OUTSOURCING

A GUIDE TO . . . SELECTING THE CORRECT BUSINESS UNIT . . . NEGOTIATING THE CONTRACT . . . MAINTAINING CONTROL OF THE PROCESS

SECOND EDITION

STEVEN M. BRAGG

WILEY
JOHN WILEY & SONS, INC.

Outsourcing

OUTSOURCING

A GUIDE TO . . . SELECTING THE CORRECT BUSINESS UNIT . . . NEGOTIATING THE CONTRACT . . . MAINTAINING CONTROL OF THE PROCESS

SECOND EDITION

STEVEN M. BRAGG

WILEY

JOHN WILEY & SONS, INC.

This book is printed on acid-free paper. ♾

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

For general information on our other products and services, or technical support, please contact our Customer Care Department within the United States at 800-762-2974, outside the United States at 317-572-3993 or fax 317-572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books.

For more information about Wiley products, visit our Web site at http://*www.wiley.com*.

Library of Congress Cataloging-in-Publication Data:

Bragg, Steven M.
Outsourcing: a guide to — selecting the correct business unit — negotiating the contract— maintaining control of the process / Steven M. Bragg. — 2nd ed.
p. cm.
Includes bibliographical references and index.
ISBN-13: 978-0-471-67626-3 (cloth)
ISBN-10: 0-471-67626-8 (cloth)
1. Contracting out. I. Title.

HD2365.B73 2006
658.4'058—dc22

2005043677

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

To Sheck Cho—

Thanks for helping me upgrade Outsourcing, one of the first books we did together.

CONTENTS

PREFACE

This second edition of *Outsourcing* addresses the nuts and bolts of how to outsource any part of a company. It covers these key areas:

- Incorporating outsourcing into company strategy
- Locating the best supplier
- Negotiating a contract
- Transitioning to the supplier
- Managing the function
- Measuring supplier performance
- Handling customer service issues
- Terminating the outsourcing arrangement

Outsourcing addresses each of these topics for every conceivable part of a company: accounting, computer services, customer service, engineering, human resources, logistics, maintenance, manufacturing, sales and marketing, and administration. In most cases, these topics are covered within Chapters 7 through 16, which are devoted to the functional parts of a company. However, some topics have grown so extensively since the first edition that they now occupy their own chapters. These topics include:

- **Contractual issues (Chapter 3).** This chapter covers general clauses to be found in nearly every outsourcing agreement, as well as specialized clauses only needed for certain functional areas of a company. The chapter also delves into the negotiating tactics required to create an agreement that is fair for both parties.
- **Managing the supplier (Chapter 4).** This chapter addresses the considerable need for companies to adequately manage functions that

have been outsourced, including ongoing oversight, communications channels with suppliers, and in-house sponsors.

- **Terminating the outsourcing arrangement (Chapter 5).** A number of issues common to the majority of premature outsourcing contract terminations are covered in this chapter. Some topics that are specific to terminations of certain types of contracting arrangements are also addressed.

In addition, Chapter 5 discusses how to account for outsourced functions, which is generally easier than accounting for in-house functions since transaction volumes are significantly reduced, but it does call for somewhat different systems than company controllers are accustomed to using.

The *mechanics* of outsourcing have not experienced massive changes in the eight years since the first edition was published. However, the *operating environment* is significantly different. First, there has been a substantial public backlash as more jobs are shifted to low-wage countries. Though there has been little restrictive legislation resulting from this outcry, companies have become more cognizant of community and government opinions of their behavior and have occasionally curtailed their outsourcing plans as a result.

A second change has been the tightening of the labor market in India. Though India still unleashes an enormous number of English-speaking college graduates into the job market every year, suppliers of accounting, computer services, and customer support labor and systems are finding that these new hires require considerable training to meet the linguistic and cultural expectations of company employees and customers. The result has been some contract terminations as companies shift out of India, or at least a reduction of supplier profits due to spiraling labor costs. Other countries with excellent English-language skills and labor forces, such as Ireland and the Philippines, have also competed more vigorously with India for an increased share of the outsourcing market.

