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School of Business and Management  
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# **Designing gainsharing model variations with logistics service company**

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## ABSTRACT

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<p>This thesis studies, in collaboration with a Finnish logistics service company, gainsharing and the development of a gainsharing models in a logistics outsourcing context. The purpose of the study is to create various gainsharing model variations for the use of a service provider and its customers in order to develop and enhance the customer's processes and operations, create savings and improve the collaboration between the companies. The study concentrates on offering gainsharing model alternatives for companies operating in internal logistics outsourcing context. Additionally, the prerequisites for the gainsharing arrangement are introduced.</p> <p>In the beginning of the study an extensive literature review is conducted. There are three main themes explored which are the collaboration in an outsourcing context, key account management and gainsharing philosophy. The customer expectations and experiences are gathered by interviewing case company's employees and its key customers. In order to design the gainsharing model prototypes, customers and other experts' knowledge and experiences are utilized.</p> <p>The result of this thesis is five gainsharing model variations that are based on the empirical and theoretical data. In addition, the instructions related to each created model are given to the case company, but are not available in this paper</p>	

## TIIVISTELMÄ

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<b>Keywords:</b> Hyödynjakofilosofia, Hyödynjakomalli, Logistiikan ulkoistaminen, Ulkoistamisyhteistyö, Avainasiakashallinta	
<p>Tässä diplomityössä tutkitaan yhdessä suomalaisen logistiikkapalveluyrityksen kanssa hyödynjakomallin kehittämistä ulkoistamiskontekstissa. Hyödynjakomallivariaatioita pyritään luomaan palveluntarjoajan ja sen asiakkaiden käyttöön kehittääkseen ja tehostaakseen asiakkaiden prosesseja ja toimintoja, luodakseen säästöjä molemmille osapuolille sekä parantaakseen yritysten välistä yhteistyötä. Tutkimuksessa pyritään kehittämään erilaisia hyödynjakomallivariaatioita, jotka voisivat toimia sisälogistiikan ulkoistamiskontekstissa. Lisäksi tutkimuksessa läpikäydään hyödynjaon käyttöönoton edellytyksiä.</p> <p>Tutkimus toteutetaan paneutumalla ensin kolmeen eri teemaan kirjallisuuskatsauksen kautta. Nämä teemat ovat ulkoistamisyhteistyö, avainasiakashallinta sekä hyödynjaon filosofia. Asiakkaiden kokemuksia ja näkemyksiä kerätään asiakashaastatteluiden avulla. Mallivariaatioiden luomisessa on hyödynnetty myös yhteistyöyrityksen työntekijöiden, asiakkaiden sekä muiden alan osaajien näkemyksiä aiheesta.</p> <p>Tutkimuksen tuloksena luodaan viisi hyödynjakomallia, jotka pohjautuvat haastatteluihin ja teoriaan. Työn tuloksena kohdeyritykselle luodaan myös ohjeistukset koskien jokaista mallivariaatiota. Nämä ohjeistukset eivät ole nähtävillä tässä työssä.</p>	

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## **LIST OF SYMBOLS AND ABBREVIATIONS**

AIFI = Acculturating, Inspiring, Funding and Injecting

CEO = Chief Executive Officer

IT-Systems = Information Technology Systems

KAM = Key account management

OEM = Original Equipment Manufacturer

PFEP = Plan for Every Part

# 1 INTRODUCTION

The purpose of this paper is to explore gainsharing arrangements in an outsourcing context and create a gainsharing model variations in collaboration with a Finnish logistics service company. A case company in this study is operating in the logistics service area as a service provider. Thus, this study focuses especially on the logistics outsourcing. The case company offers its staff, the business environment and its customers for the author in order to create and develop gainsharing model prototypes that would function in the logistics outsourcing context. The goal is to come up with various model prototypes that would work in different operating environments, situations and contexts. The model creation can be seen as the first step for the case company in adopting gainsharing arrangements. The purpose of gainsharing arrangements is to improve the collaboration between the service provider and service receiver, to enhance transparency, to encourage innovation and create savings through continuous development of the processes and operations.

In the theory part of this research paper, there are three main themes. They are the collaboration in outsourcing relationship, key account management and gainsharing. All of these three themes are addressed closely. The themes are put into an outsourcing context as the case company is functioning as service provider in the field of logistics outsourcing. In the beginning of the paper, the basic principles of the collaboration in outsourcing relationship are introduced followed by more pragmatic glance to the basics of the key account management. The close collaboration is a key element in gainsharing arrangements and, thus, it is explored more closely in this paper. The case company sees gainsharing as a sales tool for the key account managers and thus, the key account management is added to the theory part. Additionally, the gainsharing arrangements are planned to be introduced primarily with key customers in the beginning. The last two chapters of the theoretical part comprises of the gainsharing philosophy and its use in an outsourcing context. In these chapters the readers are introduced the background and the basics of the gainsharing especially in logistics outsourcing context. The empirical part of the paper is based on the interviews made by the author with the case company's employees and the key customers of the case company. The extensive literature review

supports the process of developing the gainsharing model prototypes. Below, Figure 1 illustrates the structure of this paper.

Background	Chapter	Output
<ul style="list-style-type: none"> <li>Introducing the topic of the research and the motives behind it.</li> </ul>	1. Introduction	<ul style="list-style-type: none"> <li>Background, case company introduction, goals and</li> <li>research methodology</li> </ul>
<ul style="list-style-type: none"> <li>Literature review on the subject.</li> </ul>	2. Collaboration in outsourcing relationship	<ul style="list-style-type: none"> <li>Defining collaboration and outsourcing</li> <li>Benefits and barriers</li> </ul>
<ul style="list-style-type: none"> <li>Literature review on the subject.</li> </ul>	3. Key Account Management	<ul style="list-style-type: none"> <li>Basics of KAM</li> <li>Key account manager's role</li> </ul>
<ul style="list-style-type: none"> <li>Literature review on the subject.</li> </ul>	4. Introducing Gainsharing	<ul style="list-style-type: none"> <li>Key principles of gainsharing</li> <li>Background</li> <li>Gainsharing in outsourcing context</li> </ul>
<ul style="list-style-type: none"> <li>Literature review on the subject.</li> </ul>	5. Gainsharing in outsourcing context	<ul style="list-style-type: none"> <li>Prerequisites and barriers</li> <li>Structuring a model</li> <li>Gainsharing contract</li> </ul>
<ul style="list-style-type: none"> <li>Interviews</li> <li>Literature</li> <li>Results</li> </ul>	6. Developing gainsharing models with the case company	<ul style="list-style-type: none"> <li>Prototypes of a gainsharing model</li> <li>Variations</li> </ul>
<ul style="list-style-type: none"> <li>Author's observations</li> </ul>	7. Discussion	<ul style="list-style-type: none"> <li>Discussion</li> </ul>
<ul style="list-style-type: none"> <li>Background of the study</li> <li>Results</li> </ul>	8. Summary and conclusions	<ul style="list-style-type: none"> <li>Conclusion and the results of the study</li> <li>Future recommendations</li> </ul>

Figure 1. The structure of the report

## **1.1 Background of the study**

A problem the service providers face often in the outsourcing business environment is how to illustrate the benefits of the service that they offer to their customers. During the recent years it has been recognized that customers admire transparency, expect developments and the service providers need to illustrate to the customer, how the invoice and savings they get, are formed. Additionally, it has come to an attention that companies collaborating closely achieve better results than the companies doing everything by themselves. For the case company, one way to improve their service, achieve better results and differentiate themselves from the competitors is to take advantage of the gainsharing philosophy. The goal of this paper is to come up with different gainsharing model variations and to define the prerequisites for gainsharing arrangements in logistics outsourcing context. Additionally, it will be explored, what information is needed in order to plan and develop a gainsharing model and define its implementation procedure. As result of this study, various gainsharing model prototypes are created. A prototype means that development of the model will most likely continue after the test in order to find the best solution that fits to the environment. The objectives of the study are:

1. Go through gainsharing theory, plans and models especially in an outsourcing context that are found from literature. Additionally, the theories concerning the collaboration in outsourcing relationship is extensively reviewed. This is done in order to gain understanding of the basics of gainsharing and the use of gainsharing in various environments. Also the relationship point of view is taken into account. Ultimately the goal of the study is to build various gainsharing model prototypes which would work between the service provider and service receiver.
2. Define the characteristics of a functional gainsharing model that would work in logistics outsourcing context. The model is created for the use of a service provider and its customers. This is very important phase as the as the “one size fits all” mentality does not work in gainsharing.

