

## AN EMPIRICAL INVESTIGATION INTO THE OUTSOURCING LOGISTICS CONTRACT

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### ABSTRACT

*It is widely acknowledged that a carefully designed contract is the best method of protection for companies that plan to engage in outsourcing arrangements. In the most commonly accepted definitions, outsourcing logistics involves the transfer of some logistics activities or processes to an external provider. In addition to mutual trust, constant communication and cooperation, a carefully designed and complex contract will protect both partners against financial losses and other inconveniences. All in all, even if the outsourcing logistics strategy is very popular and also very beneficial for companies, the majority of outsourcing logistics contracts fail in the first year. Starting from this fact, this paper is aiming to examine the main parts of an outsourcing contract, including performance issues, financial issues, legal issues and HR-related issues in the Romanian manufacturing industry. Our purpose is to identify the major malfunctions of such contracts in an attempt to formulate a set of recommendations for companies in order to avoid the failure of such relationships. Our research method is a quantitative one based on a questionnaire on the outsourcing logistics contracts of Romanian production companies with a wide experience in outsourcing some or all logistics activities.*

**KEYWORDS:** *outsourcing logistics, contract, Romanian industry*

**JEL CLASSIFICATION:** *L24, L14*

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### 1. INTRODUCTION

The outsourcing logistics contract is a very effective strategic tool managers can use to establish the balance of power between the parties. As indicated in the literature, there are a large number of studies that underline the fact that most of the outsourcing logistics contracts fail in the first year (Ngwenyama, O.K. & Sullivan, W.E. , 2007). Such examples range from public US companies, like the State of Connecticut that gave up all outsourcing agreements after investing large sums of money (LeSuer, S., 1999), to private companies as well. Moreover, Murphy stated that 75% of enterprises fail to recognize and mitigate the risks associated with outsourcing (2003).

As specialist literature suggests, an agreement (contract) with well-defined clauses is able to safeguard customer companies that seek to outsource logistics against conflicts of interest, providing, at the same time, a solid and reliable foundation for the relationship between customer and service provider and ultimately minimizing the risk of failure for both partners. Unfortunately, because of the complications that come with the involvement of various legal entities, of conflicting motivational triggers and even because of the passage of time itself, contracts are not infallible and may even give rise to some long-term inconveniences. The failure of the outsourcing agreement may have a lasting negative impact on the relationship with the providers of outsourced services. In

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most cases the failure of an outsourcing logistics contract generates great losses in terms of financial and other type of resources as well.

Due to these and to the fact that there are many authors that underline that the outsourcing logistics contract is under researched (Lukkassen, P.J.H & Wallenburg, C.M., 2010; Maloni, M.J. & Carter, C.R. , 2006; Marasco, A., 2008; Selviaridis, K., Spring, M., 2007), pointing out that these needs to be investigated more in the future, our objective is to analyze this topic in the Romanian industry sector.

**Table 1. Aspects addressed by researchers on outsourcing logistics contracts**

Aspects addressed	Sources
Provision buyers (logistics managers) found important to include in contracts	Boysen, S., Corsi, T., Dresner, M., and Rabinovich, E., 1999
Contract design based on agency theory	Logan, M.S., 2000
Contract importance in the purchasing process of advanced logistics services	Andersson, D & Norrman, A., 2004
Contracts as management tools in 3PL alliances	Pruth, M., 2002
Contracts in the dynamic of governing 3PL arrangements, based on multiple theoretical approaches	Halldorsson, A. & Skjøtt-Larsen, T., 2006
Contracts in relational governance, as a basis for flexibility, ongoing, dialogue, and exchange adaptation.	Selviaridis, K., Spring, M., 2007

*Source:* Olander, M., Norrman, A., 2012, p. 645.

If we take a look in table 1, we can notice the fact that there are extremely few studies available in the literature on the logistics outsourcing contract despite its importance and role. Olander and Norrman have identified only 5 relevant papers regarding this topic, and including their own study, we would get a total of six papers published in international journals. Consequently, we strongly believe that there is a lot more to discover in this area, especially related to the strategic implications of the outsourcing logistics contracts.

