

## 6.4: Global Sourcing and Its Role in Business

### Learning Objectives

1. Identify what global sourcing is.
2. Learn what comprises the best practices in global sourcing.
3. Recognize the difference between outsourcing and global sourcing.

### What Is Global Sourcing?

**Global sourcing** refers to buying the raw materials, components, or services from companies outside the home country. In a flat world, raw materials are sourced from wherever they can be obtained for the cheapest price (including transportation costs) and the highest comparable quality.

Recall the discussion of the spice trade in [Section 9.1](#). Europeans sourced spices from China and India. The long overland trade routes required many payments to intermediaries and local rulers, raising prices of spices 1,000 percent by the end of the journey. Such a markup naturally spurred Europeans to look for other trade routes and sources of spices. The desire for spices and gold is what ultimately led Christopher Columbus to secure funding for his voyage across the Atlantic Ocean. Even before that, Portuguese ships were sailing down the coast of Africa. In the 1480s, Portuguese ships were returning to Europe laden with African melegueta pepper. This pepper was inferior to the Far Eastern varieties, but it was much cheaper. By 1500, pepper prices dropped by 25 percent due to the new sources of supply. Edwin S. Hunt and James M. Murray, *A History of Business in Medieval Europe, 1200–1550* (Cambridge, UK: Cambridge University Press, 1999), 229.

Today, the pattern of global sourcing continues as a way to obtain commodities and raw materials. But sourcing now is much more expanded; it includes the sourcing of components, of complete manufactured products, and of services as well.

There are many companies that export to a country while sourcing from that same country. For example, Apple sells iPods and iPads to China, and it also manufactures and sources components in China.

### Best Practices in Global Sourcing

Given the challenges of global sourcing, large companies often have a staff devoted to overseeing the company's overseas sourcing process and suppliers, managing the relationships, and handling legal, tax and administrative issues.

### Judging Quality from Afar: ISO 9000 Certification

How can companies know that the products or services they're sourcing from a foreign country are of good quality? The mark of good quality around the world is ISO 9000 certification. In 1987, the International Organization of Standardization (ISO) developed uniform standards for quality guidelines. Prior to December 2000, three ISO standards were used: ISO 9001, ISO 9002, and ISO 9003. These standards were collectively referred to as ISO 9000. In 2000, the standards were merged into a revised ISO 9001 standard named ISO 9001:2000. In 2008, a new revision was issued, ISO 9001:2008. The standards are voluntary, but companies can demonstrate their compliance with the standard by passing certification. (Companies that had achieved ISO 9001:2000 certification were required to be recertified to meet ISO 9001:2008 standards.) The certification is a mark that the company's products and services have met quality standards and that the company has quality management processes in place. Companies of any size can get certified. To ensure high-quality products, some companies require that their suppliers be certified before they will source products or services from them. ISO 9001:2008 certification is a "seal of quality" that is trusted around the world.

In addition to quality standards, ISO also developed ISO 14000 standards, which focus on the environment. Specifically, ISO 14000 certification shows that the company works to minimize any harmful effects it may have on the environment.

Over the years, companies have learned to manage for quality and consistency.

- Companies can use unannounced inspections to verify that their suppliers meet quality-assurance standards (although this is costly when suppliers are far away).
- For consistency, to avoid disruption in getting goods, Walmart makes sure that no supplier does more than 25 percent of their business with Walmart.

- Companies can evaluate supplier performance. Cost isn't everything. Many companies use scorecards to evaluate suppliers from whom they source components. Cost is part of the scorecard, of course, but often it represents only part of the evaluation, not all of it. Instead, companies look at issues such as supply continuity, as well as whether the relationship is based on openness and trust.

## Trends in Sourcing: Considering Carbon Costs

One of the rising concerns about global sourcing is that of the carbon footprint of goods traveling long distances. A **carbon footprint** is a measure of the impact that activities like transportation and manufacturing have on the environment, especially on climate change. (The “footprint” is the impact, and “carbon” is shorthand for all the different greenhouse gases that contribute to global warming. Mike Berners-Lee and Duncan Clark, “What Is a Carbon Footprint?,” *Green Living Blog, Guardian*, June 4, 2010, accessed September 12, 2010, <http://www.guardian.co.uk/environment/blog/2010/jun/04/carbon-footprint-definition>.) Everyone's daily activities, such as using electricity or driving, have a carbon footprint because of the greenhouse gases produced by burning fossil fuels for electricity, heating, transportation, and so on. The higher the carbon footprint, the worse the activity is for the environment.