3. Benchmark and provide prototypes of a gainsharing models for the companies operating in the logistics outsourcing environment so that after this research is finished, building a gainsharing model is a clear, understandable and well-defined process.
4. Introduce the model variations for the selected customers and interview the customers about them.
5. Improve the models based on the customer interviews.
6. Test the prototype model with one case company's key customer. The key customer will be interviewed and based on their desires and experiences, the model will be configured and tested. The chosen model prototype will be coded into the extranet used by the case company and its customer where it will be accessible to both parties. The testing part of the process is not part of this research and will be done after this paper is finished.

## **1.2 Introducing the Case Company**

The case company was founded in 1990's. It is a Finnish based logistics service corporation that is specialized for managing material, information and equity flows. Originally it was founded to support logistics service companies in the area of quality systems. Nowadays the company offers and produces its own logistics services. The case company employs more than 500 people and it has 19 offices, warehouses and production sites in Finland and few other countries. Some of these warehouses are built near or right next to the customers' factories. During the recent years the company has been growing rapidly which has led to more customers, employees and revenue for the company. The most important customers for the case company operate within manufacturing and trading industries.

The case company operates within three business areas that are consultant services, logistics solutions and packages and packaging services. Consultant services consist of

developing outsourcing solutions, production planning and warehouse management. Logistics solutions include inbound, internal and outbound logistics, warehouse services and personnel leasing. Packing services comprise of different types of wooden and plywood packages, projects related to packing and packing solutions.

In consultant services, the case company is focused on the planning of the material flows and taking advantage of various workstation and trajectory analysis. In addition, services consist of developing procurement strategies and ABC- analyses. Warehouse management includes various different material flow analyses, placement of the materials and products and designing of the packages. Outsourcing the logistics and equity solutions include outsourcing warehouse operations such as the management and monitoring of the materials, information and properties. Furthermore, the case company offers services including purchasing, handling, storing and delivering materials in the behalf of the customer. In addition, the case company offers to take responsibility of managing capital flows whenever necessary. The packing services comprise of producing packages for the customers' need to packing the customer's products. Usually this takes place in customer's premises or in the case company's own warehouse. The case company offers planning and designing aid related to packages. Other services include training services and personnel leasing.

### **1.3 Research methods**

This study is conducted with a case company that operates in logistics outsourcing market. The case company offers the business environment where the created gainsharing model prototypes could function. Additionally, through the case company many interviews are done in order to collect service provider's and service receiver's (customer's) experiences, expectations and advice about gainsharing. The whole project is best described as a construction project as the goal is to build a tool or a model that fits in the environment the case company and its key customer are operating. Before developing the model, an extensive literature review is done in order to clarify the ideology behind gainsharing and its present state and its use in outsourcing relationships. The focus is especially on the logistics service area. The used research methods involve literature review and interviews. Both methods complement each other.

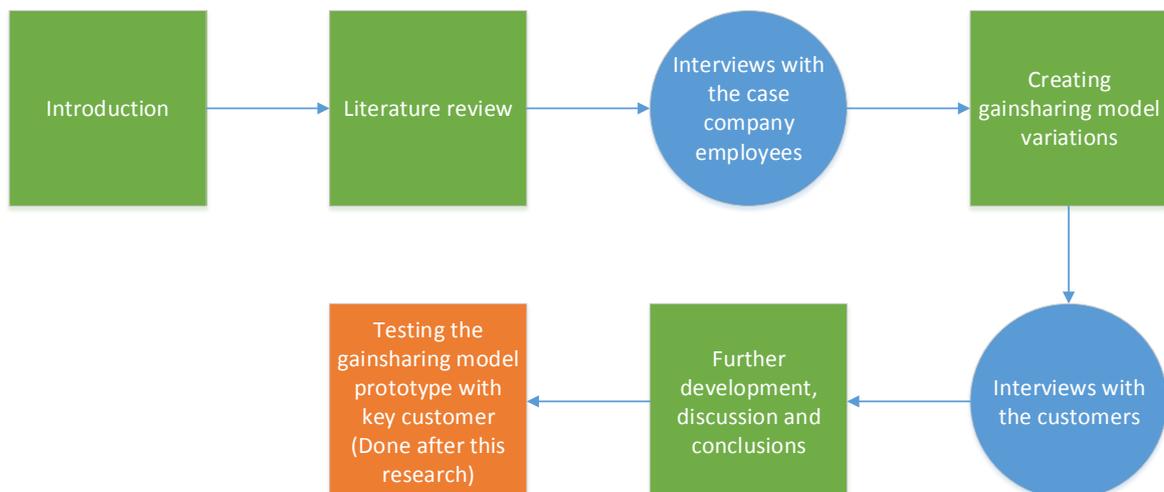
The literature review's goal is to offer a general view and create a framework for the whole research. (Baumeister et al. 1997, p. 312) The theory part of this study consists of three parts or themes which are gainsharing, key account management and collaboration in outsourcing relationship. While gainsharing and collaboration in outsourcing relationship are explored extensively and more theoretically, a more pragmatic viewpoint is taken when examining key account management. In the gainsharing part, the background, philosophy, benefits and barriers are introduced with prerequisites, measuring problems and structuring the gainsharing model itself. Third part of the theory focuses on the outsourcing relationships and as the customers that the case company has, are companies that outsource their operations. The goal of the theory part is to offer tools and information for the development of the gainsharing model prototypes.

The interviews' purpose is to bring together various perspectives, gather experiences and advice and use the most suitable ones in order to create prototypes of a gainsharing models that fit to the business environment the case company is operating in. Obviously interviewing people is an efficient way to collect information that supports the theories and perceive potential impediments, problems and improvement targets. When interviewing the customers, it is important to understand and recognize the business environment they operate in and the issues they face frequently. In addition, the gainsharing model or the prototype should be developed based on the customer needs and requirements but simultaneously keeping in mind the restrictions and limitations that there may be.

As mentioned, the data for the empirical part of the study was gathered by interviewing different personnel comprising of case company's own employees and customers. Interviewing as research method is a very efficient. A major benefit is the collection of huge amount of information in a rather short time. (Griffin 2005, s. 211) Other benefits are the personality and the creation of personal contact with between interviewer and interviewee. The personal contact often creates trust between parties and furthers the process of getting the needed answers and information. Also getting more explicit and clarified information is more likely in an interview. As the people are physically in the

same space it is possible to see the other person's reactions and body language which can often reveal valuable information also. (Watkins et al. 2012, s. 106)

As the main goal of the interviewing was to find out customer's expectations and experiences of the gainsharing, it was imperative to find the right people to be interviewed from the customers' side. The case company had introduced a gainsharing model with one of the key customers earlier, so it was also important to interview the people involved in that process and find out their experiences on the matter. The goal was to get as many point of views to the matter as possible. The interviews were recorded and transcribed. The data and information collected by using content analysis method. After sorting out the data gathered into smaller groups based on the structure of the interview. The data was first handled question by question and after that as a whole. The results were reflected to information gathered from the literature review. The figure below illustrates the progress of this study. As it has been mentioned, the testing will be conducted after this study is finished. Below in the figure 1 the progress of this study is illustrated



**Figure 1. The progress of this study**

## 1.4 Value proposition

The case company promises savings and yearly price discounts via continuous developments and innovations to its customers who outsource their logistics to the case company. Thus, it is important to understand the real meaning of value proposition. To

take advantage of the gainsharing philosophy is one way to convince and illustrate the promised savings to the customer.

The value proposition concept is used widely in theory and in practice. It is understood that companies need do more than just claim their superiority in order to sell their products and services. To acquire new customers, companies need to illustrate the gains and capabilities the buyer gets when purchasing the products or services. (Camlek 2010, 121-123) When a company is expressing verbally the value that their service or products create to customer, it is giving its value proposition. Today, the competition in the market is harsh and the economy is unstable. The value proposition is one way for the service provider to tempt and convince customers to choose the company or, at least, generate interest towards the provider.

Nowadays the customers are not necessarily after the best prices but rather the better value and this why value proposition has a significant role. (Manning and Reece 2007, 157) Value proposition is an important tool for marketers. Lanning (2000, 2-6) defines value proposition as “a clear simple statement of the benefits, both tangible and intangible that the company will provide, along with the approximate price it will charge each customer segment for those benefits.” Frequently value proposition is seen as a way to create positioning and branding in products or services. Lanning (2000, 2-6) adds that it is “much wider strategic tool that involves important trade-offs for the organization.”