## 2. THE OUTSOURCING LOGISTICS CONTRACT

Companies have now realized that the vector for success is what today, in the context of sustainable development of society, we call global performance (Pintea O.M., 2012, p. 745). In today's economy companies are in a continuous search of improved performance, excellence and competitive advantage. The only way to achieve this is through continuous differentiation and innovation, whether it refers to the creation of new products and services, or it relates to the reorganization of processes or business models (Borza, A., et.al., 2012). As some authors suggest, competitiveness could be achieved by implementing a strategy of operational excellence (Florian, G.L. & Constancioara, A., 2013). Excellence can also be attained by a careful examination of the main outsourcing logistics contracts, before noticing the failure of such agreements by counting the damaged shipments, the fill rates, the transportation costs or any other performance indicators. Some authors have examined long time ago the impact of outsourcing on organizational strategy (Grover, V., Cheon, M, Teng, J.T.C., , 1994) and concluded that because good outsourcing practices influence positively the whole organizational strategy, these two elements are strongly related.

The outsourcing contract can be defined as the most important instrument for defining the fights, the liabilities, and the expectations of both parties which guides behaviors of both parties concerned (Lee, M.L.C., 1996). Furthermore, we are interested in exposing the secrets of a successful

outsourcing logistics contract. This can be defined as one that has been in place for more than 2 years and the outsourcing organization is satisfied with the vendor's performance and intends to renew it (Ngwenyama, O.K. & Sullivan, W.E. , 2007, p. 617). The contract is a very important part of the relationship because it impacts both the design and management of the relationship, and also because of its function of solving issues and disputes when they appear (Olander, M., Norrman, A., 2012). When a dispute between the two parties involved in an outsourcing logistics relationship gets to court, the contract will be analyzed in extreme detail and interpreted in conjunction to the legal system of the country. This is another reason why companies must pay more attention when drafting such agreements.

The above mentioned definition of a successful outsourcing logistics contract might be a bit abrupt, but because of its simplicity it can be very difficult to contradict. In our attempt to identify those elements that make a contract successful, we must turn our focus to the outsourcing logistics risks as the contract is the best way to eliminate a very large part of the risks associated with the outsourcing logistics strategy and process.

Because the outsourcing logistics relation has many associated risks, as most business contract do, it is obvious that not all of them can be included in the contract from the very beginning, but it is advisable that the two parties identify as many risks as possible and try to get protection against them through the contract. In this research we are trying to find out which are the main categories of risks included in the outsourcing logistics contracts in the Romanian industry sector.

In our view, all risks associated with the outsourcing logistics contracts can be classified as follows:

- a) Strategic risks;
- b) Operational risks;
- c) Tactical risks.

Other authors add another one called composite risks. This is related to long term risks as the loss of proficiency in the performance of the outsourced processes in the future due to the lack of knowledge (Lazzarotto, B.O., et.al., 2014). We can find a large number of risks, but in the literature the supplier dependence risk (Handley, S. & Benton, W., 2009) is the one considered worst. Another frequently mentioned risks refers to being linked to the service provider's deficient capabilities (Quelin, B. & Duhamel, F., 2003). Besides these risks there is also the loss of know-how risk (Bettis, R., et.al., 1992; Martinsons, M., 1991) which can drastically affect companies that outsource logistics activities.

## RESEARCH METHODOLOGY

In order to identify the main aspects included in an outsourcing logistics contract used in Romanian industry sector we approached the investigation with a quantitative research method. This study is part of a broad ongoing research on outsourcing logistics practices in Romanian manufacturing industries. We wanted to investigate how things are done in the Romanian industry as it is a well-known fact that when it comes to outsourcing logistics the theory and the practice are not on the same page most of the times. Consequently, we choose an initial sample of 100 production companies in various industries from the North East part of Romania to which we distributed the questionnaires on line. This population was selected out of a total of 3500 provided by the Chamber of Commerce. Respondents were asked to rank on a scale from 1 (= not important) to 5 (very important) the most important aspects of an outsourcing logistics contract. After distributing the questionnaire, we received 29 valid responses. This response rate similar to other response rates reported in supply chain empirical studies (Constangioara, A., 2013).