In global sourcing, although transporting goods by air and truck has a high carbon footprint due to the fossil fuels burned, ocean transport doesn't. Also, the carbon-footprint measure doesn't just focus on distance; it looks at all the fossil fuels used in the manufacture of an item. For example, when one looks at the total picture of how much energy is required to make a product, the carbon footprint of transportation may be less than the carbon footprint of the manufacturing process. Some regions have natural advantages. For example, it is more environmentally friendly to smelt aluminum in Iceland than locally because of the tremendous amount of electricity required for smelting. Iceland has abundant geothermal energy, which has no carbon footprint compared to generating electricity by burning coal. It's better for the environment to smelt the aluminum in Iceland and then ship it elsewhere.

Similarly, it is more environmentally sound for people in the United Kingdom to buy virgin wood from Sweden than to buy recycled paper made in the United Kingdom. Why? Sweden uses nuclear energy to make paper, which has a much lower carbon footprint than electricity in the United Kingdom, which is generated by burning coal. Even though the paper is recycled, the electricity costs of recycling make it more harmful to the environment.

Perhaps one of the most-effective changes companies can make to help the environment is to work collaboratively with their trading partners. For example, an agreement between potato-chip manufacturers and potato suppliers eliminated wasted resources. Specifically, the physics of frying potato chips requires boiling off the water in the potato, which consumes a large amount of energy. Although boiling off the water would seem to be a requirement in the cooking process, UK-based Carbon Trust discovered a man-made practice that increased these costs. Potato-chip manufacturers buy potatoes by weight. Potato suppliers, to get the most for their potatoes, soak the potatoes in water to boost their weight, thus adding unnecessary water that has to be boiled off. By changing the contracts so that suppliers are paid more for less-soggy potatoes, suppliers had an incentive to use less water, chip makers needed to expend less energy to boil off less water, and the environment benefited from less water and energy waste. These changes had a much more beneficial impact on the environment than would have been gained by a change in transportation. MIT Center for Transportation and Logistics and Council of Supply Chain Management Professionals, “Achieving the Energy-Efficient Supply Chain” (symposium, Royal Sonesta Hotel, Cambridge, MA, April 30, 2007).

## Outsourcing versus Global Sourcing

In **outsourcing**, the company delegates an entire process (e.g., accounts payable) to an outsource vendor. The vendor takes control of the operation and runs the operation as it sees fit. The company pays the outsource vendor for the end result; how the vendor achieves those end results is up to the vendor.

Companies outsource for numerous reasons. There are many advantages to outsourcing:

- Reducing costs by moving labor to a lower-cost country
- Speeding up the pace of innovation by hiring engineers in a developing market at much lower cost
- Funding development projects that would otherwise be unaffordable
- Liberating expensive home-country-based engineers and salespeople from routine tasks, so that they can focus on higher value-added work or interacting with customers
- Putting a standard business practice out to bid, in order to lower costs and let the company respond with flexibility. If a new method of performing the function becomes advantageous, the company can change vendors to take advantage of the new development, without incurring the delays of hiring and training new employees on the process.

Pharmaceutical company Eli Lilly and Company uses outsourcing to bring down the cost of developing a new drug, which stands at \$1.1 billion. Lilly hopes to bring down the cost to \$800 million through outsourcing. The company is outsourcing the heart of the research effort—drug development—to contract research organizations (CROs). Jonathan D. Rockoff, “Lilly Taps Contractors to Revive Pipeline,” *Wall Street Journal*, January 5, 2010, accessed September 7, 2010, <http://online.wsj.com/article/SB10001424052748704247504574604503922019082.html>. It does 20 percent of its chemistry work in China, for one-quarter the US cost. Lilly hopes to reduce the cost of clinical trials as well, by expanding those efforts to BRIC countries (i.e., Brazil, Russia, India, and China). Paul McDougall, “Drug Company Eli Lilly Outsources Clinical Data to India,” *InformationWeek*, November 20, 2006, accessed September 7, 2010, [www.informationweek.com/news/global-cio/outsourcing/showArticle.jhtml?articleID=194500067](http://www.informationweek.com/news/global-cio/outsourcing/showArticle.jhtml?articleID=194500067); Patricia Van Arnum, “Outsourcing Clinical Trial Development and Materials,” *Pharmaceutical Technology* 6, no. 34 (June 2, 2010): 44–46.

## The Hidden Costs of Outsourcing

Although outsourcing’s costs savings, such as labor costs, are easy to see, some of the hidden costs aren’t as visible. For example, high-tech products that spend months traveling by ocean face product obsolescence, deterioration, spoilage, taxes, loss due to damage or theft, and increased administrative and business travel costs. Threats of terrorism, religious strife, changing governments, and failing economies are further issues of concern. Stanley Furniture, a US maker of home furnishings, decided to bring its offshore production back home after product recalls from cribs made in Slovenia, transportation costs, and intellectual property issues outweighed the advantages of cheap goods and labor. Sarah Kabourek, “Back in the USA,” *Fortune*, September 28, 2009, 30. All of these hidden costs add up to a world that is less than flat.