## **1.5 Transparency**

Transparency is one of the most essential element between the service provider and service receiver in order to assure the gainsharing arrangement will work. Transparency in outsourcing relationship means that both parties have access to the information related to deliveries, services and products. Transparency is an important element in order to manage and execute the improvements and developments concerning the service receiver's processes and operations. The controlling, planning and following material flows are much more efficient in every stage of the supply chain when there is enough information available. Additionally, detecting deflections becomes easier. (Mäkelä et al. 2006, 26.)

The transparency requires open communication and information sharing between the parties. The goal of the transparency is to take advantage of the real-time information in different parts of the value chain. The most important benefits of transparency are the avoidance of the capacity problems, overstocking and availability problems. (Haapanen et al. 2005, 146.)

The flexible procedures, that are supported by the comprehensive, efficient and transparent data management, in all of the processes in the company can be held as a significant factor that improves the company's competitiveness. This sort of data management demands information gathering and combining from various sources and IT-systems which ensure that the right information is available in the right place in the right time. (VTT 2007)

## **1.6 Restrictions and limitations**

The limitations of the study are:

1. The gainsharing is mostly studied in logistics outsourcing context
2. The study is limited to use of gainsharing model in a mid-size logistics service company operating mostly Finland and few other European countries
3. The amount of customers involved and interviewed is limited.
4. The amount of measures at the case company is limited.
5. The amount of created model variations is limited.
6. The testing of the created prototypes will be done after this research.

## **2 COLLABORATION IN OUTSOURCING RELATIONSHIP**

In this chapter the focus is on defining outsourcing, finding out the key reasons why companies outsource their business processes and operations and how should the relationship between outsourcer and the service provider be managed and maintained. Additionally, some of the typical obstacles and barriers for a successful outsourcing relationship are introduced. As this master thesis is conducted in collaboration with a company operating in logistics service business, the logistics context is taken heavily into account.

### **2.1 Defining outsourcing**

Outsourcing is a common form of strategic alliance. (Zineldin and Bredenl w 2003) Outsourcing is taking place when a company is strategically using external service provider to execute and manage operations or processes which are not seen as core business of the outsourcing company (Rushton and Walker 2007, 4). A core business or activity is the essential reason why the company exists in the market. The core activity brings value to the customers and it is the main determinant of the company's competitive advantage. (Agrawal et al. 2005) In many cases outsourcing is seen as a make-or-buy decision. The potential outsourcer needs to evaluate whether it is better to produce the service in-house or use outside service provider to execute the service. (Zineldin and Bredenl w 2003)

According to Embleton and Wright (1998), outsourcing concerns such questions as "The transfer of routine and repetitive tasks to an outside source," and "having an outside vendor provide service that you usually perform in-house" and "paying other firms to perform all or parts of the work". These definitions imply that the outsourcing company strives to use resources of a service provider to execute activities that would have been executed otherwise by the company's own employees with the outsourcers internal resources. (Embleton and Wright 1998)

Iloranta et al (2008) conclude that outsourcing takes place when a company transfers processes, that it has done before in-house, to an outside party, usually a service provider, to be executed. The outsourcing comprises of buying components, intermediate products and entire business or production processes from an outside of the company. What differentiates outsourcing from subcontracting is the transferring of the workforce, know-how, infrastructure and property to a service provider. (Iloranta et al. 2008)

## **2.2 Outsourcing logistics processes**

It used to be normal for a company to own the trucks for transportation and warehouses in order to take care of their material flow. Nowadays buying or outsourcing those services is often seen necessary for a profitable business. The growing expectations towards increasing profits and productiveness in a business world have forced companies to pay more attention to their core business. Today outsourcing logistics, or part of it, is a very common procedure that companies chooses to perform. The outsourcers use service providers whose core business is in logistics services to operate their logistics processes enabling them to focus on their core business more efficiently and gaining better performance from the service provider than they would get by doing it all by themselves. (Jalanka et al. 2003, 10)

Karrus (2005,27-28) separates logistics process to five different flows. The flows are

1. Material flow
2. Equity flow
3. Information flow
4. Organizational flow
5. Recycling flow

Most important flow that influences to the value of the product is the material flow. Other two main flows are recycling and equity flow. Nowadays information flow is often not seen as a flow, but more as static information. Organization flow describes primarily the boundary between two organizations, for example, a service provider and a service receiver. (Karrus 2005, 27–28.)

The scale of the relationship between outsourcer and service provider defines the extent of the outsourced processes which can vary significantly depending on the case. The outsourced processes in logistics may include transportation, distribution, warehousing, order processing, monitor deliveries, invoicing, picking, packing and so on. The more processes outsourced, the more efficient collaboration between two parties is required. The focus is especially on the real-time information flow. (Jalanka 2003, 8–17) Figure 1 gives an example of outsourced logistics processes.

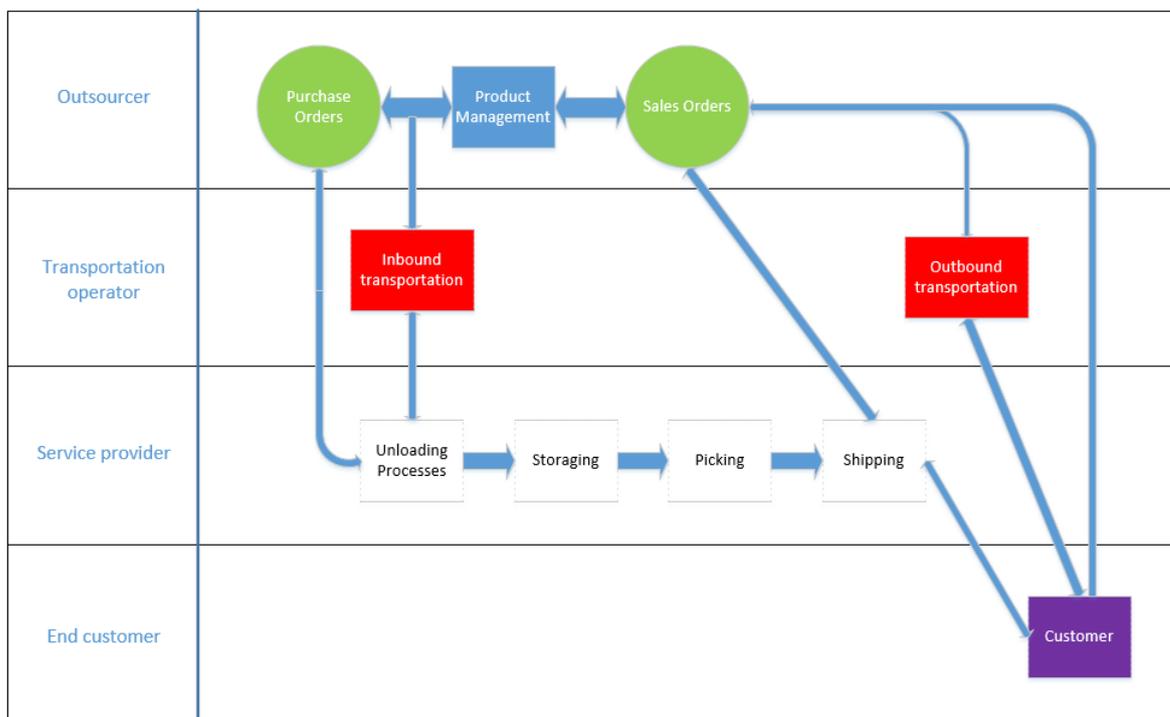


Figure 2. Example of outsourcing logistics. (Adapted from Jalanka et al. 2003, 17)

### 2.3 Benefits of outsourcing

Typically, when the business processes are being outsourced, the company is seeking savings, improved efficiency and competitiveness. The outsourcing company is realizing that, in order to focus more efficiently in its core business, it needs to outsource some of its business processes. Jalanka (2003, 11) lists reasons for outsourcing which are greater flexibility, enhanced service level, lowered costs and releasement of the capital that has been committed into its inventory. In many cases the outsourcing company is lacking

space, technology, knowhow, IT- systems and equipment. Instead of investing a large amount of money to acquire them, the outsourcer uses service provider whose core business is in these types of services and who owns the needed technology already. The chosen service provider ideally possesses the knowhow and methods how to improve the processes in its area of business and how to use the human and other resources most efficiently. (Jalanka 2003, 11) There are also other reasons why companies might want to outsource. Macmillan (2008) writes that outsourcers might use service providers to improve their customer satisfaction or to gain an access to the international distribution networks. Zineldin and Bredenl ow (2003, 453) add that important benefits of the outsourcing are the risk sharing with a partner, quicker access to the markets and improved strategic flexibility. Agrawal et al. (2005) states three reason which are cost- and risk-sharing, cost reduction and an access to technological expertise and taking advantage of the technological synergies.

