

*Impact of Outsourcing on Company Performance:
Study on a Local Public Limited Company in
Bangladesh.*

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Submitted to

Institute of Governance Studies

BRAC University, Dhaka, Bangladesh

*In Partial Fulfillment of the Requirement for the Degree
“Master’s in Procurement and Supply Chain Management”*

Institute of Governance Studies

BRAC University, Dhaka, Bangladesh

December, 2012

Abstract

With the increasing of globalization, outsourcing as a strategic tool has attracted much attention in recent years. Many organizations chose outsourcing as a tool of competitive advantage. Outsourcing is a complex process and improper strategy pathway can create formidable barriers against firm performance. Employing the core competency theory, this paper systematically investigates the firm outsourcing strategy design, operation model and impact on company performance. It also makes a comprehensive analysis on the relationship between core competency and outsourcing. This study investigates factors that influence the make or buy decision of a local public limited company . The research, more specifically examines the core competence thinking for decision making in relation with outsourcing as strategic decision taken by the top management of the company.

Key Words: *Core competency, organizational competency, outsourcing, DESCO, strategy, make-or-buy.*

Acknowledgements

I would like to express my gratitude to the many people that, in one way or another, contributed to this thesis. However there are a few persons that I would like to thank above all. My gratitude to all the colleagues and participant and official of CIPS cohort-i. Without them I would not have lasted one and half year in this pain full course. Especially I would like to thanks Dr. Rizwan Khair and Mr. Fuad for their valuable suggestions, helps and many more. My appreciation goes furthermore to all the managers that allowed me to interview and give me the access to their procurement information.

It will be unfair if I fail to express much gratitude to my dissertation supervisor Prof. Iftekhar Ghani Chowdhury, Vice-Chancellor, State University of Bangladesh. He was my first choice to guide me in this process; ever since he was my facilitator for another course. He invested in numerous of pleasant interactions that were filled with humor. Prof. Chowdhury really motivated me to squeeze out all the potential merit that this subject contains. And for that, I am most grateful. Finally, most of the credits belong to my parents. The amount of patience, encouragement and pride that they have expressed towards me in my student years means more to me than they could ever imagine. I hope that by dedicating this disstertation to them they will understand what they mean to me.

Declaration

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Chapter-1: Introduction

Strategic thinking of business has changed radically from the early 60s. A systematic approach of management and market strategy is ever changing . Now-a-days customer loyalty, customer service and significant quality are main concern for every business. Various quality initiatives have developed since 2nd World war for process improvement but more need to be done. This need has led to the outsourcing ideology.

Outsourcing has been a global trend in business for several decades. Some managers even consider it a panacea for the company. If there have been companies, there has been outsourcing too. Now outsourcing is more popular than it was before.

Core competence has received much attention of theorist and management team as strategic choice. Now it is claimed that concentrating on core competencies and outsourcing the rest is a recipe for success. Outsourcing plays an essential role in company performance.

Outsourcing can provide major benefits for organization and can add values for customer perspective. Outsourcing of facilities , catering or call center, security or cleaning are advantageous in most cases. One things to remind that the risk and vulnerability of this items is minimal.

In case of outsourcing production, IT, marketing, product development, logistics, procurement or HRM the question of benefits and risks are far more debatable and need risk benefit analysis. In fact, in most of the outsourcing cases, anticipated benefits have not been materialized. What are the motives and risks of outsourcing and which are the key factors that affect outsourcing decision? These are the questions which this study seeks to answer.

Outsourcing is taken into account considering as per transaction cost economics (TCE) analysis and the resource based view (RBV) of the firm. As per transaction cost economics the conditions under which an organisation should manage an economic exchange internally within its

boundaries i.e. hierarchies and the conditions suitable for managing an economic exchange externally i.e. markets. According to transaction cost economics, a company will make the outsourcing decision on the basis of reducing production and transaction costs.

Production costs include direct costs involved in creating the product or service plus labor and infrastructure costs. Transaction costs refer the costs of transaction that include the costs of selecting suppliers, negotiating prices, writing contracts, monitoring performance, as well as the potential for opportunities from suppliers.

As per TCE methodology organizations should employ hierarchical governance or employ a governance structure that uses less specialized investments in order to reduce the potential for opportunism. Another prominent theory employed in the outsourcing decision is the resource-based view which views the firm as a bundle of assets and resources that if employed in distinctive ways can create competitive advantage.

The resource should be valuable, rare and high in demand, inimitable and difficult to substitute. Main resource of an organization contain human resource, finance, information and physical assets. A major concern of the resource-based view is how an organization's capabilities develop and affect its competitive position and performance. Proponents of the resource-based view argue that heterogeneity in an organization's knowledge-based resources and capabilities explain differences in performance and the sustainability of a competitive advantage.

Therefore, the outsourcing decision is influenced by the ability of an organization to invest in developing a capability and sustaining a superior performance position in the capability relative to competitors. Processes in which the organization lacks the necessary resources or capabilities internally can be outsourced. Organizations can access complementary capabilities from external providers where they can gain no advantage from performing such processes internally. Although the RBV and TCE are focusing on two different issues I.e. the search for competitive advantage and the most efficient governance structure.

The trend towards specialization in many product and service markets has been opened up opportunities for further outsourcing as specialist suppliers chase demand through offering a wider range of capabilities in more critical business areas. Organisations have to deal with these two important issues when making outsourcing decisions. Practitioners have to assess their capabilities across a range of business areas as they are increasingly being confronted with constraints on resources. This means that they have to prioritize resource allocation in certain key business areas where they possess strengths and outsource less critical areas. Furthermore, organizations perceive outsourcing as a means of attaining performance improvements in many areas of the business. Specialist suppliers are expected to deliver cost efficiencies whilst at the same offer a higher value. However, the potential for performance improvement has to be balanced against the potential for opportunism in the supply market.

The main focus of this study is to relate the relationship between core-competence thinking and outsourcing decision and find out the impact of outsourcing on company performance. The required level of relationship will be examined through literature review. The framework of outsourcing will then be discussed and followed by recent trend of core-competency approach.

After the literature review the main research will be undertaken through sampled selected organization. The performance of the organizations will measure according to outsourcing criteria. Relationship between outsourcing and core competence will be evaluated as per impact on performance of the organization.

Chapter-2: Behind the outsourcing

2.1 Introduction

Outsourcing is a common practice among both private and public organizations and is a major element of business strategy. Many organizations now outsource some of the functions they used to perform internally previously. Due to widespread outsourcing practices, it has then become an important topic in the literature. Numerous reasons why outsourcing is initiated have been identified by researchers. Organizations may expect to achieve many different benefits through successful outsourcing, although there are significant risks of unsuccessful outsourcing. In this chapter, the benefits, risks and motives of outsourcing will be discussed.

2.2 Definition of Outsourcing

There are many definitions of outsourcing viewed from different perspective. Outsourcing Institute define outsourcing as ‘The strategic use of outside resources to perform activities traditionally handled by internal staff’[1]. Hence outsourcing is not a synonym of procurement. Lonsdale and Cox define outsourcing as the process of transferring an existing business activity, including the relevant assets, to a third party[2].

Outsourcing also may be defined as the retention of responsibility for the delivery of services by an organization but devolution of the day to day performance of those services to an external organization, under a contract with agreed standards, cost and conditions[3].

Generally speaking, outsourcing is an abbreviation for “outside resource using”[4], “the significant contribution by external vendors in the physical and/or human resources associated with the entire or specific components of the IT infrastructure in the user organization”[5], “the transfer of the production of goods or services that had been performed internally to an external party”[6], “Products supplied to the multinational firm by independent suppliers from around the world and the extent of components and finished products supplied to the firm by independent

suppliers” [7], “The reliance on external sources for manufacturing components and other value adding activities” [8]

Hence, from above discussion we may say that outsourcing is a strategic system of achieving competitive advantage by using external resources in the form of transferring functions to an organization where it excels.

2.3 Outsourcing Features

Sometime outsourcing is confusing with subcontracting and service contract. A number of factors distinguish outsourcing from service contract and subcontracting[3].

- Duration of contract is long-term for outsourcing.
- Suppliers are autonomous to perform their task but scenario is different for other cases.
- Responsibilities is transferred to external organization in outsourcing
- Transfer of employee is possible for outsourcing. In this regards United Kingdom has circulated new regulation, TUPE(Transfer of Undertakings and Protection of Employment)
- Very close long-term relationship with supplier for outsourcing but typical relationship in other cases.

Special features have come out in many researcher’s works such as

- ✓ A close link between outsourcing process and the key success factors of a firm in an Industry.
- ✓ A long-term commitment between the client and the service provider. Previous research, based on more than one hundred major contracts, shows an average contract duration of 6-7 years.
- ✓ The transfer of ownership of a business function previously intenalised, often including a transfer of personnel and physical assets to service provider.

2.4 Outsourcing Advantages

Is it fashion, is it a trend or is it a hard-headed decision that attracts an organization to outsourcing ? Most western companies outsource primarily for short-term cost savings. In literature many potential benefits of outsourcing have been identified. Different researchers emphasize motives in different way. However, within the literature, there seems to be a wide acceptance of the most common motives for outsourcing. The review of literature reveals that many motives for outsourcing are overlapped. Moreover, each research is done from very different perspectives that can vary from pure operational to strategic.

Lonsdale & Cox categorize five main reasons why companies outsource i.e.; focus resources on core activities, cost reduction, convert fixed costs to variable, benefit from supplier's investment and innovation and improve time to market. [2]

Main reasons and benefits that drive in-sourcing to outsourcing is listed below

1. To improve company focus.
2. To access world class capabilities.
3. To accelerate reengineering benefits.
4. To share and minimize risks.
5. To free resources for other purposes.
6. To infuse cash into the organization.
7. To make capital funds available.
8. To reduce and control operating costs.
9. To provide resources not available internally.
10. To manage or control difficult or out of control functions.
11. To provide the organization's buyer (s) with greater flexibility.
12. To decrease the organization's product-design cycle time.
13. To improve efficiency and to establish competitive advantages.
14. To gain access to technology that would be too expensive to duplicate internally.
15. To improve employee morale by outsourcing mundane, non critical tasks leaving more critical duties to the remaining in house labor force.

16. To improve turnaround times and correcting poor financial performances.
17. To increase control and effectiveness, enhance operations, and improve customer service.
18. To improve continuously the organization's state of market expertise, including best business practices.
19. To acquire complete solutions and better network performance.
20. To avoid large capital expenses.
21. To free management's time.
22. To make capital funds available.
23. To free non-capital resources for use elsewhere.
24. To replace outdated systems.
25. To improve service levels.
26. To centralize and increase on time delivery.
27. To eliminate inventory.

Does outsourcing really bring benefits to organization? Let us have a look into some well-known organization practicing outsourcing.