A third change has been the dramatic rise of China as a manufacturing powerhouse due to its rock-bottom labor costs. Though China must still overcome considerable internal logistical problems and is seeing some labor cost increases due to a tightening labor market, it appears likely to be the manufacturing location of choice for many years to come.

A fourth issue is the surprising number of major outsourcing deals that have gone sour, especially in the computer services area. When the first edition of *Outsourcing* went to press, massive new outsourcing deals were being announced on a weekly basis, but no one really knew how they would turn out. Now we know—some, such as BP's long-running accounting outsourcing deal with Accenture, have become industry models of success. However, an example of a less successful deal is EDS's infamous computer services deal with the U.S. Navy, which has cost EDS more than $1 billion (and counting).

This book is designed to keep outsourcing deals from failing by using solid management techniques to find the right supplier and develop a working partnership that pays off for both parties. Hopefully, *Outsourcing* can help you avoid the pitfalls in which some deals become mired, and instead achieve significant strategic and tactical improvements in your business.

STEVEN M. BRAGG
Centennial, Colorado
January 2006

About the Author

Steven Bragg, CPA, CMA, CIA, CPIM, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young and auditor at Deloitte & Touche. He received a master's degree in finance from Bentley College, an MBA from Babson College, and a bachelor's degree in economics from the University of Maine. He has been the two-time president of the Colorado Mountain Club, is an avid alpine skier and mountain biker, and is a certified master diver. Mr. Bragg resides in Centennial, Colorado. He has published the following books through John Wiley & Sons:

Accounting and Finance for Your Small Business
Accounting Best Practices
Accounting Reference Desktop
Billing and Collections Best Practices
Business Ratios and Formulas
Controller's Guide: Roles and Responsibilities for the New Controller
Controller's Guide to Costing
Controller's Guide to Planning and Controlling Operations
Controllership
Cost Accounting
Design and Maintenance of Accounting Manuals
Essentials of Payroll
Fast Close
Financial Analysis
GAAP Guide

GAAP Implementation Guide
Inventory Accounting
Inventory Best Practices
Just-in-Time Accounting
Managing Explosive Corporate Growth
Outsourcing
Payroll Accounting
Payroll Best Practices
Sales and Operations for Your Small Business
The Controller's Function
The New CFO Financial Leadership Manual
The Ultimate Accountants' Reference

Also:

Advanced Accounting Systems (Institute of Internal Auditors)
Run the Rockies (CMC Press)

Subscribe to Steve's free best practices newsletter at www.stevebragg.com.

1

STRATEGY OF OUTSOURCING

International Data Corporation predicts that the outsourcing market *just for computer services* will reach $1.2 trillion by 2007. Why are so many companies diving into the pool of outsourcing? This chapter discusses many reasons, some strategic and others not so strategic, for this occurrence. In addition, since a decision to outsource should not be made without full consideration of the many risks that go along with moving a function over to a supplier, a list of risks is itemized. Also, there is a discussion of who makes the outsourcing decision and how this may vary by the function to be outsourced. Finally, there is a brief description of the suppliers who provide outsourcing services—how they operate and why they can provide services of higher quality than a company's in-house functions. This discussion is included in the strategy chapter because the executive who makes the decision to outsource must know the nature of the supplier to whom the executive is handing a large part of the company's functions.

OVERVIEW OF OUTSOURCING

There are a large number of reasons why a manager should consider outsourcing a function. These reasons, as enumerated in this section, include anticipated cost savings, the need for better skills and management, and handling overflow situations. A company will be more likely to outsource a function if there are multiple reasons for doing so, such as the need for reducing costs as well as selling off assets to the supplier (two reasons that go hand-in-hand for a financially troubled company).