Lacity and Willcocks (2013) go further than the previous writers. They argue that “most successful clients concentrate less on cost savings and more on achieving innovation.” Obviously saving money is one motivator for outsourcers but there is more. Nowadays the companies who outsource, expect much more than reduced cost and access to skills. The service provider has to be able to offer more than just short-term savings or meeting the minimum requirements that are stated on the contract. Based on Lacity and Willcocks (2013) the outsourcers are actually looking for is continuous improvements and innovations. In the high performing relationships many innovation projects are executed either by the service provider or in collaboration in order to generate major improvements to the outsourcers operations, performance and processes.

#### **2.4 From conventional relationship towards collaborative partnership**

In a traditional outsourcing relationship working together for the mutual success has proven to be difficult challenge. Ultimately the goal for a service provider and service receiver is to make profit. In an outsourcing relationship the profit for the service provider comes from the service receiver. Conventionally, it has been believed that in order to maximize one’s profit it has to battle against the other party in the relationship. (Vitasek et

al. 2013, 11-14) But nowadays as the operational environment in business world is changing and continuously becoming more and more globalized, the focus is moving towards the companies' capabilities and customer orientation and this has increased significantly the collaboration between companies. Today the companies are not always able to meet the complex demands of the customers by themselves. They rather need partners and their capabilities in order to meet requirements. (Toivola 2006, 27)

Vitasek et al. (2013, 11-15) introduce a business outsourcing model they call "vested business model". In this vested model the parties in outsourcing relationship abandon the idea of trying to maximize one's profit at the expense of the other. This means that the win-lose situations are to be avoided. Vested outsourcing means that both parties are "mutually committed to each other's success, creating a long-term win-win relationship based on achieving mutual determined goals." The essence of the vested outsourcing is that service receiver and service provider strive to maximize their profit by working together.

The vested business model is seen as a hybrid of shared-value and relational economic principles. It goes further than the traditional transaction-based model and performance-based model. The vested methods can be compared to lean methods as they share same ideas. Both methods strive to recognize the activities that do not bring value to the process and remove them. In addition, both methods' goal is to enhance or improve the performance. The outsourcing parties are driven to collaborate and innovate together in order to achieve real improvements that are beneficial for both parties. (Vitasek et al. 2013, 15)

## **2.5 Impediments for a successful outsourcing relationship**

When the outsourcing of logistics processes is discussed, the truth frequently is that outsourcing companies do not wish to outsource all of their logistics and order-to-delivery processes to the service providers. According to Rushton and Walker (2007, 19) the most common reasons not to outsource is when logistics is seen as a core process or too important for the company's success or when the company does not see the potential financial savings and they are afraid of losing control. In today's business world the IT-

systems play an important role and their integration between the service provider and service receiver is a vital part of the success. One impediment for outsourcing is the potential decrease of the service level. For a service provider it is a challenge to convince the potential outsourcer that the provider's logistics knowhow is better than the outsourcer's and the gains and savings are real. Macmillan (2008) mentions that the risks of outsourcing relates to losing control over the logistics processes, internal capabilities and customer contacts. Typically using third party logistics improves flexibility and changes demand but the problems arises from the meeting of the customer's demands. Agrawal et al (2005) argues that major risks and impediments for the successful outsourcing relationships are distinct when there is:

1. A dominating party
2. Mismatch in the culture and management
3. Opportunistic behavior of either party
4. Lack of trust
5. A chance of high transaction costs associated with the time and effort required to manage, monitor and control the collaboration

No outsourcing relationship is perfect and there are always opportunities for improvements. Very often a company chooses to outsource its processes to the service provider without paying enough attention to the agreement and the possibilities. The goal for the outsourcer is to get rid of the process and focus on the core business without realizing the potential benefits lying in the relationship. Vitasek et al (2013) clarifies ten reasons or "ailments" why the outsourcing relationship might go wrong. The reasons are introduced below.

### **2.5.1 Ailment 1. Penny Wise and Pound Foolish**

The first reason is easy to recognize. Frequently, the reason to outsource, is only based on costs. Being "Penny Wise and Pound Foolish" means that the company is outsourcing in order to get the best price. This normally means that the outsourcer is a giving a constant pressure on the service provider to cut the costs. In this case, the outsourcer has, more or less, defiant and oppressive attitude towards its service provider. Usually the benefits are short-term in this type of relationship. When the outsourcer is going after the cheapest

price, the trade-off is often made in service or quality. Frequently, the decision-making managers or executives sees outsourcing as a solution to fix financial and balance sheet problems. If an outsourcer is constantly bidding and looking for better prices, this might lead to an endless loop where the company keeps changing its service provider because of the better offers. The problem in this instance is that the value lying in the relationship is not taken into advantage and the service provider do not have time to execute or implement real innovations. Also in this sort of relationships the service provider is often afraid of investing as the contract is always on the edge. In the worst case scenario, the outsourcing company can face real difficulties to find proper service providers as they have gained the reputation of switching partners continuously. Other consequence might stem from the low prices. As the prices and the service provider profit margin have been pushed down, the service provider might go bankrupt leaving the outsourcer to a difficult position where it has to find a new partner as quickly as possible. (Vitasek et al. 2013, 27-28)

### **2.5.2 Ailment 2. The outsourcing paradox**

This ailment occurs when the outsourcing company defines clear set of tasks, frequencies and measures that are expected from the service providers. Basically the outsourcer manifests how the work is supposed to be done. Even though a clear document is usually created that involves details of the work procedures etc., the problem is that it is not created by the service provider. An example of this takes place when an outsourcer decides how many people should be working in an outsourced warehouse or defines how an assembly should be done. In this sort of situations, the service provider is often doing what it is told, even if, the service provider would have a better and more efficient way of doing it. What actually has happened is that the outsourcer has hired the experts to operate their processes but insisted on choosing, how the work is done. This means that the processes are still done inefficiently and the innovation and introducing new methods has become difficult for the service provider. The truth is that, both, poorly written specifications and tightly written specifications, can create obstacles to a successful outsourcing arrangement. (Vitasek et al. 2013, 28-30)

### **2.5.3 Ailment 3. Activity trap**

Often companies that deal with the outsourcing paradox face also activity trap. In outsourcing relationships, the pricing model used is often based on the transactions that the service provider executes. In many cases there are pointless transactions that still bring money for the service provider and consequently the service provider is not willing to abandon these types of activities as they would result lower revenue. The transaction-based models often lack of incentives for the service provider to develop its processes and reduce costs as they would decrease its profits. Another important factors creating activity traps are so called “illogical” or “perversed” incentives. These can be, for example, some old materials that is not used but still stored in a service provider’s warehouse. If the service provider is getting paid of storing these unused materials, there is no incentive for them to get rid of them unless the parties have agreed on gainsharing model that seeks identify these types of “wastes” and provide benefits for the service provider. (Vitasek et al. 2013, 30-31)

### **2.5.4 Ailment 4. The junkyard dog factor**

This ailment may take place when the outsourcer uses old employees to collaborate with the service provider and to come up with the standard of work. The problem occurs when the old employees insist that the old ways of executing processes are introduced to the service providers. This often leads to misaligned desired outcomes meaning that the outsourcer gets what is says in the contract but not what is was desiring when the outsourcing decision was made. Inefficient and overbuilt infrastructure is often found in the junkyard dog factor because the goal for the service provider is to keep jobs and earn more revenue and there are no incentives to introduce new and more efficient methods and innovations. (Vitasek et al. 2013, 31-33)

### **2.5.5 Ailment 5. Honeymoon effect**

Honeymoon effect is normal in the beginning of outsourcing relationship. Typically, in the beginning of the relationship, the atmosphere between parties is positive. The service provider is focusing on meeting the targets set on the contract. The targets might be related to improving service levels or other chosen measures or other requirements and expectations that the service receiver has seen important. Often the service provider is

doing just what it is expected, but not putting any extra effort to improve the processes because there is a lack of incentives to do so. This might lead to problems in future if the service provider is not willing to invest in people and technology in order to improve their capabilities. Obviously it is just a matter of time when the outsourcer starts considering its options and seeking for a better provider. This can get very costly for the outsourcer. (Vitasek et al. 2013, 33-34)