2.4.1 Case#1: Rank Xerox

Rank Xerox develops and manufactures document processing products. In 1994 the company outsourced its facilities management (e.g. security, catering, cleaning and gardening) to CBX Ltd. Rank Xerox and CBX made a large five years agreement and facilities management staff transferred to CBX Ltd. Outsourcing was a part of the large restructuring program, which aim was to simplify company's processes. Rank Xerox and its new supplier set a common goal to reduce costs and improve quality. To help achieve this goal, they created in the contract an incentive for CBX to reduce costs. In addition, cost savings were passed to Rank Xerox. To improve quality, Rank Xerox consulted its end users on a regular basis.

Outsourcing strategy turned out to be a success. Rank Xerox gained cost savings from 5 % to 62 % depending on the activity. CBX could generate cost saving because of economies of scale. According to Rank Xerox, they would never been able to achieve such cost savings without outsourcing. Outsourcing arrangement also freed managers to focus on their core business. In

addition, quality improved and parties had a mutual trust. In summary, the outsourcing was a huge success at all aspects. But, the success did not come by itself. Instead, both parties worked hard with commitment and they had a common goal to reach for[9].

2.4.2 Case#2: Nike

Nike started as a small company that imported Japanese shoes to athletes. By the end of its first decade in 1972 sales has reached just \$2 million. Even though the growth was relatively slow of those early years, the founders continued to experiment with new prototypes and performance designs. By the end of the first decade Nike had already developed the core competencies in brand building and design, which was the basis for its forthcoming rapid growth.

Nike decided to focus primarily on its core competencies and outsourced most of its production and much of its sales, distribution and advertising. Nike created maximum value by concentrating on the production of what was unique to them, such as research and development. This strategy led to huge, \$700 million, growth of sales by the end of its second decade. What is worth noting is the fact that Nike successfully applied this focus strategy before its potential was generally recognized [10].

2.4.3 Case#3: Apple

When Apple Computer developed Apple 2, it decided to outsource 70 percent of its components and manufacturing. Apple knew that it could not be the best at making everything themselves, for example chips, boxes, monitors and keyboards. It decided to focus on its own operating system and supporting software and outsourced critical items, where it had no unique skills, like design, printers and marketing.

Outsourcing enabled Apple to benefit from its suppliers' R&D and technical expertise, to avoid unnecessary investments and also to keep itself flexible to adopt new technologies as they became available. In addition its leverage of invested capital improved dramatically. [10]

From the above three cases it is clear that outsourcing helps manager to manage it easily. Also outsourcing add value to the organization.

2.5 Outsourcing: Risk

Though outsourcing is beneficiary for organization but risks are related to it. In an ideal world, markets would operate effectively without any friction or transaction costs.

Different authors emphasize risks in different ways, but there seems to be a broad acceptance of the most important risks. A vast majority of the authors agree that the most relevant risks of outsourcing are: loss of critical knowledge and competence and the risk of dependency.

So the risks of outsourcing are listed below:

1. Loss of core activities and critical knowledge
2. Loss of strategic flexibility and innovativeness
3. Reduction in in-house technique and expertise
4. Lack of supplier responsiveness
5. Loss of control over decisions
6. Interruptions to supply
7. Poor quality of supply
8. A fall in employee morale
9. A loss of internal coherence
10. Confidentiality leaks and loss of intellectual property rights
11. Unexpected costs
12. Reputation risks and customer satisfaction

Many well-known organizations are practicing outsourcing as a strategic tool to avail competitive advantage. With some benefits, organizations are facing challenges and risks of outsourcing.

2.5.1 Case#1: IBM

IBM is a famous example of outsourcing. When IBM launched its first PC in 1981, the company decided to outsource the production of all the major components. It purchased microprocessors from Intel and operating systems from Microsoft. At the time both Microsoft and Intel were small suppliers. The main reason to outsource was IBM's willingness to beat its main rival Apple in time to market. At first IBM's strategy was a success. By 1985, its market share had grown to 41 %. However, soon IBM was in the face of difficulties and its outsourcing decision set the destiny of the entire industry. IBM had developed PC architecture, but it could not prevent its suppliers to create IBM compatible PC component markets. At first, its competitors had difficulties to achieve compatibility, but eventually compatibility was widespread. Other PC manufacturers could buy microprocessors from Intel and operating system from Microsoft. Consequently, a competitive PC markets had evolved. By 1995 IBM's market share half fallen to just 7,3 %. In summary, IBM gave a possibility for Microsoft and Intel to grow the one of the largest and most successful companies in the world. [11]

2.5.2 Case#2: Schwinn

Case of bicycle manufacturer Schwinn is well known example of outsourcing risks. In 1981 Schwinn decided to outsource its manufacture of bicycle frames to Taiwan supplier Giant. After six years, Giant was able to introduce first mass-produced carbon fiber bicycle frame. In 2001, Giant developed new resonance free suspension system. Nowadays Giant sells successfully products under its own brand. Giant absorbed critical knowhow and advantaged technology from Schwinn. In summary, Schwinn outsourced activities just to see Giant emerge as one of its toughest competitors.[12]

2.5.3 Case#3: GE

Case of GE illustrates how supplier can obtain critical learning opportunities. Its decision to outsource turned out to be fatal. In the early 1980's GE outsourced the production of some of its microwave oven models to Samsung. At the time Samsung was small and unknown company.

However, GE became soon deeply dependent on Samsung. Samsung was able to scale up its production and engineering to levels that would not otherwise been possible. As a result, Samsung became one of the largest consumer appliance manufacturers. [10]

2.5.4 Case#4: Mattel

Mattel is the world's largest manufacturer of toys. Outsourcing was a central tool in its value chain management. The company has outsourced production to China. However, in 2007, the company was in the face of a major quality problem. Its Chinese suppliers failed to meet its quality expectations. Products which Chinese suppliers had produced contained too high levels of lead. As a result, Mattel had to recall over 4 million toys that were manufactured in China. Yet, this was not even the worst part. In addition to those 4 million toys, Mattel had to recall 20 million toys just in the span of two weeks. Probably, the costs from this scandal outweighed plainly the cost savings the company had gained from outsourcing. This all happened, even though, the company had in place an appropriate audition and inspection systems. The lesson to be learned from this case is that risks of poor quality are never fully under control if production is carried out by suppliers. [13]

2.5.5 Case#5: Thornton Equipment

Thornton equipment is a large specialty equipment manufacturer. In 1980's it was facing pressures to cut costs in order to increase its margins. The company decided to make an easy solution: lower its overhead cost structure. As a result, the company outsourced a part of its production. Anticipated cost saving were around \$3 million. However, a reality turned out to be far from that[14].

Six months after outsourcing, it was realized that overheads were not decreasing as was expected, but actually rising. There were several reasons for that situation. First, most of the outsourced components went through the same processes as the components that remained in-house and with fewer staff maintenance and work scheduling began to suffer. Some laid off

workers had to be re-hired. Second, because of outsourcing, manager paid less attention to improving core process technologies. They postponed some important technological updates. Moreover, management of outsourced activities incorporated new logistical activities, such as billing and shipment. Supplier network required more personnel. The company also suffered from excess capacity, which had negative impact on overhead costs. As a result, the company's production processes fragmented, productivity decreased and overhead costs were higher than before outsourcing. The lesson to be learned from this case is that, if outsourcing is used as a quick fix tool to cut costs, the outcome may be something totally different than was expected.[14]

2.5.6 Case#6: Thomas Medical Systems (disguised name)

Thomas Medical System is a supplier of diagnostic imaging systems. Apollo B was their newest product series. In development of Apollo B, the company relied more on outsourcing. Their strategy was to purchase complete modules, instead of assembling those themselves from components. Outsourced assembly was expected to be more cost effective and another objective was to turn fixed costs into variable. However, outsourcing did not provide anticipated cost savings. Neither Thomas Medical System, nor the suppliers fully understood the changes they should have made in their processes to successfully cope with the new division of work. For example, their CAD/CAM systems were incompatible and they had different approaches to engineering. In addition, the buyer had overestimated the supplier's performance in some areas. Difficulties were mostly due to the lack of a clear outsourcing policy. Another reason was the fact that they simultaneously developed a new product and a new way of working. That proved to be a mistake. The simple matter of fact is that Thomas Medical Systems did not take into account all aspects of outsourcing process.[15]

2.6 Nature of Outsourcing

The journey of outsourcing began with physical components only but now it has radically shifted to both physical and intellectual component. Many western companies outsourced their call

centre to Asia. According to study conducted by Outsourcing Institute in 1997, outsourcing is focused on things like information technology (30%), human resources (16%), marketing and sales (14%), finance (11%) and administration (9%). [16]

Chapter-3: Organizational Competence

3.1 Introduction

Competencies refer to skills or knowledge that lead to superior performance. These are formed through an individual/organization's knowledge, skills and abilities and provide a framework for distinguishing between poor performances through to exceptional performance. Competencies can apply at organizational, individual, team, occupational and functional levels. Competencies are individual abilities or characteristics that are key to effectiveness in work. In this chapter organizational competence, core competence will be discussed.

3.2 Definition and Classification of OC

Competencies refer to skills or knowledge that lead to superior performance. These are formed through an individual/organization's knowledge, skills and abilities and provide a framework for distinguishing between poor performances through to exceptional performance. Competencies can apply at organizational, individual, team, and occupational and functional levels. Competencies are individual abilities or characteristics that are key to effectiveness in work.

Competence are the activities or processes through which the organization deploys its resources[17]. The core competence of a firm is a bundle of skills and technologies that represents the sum of learning across individual skill sets and individual organizational units. A core competence provides a competitive advantage through being competitively unique and making a contribution to customer value or cost.

The term competence is often used as it is used in our daily speech; to code a broad range of our experiences related to craftsmanship, specialization, intelligence, and problem solving. As such, competence remains an experience-near concept which needs further conceptual clarification if it is to serve the purpose of theory building.

Wikipedia define core competence as the result of a specific unique set of skills or production techniques that deliver value to the customer. Such competences empower an organization to access a wide variety of markets.

There are basic two type of organizational competence: Threshold Competence and Core Competence. Threshold competencies are those basic capabilities necessary to support a particular strategy that enable the organization to compete in a given market and Core competencies are distinctive value-creating skills, capabilities and resources which add value in the eyes of customer; are scarce and difficult for competitors to imitate; and are flexible for future needs. Other competencies are behavioral competencies, differentiating competencies, professional competencies or functional competencies.

Competencies are not "fixed"—they can usually be developed with effort and support (though some are harder to develop than others). Employees and their managers together can identify which competencies would be most helpful to work on to improve the employee's effectiveness. They can then integrate those into a learning plan that may include on-the-job experience, classroom training, or other developmental activities.