- **Acquire new skills.** A company may find that its in-house skill set is inadequate for a given function. This may result in minimal improvements to the function in the future, if any. A company can overcome this problem by handing over the function to a supplier who specializes in that function and who therefore is highly competent in its administration, using well-trained and experienced staff as well as the most current procedures and technological advances. This reason is most commonly used for outsourcing functions that require high skill levels, such as engineering and computer services.
- **Acquire better management.** A company may find that an in-house function is not performing as expected, not because of any problems with the staff but because of poor management. Symptoms are high turnover, absenteeism, poor work products, and missed deadlines. It can be very hard to obtain quality management, so outsourcing the function to a supplier just to gain access to the supplier's better management can be a viable option. It may also be possible to "rent" management from the supplier. This can be a good option in all functional areas, though it is more common in areas requiring high levels of expertise, such as engineering.
- **Enhance controls.** In the era of Sarbanes-Oxley, company management is increasingly concerned about its ability to provide sufficient control over its operations. By shifting some functions to a quality supplier whose operations can be readily certified, a considerable portion of the pressure to maintain adequate controls can be alleviated. This is a particularly important issue when the accounting function is outsourced, since many key control points are located in that area.
- **Focus on strategy.** A company's managers typically spend the bulk of each day handling the detailed operations of their functional areas—the tactical aspects of the job. By outsourcing a function while retaining the core management team, a company can give the tactical part of each manager's job to a supplier, which allows the management team to spend far more time on such strategy-related issues as market positioning, new product development, acquisitions, and long-term financing issues.
- **Focus on core functions.** A company has a very small number of functions that are key to its survival. It may want to focus all of its

energies on those functions and distribute all other functions among a group of suppliers who are capable of performing them well enough that company management will not have to be bothered with the details. A company may even want to outsource core functions that are expected to become less important in the near future due to changes in the nature of the business. A company can even outsource a function that is considered key to company survival if it can find a supplier that can perform the function better—in short, only keep core functions that *the company can do better than any supplier.* For example, a company may be the low-cost manufacturer in its industry, which allows it to maintain a large enough pricing advantage over its competitors to be guaranteed a large share of the market. Management can focus solely on the manufacturing function and can outsource everything else.

- **Avoid major investments.** A company may find it has a function that is not as efficient as it could be due to a lack of investment in the function. If the company keeps the function in-house, it will eventually have to make a major investment in order to modernize it. By outsourcing the function, the company can permanently avoid having to make this investment. Furthermore, it can use outsourcing to keep up with the latest technology. The most advanced suppliers realize that their ongoing use of and investment in the latest technology allows them to drive down costs and attract more customers, so companies and suppliers have mutually beneficial goals in this area. For example, a company outsourcing its entire accounting function can frequently take advantage of the most advanced enterprise resources planning (ERP) software—such as SAP or Oracle—being used by the supplier.
- **Assist a fast-growth situation.** If a company is rapidly acquiring market share, the management team will be stretched to its limits building the company up so that it can handle the vastly increased volume of business. In such situations, the management team will desperately need additional help in running the company. A supplier can step in and take over a function so that the management team can focus its attention on a smaller number of core activities. This is especially useful when the supplier has a sufficient preexisting capacity to handle massive increases in transactional volume by the company; rapid scalability becomes a crucial outsourcing advantage.
- **Handle overflow situations.** A company may find that there are times of the day or year when a function is overloaded for reasons that are

beyond its control. In these situations, it may be cost-effective to retain a supplier to whom the excess work will be shunted when the in-house staff is unable to keep up with demand. This is a reasonable alternative to the less palatable option of overstaffing the in-house function in order to deal with overflow situations that may only occur a small percentage of the time. This is a popular option for help desk services as well as customer support, where excess incoming calls are sent to the supplier rather than having customers wait on-line for an excessively long time.