### **2.5.6 Ailment 6. Sandbagging**

The 6<sup>th</sup> ailment is related to preventing the honeymoon effect from occurring. The outsourcing company is introducing incentives to service providers to enhance their performance and to innovate. This is seen as a good way but does not always guarantee results. The problem here is again perverse incentives. An example is when the company awards its service provider on every improvement they make. In order to get more financial benefit, the service provider introduces improvements incrementally rather than providing the best solutions possible instantly. This is also a way for a service provider to hold back some of the saving possibilities, in case there is problem of reaching targets in future. (Vitasek et al. 2013, 34-35)

### **2.5.7 Ailment 7. The Zero-sum game**

The zero-sum game is a very typical ailment that has negative effects on the outsourcing relationship. The thought behind this ailment is that if there is something good for the other outsourcing party then it is consequently bad for the other party. This is a mistake that both parties in the relationship fall frequently. The parties fail to understand that by collaborating and finding a win-win solution, the sum of benefits is actually often better than when one party wins and the other loses. (Vitasek et al. 2013 pg. 35)

### **2.5.8 Ailment 8. Driving blind disease**

Driving blind disease happens when the performance of the relationship is not correctly governed. This means that the right measures are not used in order to clarify the costs and other important factors of success. A research company called Aberdeen Group notifies that it is a very big challenge in an outsourcing relationship to realize the actual savings. The term “saving leakage” is used here meaning the difference between real and actual

saving and identified savings. If the driving blind disease is to be avoided companies need to identify and use correct measurements and key cost drivers. This can be done by introducing scorecards or dashboards to help measuring the performance of the service provider. (Vitasek et al. 2013, 35-36)

### **2.5.9 Ailment 9. Measurement minutiae**

This ailment takes place when the company is trying to measure everything. There might be hundreds of different measures in use but in reality no one knows what they are actually measuring. In the worst case scenario company might use extensive amount of worktime just produce these measurement reports without knowing what they are actually used for. Too much good can be bad. (Vitasek et al. 2013, 36-37)

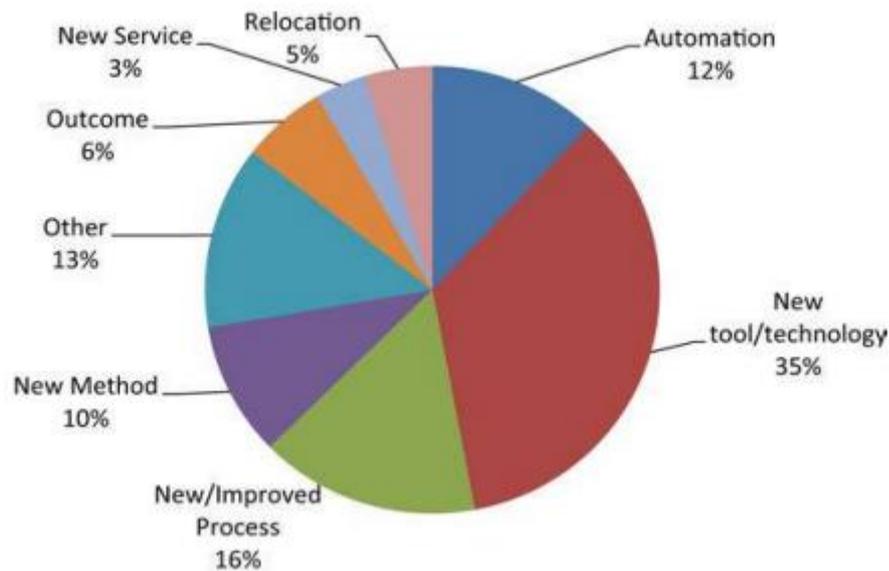
### **2.5.10 Ailment 10. The power of not doing**

This ailment is quite simple. Many times companies identify processes or targets that should be improved, but choose not to do anything. For the service provider, again, this might originate from the lack of incentives. Some cases the outsourcer might have impressive measurement system that makes it easy to recognize processes that should be improved but they choose not to because of the lack of time or willingness. This is often a sign of unclear roles of management. (Vitasek et al. 2013, 37)

## **2.6 Cultivating innovations in outsourcing relationship**

Before concentrating on the innovations in outsourcing relationship, it is important to define innovation. Lacity and Willcocks (2013) offer two definitions which are “realizing there is a different and better way of doing something, and combining this with the ability to deliver.” and “something that improves the customer’s services or costs, regardless of its novelty.”

Lacity and Willcocks (2014) studied what the innovations usually consist of. Based on the surveys and interviews, they formed eight categories of innovation. The eight categories and their shares are introduced in figure 1 below.



**Figure 1. Categories of innovation. (Lacity and Willcocks 2014)**

Based on Lacity and Willcocks research (2014), introduction of new technology or tool is the most usual type of innovation. These innovations can be, for example, a new product tracking tool, introducing warehouse management system and such. New or improved process was the second most common type of innovation. The innovations could consist of bringing lean methods to the warehouse, introducing 5S or training and educating new workers to learn new method of working. The “other” category that had 13 % share, comprises of activities such as restructuring the organization or establishing a center of excellence. The fourth largest category was the automation which means that some of the old processes are being automated.

In order to build an innovative and high performing relationship, companies and service providers need to put a lot of effort and time towards it. An innovation does not come automatically. The service providers are always willing to innovate and come up with new solutions to enhance customer’s processes if there are incentives to do so and it is possible for the service provider to improve their margin. One way the outsourcer can motivate its service providers to come up with innovations is to offer them a piece of the achieved profit margin. In other words, this means that the profit that is gained from the innovation is shared between the outsourcing parties. Normally, when innovations are executed, they provide some sort of efficiency or quality improvements or, for example, cost savings. This

ultimately means more money or profit. In order to motivate service provider to generate more profit for the outsourcer, the service provider should get some of that extra profit achieved. (Lacity and Willcocks 2013)

When the collaborative culture is established and managed well between service provider and service receiver, the continuous flow of new innovations can be expected. Lacity and Willcocks (2013) call this “dynamic innovation”. Lacity and Willcocks (2013) states “a dynamic innovation view looks at how year-on-year programs accumulate to improve the client’s overall performance”

## **2.7 Pricing in outsourcing relationship**

The form of pricing in outsourcing influences considerably how the relationship will work out. Agrawal et al. (2005) list three typical forms of pricing which are:

1. Cost-plus
2. Fixed price
3. Gainsharing

The structure of pricing plays a key role when considering incentives, interaction costs and the service provider’s negotiation position. (Agrawal et al. 2005) Cost-plus-fixed-fee pricing form means that the service receiver pays the service provider for the actual costs of executing the contract. In addition, service receiver pays a fixed fee. (Loeb and Surysekar 1998)

A fixed price form is in use when the service provider is paid predefined price on every type of service the service provider is offering. (Bajari and Tadelis 1999) In gainsharing contract the parties in an outsourcing relationship agree on the baseline price of the service. If the costs that were forecasted or estimated turn out to be lower, the difference is shared between the parties in a ratio that has been agreed on the contract. Again, if the costs were underestimated the provider should be responsible for the difference. (Auguste et al. 2000)

According to Auguste et al. (2000), most frequently used pricing forms, which are gainsharing and cost-plus form, often demolish more value than creates it. In the cost-plus

form the obvious problem is the lack of incentives for a service provider to innovate and decrease costs. In these sort of pricing contracts, the service provider's revenue does not depend on the efficiency improvements is could complete. For the service provider reducing costs for the outsourcer might even lead to reducing its own profit margin.