Organizational competencies also include extensive understandings of various underlying technologies (both general and specific) supporting products and services. Therefore, rather than being directly a component of the organizational competence, technologies are objects of a set of understandings included in a competence. Similarly, individual products and services are not encompassed directly within the competence. Instead, understandings of the capability underlying a type of product or service are included. Familiarity with these capabilities usually arises from understandings of various technologies[18]

Organizational competencies for telephone company are categorized in following table:

Competence Component Categories		Competence One	Competence Two	Competence Three
Understandings	1) Core Phenomenon	Communication Network	Document	Silicon Design integrated circuits Manufacture integrated circuits
	2) General Technologies	Communication Electrical Systems Network Light	Text Paper Color Electricity	Electrical systems Materials
	3) Product/Service Technologies	Switching Multiplexing Routing Transmitting	Imaging Marking	Controlling data Storing data
	4) Product/Service Sub-technologies	Optical Networking Optical Switching Optical Transmission	Color Digital Imaging Color Copying Digital Printing	Personal computing Digital entertainment
	5) Product/Service Classes	Optical switches Optical Transmitters	Color copiers Digital printers	Micro-processors Routers
Skills	6) Functional and Technological Skills	Manufacturing optical switches Engineering optical transmitters Optical switching	Installing color copiers Repairing digital printers Color Imaging	Designing microprocessors Manufacturing routers Micro-processing

		Optical transmitting	Digital marking	Data routing
	7) Integrated Skills	Creation and management of communication networks	Provision of document management equipment, software, and services	Provision, including creation, of computers and their components.

Table-3.1 [18]

3.3 Core Competencies

A core competency is a concept in management theory originally advocated by CK Prahalad and Gary Hamel [19]. The concept of core competencies evolved from the resource-based view of the firm which emphasized the fact that competitive advantage rests on the firm's possession of unique quality difficult to imitate e.g. skills, knowledge, resources and competencies[19]. These causally ambiguous inimitable capabilities serve to provide sustainable competitive advantage to the firm. This view emerged as a counterpoint to market structure analysis of competitive strategy.

Three criteria that distinguish a core competence from competence are as follows [19]

1. A core competence must contribute significantly to customer benefit from a product
2. A core competence should be competitively unique, and as such, must be difficult for competitor to imitate.
3. A core competence should provide potential access to a wide variety of markets.

A firm's core competencies are thus defined as a set of problem defining and problem-solving insights that foster the development of idiosyncratic strategic growth alternatives.

Core competencies when viewed as unique knowledge for problem definition and problem

solving can form the basis of a firm's competitive advantage and can also be leveraged in a wide variety of markets for future products. The concept of core competencies is distinct from the traditional strategic thinking of competing for market share and also from Porter's low cost-differentiation Strategy. The competition in the product/market arena is essentially for market share.

A core competence is not product or service specific. Core competencies contribute to the development of a range of products and services which is why understanding and exploiting them is important for successful growth. Examples:

- Sony- customer benefit is pocket ability and core competence is miniaturization.
- Federal Express- benefit is on time parcel delivery and core competence is logistics management.
- Rosecrans- benefit is freedom from addictive behavior and core competence is adult and adolescent education.
- Carpenters Place- benefit is a changed lifestyle and the core competency is customized client case management.

These core competencies are not product or service specific. They enable these organizations develop a number of products and services which explains why they are important in developing their competitive strategy. Organizational competencies must pass three tests to be considered core competencies.

1. The competency must make a significant contribution to customer perceived value or to the financial health of the organization.
2. The competency must be unique or performed in a way that is substantially superior to its peers.
3. The competency must be capable of being applied to a range of new products and services.

Core competencies are determined by a business's tangible and intangible resources and its capabilities. But core competencies often have their roots in areas that are very hard to quantify. Qualities such as personality traits, background, and market pressure can influence an individual

or business into developing the resources or capabilities needed to maintain a core competency. When considering a business's resources, certain things probably spring to mind, namely those items that are easily listed on a balance sheet: facilities, equipment, vehicles. These tangible resources are certainly very important aspects of creating core competencies. For example, the old adage in retail is that the three most important factors are location, location, location.

The principle is certainly applicable in any business- are you accessible to your key clients? But intangible resources are often more important. For example, do you have an excellent reputation and network of contacts within your area of expertise? Are the employees within your business competent professionals with excellent communication skills? Those items are hard to put a dollar value on. They are, however, virtually priceless and key to the development of core competencies.

From the above discussion competency are evident that has four distinctive criteria as follow:

Valuable: The first criterion that a resource or capability must meet before it can be considered a core competency is value. Simply put, customers and clients must need that service/skill/product and they must be willing to pay for it or else, the business will see no benefit from providing it.

Rare: A rare resource or capability is, of course, one that is possessed by few, if any, current or potential competitors. If something is valuable to a customer, it is only a core competency if it is not readily available from other businesses in your area.

Costly to Imitate: Once you have discovered aspects of your business that are both valuable to customers and rare among competitors, the next step is to ask yourself how difficult it would be to imitate. Note that it doesn't have to be impossible to imitate, it just has to be expensive for your competitors to do so. The price tag has to be high enough for those competitors to concede to you that aspect of the market.

Organized to be Exploited: But none of those other three elements really matter unless a business is organized and able to exploit those resources and capabilities into core competencies.

Chapter-4: Outsourcing and Core Competence

4.1 Introduction

Outsourcing is a common practice among the organizations and is a major element in business strategy. The primary question is to choose appropriate activities for outsourcing which leads to a make-or-buy strategy. Make-or-buy decisions are normally considered as strategic decisions. However, there are many factors influencing the make-or-buy decisions such as quality, delivery performance, cost, flexibility and innovation. A good decision on buy or make could be made through investigating the available resources. Many researchers analyzed make-or-buy decision-making based on resource viewpoint where the decision is made by focusing on the firm's resources. In this chapter, I will discuss about the influence of core competence thinking on outsourcing decision.

4.2 Factors that Influence Make or Buy Decision

Welch and Nayak introduced three factors namely “maturity level of process technology”, “competitors' process technology position”, and “importance of process technology” as basis for a decision matrix called “strategic sourcing model”[20].

Outsourcing has close relationship with core competency. Many researcher proposed core competency as the make or buy decision making tools or factors.

Williamson argues that make or buy decision depends on comparison of transaction cost of every approach. The determinant of transaction cost is asset specificity. An asset is "specific" if it makes a necessary contribution to the production of a good and it has much lower value in alternative uses. There are various kinds of specificity including physical asset specificity, location specificity, human asset specificity, dedicated assets. [17]

Ray Carter have examined the contractor competence and organization's competence to outsource what is core to contractor but noncore to organization.[17]

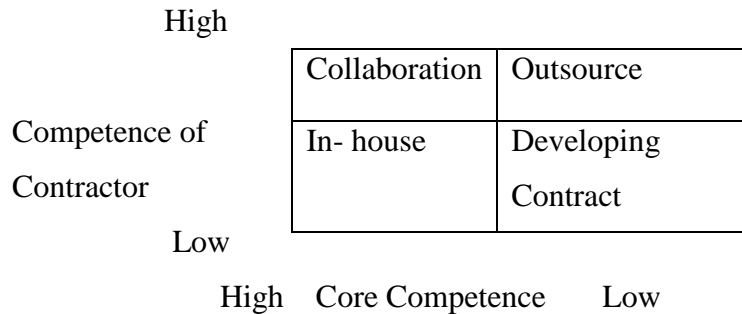


Fig-4.1: Outsourcing and Core competence

Cox argues relational competence analysis as the make or buy decision where asset specificity and competency.[17]

- Core Competence reflect high asset specificity. The firm want to maintain a hierarchical control over the process. So the prefer in-house rather than outsource.
- Complementary competency reflect medium asset specificity. The want to outsource to take the advantage of potential efficiency and synergy but don't want to lose the control over the process.
- Residual competence reflect low asset specificity and firm take the advantage.

4.3 Outsourcing decision making framework

Every decision-making process is triggered by some stimulus, which may be the output of some preceding process. The process is terminated by a definite output (response). It is this output that is used to identify/designate the decision making process. The process receives information input that can be subjective (e.g., opinion of other persons) or objective.

M. Cheshmberah et al propose four dimensional framework of outsourcing. [21] The framework is as follows-

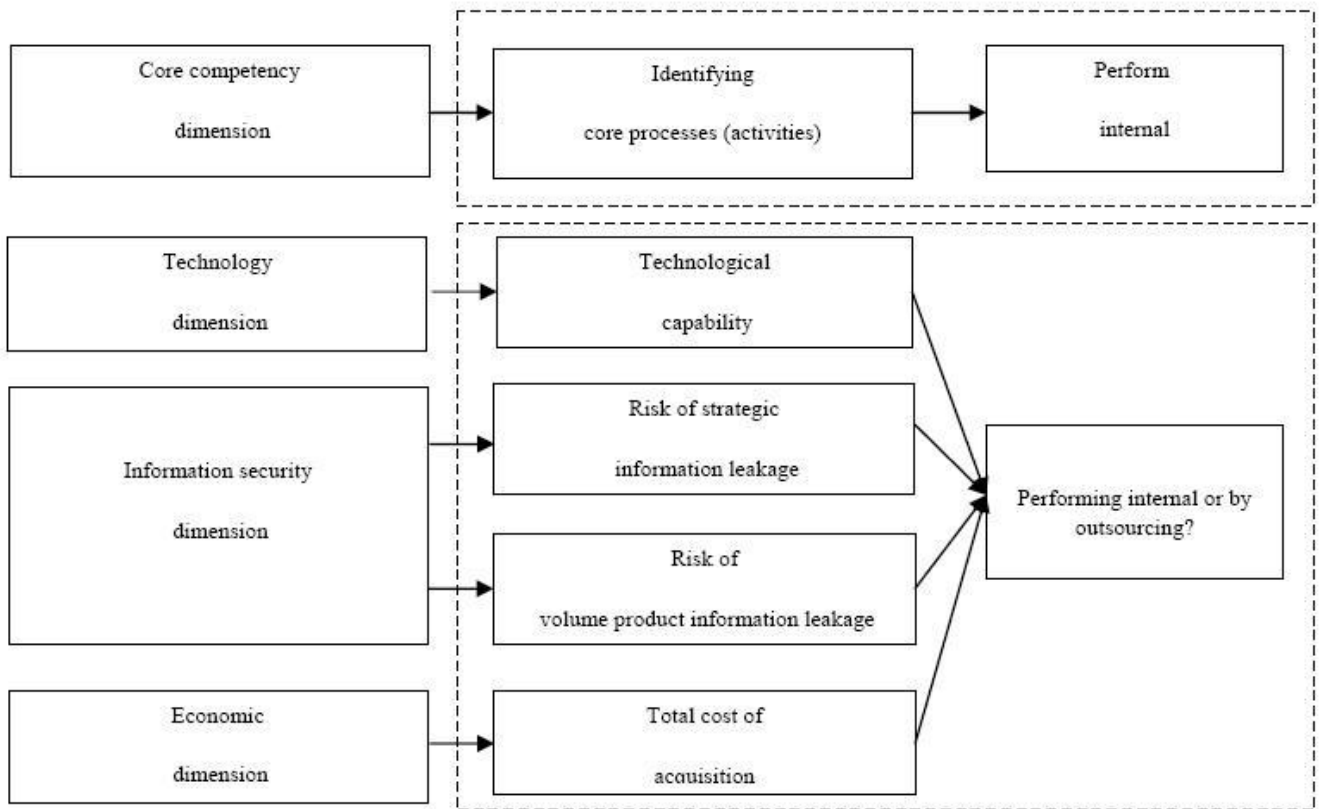


Fig- 4.2- Outsourcing decision making framework

Platts et al described a structured methodology for addressing the make- vs.-buy questions and reported on its application within a manufacturing company. The make-or-buy process is composed by three phases. In the first phase (preparation), the project team is selected and briefed and the component family or process to be considered is identified and specified. The second phase (data collection) is the major phase of the process and requires the specification, the gathering, and the weighting of the factors influencing the performance of in house and external supply against each of these. Finally, during the third phase (analysis and results), the results of the weightings and ratings are combined to give a single figure which