Manufacturing outsourcing is also called contract manufacturing. The move to **contract manufacturing** means that companies like IBM have less control over manufacturing than they did when they owned the factories. Contract-manufacturing companies such as Celestica are making IBM products alongside Hewlett-Packard (HP) and Dell products. Celestica’s own financial considerations influence whether it gives preference to IBM, HP, or Dell if there is a rush on manufacturing. The contract manufacturer’s best efforts will go to whichever client negotiated the best terms and highest price; this makes companies more vulnerable to variability.

Quanta Computer, based in Taiwan, is the largest notebook-computer contract manufacturer in the world. Quanta makes laptops for Sony, Dell, and HP, among others. In June 2010, Quanta shipped 4.8 million laptops, a laptop-shipment record. Carter Sprunger, “Quanta Computer Breaks Laptop Shipment Record in June,” *Notebooks*, July 9, 2010, accessed October 28, 2010, <http://notebooks.com/2010/07/09/quanta-computer-breaks-laptop-shipment-record-in-june>. For consumer electronics, outsourcing has become the dominant way of doing business.

## Managing Outsourced Services

If a company outsources a service, how does it guarantee the quality of that service? One way is through service-level agreements. **Service-level agreements (SLAs)** contractually specify the service levels that the outsourcer must meet when performing the service. SLAs are one way that companies ensure quality and performance when outsourcing services. SLAs typically include the following components:

- Scope of services
  - Frequency of service
  - Quality expected
  - Timing required
- Cost of service
- Communications
  - Dispute-resolution procedures
  - Reporting and governance
  - Key contacts
- Performance-improvement objectives

### Johns Hopkins Enterprise’s SLA for Accounts Receivable

Johns Hopkins Enterprise expects the following service levels for accounts receivable:

- Contact the customer after forty-five days if the open invoice is greater than \$10,000.
- Contact the customer after sixty days if the open invoice is between \$3,000 and \$10,000.

- Contact the customer after ninety days if the open invoice is less than \$3,000.
- Contact the department within two days if the customer claims the invoice will not be paid due to performance. At this point, it is the department's responsibility to resolve and the invoice will be closed as uncollectible. Once the disagreement with the customer is resolved, a new invoice will be issued.
- All issues that the A/R Service Center can fix will be completed within three business days. Follow-up calls will be made within five business days. "Accounts Receivable Shared Service Center Service Level Agreement," Johns Hopkins Enterprise, last updated July 1, 2009, accessed November 23, 2010, [ssc.jhmi.edu/accountsreceivable/inter\\_entity.html](http://ssc.jhmi.edu/accountsreceivable/inter_entity.html).

## Entrepreneurial Opportunities from Outsourcing

Crimson Consulting Group is a California-based firm that performs global market research on everything from routers to software for clients including Cisco Systems, HP, and Microsoft. Crimson has only fourteen full-time employees, which would be too few to handle these market research inquiries. But Crimson outsources some of the market research to Evalueserve in India and some to independent experts in China, the Czech Republic, and South Africa. "This allows a small firm like us to compete with McKinsey and Bain on a very global basis with very low costs," said Crimson CEO Glenn Gow. Pete Engardio with Michael Arndt and Dean Foust, "The Future of Outsourcing," *BusinessWeek*, January 30, 2006, accessed November 18, 2010, [http://www.businessweek.com/magazine/content/06\\_05/b3969401.htm](http://www.businessweek.com/magazine/content/06_05/b3969401.htm).

For example, imagine a company that has an idea for a new medical device, but lacks market research into the opportunity. The company could outsource its market research to a firm like Evalueserve. For a relatively small fee, the outsourced firm could, within a day, assemble a team of Indian patent attorneys, engineers, and business analysts, start mining global databases, and call dozens of US experts and wholesalers to provide an independent market-research report.

### KEY TAKEAWAYS

- Global sourcing refers to buying the raw materials, components, complete products, or services from companies located outside the home country.
- Information technology and communications have enabled the outsourcing of business processes, enabling those processes to be performed in different countries around the world.
- Best practices in global sourcing include the following components:
  - Using ISO 9001:2008 certification to help ensure the quality of products regardless of where they are produced
  - Considering not just the quality of products but also the environmental practices of the company providing the products, through ISO 14000 certification
  - Using service-level agreements to ensure the quality of services
- Entrepreneurs benefit from outsourcing because they can acquire services as needed, without having to build those capabilities internally.

### EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Why do companies source globally?
2. What are some ways in which to ensure quality from unknown suppliers?
3. When and how would you use a service-level agreement?
4. Is contract manufacturing the same as outsourcing?
5. Explain the advantages and disadvantages of outsourcing.

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