With gainsharing pricing form there is more incentives for the service provider to innovate and strive to improve the efficiency. The problem with gainsharing is the necessity of interaction and the costs related to it. Gainsharing contract is the most expensive type. The negotiations and monitoring procedures need to be carefully designed and agreed. The gainsharing arrangements have to be defined for every situation and cost estimates calculated accurately. (Auguste et al. 2000)

Freehills et al. (2013) introduce a target cost pricing model. This type of model is supposed to improve the sharing of the achieved savings between the outsourcing parties and restrain the overspending. The target cost model is said to be suitable especially for the big and highly risky infrastructure projects. Basically in this pricing model the desired outcomes are defined and the service provider is given incentives for innovative behavior. Additionally, the risks are shared. The target cost pricing model is seen as a type of a cost reimbursable model where the service provider is paid based on the actual costs. In this type of model, the parties have set target cost for certain activities. The target costs should comprise of the real and carefully estimated costs. In the logistics outsourcing context, this would mean that measures should be available or work study should be conducted in order to identify the real costs. In situation where the actual costs are less the target costs, service provider is paid share of the gained savings. The share the service provider gets has been agreed on the contract. On the other hand, if the costs are more than expected, the service provider is responsible for its part of the cost overrun. So this type of pricing model includes painsharing as well. (Freehills et al. 2013)

### **3 KEY ACCOUNT MANAGEMENT**

In this chapter, the key account management is approached from the more pragmatic point of view. The goal of the chapter is to introduce the reader how the key account management works in the case company. Additionally, the theory concerning key account management and its principles are introduced shortly. The gainsharing model prototypes that are developed in the end of this paper are to be used in the case company as sales tool for the key account managers. Obviously this means that the gainsharing agreements are primarily made with the key customers. The case company sees gainsharing as a mean to improve customer service, provide transparency to customer and clarify and illustrate the savings and billing. In overall, the gainsharing model could be used by anyone working in a business environment where gainsharing would be useful arrangement. Sometimes it can be used by the sales people, financial director, development engineers or the CEO of the company.

According to Sin et al. (2005) the truth is that not all customers bring as much as profit to the company than others. This statement is aligned with the well-known Pareto rule which argues that 80 % of the profits the company get comes from 20 % of its customers. The customers that are the most profitable are the company's key customers. When the case company defines its key customers they consider the customer's turnover, profitability and future potentiality.

#### **3.1 Defining Key Account Management (KAM)**

The case company takes key account management seriously. For them it is very important that the key customers get the best service and the potential issues are tackled and avoided as efficiently as possible.

In theory, the key account management has the grounds in the customer focus and relationships marketing where the KAM has developed further. It focuses on a long-term relationship that brings benefits for both parties in the relationship. These parties are, for

example, buyer and seller or service provider and service receiver. (McDonald et al. 2000, 25)

The definitions of key account management vary depending on the context the term is used. Brady (2004) explores key account management from the relationship marketing point of view. Ojasalo (2001) considers KAM as a marketing management approach based on relationship management where the importance lies on the long-term relationships. Same way Brehmer and Rehme (2009) explain KAM as a mean to improve sales through managing existing customer relationships more efficiently. This also includes continuously seeking new opportunities from them and simultaneously meeting the ever changing customer requirements and demands. According to McDonald et al. (2000, 25) key account is strategically vital customer for a firm functioning in the business to business market. McDonald et al. (2000, 25) defines KAM as a “management approach adopted by selling companies aimed at building a portfolio of loyal key accounts by offering them on a continuing basis a product/service package tailored to their individual needs”

According to Sharma (2003, 141) the key account management is very important in today's business world as the need just-in-time systems has increased leading to more collaborative and close relationship between buying and selling companies. He introduces very similar aspects than the earlier authors concerning key account management. His main idea behind KAM is a long-term relationship between buyer and seller. The focus is on creating, managing and maintaining strong relationship with the key clients. Sharma (2003, 141) also mentions taking in considerations the key customer's special needs that should be fulfilled. This is what differentiates key account management from the normal business relationship.

From these definitions above two main issues affiliated with KAM arise: individualistic approach toward certain key customer and importance of the relationship management.

### **3.2 Key account manager**

For all the biggest and most important customers who meet requirements of being a key customer, there is a key account manager assigned in the case company to take care of daily business between the companies.

When companies conduct business, create a relationships and manage and maintain them, the people or the employees are needed in order to do that. All the decisions are made by the employees not by the company. The person who is responsible of the relationship plays a key role. If the contact people between companies have a strong relationship, the problems and other issues may be solved and forgiven whereas if the contact people do not like each other, one mistake might end the relationship.

Key account manager can be seen as a person who is responsible for managing and maintaining the business relationship between the company and its key customer. In bigger companies there are more likely various key customers meaning that there are also more key account managers. As there are differences on the size of the companies and their needs and requirements the organizational structure for both companies becomes more complex. In these situations, the emphasis is on the coordination of the collaboration and this the key account manager's main task. The key account managers are the ones who usually have the updated information and the in-depth knowledge about the customers' needs, problems and ways to conduct business. They have the responsibility to manage the relationship in a way that the both parties stay content and to act whenever issues arise. For the company, the key account manager is the main source of information related to the key customer. The key account managers should be the ones who know the strengths and weaknesses of the key customers. (Pardo, 1999, 276-297; Nätti et al. 2006, 306-307)

The case company has several key account managers that are responsible for certain key customers. They deal with their own key customers on the daily basis making sure that the customer stays satisfied. Obviously when problems take place, the key account manager takes actions to solve the problem for the customer. The gainsharing model that is built in the end of this paper is going to be a tool for the key account managers to illustrate the

savings and a way to decide how to share the financial benefits achieved by continuously developing the operations and processes.

### **3.3 Who are the key customers?**

In the identifying stage a company needs acknowledge their strengths and weaknesses and strive to align them with potential key customer's strengths. It is wise to keep in mind that it is cheaper for a company to keep a client than to acquire a new one. As it has been mentioned before, the key customers for the case company is someone with over certain amount of yearly revenue and has a lot of potential processes and operations that the case company could take over. In the logistics service markets where the case company operates in, the environment fluctuates continuously. The outsourcing contracts are normally made for few years meaning that there is always a risk that there will not be a new contract after the current one runs out. The decision concerning, who are the key customers, has to be made carefully.

Burnett (2002, 66-69) lists two aspects that how to decide the attractiveness of a potential key customer. These are the psychographics and demographics. The psychographics includes the buyer's and seller's shared values and attitudes. These are mostly non-physical components of the relationship such as ability to solve problems, responsiveness, attitudes towards environmental issues and the means of negotiation. When the companies strive to deepen the relationship they should share some common attitudes, procedures and values in order to avoid arguments and conflicts. The demographic aspect consists of the physical parts in the relationship. These are the benefits parties gain when conducting business together, such as competitive prices, enhanced quality, performance and brand strength.

Burnett (2002, 66-69) also talks about objective and subjective information. The objective information is often available as it comprises of the various figures. These figures may include profitability, turnover, product/service range offered, cost of relationship and investments. Subjective information is more difficult to measure. It consists of issues such as trust, relationship strength, reputation and so on.

One thing company should keep in mind that sorting customers, for example, into two categories, key customers and normal customers, do not enhance equality. Often the sorting is done by checking the size of the profit and turnover. (Pardo, 1999, 276-297) The case company has nowadays both types of customers. In future the goal for the case company could be that it only has customers that fulfill the demands of being key customers.

## **4 INTRODUCING GAINSHARING**

In this chapter, the ideology behind the gainsharing is introduced. It is important to acknowledge that gainsharing is traditionally used as internal tool for a company to improve their performance and processes and so on. In this paper the gainsharing model prototypes are created to fit to logistics outsourcing context meaning that the model will be used between two parties, service provider and service receiver. In this chapter the gainsharing is defined and the background of the gainsharing is introduced shortly. Next the principles of gainsharing are explained and how the principles of gainsharing are used in various environments nowadays. Then the gainsharing ideology is put to an outsourcing context and explained how the gainsharing works between two parties.

### **4.1 Gainsharing background**

The gainsharing philosophy has been around a long time. The people in ancient times already accepted the fact that working together and sharing the outcome is more beneficial than doing everything by oneself. For example, rather than going on a hunt individually, it was better to go on a group and share the catch. The first known gainsharing plan in a business world was introduced already in 1936. Since then its popularity has been rising and the companies have been adopting the philosophy in order to enhance the productivity and quality, to engage the employees and improve the relations and also to cut costs. (Band et al. 1994) In his master thesis, Czekalski (2006) defines “Gainsharing is a philosophy of incorporating employee participation, recognition, problem identification, and accountability while improving personal and organizational performance”

The gainsharing term was introduced by Fredrick Taylor who is seen as the “father of scientific management”. Mr. Taylor came up with the idea of sharing any positive margin between all the members of a company that were achieved in a given period of time. The positive margin composes of the difference between actual costs and assumed costs. If the actual costs are less than expected, there is a positive margin that can be shared with the members on an agreed ratio. Nowadays there are several gainsharing models, formulas and plans concerning company’s internal improvement context. This is understandable as the gainsharing philosophy has been used in various areas of business. This means that an

organization operating in a certain circumstances has to customize the gainsharing ideology to fit their environment. Despite of this, all the gainsharing models still have the same three components including reward system, management practices and employee participation plan. (Band et al. 1994) How to build a gainsharing model for the use of two companies brings its own challenge to the table. The idea of involving these three components to the gainsharing model is still valid with it a small twist.