The questionnaire had 4 main parts, the first one included questions regarding the size of the companies, number of employees, manufacturing sector and geographical presence. The part that we are focused on in this present paper is the biggest one in our questionnaire and it refers to the outsourcing contract, and the main hypotheses are stated below.

*H1. Romanian outsourcing logistics contracts include agreed upon incentives for both parties involved in the process.*

*H2. Romanian outsourcing logistics contracts include a large variety of performance indicators.*

*H3. Romanian outsourcing logistics contracts cover the main risks associated with this process.*

## INTERPRETATION OF THE RESULTS

We focus on developing this study on the role of the outsourcing agreement in ensuring the efficiency and effectiveness of outsourcing activities emerged. Many authors (Platz, L.A. & Temponi, C., 2007; Power, M.J., Desouza, K.C., Bonifazi, C., 2006; Brown, D. & Wilson, S., 2005) believe that an outsourcing contract has to approach each of the criteria listed below in a highly considerate and thorough manner:

- performance issues;
- financial issues;
- legal issues;
- HR-related issues.

In our view, a notable limitation of the above mentioned list is the absence of environmental issues. Companies that get involved in outsourcing activities become long-term strategic partners and, therefore, one's image may affect the other ones. Environmental protection issues raise increasing amounts of concern in international forums and debates; they should be therefore included in outsourcing contracts and among the logistic service provider evaluation criteria.

No environmental-related criteria have been included in the list. However, we believe they are exceedingly important and strongly recommend that outsourcing contract take such issues into consideration. A shallow approach to environmental issues is likely to discount the polluting effects of handling, shipment/transportation, and storage and even reverse logistic technologies. All these will produce devastating effects that will further trigger massive losses of financial resources and goodwill.

The respondents of our survey have revealed interesting facts regarding the items they consider being of primary relevance in an outsourcing agreement. Table 2 shows that, according to the interviewed, the most important criteria applicable to this type of contract are financial in nature, with 90.7%. Legal issues rank second with 75.9%, followed by performance issues, with 68.5% and HR-related issues, with 51.9%. It should be noted that all of the four major issues of an outsourcing agreement appear to be of genuine interest to Romanian industrial companies.

**Table 2. Key elements of the outsourcing agreement**

Key contract issues:	Scores
Legal issues	75,9%
Performance issues	68,5%
Financial issues	90,7%
HR issues	51,9%

*Source:* authors' statistical processing results

We will further onfocus on the analysis of the criteria considered being important for the implementation of a successful outsourcing agreement. Most problems that occur in the supply chain subsequent to the logistics outsourcing can be traced back to a poorly designed contract. It is therefore vital for the company in question to define its main objectives in the clearest possible terms.

After collecting all the valid questionnaires we used a statistic program in order to analyze and structure the responses. Given the results, we were able to order in terms of importance the main aspects included in an outsourcing contract by Romanian companies. Consequently, we were able to identify the 10 most important ones based on the average mean, as this is a parameter that highlights the essential out of a statistic population (Buiga, A., et.al., 2004). Based on the scores (ranging from 1=not important to 5=very important) that the respondents gave to each assertion, we calculated the average mean and obtain the ranking.

**Table 3. Main aspects included in the outsourcing logistics contracts**

	<i>Aspects included in the outsourcing logistics contract</i>	<i>Average mean</i>
1.	Methods to determine the costs of the service;	4.36
2.	Quality improvement incentives;	4.16
3.	Securing an optimum level of quality;	4.12
4.	Performance measurements;	4.12
5.	Order status information on a regular basis;	4.10
6.	Rewards and penalties system;	4.05
7.	Data privacy clauses;	4.03
8.	Intellectual property rights;	4.01
9.	Contract termination conditions;	3.93
10.	Clear dispute settlement procedures.	3.90

*Source:* authors' statistical processing results

Based on the results shown in table 3, we can see that for our respondents the most important risks of the logistics contract refers to the elements of cost. Outsourcing logistics is still seen as a good cost reduction strategy and this is the main advantage that most companies aim to obtain when deciding to engage in such relations. The very high means obtained by the methods to determine the costs of the service gives us a clear view on the matter and confirms once again the information revealed in table 2 also, where it is underlined that 90.7% of the respondents consider that the most important criteria applicable to this type of contract are financial in nature.