- **Improve flexibility.** This is similar to using outsourcing to handle overflow situations, except that the supplier gets the entire function, not just the overflow business. When a function experiences extremely large swings in work volume, it may be easier to eliminate the fixed cost of an internal staff and move the function to a supplier who will only be paid for the actual work done. This converts a fixed cost into a variable cost—the price of the supplier's services will fluctuate directly with the transaction volume it handles.
- **Improve ratios.** Some companies are so driven by their performance ratios that they will outsource functions solely to improve them. For example, outsourcing a function that involves transferring assets to the supplier will increase the company's return on assets (which is one of the most important measurements for many companies). The functions most likely to improve this ratio are those heavy in assets, such as maintenance, manufacturing, and computer services. Another ratio that can be improved is profitability per person. To enhance this, a company should outsource all functions involving large numbers of employees, such as manufacturing or sales.
- **Jump on the bandwagon.** A company may decide to outsource a function simply because everyone else is doing it. If a major company suddenly dives into outsourcing, other companies will give the activity more credence and will be more likely to outsource, too. Also, a large amount of coverage of outsourcing in various national or industry-specific publications will give company management the impression that outsourcing is the coming trend, and they must use it or fail. For example, due to the large amount of publicity surrounding some of the very large computer services outsourcing deals, the bandwagon effect has probably led to additional outsourcing deals for the computer services function.

- **Enhance credibility.** A small company can use outsourcing as a marketing tool. It can tell potential customers the names of its suppliers, implying that since its functions are being maintained by such well-known suppliers, the company's customers can be assured of a high degree of quality service. In these instances, the company will want to hire the best-known suppliers, since it wants to draw from their prestige. Also, for key functions, the company may even want to team up with a supplier to make joint presentations to company customers, since having the supplier's staff present gives the company additional credibility.
- **Maintain old functions.** A company may find that its in-house staff is unable to maintain its existing functions while also shifting to new technology or to a new location. Outsourcing is a good solution here, for it allows the company to focus its efforts on implementing new initiatives while the supplier maintains existing day-to-day functions. This reason is most common in computer services, where suppliers are hired to maintain old "legacy" systems while the in-house staff works on a transition to an entirely new computer system.
- **Reduce costs.** A company may emphasize cost savings for a variety of reasons, such as being in a poor financial position, or because of a goal to increase profits. Reducing costs by using a supplier is possible but not in all situations. A supplier clearly has lower costs if it can centralize the work of several companies at one location, such as a central truck maintenance facility or a data processing center. It can lower costs if it can buy materials or supplies at lower costs by using volume purchasing. It can also purchase assets from a company, then lease the assets back as part of an outsourcing deal, thereby giving the company an up-front cash infusion. Finally, suppliers' costs are lower than a company's because they typically exercise very tight control over fringe benefits, have lean overhead structures, and use advanced telecommunications to employ staff in low-wage areas around the world. Further, they can achieve greater capacity utilization if they have multiple clients, since they can reallocate staff to match fluctuations in each client's transaction volume. Yet another cost-reduction technique is for them to base their operations in countries that offer extensive tax holidays or tax breaks in exchange for employing their citizens.
- **Improve performance.** A company may find that it has a function that has bloated costs or inadequate performance. To "shake up" the

function, company management can put the function out to bid and include the internal function's staff in the bidding process. The internal staff can then submit a bid alongside outside suppliers that commits it to specific service levels and costs. If the bid proves to be competitive, management can keep the function in-house but hold the function's staff to the specific costs and performance levels noted in its bid. As long as suppliers are told up front that the internal staff will be bidding and that the selection will be a fair process, they should not have a problem with this type of competition. This approach can be used for any functional area.

- **Begin a strategic initiative.** A company's management may declare a complete company reorganization, and outsourcing can be used to put an exclamation point on its determination to really change the current situation. By making such a significant move at the start of the reorganization, employees will know that management is serious about the changes and will be more likely to assist in making the transition to the new company structure.