## **4.2 What is gainsharing?**

Often companies have failed to understand the meaning of gainsharing. Gainsharing term is used in various context in the literature. Frequently gainsharing is seen as a program to improve productivity or an incentive plan. Sometimes gainsharing is mixed with profit-sharing and worker motivation program. Sometimes it is seen as a mean of increasing employees' wages. Gainsharing is much more than this. In fact, in the philosophy of gainsharing all of these points of views are integrated. The main areas of interest are:

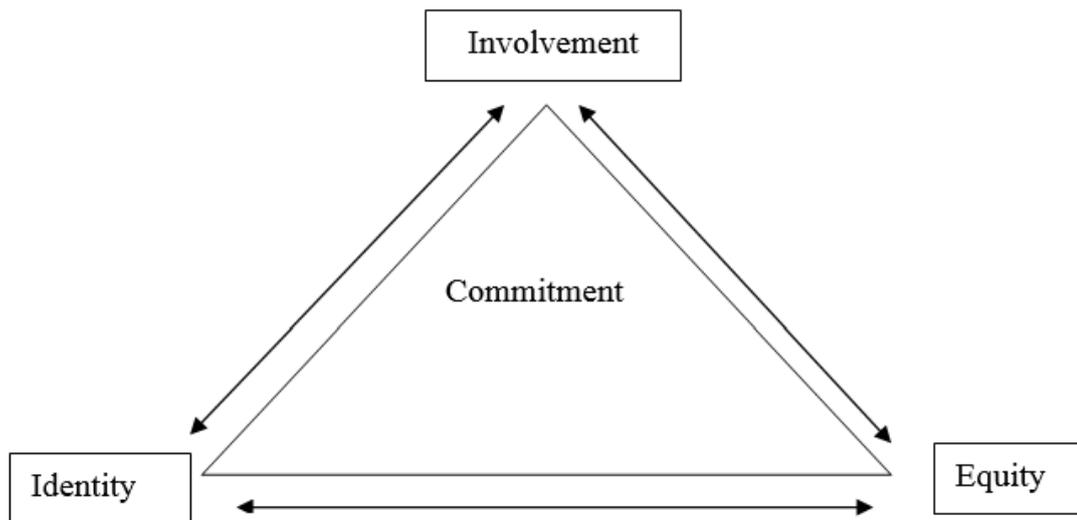
1. the company's goals and objectives or in other words, the desired outcomes
2. the systems that are needed in order to accomplish the objectives and goals,
3. the continuous development of the communication and information flow
4. generation of innovative ideas and suggestions for the development and
5. improvement of the teamwork and co-operation between all of the members involved. (Bullock and Bullock 1982)

As mentioned before, traditionally the gainsharing is used as internal tool within a company is to involve all the individuals, including management and employees to reach the company's target and goals and to share the benefits fairly between all the members. (Bullock, R J., Bullock, P. F, 1982) Gainsharing can also be defined as a system for a company to engage its workers to the development of the company by distributing the gains between everyone involved. Normally these "gains" mean money or profit that is shared between the management and the employees. The employee participation is very important in gainsharing. It means that all the members of the company take part to solving problems and sharing their ideas in order to improve company's productivity or quality or, for example, to cut costs. (Band et al. 1994) Below figure 2 shows different definitions of gainsharing depending on the environment it is used.

	Field	Authors	Concept	Definition
Gainsharing literature	Human Resources Management	Gross and Duncan(1998) Welbourne and Gomez Mejjia(1995)	Gainsharing	Gainsharing is not a single type of incentive program. it is an umbrella for a family of aggregate pay-for-performance approaches that link financial rewards for employees to improvement in the performances of the entire unit
	Vendor Relationship Management	PR Newswire (2007)	Gainsharing	Gainsharing provides financial and qualitative incentives to the vendor for exceeding goals.
	Health Care	Ketcham and Furukawa (2008)	Gainsharing	gainsharing arrangements are contracts where physicians receive cash payments for reducing hospital spending
Related literature in supply chain management		Li and Kouvelis(1999)	Risk-sharing	within a prespecified price window the firm pays the realized price, but outside of it the firm shares, in an agreed way, added costs or benefits
		Cachon and Lariviere (2005) Pasternack (2002) Gerchak and Wang (2004)	Revenue sharing	Under a revenue-sharing contract, a retailer pays a supplier a wholesale price for each unit purchases, plus a percentage of the revenue the retailer generates.
		McAfee and McMillan (1986) Chu and Sappington(2007)	Cost-sharing	payment which reimburses part of the cost actually incurred.

**Figure 3. Definitions of gainsharing. (Feng 2009)**

Robert L. Masternak, a President of Masternak & Associates which is a specialized consulting firm focusing in Gainsharing design, installation, training, and monitoring activities, mentions four principles to understand why gainsharing is effective. The principles are all included in the strategy used to install and maintain a successful model. These four principles are related to each other and together they are reinforcing. (Masternak & Associates 2016) The figure 3 below demonstrates Masternak's gainsharing triangle including these four principles.



**Figure 4. Masternak's gainsharing triangle (Adapted from Masternak & Associates 2016)**

The idea behind gainsharing is that it is fair to share the equity. A reward system is instituted in companies using gainsharing. To improve company's performance is a common goal for everyone working in the company. Everyone's contribution is expected. The financial savings achieved through the development are fairly distributed between the employees and the management of the company. (Masternak & Associates 2016) In the outsourcing relationship this would mean that the savings achieved by, for example, executing development projects or improving service receiver's processes, would be shared between the parties based on the gainsharing model that has been taken into use in contract.

Identity relates to the sense of purpose, belonging accountability and ownership. In gainsharing, the performance is monitored and measured. It is also communicated to everyone involved. The achieved gains, which are typically presented in financial value are shared. This creates appreciation within employees and creates innovative atmosphere in the company. The workforce is willing to work towards company's goals and share their ideas for improvement projects. Gainsharing often encourage workers to get better understanding of their work which can lead to more innovative solutions and recognition for the need of change. Identity is a key to advancing employee involvement. (Masternak & Associates 2016) In the outsourcing context, the key issue is get the both parties keen on developing the processes and operations and that they realize their role in the gainsharing

arrangement. Both parties need to be convinced that the gainsharing arrangement beneficial for them. To choose the right measurements and monitor them is vital part of the success of the gainsharing arrangement.

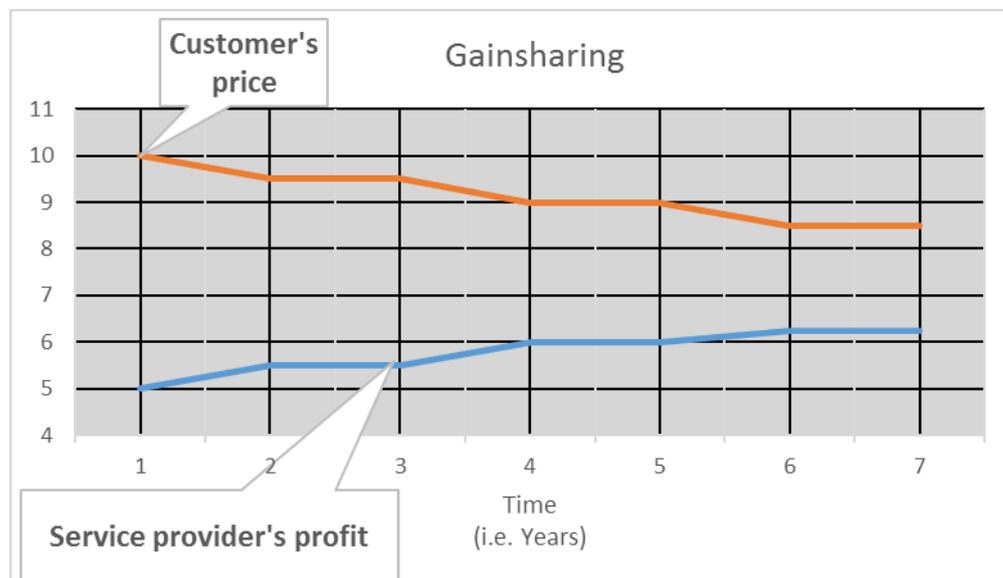
Involvement is very important in gainsharing. Frequently the knowhow and the ideas of improvement are hidden within the workforce. The challenge for the managers is to motivate the employees to reveal and share their ideas and gainsharing is a potential way to do it. Often the employees can offer the best solution for a problem. In a company that using gainsharing in order to enhance its performance, everyone is involved in the process of innovating new solution, making decisions, generating suggestions and implementing them. When the employees are involved, a sense of fellowship is created and the support towards changes is easier to achieve. (Masternak & Associates 2016) This is almost same than identity. Both parties in the outsourcing relationship should be involved in the innovation process. For example, the service provider may have the knowhow and technology to implement new innovations or processes but the service receiver has the insight of the processes and the experience how things have worked earlier. Obviously often investments are needed in order to bring new technologies in and this mean that both parties have to acknowledge the risks and agree on them.