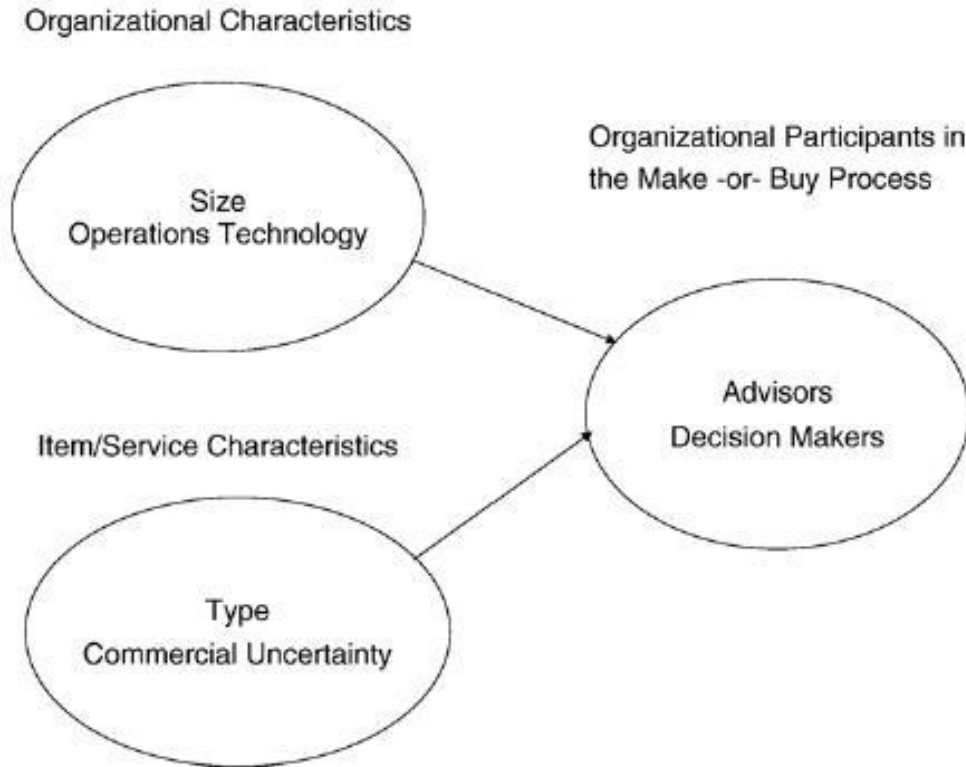


Fig-4.3: Conceptual model.

provides an indication of the relative merits of making or buying when a wide range of factors are taken into account[22].

Mark Sena et al propose another framework for outsourcing IT. They suggest a framework depicted in Figure 4 as a basis for examining the perspectives of executives and IT professionals on IT strategic issues, IT investment and resource management as affects for make-or-buy decisions. The focus of this particular study is on the Make-Buy quadrant and its relationship with the other metrics in the framework[23].

Figure 4 represents a model for investigating the current state of organizational computing, particularly as it relates to issues of strategic importance.

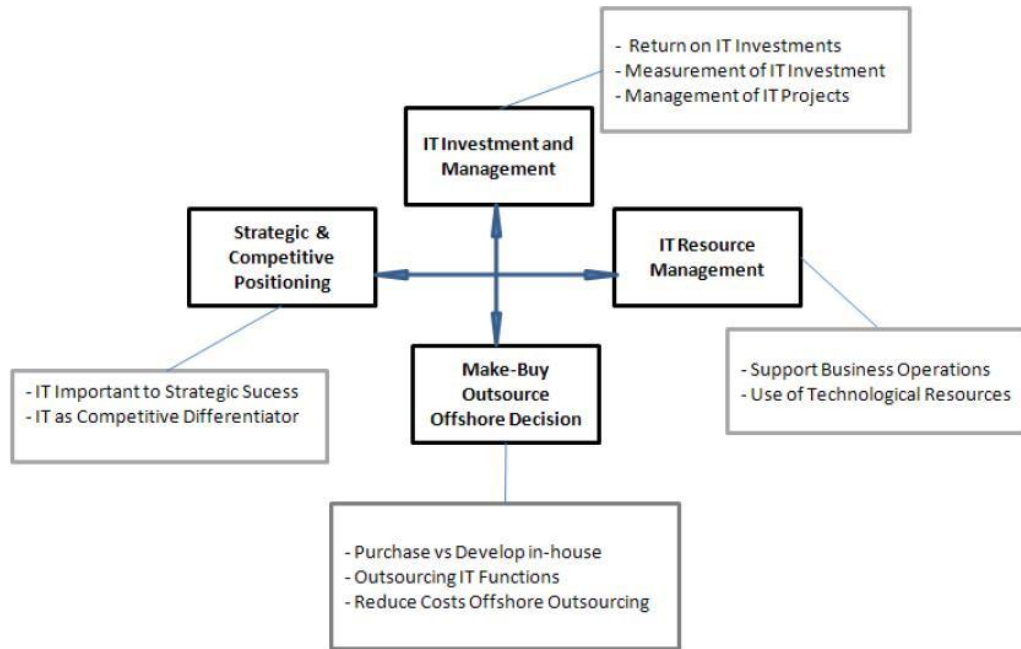


Fig-4.4: Make-Buy Outsourcing Framework

Probert has attempted to rectify the situation by proposing a four-stage process to the make or buy strategic decision[24]. The various stages in his methodology are:

- Initial business appraisal collection of company, competitors and supplier data as well as evaluation of strategic issues which face firm.
- Internal/external analysis identifying major parts families, manufacturing processes, cost allocations and alignment of parts and technologies on the competitiveness/importance matrix.
- Evaluation of strategic options assessment of the various sourcing options which are identified in Stage 2 in conjunction with the business data obtained.
- Choose optimal strategy applying financial decision support models to evaluate the various sourcing strategies and to identify the most appropriate fit with the organisation's current and future operations.

Probert applied the strategic make or buy methodology to six engineering manufacturing businesses and they reported positively in terms of its usefulness with projected business results of 20-40 per cent improvements in return on capital employed and 30-60 per cent stock/lead-time reductions.

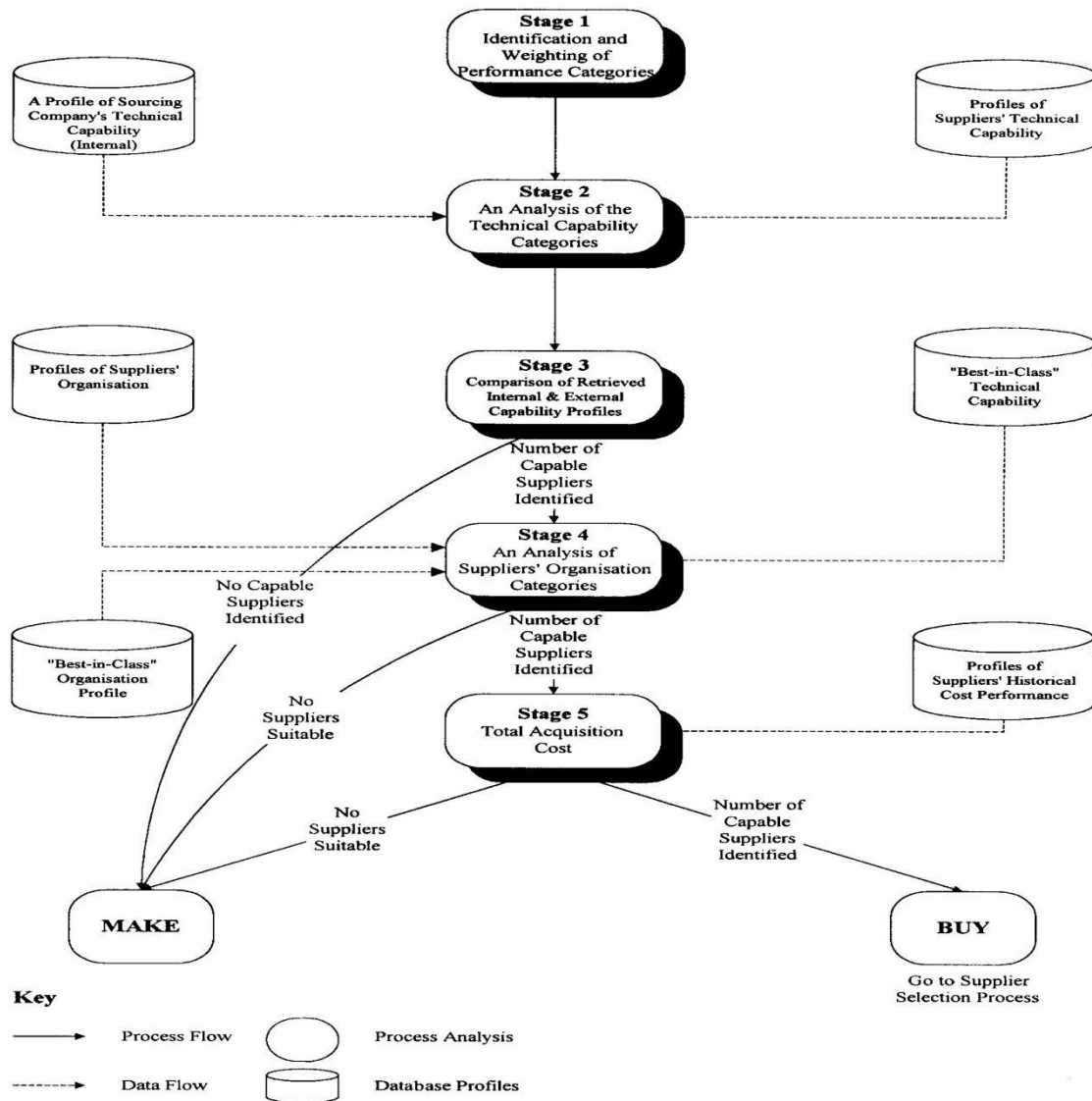


Fig-4.5: Make or Buy Model

Thomas et al propose a new framework for outsourcing decision [25].