Before deciding to outsource based on one or more of the previous reasons, a manager should consider the underlying reasons why outsourcing is being considered in the first place. It may be due to one of the previous reasons, but a deeper problem may be that the function in question is not doing a good job of trumpeting its accomplishments, or of showing management that the cost of keeping the function in-house is adequately offset by the resulting benefits. In these cases, it may do no good to outsource the function because management may be replacing a perfectly adequate in-house staff who is not good at publicizing itself with a supplier who performs no better but who is quick to point out how much it is doing for the company. If management suspects that this may be the reason why outsourcing is being considered, it is useful to bring in a consultant who can review the performance of the in-house employees and see if they are, in fact, doing a better job than they are saying.

The manager who is making the outsourcing decision should also consider that it is not necessary to outsource an entire functional area—instead, the manager can cherry pick tasks within the function that are clearly worthy of being outsourced and keep all other tasks in-house. This reduces the risk of having the chosen supplier do a bad job of handling its assigned tasks, since fewer tasks are at risk, and it allows the company to hand over the remaining functional tasks to the supplier as it becomes more comfortable with the supplier's performance. For example, a company can outsource just the help desk part of its computer services function, or it may add network services, telephone services, application development, or data center operations tasks to one or more suppliers. These options are all available to the manager who is edging into a decision to outsource.

The typical outsourcing path that a company follows starts with a function that has minimal strategic value and will not present a problem even if the supplier does a poor job of providing the service. If the company's experience with these low-end functions proves successful, then company management will be more likely to advance to outsourcing those functions with more strategic value or with more company-threatening consequences if the provided service is inadequate. These functions include accounting, human resources, and logistics. Finally, if the company continues to perform well with all or part of these functions outsourced, it will consider moving to outsourcing the most important functions; typically, these are manufacturing, computer services, and engineering (though this may vary considerably by industry). This progression is shown in Exhibit 1.1. Thus, many companies experiment with outsourcing functions of low importance and later include functions with more strategic importance, depending on their earlier experience with the other functions.

The list in Exhibit 1.1 appears to contain an overpowering number of reasons why a manager should outsource every corporate function. However,

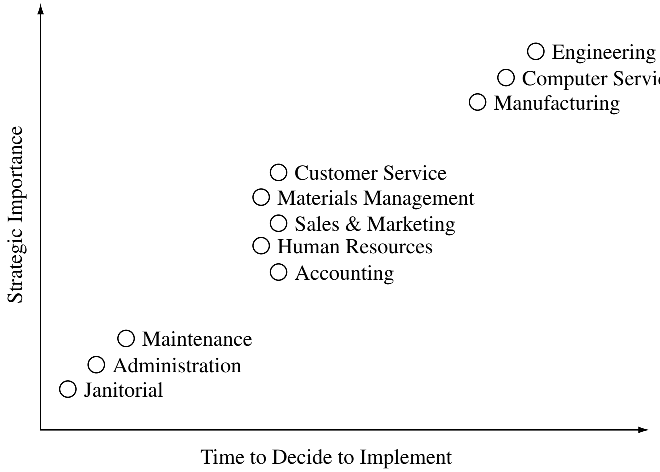

EXHIBIT 1.1 TYPICAL OUTSOURCING PATH

the following section contains a number of cautionary thoughts to consider before calling in a supplier.

OUTSOURCING RISKS

While there are many good reasons to outsource a function, there are also a number of risks associated with doing so. These can range from minor pricing issues to nonperformance by a supplier of a key function. The person making the outsourcing decision must be aware of these risks before making the decision to hand over a function to a supplier. This section lists several of those risks, as well as how to mitigate them.

- **Future change in supplier circumstances.** One risk is that the supplier's situation may change in the future, causing problems in the outsourcing relationship. For example, the supplier may have financial difficulties, be bought out by a company that does not want to be in the outsourcing business, or undergo a shift in strategy that forces it to provide different services. Also, the technology needed to service the company's needs may change over time, and the supplier may no longer be able to service that new technology. These risks can be lowered by having an independent consultant perform a thorough analysis of the capabilities, financial position, and competitive positioning of a prospective supplier, as well as by ensuring that there is a termination clause in the outsourcing contract that allows the company to back out of the contract if any of the above circumstances occur. Also, these risks are less important if there are a large number of competing suppliers to whom the company's business can be shifted. Alternatively, the risk is greater if there are few competing suppliers.
- **Perceived risk lower than actual.** Another risk is that available information about the success of outsourcing is usually skewed in favor of success stories. An excess of this type of information may lead company management to the conclusion that it must outsource a function (the bandwagon effect) when in reality the number of outsourcing successes are fewer than reported. This skewing problem is caused by the timing of stories about outsourcing—they are almost always published for outsourcing deals that have just been signed, when no problems between companies and suppliers have yet surfaced. These stories find their way into various publications because they are being pushed by the public relations departments of the suppliers as a form of free

