportunity to hedge at low transactions cost, minimize the additional exchange risks that businesses face under a floating exchange rate regime.

But even with well-developed foreign-exchange markets and the ability of firms to hedge, some still fear that a flexible exchange rate will introduce undue risks and uncertainties. They argue that fixed exchange rates are the solution. But a fixed exchange rate is no panacea. Over time, a fixed nominal exchange rate can actually heighten uncertainty and, eventually, add to volatility. A fixed rate limits the actions of central bankers because monetary policy must be aimed at protecting the fixed level of the exchange rate.

Source: *David Dodge, Governor of the Bank of Canada*