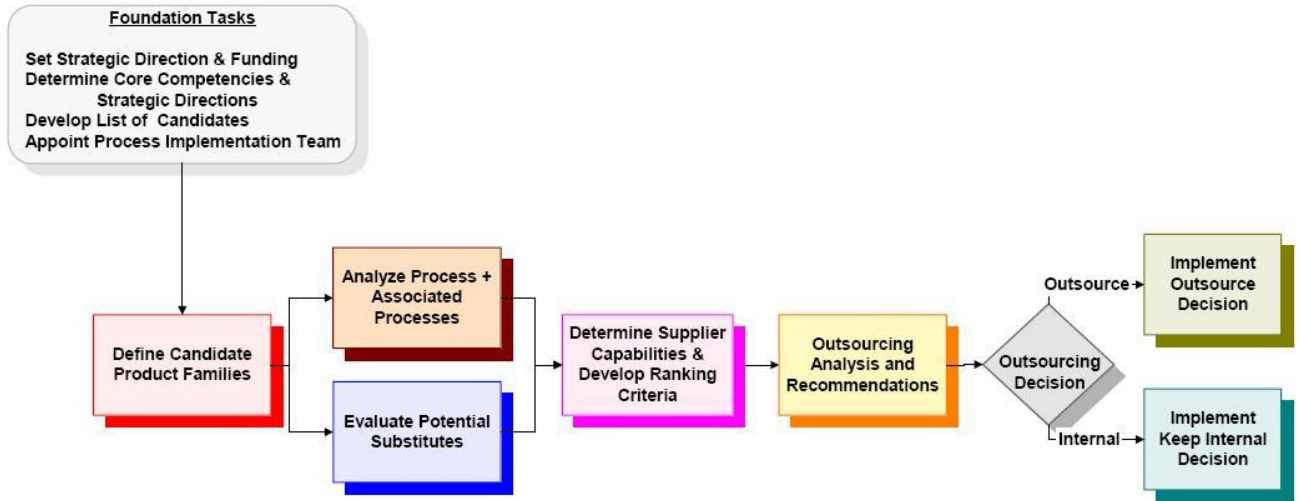


Fig-4.6: Outsourcing Decision Framework

Kremic and Tuckel propose a three stage outsourcing decision framework[26]

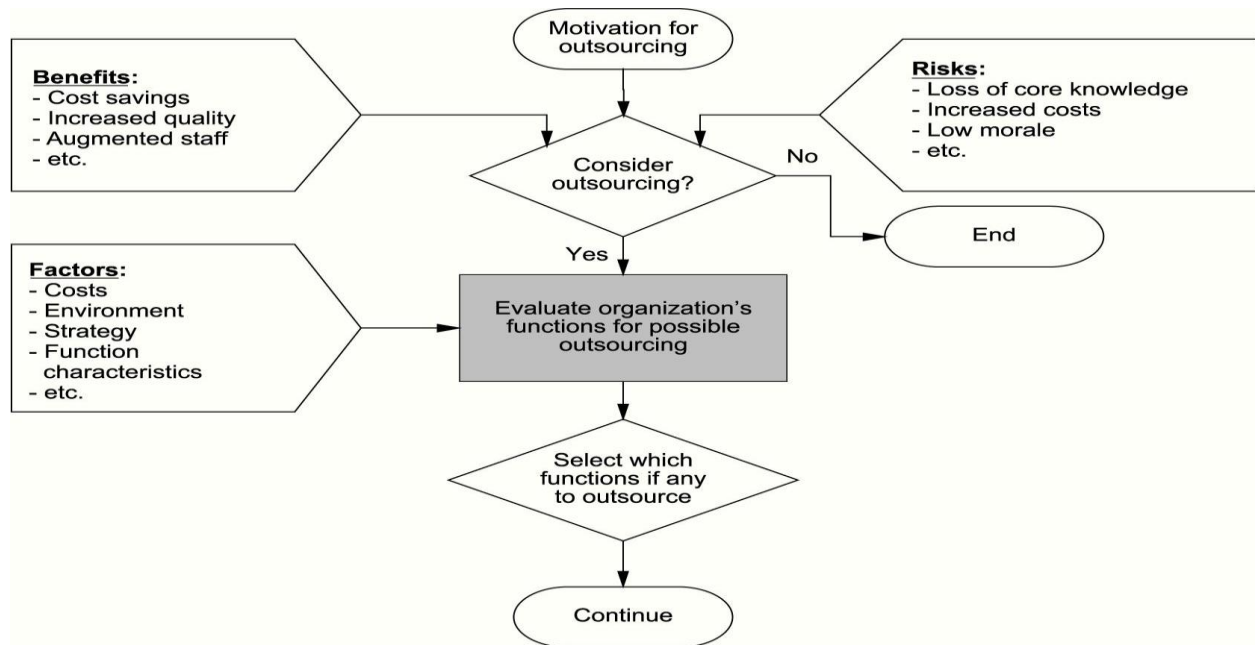


Fig-4.7: Outsourcing Decision Framework

An outsourcing framework is provided by McIvor[27]. It is a four stage framework, as follows

Stage-1: Define core activities

It is essential to distinguish between non core and core activities(those adding value to the customer and therefore key source of competitive advantages. Companies such as IBM, Apple, Honda build their strategies around their core activities and outsource as much of the remainder as possible.

Stage-2: Evaluate relevant value chain activities

This involves analyzing the competence of the company compared to those of the potential providers comparing the ability to add value and the implication for the TCO. Activities for which the company has neither a strategic need for special capabilities can be outsourced to more competent providers who have a lower cost base.

Stage-3: Total cost analysis

At this stage if after analysis of total costs the company is more capable than the external source then it should retain in-house capability. If a number of capable suppliers exist, then move to the final stage.

Stage-4: Relationship analysis

At this stage companies are attempting to select suppliers who have the ability to initiate to and develop suitable relationships which will add value and provide kaizen.

Lonsdale & Cox illustrate outsourcing as a six step process, which can be seen from figure-8[27]. They divide the process in two main stages: internal assessment and external assessment. This logic is followed in this framework as well. Thus, the decision framework contains two

main parts, internal analysis and external analysis. In addition, third part is an analysis of the type of appropriate relationship between a buyer and a supplier.

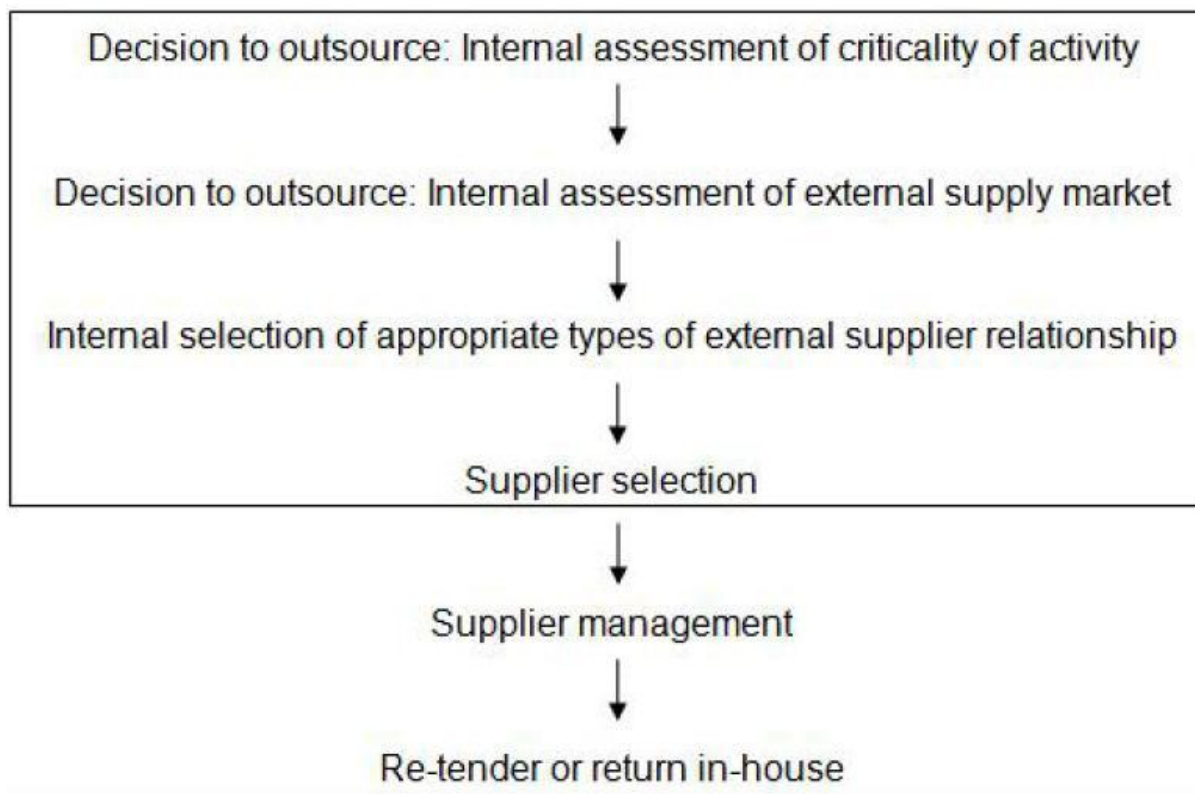


Fig-4.8: Outsourcing Decision Framework

From the above models it is clear that the main determinant of outsourcing is core competence. Every model of resource based view take consider the core competence thinking as the decision making factors. So for outsourcing, a company need assess their core competence and outsource anything else.

4.4 A process for outsourcing Considering Core Competence

Many organizations have rushed into outsourcing and many of them regretted it. Sometimes those who advocate processes which take time and cost money before making a decision are ridiculed as being over-cautious.

Mike Fogg have cited six stage process for outsourcing [3]. A process for outsourcing must include the flowing steps.

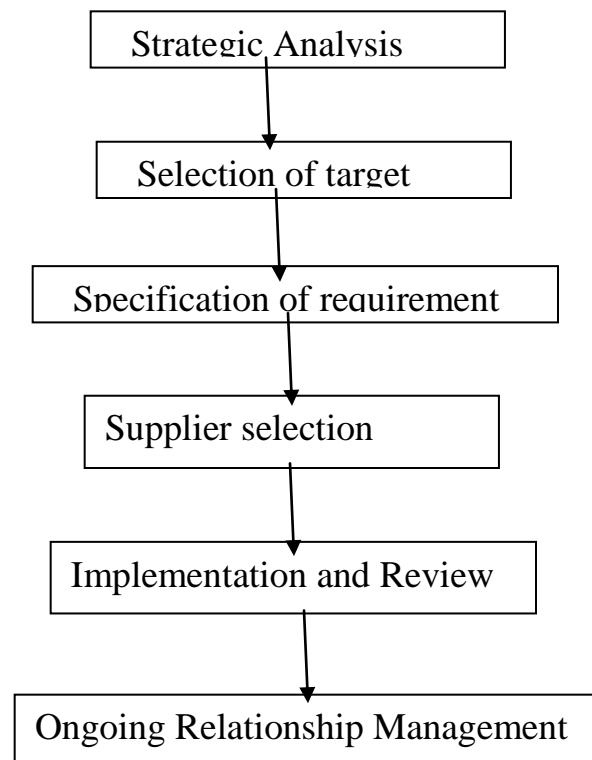


Fig-4.9: Outsourcing Process

4.4.1 Strategic Analysis

The first step of the process identification of core competence. Hamel and Prahalad give three tests to see whether competencies are true core competencies[19]:

1. **Relevance:** Firstly, the competence must give your customer something that strongly influences him or her to choose your product or service. If it does not, then it has no effect on your competitive position and is not a core competence.
2. **Difficulty of Imitation:** Secondly, the core competence should be difficult to imitate. This allows you to provide products that are better than those of your competition. And because you're continually working to improve these skills, means that you can sustain its competitive position.