advertising. These same suppliers are not going to go out of their way to advertise the failure of any outsourcing deals, nor will the companies for whom they are working, since neither party wants to acquire a reputation for not being able to manage an outsourcing deal.

- **Political fallout.** A very serious risk, especially for a large company that dominates a local economy, is that there can be significant fallout within the community if the company lays off a large number of workers as a result of an outsourcing arrangement. There are many outsourcing deals where employees are not rehired by the supplier, so this throws many employees out of work. If the local area is highly dependent on the company to maintain the local economy, this can generate a very large outpouring of bad feelings, quite possibly resulting in local boycotts, strikes, and bad publicity that may spill over into the national press. This is less of a risk for companies located in large metropolitan areas, where laid-off workers can easily find new jobs within the region. One way to mitigate this risk is to only pick suppliers who guarantee that they will hire a large proportion of the company's employees and retain them for a fairly long time, such as a minimum of one year. The person deciding to outsource should consider the impact on the local community before doing so.
- **Supplier failure.** It is possible that a company can outsource a function that is critical to its existence, watch the supplier fail at providing the service, and have this bring about the failure of the entire company. This risk is heaviest for the major corporate functions, such as computer services, engineering, or manufacturing. Only by carefully selecting the appropriate supplier, tightly controlling the transition to the supplier, and continually monitoring the supplier's subsequent activities can this risk be mitigated.
- **Loss of confidential information.** There are a number of outsourcing scenarios where a company must send confidential information to its supplier, such as human resources, accounting, computer services, and engineering. There is a serious risk that this information may be stolen or lost at the supplier location. This is a particular concern where low-wage supplier employees have access to sensitive information and have a monetary incentive to sell it.
- **Local responsibility.** When a company outsources work that it is performing for its own clients, the company is ultimately responsible for

the quality of that work. For example, a CPA firm that does the tax returns for its clients can be sued by those clients if the tax returns are outsourced to a third party that completes them improperly.

- **Job loss.** Finally, there is the risk that the person sponsoring the switch to outsourcing may lose his or her job if the outsourcing does not work. Outsourcing is a major change, in some cases involving a transfer of large parts of the company to a supplier and possibly having the supplier run a strategically major function for the company. If these changes do not work as planned, the outsourcing drive could backfire on the project sponsor and lead to a dismissal. In short, sponsoring such a major change and seeing it fail can lead to termination of one or more of a company's management staff.

Generally speaking, some functions can be outsourced at considerably less risk to a company than others. For example, benefits administration, maintenance, and telemarketing are considered to be low risk because they are not core areas and can usually be switched to a new supplier fairly rapidly. In contrast, customer service, accounting transactions, and computer services require considerably more effort to switch to a new supplier and can severely impact company operations if they are improperly handled. Thus, these areas are of at least medium risk. Finally, such areas as investment analysis, cash flow forecasting, and product pricing could have rapid catastrophic results if improperly handled, so they are considered to be high-risk functions for outsourcing.

There are a number of serious risks to be factored into the decision to outsource a function. These include changes in a supplier's business situation, trying outsourcing based on overly optimistic press reports, losing the support of the local community, having the supplier fail at providing a key service, and having the project sponsor fired if an outsourcing deal fails to perform as expected. These risks can, in some cases, bring down the company or significantly worsen its competitive or financial position, so they must be carefully weighed alongside the many reasons why it is a good idea to outsource a function.