All in all, we were happy to notice that our respondents are also concerned about the level of quality they receive from the logistics service providers as the next four aspects included in the contract in terms of popularity refer to the quality aspects. Our respondents seem to focus on quality improvement incentives, securing an optimal level of quality, performance measurements and receiving regular order status. We were surprised to see that the rewards and penalties clause ranked only on the 6<sup>th</sup> place, with an average mean of only 4.05. Date property rights and termination clauses ranked on the last places also.

Going back to our three hypothesis, we notice the fact that the first one is confirmed as the 2<sup>nd</sup>, 6<sup>th</sup>, 7<sup>th</sup> and 8<sup>th</sup> places in our ranking include aspects related to incentives for both parties that represent a priority for our respondents. The second hypothesis refers to the performance indicators. We were pleased to see that our respondents place grate value on the performance indicators and from all the large list included in our research many of them ranked among the first ten, as follows: on 1<sup>st</sup>, 3<sup>rd</sup>, 4<sup>th</sup> and 5<sup>th</sup> place. We can consequently conclude that H1 and H2 are confirmed. Unfortunately, the third hypothesis was not confirmed as from all the outsourcing logistics related risks that we detailed in this research, our respondents places a high value only on the contract termination clauses (places 9<sup>th</sup> and 10<sup>th</sup> in our ranking). Therefore, H3 was not confirmed because we aimed to see a wider variety of risks addressed in the Romanian outsourcing contracts.

- H1. Romanian outsourcing logistics contracts include agreed upon incentives for both parties involved in the process – confirmed.*
- H2. Romanian outsourcing logistics contracts include a large variety of performance indicators – confirmed.*
- H3. Romanian outsourcing logistics contracts cover the main risks associated with this process – not confirmed.*

## CONCLUSION

In this paper we analyzed the outsourcing logistics contract through an empirical study in the Romanian industry. We started our investigation with a survey through which we aimed to identify a list of the 10 most important aspects companies focus on when closing an outsourcing logistics contract. After gathering the data, based on our analysis we were able to confirm the first two hypothesis of the study, regarding a set of agreed upon incentives and some key performance indicators included in the contracts. Due to the fact that our third hypothesis was not confirmed, we plan to research it thoroughly in our future papers. Although this research has a wide variety of limitations, regarding mainly the small number of valid questionnaires and the small sample, we plan to reduce this fact in our future endeavors by reaching out to more Romanian companies that engage in outsourcing logistics.

All in all, we want to underline that poor outsourcing logistics contracts lead to the end of the relationship and too great losses in terms of financial resources. Contracts are tools not only for managing risks, but also for managing commitments and creating, allocating and protecting value, as well as facilitating communication, coordination, motivation and control (Olander, M., Norrman, A., 2012). Other authors also emphasize the importance of such written agreements, underlining the fact that good contracts prevent future problems and disputes (Andersson, D & Norrman, A., 2004; Boysen, S. et.al., 1999; Juttner, U. et.al., 2003), and recommend that contracts be better negotiated (Muresan, I. N., et.al., 2012).

All in all, our findings reveal that outsourcing logistics contracts are not used to manage the day to day relationship with the partners as business people engaged in such long term collaborations rely a lot on mutual trust.

Furthermore, when it comes to outsourcing logistics contracts, the literature has shown that traditionally used laws and standard form contracts do not support the business deals on the whole (Olander, M., Norrman, A., 2012). Also companies must offer a memorable experience (Petre, A., et.al., 2012). Our study confirms this also. Consequently we strongly believe that future outsourcing logistics contracts must be innovative and adapted to each relation in particular, adding each time mutually agreed upon incentives, penalties, means of control, performance indicators and communication lines.

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