3. Breadth of Application: Thirdly, it should be something that opens up a good number of potential markets. If it only opens up a few small, niche markets, then success in these markets will not be enough to sustain significant growth.

This gets to the heart of the organization and must involve key stakeholders.

4.4.2 Selection of target areas

Once the core areas are identified and ring-fenced, areas of the business which form a target for outsourcing must be identified. Again this must involve key stakeholders. For each target area this process will involve[3]

- A supply positioning analysis, with particular emphasis on the risk
- An assessment of the extent to which the problems in the target area can be corrected before outsourcing
- Understanding whether a better return on investment can be obtained from retaining in-house or outsourcing
- A clear understanding of the objectives of the outsourcing projects
- A clear plan of the project including stakeholder involvement and sign-off
- A clear statement of how and where this area interfaces with core process
- Considering other options like internal SLAs, JVC
- Considering the financial, tax, and legal implications of all options against the status quo
- Communication to members of the organizations impacted by the process

Developing a business case may be the vehicle which encompasses this information.

4.4.3 Specification of the Requirement

Specification is the statement of needs or what organization actually wants. There should have the reflection of the current scenario. The specification must:[3]

- Be clear and unambiguous
- Include measurable performance criteria of the level of KPI

- Recognize any remaining problems and highlight them
- Describe the relationship sought with the supplier
- Reflect issues like confidentiality and security
- Identify licensing issues and contract assignments necessary as part of the outsourcing contract
- Consider the terms and condition of the contract

4.4.4 Supplier selection

Supplier selection must be rigorous and include a supplier appraisal, a tender process or alternative a negotiation based upon the specification, due diligence concerning the supplier, and result in a business case which demonstrates clear benefits to the purchasing organization before the outsourcing projects goes ahead. Factor which need to be considered are:[3]

1. A supplier preferencing and market management matrix analysis
2. Whether the market will be interested in this requirement
3. Sharing any outstanding problems with the potential supplier
4. Assessing the cultural fit between the two organization
5. Sharing sufficient information with the supplier to enable them to make their best offers
6. A site survey by supplier and discussion with users
7. Selection criteria not based only price but also other factors
8. Appropriate terms and conditions and the means of termination

4.4.5 Implementation and Review

Implementation of the contract may take few months. Communication internally is vital , particularly to people impacted by the change, and joint working parties need to be establish with supplier to discuss:[3]

- Contract management processes, including meetings, reporting and escalation process
- Handover planning

- Changes in working practice
- Changes of procedures
- Status of the projects that will be live across the boundary of the outsourcing
- Linkages with other areas of the business and other suppliers

It is vital that communication channels remain open between the people managing the contract of both organization. At the end of the process it is essential for both organization to review the process.

4.4.6 Ongoing relationship Management

The key to a successful ongoing relationship is the ability to alter them as the true extent and scope of the work required emerges. To enable effective relationship management many firms operate with an alliance board and alliance team structure. Most firms with successful outsourcing relationships are better at managing relationships at three levels.

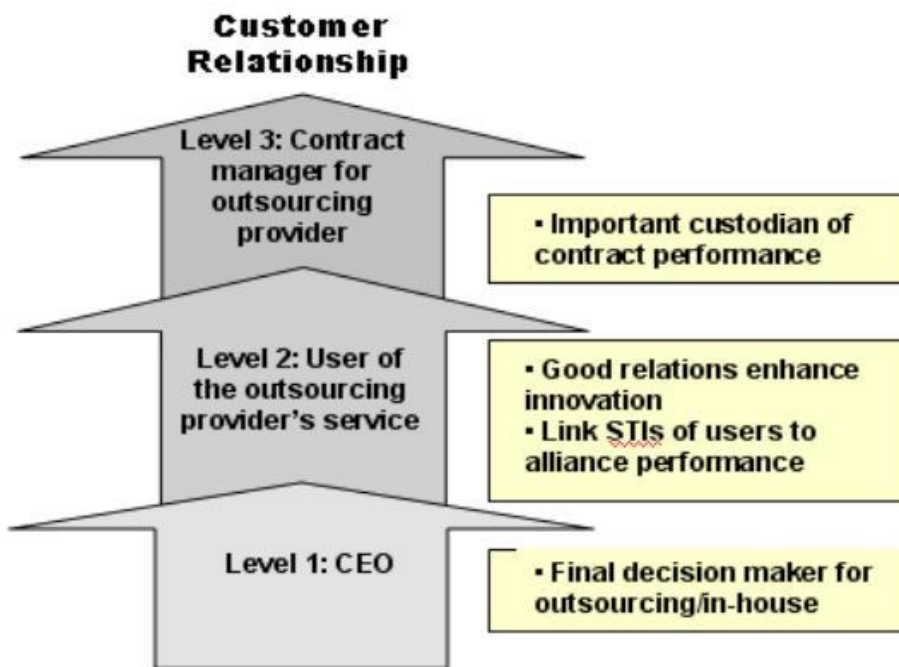


Fig-4.10: Three level relationship

There is a debate over the question whether companies should use adversarial or partnership relationships. However, some guidance is provided by Leavy[28]. He points out that having the right mix of relationships seems to be most successful strategy. However, the question remains what type of relationship should be used for each outsourced activity. Selecting the right relationship is a decision that depends on many factors, like company's competitive positioning, value proposition, flexibility needs, needs of control, supplier capabilities, criticality of activity, asset specificity and number of available suppliers.

If outsourced activity is critical, partnership relationship may be more advisable. On the other hand, for peripherals activities adversarial relationship may be more appropriate . If the main motive for outsourcing is an access to supplier's technology, partnership might be preferable. So the relationship is depend on the context. One relationship style is not feasible for all cases of outsourcing.

Chapter-5: Research

5.1 Introduction

In this research, a well known company working in Bangladesh was studied to understand outsourcing strategy and outcome. The research question is as follows : if the company follow core competency thinking for its outsourcing decision making process and what is the impact of outsourcing on company performance. The hypothesis is that the company outsources its non core competence and gain profit and the company has a strong outsourcing strategy based on core competence. In this chapter, We will test the hypothesis whether it is true or wrong.

5.2 Methodology

In this study of core competence thinking as the basis of outsourcing strategy has been to understand the outsourcing strategy of the company. For this purpose primary and secondary data were required. A questionnaire designed to collect the data and others data were collected from annual report, news paper and also from the company website.

5.3 Dhaka Electric Supply Company Ltd.

Dhaka Electric Supply Co. Ltd. (DESCO) was created as a distribution company in November 1996 under the Companies Act 1994 as a Public Limited Company with an Authorized Capital of Tk. 5.00 billion. However, the operational activities of DESCO at the field level commenced on September 24, 1998 with the taking over of the electric distribution system of Mirpur area (comprising Kallayanpur, Kafrul, Pallabi Sales & Distribution Division) from the erstwhile Dhaka Electric Supply Authority (DESA) with a consumer strength of 71,161 and a load demand of 90 MW. In the subsequent years of successful operation and performance, the operational area of DESCO was expanded through inclusion of Gulshan Circle (comprising Gulshan, Baridhara, Uttara, Dakshinkhan Sales & Distribution Division) in April, 2003 and Tongi Pourashava Area

in March, 2007. Today, the total consumer strength stands at 4,46,129 as of 30th June, 2010 with a maximum load demand of 622 MW.

The area under service of the Company is about 220 square kilometers which comprises the areas bounded by the Mirpur Road, Agargaon Road, Rokeya Sarani, Progati Sarani, New Airport Road, Mymensingh Road, Mohakhali Jheel, Rampura Jheel connected with the Balu River in the South and East and the Turag River in the West and areas under Tongi Pourashava in the North. Recently Purbachal Model Town a Rajuk project, situated on the east side of the Balu River and adjacent to Dakshinkhan area, has also been included under the operational area of DESCO.

5.3.1 DESCO at a Glance

- Certificate of Incorporation in 1996
- Takeover of Mirpur area from erstwhile DESA and commencement of commercial operation in 1998
- Takeover of Gulshan Circle from erstwhile DESA in 2003
- Establishment of Sales & Distribution (S&D) Division in 2004
- Inauguration of Prepaid Metering System in 2005
- Company goes public in 2006 by listed in Dhaka Stock Exchange
- Takeover of Tongi Pourashava Area
- No of sales and distribution division is 9
- No of consumer 446129
- No of employee is 993
- No of 33/11KV sub-station is 22
- Capacity of 33/11 KV sub-station is 770/1078 MVA
- 82.8Km 33KV overhead line
- 208.38 Km 33KV underground line
- 4810 Nos distribution transformer
- Maximum demand is 622MW
- System loss 8.86
- Provide electricity in 220 sq. KM

- Authorized capital 5000MTK
- Paid up capital 1601.7MTK
- No of shares 16,017,044
- Percent of share to capital market is 25%
- Net profit after tax and interest is 1789 MTK
- Earning per share is 111.68

5.3.2 Procurement of DESCO

DESCO uses both GoB and its own funds for procurement. For using GoB fund DESCO needs to strictly follow Public Procurement Rules-2008 and it has own procurement guide lines for their fund. The procurement guide line is approved by the board of directors. DESCO has a well established procurement department under the Director of Procurement, Finance and Accounts. Procurement structure is centralized. All related decision is taken by the procurement department. Despite this, every head of department enjoy some sorts of procurement power within a specific value but they have to take prior permission from the Director of Procurement, Finance and Accounts.

As a public limited company, owned 75% by Government, the main focus of company is to achieve value for money. It has basic options of procurements, like open tendering, limited tendering, quotation method and cash purchasing. Ensuring accountability management suggest open tendering but in case of quotation and cash purchase method accountability and value for money is not justified.

There is some weakness with preparation of specifications. The specification of requirement is prepared by the technical department. Cross functional team for making specification is required. The user is not always included in purchasing process. So sometimes there may raise confusion and the purchased good may not match with requirement of customer.

DESCO's procurement data is given in the table below.