INITIATING OUTSOURCING

The person within a company who makes the decision to outsource will vary depending on the function. For example, a low-level manager can easily outsource the janitorial function and may even be safe in not notifying senior management of the decision to do so. The same goes for most administrative functions and some aspects of maintenance. However, it is inappropriate for most other functions to be outsourced without the input of the most senior company executives. Most functions are not only more strategically important than janitorial services, but they also involve laying off large numbers of people or significantly changing the cost structure of the company. Therefore, it is most appropriate for someone at the chief executive officer or chief financial officer level to make the final decision to outsource. For major outsourcing decisions involving very large layoffs or cost savings, it is even possible that a company's board of directors will vote on the issue. If a lower-level manager tries to make the decision for any function but the few exceptions already noted, the decision should be moved up to the top of the company instead—the decision is just too important for a low-level manager to make.

COMPANIES THAT TAKE OVER OUTSOURCED FUNCTIONS

Moving a company function to a supplier is an important decision that may have a major negative impact on the company if the arrangement does not go well. The decision maker should be aware of how suppliers operate and what their objectives are before making the decision to hand them a key company function, since this knowledge may impact the manager's decision. This section explores how suppliers make money in the outsourcing arena, how they compete against each other, the areas in which a supplier can truly provide a cost savings to the company, and how the company should treat a top-notch supplier. Only by understanding the supplier's operating paradigms can a company manager make an informed decision on whether to outsource a function.

A supplier makes money by standardizing a portion of the work involved with a function. The supplier has become so good at one activity that it can regularly beat the performance of any company with whom it does business. The supplier may achieve this cost advantage by paying particular attention to streamlining the function, by using only the most experienced and knowledgeable management, by using only the latest technology, or by having such a large-volume operation that it can obtain very low costs per transaction. For example, a computer services provider has lower processing costs because it can run all of the program processing for many companies through one large data processing center that combines the overhead for all of those companies into one facility—this is a permanent cost advantage that a company cannot match.

The key point to note in the preceding paragraph is that a supplier has a cost advantage in only a portion of a function. It usually does not have an advantage for any customized work that is, by definition, incapable of being standardized. For this part of the work related to a function, it is likely that the company and not the supplier is the low-cost provider because the company does not have to earn a profit when it performs the function, nor does it incur any overhead costs to market the function. What this means for someone making the decision to outsource is that the supplier will focus on its ability to provide low-cost services during its presentation to company management, but there are many activities within a functional area that the supplier cannot provide at a lower cost—if anything, it will cost the company *more* money to outsource! Of course, a function may still be worth outsourcing for many reasons that are not related to cost, as were enumerated earlier in this chapter.

How do suppliers compete against each other? The decision maker must know this in order to differentiate between the bids received from various suppliers. First, nearly all suppliers try to lock in a company for as long a contract as possible. Not only does this give the supplier an assured flow of revenues, but it also locks out its competitors from dealing with the company. Second, suppliers try to keep the initial cost of a contract as low as possible in order to obtain a company's business, then build various clauses into the contract that allow it to increase its prices later. This gives the supplier the lowest initial bid in order to obtain the company's business but still allows it to earn a profit on a deferred basis. Third, suppliers like to offer free consulting services not only in advance but also during the term of their relationship with a company. These services are targeted toward recommending the services of the supplier to the company and sometimes focus on the FUD principle: Fear, Uncertainty, and Doubt—e.g., if you do not outsource immediately with us—and not to the competition—all kinds of terrible things will happen. The decision maker can counteract these supplier techniques by reducing the length of contract terms, examining the total cost of a supplier proposal over the full term of the contract, and taking the results of free supplier consulting work with a liberal degree of skepticism.

There are a small number of truly top-notch suppliers in every functional area. These suppliers usually have all of the business they can handle, for they have acquired a reputation for exceptional service that keeps companies coming to them for business. In these cases, the company must be extremely careful to treat the supplier as well as possible. If the company