	2008	2009	2010	Ave.	Remark
Annual Procurement Volume (Tk.)	649892996	4380623804	2591026886	2540514562	Exclude purchase of Electricity
Procurement of Goods and Related(Tk.)	370911811	3584094636	2096556826	2017187758	
Procurement of Works and Physical Services(Tk.)	59476948	557901078	193473710	270283912	
Consultancy and Intellectual Service (Tk.)	9809647	5145048	3510016	6154904	
Outsourcing Expenditure(Tk.)	209694590	233483042	297486334	246887989	

Table-5.1: DESCO's overall Procurement data

5.3.3 Outsourcing in DESCO

DESCO started its journey of outsourcing from the very beginning. The area which were outsourced are the major technical activities like scheduled maintenance of the sub-stations and switching stations, trouble shooting & breakdown maintenance, overhead line maintenance, handling of the customer service complaints, line & equipment maintenance. On the other hand, commercial support activities like meter reading, distribution of monthly electricity bill, service disconnection of the defaulter consumers, house wiring inspection, installation of new connection meters, changing of old or unserviceable meters etc. have also been outsourced. Other logistic support services like security service, cleaning service and transport service have also been outsourced.

The contract duration varies from case to case but not less than 2years. There has an option for time extension and value extension up to a certain percentage of contract. But contract renewal is

quiet impossible for the procurement guide line. The supplier need participate further tender and need to win for renewal otherwise it is not possible.

The following figure shows yearly outsourcing expenditure:

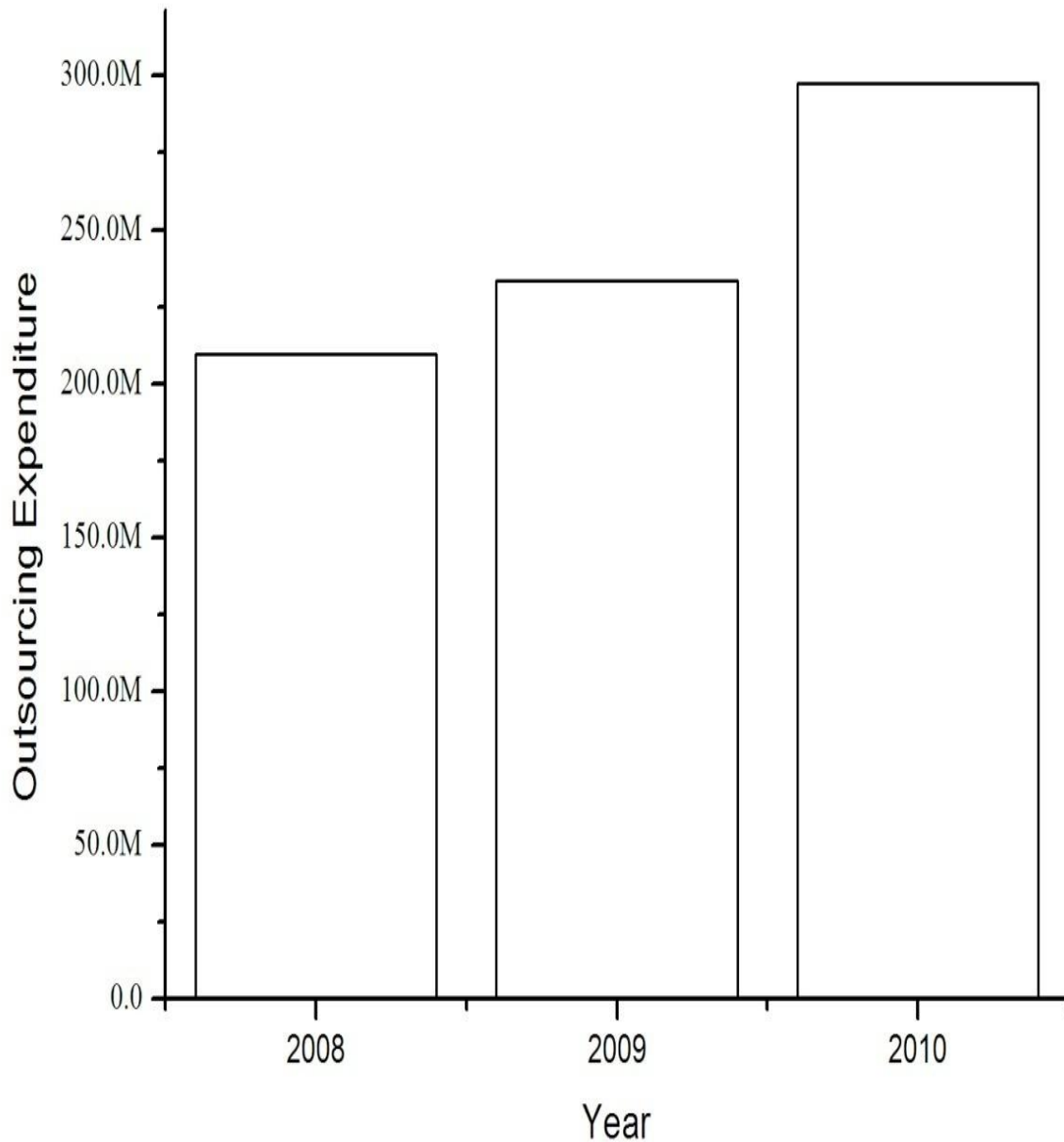


Fig-5.1: Yearly Outsourcing expenditure of DESCO

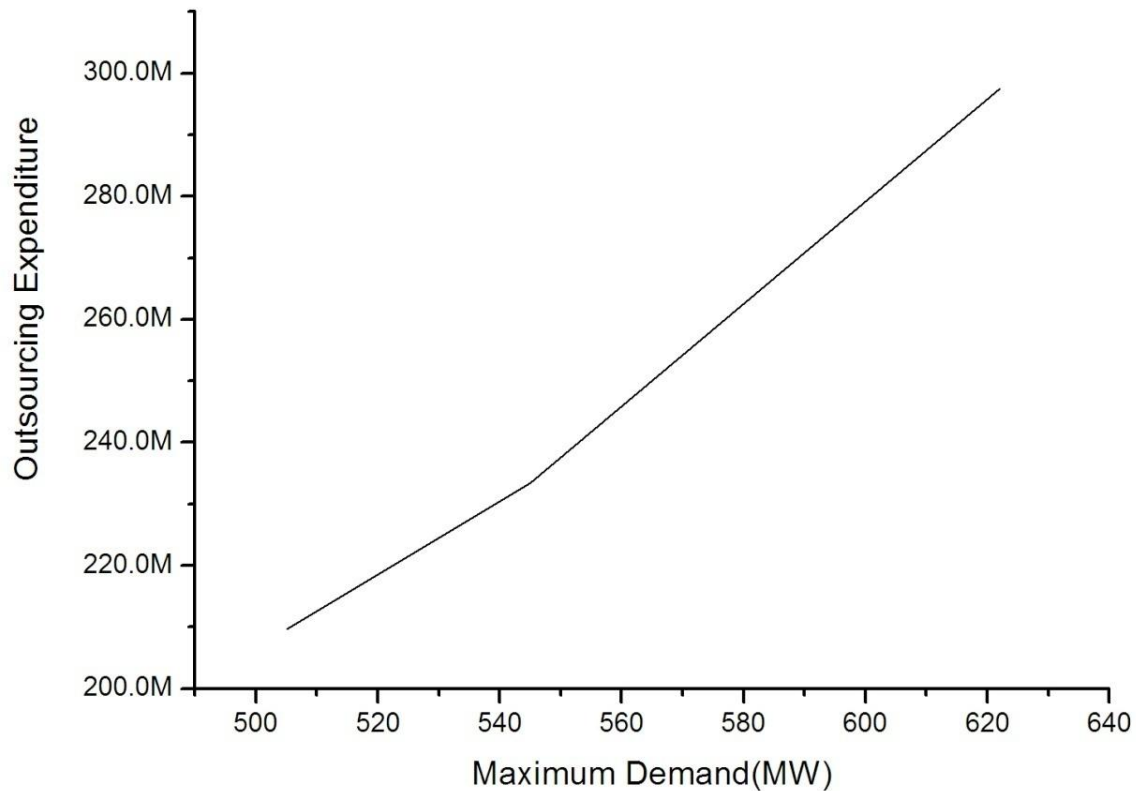


Fig-5.2: Maximum Demand Vs Outsourcing Expenditure

From the above figure it is clear that outsourcing expenditure is increasing with the increase in demand as indicated in figure 5.2.

Now the question is why they start outsourcing. The decision came from the first top management. Top management were experienced and they used their previous knowledge of managing power distribution organization. Another factor motivated them to outsource was lack of man power. As a government owned company there was lengthy process to recruit man power. Hence they purchased the service of line maintenance, sub-station maintenance and so on. Compared the performance with similar organization, top management decided to continue outsourcing.

DESCO outsourced very vast area of activity as has been mentioned above. Now the question is does it comply with the concept of core competence. This needs examination.

DESCO is a power distribution company. It purchase power(Electricity) from Power Grid Company of Bangladesh(PGCB) and sell to retail consumer. Bangladesh power sector structure is as follows

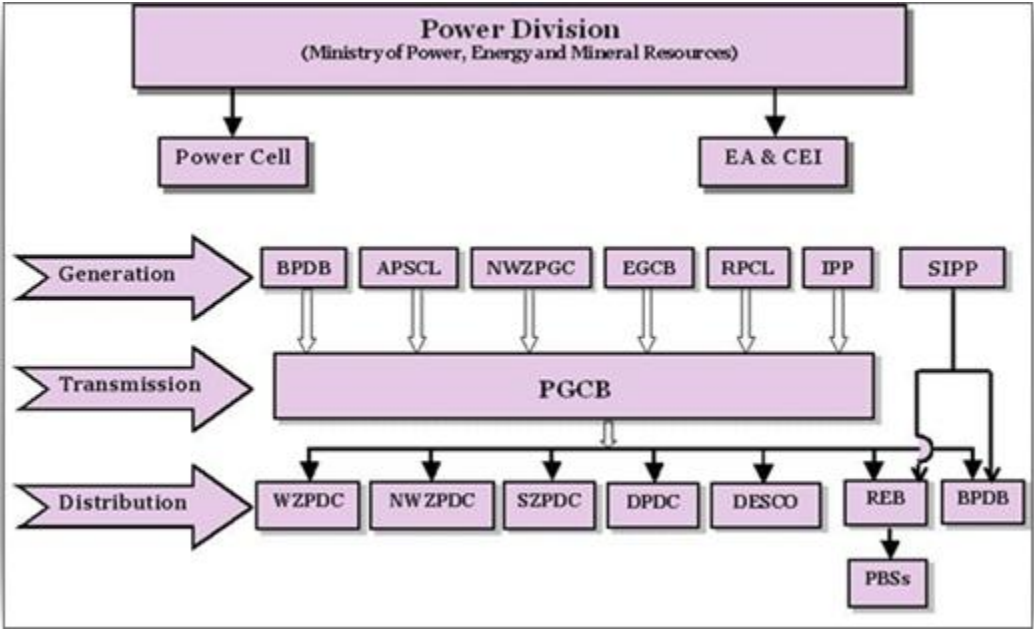


Fig-5.3: Power Sector Structure

As Distribution Company the core competence of DESCO is management. So the other functions may be outsourced.

DESCO has more option to outsource. IT is operated fully in house. Now many organizations practice outsourcing IT where DESCO is practicing in-house. So DESCO may outsource its IT to an external organization for better performance.

5.3.4 Impact of Outsourcing

Outsourcing has a very good impact on company performance. Performance measurement is not so easy. The performance indicator for Distribution Company is system loss, collection ratio and profitability.

System loss: System loss is the difference between power imported and sold. It is calculated in percentage. System loss = $\frac{\text{import} - \text{sale}}{\text{import}} \times 100\%$. Year wise system loss data are given in the table below.

Year	System loss (%)
2008	10.91
2009	9.79
2010	8.86

Table-5.2: Year wise System loss

There are many causes of system loss. Some causes are like- illegal connection, use of damage meter, meter tampering and technical losses. Technical losses for a well and healthy system is not more than 4%. So the system loss may reduce up to 4%.

In DESCO disconnection of illegal line, meter reading, and bill collection are outsourced. So the organization need to reduce work load of meter reader for care full reading and also need to check the meter periodically. This element will increase extra cost of outsourcing.

Figure 5.4 shows relationship between system loss and outsourcing expenditure. From the figure it is clear that system loss is decreasing with increase of outsourcing expenditure. So the impact of outsourcing is positive for the company.

The overall system loss in this sector is 12.74 where DESCO has achieved single digit. So in the performance relating to the system loss DESCO is pioneer and role model for the sector.

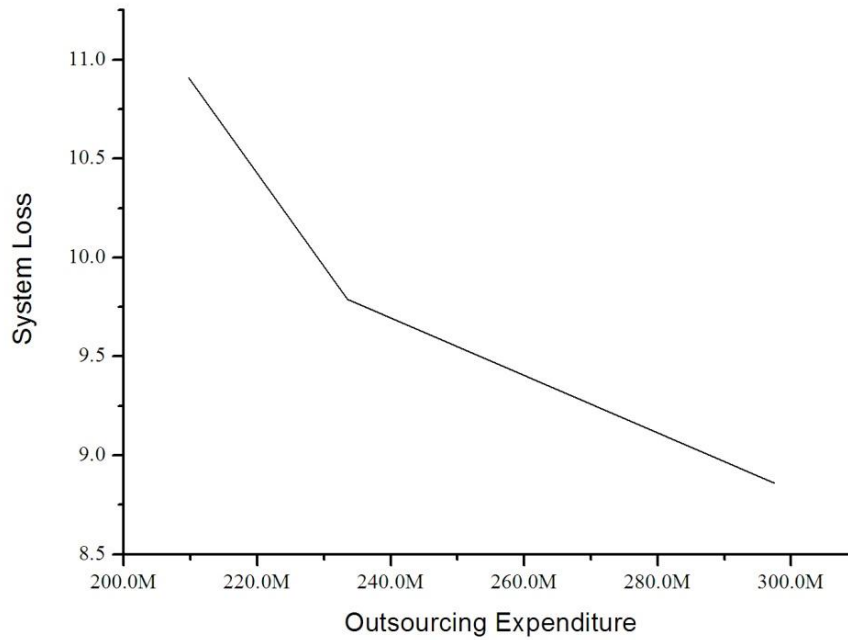


Fig-5.4: Outsourcing Expenditure Vs System loss

Collection ratio: It is the process to collect the amount sold to consumers. In case of prepaid metering collection happen before but in most cases it is not so easy. The most effective tool to recover outstanding bills from the defaulters is disconnection of power line. This services is outsourced. A total number of 24,009 defaulting consumer services were disconnected with the help of the outsource contractor and by the company’s own staff during the year 2010. Moreover, 12,432 nos of illegal consumer services were traced and disconnected during this year.

Year	Collection Ratio(%)
2008	101.01
2009	98.18
2010	98.78

Table-5.3: Year wise collection ratio

DESCO were able to achieve 100% collection and more than that. It also collect the previous year due.

No of Employee: DESCO's maximum demand is 622MW and no of employee is 993. A similar organization, Dhaka Power Distribution Company, whose maximum demand is 1200MW has 2600 employee. So at same ratio DESCO would have 1300 employee if it did not outsourced. Hence outsourcing down size the organization by 300 employee.

DESCO's expenditure for employees is 619,018,529 Taka. So for fully in-sourcing the employee expenditure will increase by 30%.

Profitability: DESCO is only profitable power distribution organization in Bangladesh. Data regarding the profit are given in the table below. It continuously increase its net profit.

Particulars	2009-10	2008-09	2007-08
	(MTK)	(MTK)	(MTK)
Revenue from Operations	10,989	10,005	9,189
Cost of Sales	(8,656)	(7,860)	(6,953)
Gross Profit	2,333	2,145	2,236
Expenses	(799)	(487)	(484)
Operating Profit	1,534	1,658	1,752
Financial Expenses (Net)	(221)	(170)	(256)
Non Operating Income	880	669	576
Taxation	(373)	(533)	(1,072)
Net Profit for the year	1,789	1,607	1,001

Table-5.4: Financial result of DESCO

Now the relationship between profit and outsourcing are presented in figure-5.5. With increase the outsourcing expenditure, the profitability also increases.

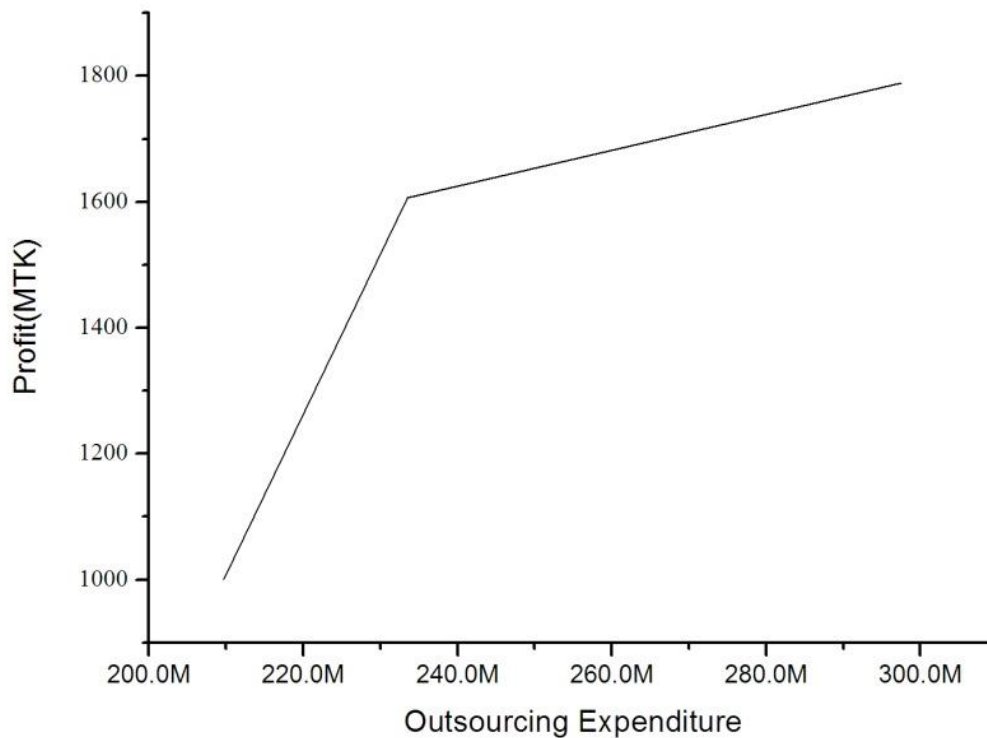


Fig-5.5: Outsourcing Vs Profit

DESCO have faced some risks with outsourcing. The suppliers frequently change their employee. So the speed of works decreases and need to establish new relationship. Many outsourced employee have found engaging illegal relationship with customer and also found them stealing the property of DESCO.

5.3.5 Findings

In power sector, the distribution organizations are struggling for existence where the earning per share of DESCO is 111. From the above analysis, it is clear that DESCO enjoys several benefits from outsourcing. The benefits include downsized organization, improved system-loss, improved collection ratio, better customer satisfaction etc. But there present some risks component.

Chapter-6: Conclusion and Recommendation

6.1 Introduction

The last chapter of this dissertation gives a summary of the results. The conclusion of this study will be presented by answering the initial problem statement. The chapter wraps up with an overview of the research's limitations and suggestions for future research.

6.2 Conclusion

Outsourcing can be a element of competitive advantages for businesses. For outsourcing to be successful the decision needs to be informed. Good, hard, detailed information in the hands of capable management can help avoid a costly step, one that is not easily reversed. Ultimately, for outsourcing in any form to be successful, quick response times to strategic opportunities and threats are essential. Effective management of the outsourcing relationships is an organizational imperative.

Throughout this study many impact for outsourcing have been identified. Furthermore, this study has proved that outsourcing incorporates a wide variety of advantages for organization That leads to a conclusion that, outsourcing brings lots of benefits for the organizations. However there are confusion about core competence and managers understanding of core competence.

Throughout the literature study several outsourcing cases have demonstrated that for some companies outsourcing has been a successful decision and for others more or less unsuccessful. However, the argument to be made is that successful outsourcing cases do not prove that the same strategy would guarantee a success to any other company. Correspondingly, if some company appears to be failed because of outsourcing, it does not prove that the same would happen again. There are many factors that affect outsourcing decision and every company operates under different circumstances. There is no tool that exactly tells what, when or how a company should outsource. One conclusion that can be drawn from this study is that outsourcing decisions, like all business decisions, are context dependent.

In literature, the discussion is often based on few well known cases, like Nike or IBM. Nike is one example of successful outsourcing while IBM is considered one of the most fatal outsourcing decisions of history. Nike's strategy is indeed successful, but only few have recognized the fact that such a strategy may not be possible without a powerful brand that Nike enjoys. Thus, following Nike's example may not work for other companies.

6.3 Limitations and Suggestions for Future Research

Every research project is bound to have some limitations. This thesis is no exception. Although it is easy to think about it in retrospect; the following mentioned limitations are meant to help future researchers to improve the initial framework that this thesis has explained. These limitations are furthermore meant to allow the reader to understand why certain research choices have been made.

First limitations are finally suitable organizations practicing outsourcing. I have talked with many purchasing managers whether they practice outsourcing or not. I was surprised that some of them did not have the basic idea about outsourcing and some manager meant purchasing only security service as outsourcing.

Secondly; organizations were not interested to provide data about outsourcing. They think it very confidential and business secret.

Third limitations may be summarized as the access to company's procurement guide lines. Moreover some companies have no written document about procurement. What the managers say is law about their procurement.

The further scope of this research is to extend comparative analysis to two organizations that practice outsourcing. Comparative analysis may compare benefits, risks and motives of outsourcing.

Reference:

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