Commitment is seen as the key principle for a successful gainsharing plan. Especially the management support and commitment are in an important role. In order to be successful, company needs management team that is dedicated to continuous improvement and not afraid of making changes that are needed. The gainsharing plan should have long term focus. (Masternak & Associates 2016) In the outsourcing relationship both parties have to be committed. Gainsharing arrangement is a time-consuming method and both parties need to be involved and committed to it in order it to be successful.

Most of the views introduced previously in this chapter are traditional views that are related to gainsharing mostly used in order to create innovations inside one company. Nowadays as outsourcing is taking place all over the world, some of the gainsharing principles have been adopted between outsourcing partners including service provider and service receiver. There is a constant pressure on the service provider to cut costs, improve

efficiency, continuously develop the processes and lower the prices. That is a reason why gainsharing agreements are gaining increased popularity in outsourcing contracts. (Kapadia 2010) Most of the principles, areas of interests and theories explained above, are valid in an outsourcing context.

Agrawal et al (2005) sees gainsharing in an outsourcing context as “an element that seeks to express the economic benefits in business relationship between the companies”. Digrius and Koenig (2006) describes gainsharing as alternative in which the service provider is compensated partly or as a whole depending on the savings or profits that their project delivers. Kapadia (2010) defines gainsharing in between outsourcing partners as “a contractual structure where the organization and its service provider agree to share financial gains as a result of continuous improvement and / or innovation.” Often this means that the service provider is expected to enhance the performance and execute improvements to the service receiver’s processes. These improvements might comprise of introducing new technologies, processes or services. The goal for the service provider is to save money for the service receiver by offering better prices while simultaneously increasing its profit margin. The figure 4 illustrates the situation.



**Figure 5. Development of the contract price and service provider’s profit in gainsharing (Adapted from Defensive Material Organization, 2010)**

### 4.3 Gainsharing in outsourcing context

Goel (2008) states that “Phrases such as “gainshare,” “skin in the game,” “risk-reward structures,” and “promoting and encouraging innovation” are often heard in the context of outsourcing arrangements these days”. As it has been mentioned the trend today is that the companies today are more willing to focus on their core business and outsource the part of the business that is not its core business. To form a profitable and functional outsourcing partnership, there are many factors that need be considered carefully as the studies show that many things might go wrong and form impediments to a successful relationship. (Goel 2008) Kapadia (2010) emphasizes in his article that organizations nowadays are more willing to have continuous improvement clauses in the contracts. In theory this sounds good for both parties, as the service receiver engages the provider to improve the processes continuously and the service providers are given an opportunity to increase its involvement in the service receiver’s operations and processes meaning obviously more potential profits to them.

According to Goel (2008), the companies that outsource nowadays are looking for an outcome-based orientation rather than the conventional transaction-based orientation. The reason to outsource today is found to be more strategic due to the continuing globalization and delivery models. The truth is that in the outsourcing relationships the success of service receiver relies heavily on service provider’s ability to innovate and to perform the outsourced operations. So why do companies outsource and not do it all by themselves? Some of the key reasons found from the literature are:

- Companies need to cut costs and improve their performance and efficiency while growing within a recessionary and highly competitive markets.
- The business world is increasingly more interdependent due to the continuous development of the technologies and globalization. Business networks extends all the parts of the world and the success of the company relies on its relationships that exist.
- Swift changes and competitive dynamics have forced companies to seek for assistance from service providers.

- Often the service providers have the knowledge and experience that the service receiver is lacking. It can be a huge asset for the receiver. The capabilities, the receiver and provider have, may be complementary. (Goel 2008).

The goal of gainsharing in outsourcing relationship is to enhance innovative behavior between both parties. Primarily the innovations are targeted to affect and improve customer's business in quantitative and qualitative way. In addition, the innovations are supposed to allow risk- and reward-sharing between service provider and service receiver. The innovations that bring marginal improvements to the operations or processes are not counted. The marginal improvements can be assumed to be executed whether there is a gainsharing arrangement between the parties or not. (Goel 2008) Also there is no point to apply gainsharing if innovation is expected to create marginal savings. The reason for that is that gainsharing demands both parties' participation which means that if the savings were shared in every situation the gain would be lost easily as the involvement costs would be higher value than the value of the savings. (Agrawal et al. 2005) The innovations that actually make a major difference are the ones that would not necessarily take place in a normal course of business. They may involve either new technologies or business processes or combine both. These types of actions frequently need investments and the service providers are rarely willing to take any additional risks if there is no incentives or possibilities for them to increase their profit. (Goel 2008).

The purpose of gainsharing is to stimulate the service provider to continuously develop the operations in order to generate incremental value in addition to the baseline price agreed in the contract. To create incremental value, often means more investments, efforts and risks. Normally there is a base price agreed between the partners that is based on different pricing models. Gainsharing can be seen as an extra layer that functions across the different pricing models. (Goel 2008)

## **5 GAINSHARING IN OUTSOURCING RELATIONSHIP**

In this chapter, the prerequisites and barriers for gainsharing are introduced based on the theory found from the literature. The structuring of the gainsharing model, measuring gainsharing and gainsharing for incenting innovation are also explained. The reasons, why companies implement gainsharing plans, what are the benefits and what kind of problems there might be when implementing gainsharing arrangements, are identified. The goal is to find enough information from the literature to support the development process of the gainsharing models.

### **5.1 Prerequisites for the use of gainsharing**

In order to form a successful relationship and suitable environment for the gainsharing to function properly, there are multiple factors that the service provider and receiver should consider. First one is the relationships between the outsourcing parties. According to Lee (2001) and Goel (2008), there must be a high degree of trust between the members and the relationship needs to be strong meaning that the parties have to know each other and recognize each member's capabilities and weaknesses. When the parties trust each other, it provides a fruitful environment to develop the processes. Trust and strong relationship are prerequisites for a high degree of transparency and good communication and information flows which are essential to the gainsharing. (Goel 2008) In order to create innovative atmosphere between the outsourcing parties the environment needs to be stable and there must be trust and mutual respect between the parties. According to Kapadia (2010), an efficient governance excellence program should be introduced to assure the proper environment for gainsharing.

One important factor is the defined processes involving innovation initiatives. The defined processes comprise of different stages in innovation process. These stages are identification, evaluation, approval and implementation of innovation ideas. The method, how to facilitate the innovation projects, should be planned carefully as the clearly defined processes ensure that great ideas will not be wasted, but rather taken forward. To take advantage of the IT-systems is a good example to help the identification process. For example, the employees should have an access to company's intranet where they could and

also should suggest improvements and innovation ideas. This makes it also easy for the managers to read and evaluate whether the ideas are valid. Often, in order to ensure that the innovation ideas are taken forward, a group of people should form an innovation team involving members from the service provider and service receiver. This group of people is responsible of making sure that all the suggestions and innovations ideas are evaluated the best ones implemented. The team works simultaneously as a director, a monitor and an implementer. (Goel 2008)

## **5.2 How to structure a gainsharing model?**

Imberman (1993) gives very straightforward and simple examples how gainsharing work. Even though, Imberman (1993) sees the gainsharing as tool for a company to enhance its internal processes and bring savings to itself, some of the concepts fit in the outsourcing context just as well. First of all, it is important to recognize the people that should be educated and involved in gainsharing. Normally these people are the employees who work in the process and have direct influence on the activity or process. For example, if the gainsharing is deployed in the warehouse or in a manufacturing plant, the people working as warehouse worker, assembler, engineer, forklift driver, production worker and so on should be involved in development of the processes related to the warehouse management or production planning. These are the type of people who usually have the insight and ideas about bottlenecks, problems and improvements needed. (Imberman, 1993)

The one-size-fits-all mentality does not work in gainsharing. It is important to tailor the gainsharing model that responds to the situation. The companies need to have a clear idea what are the benefits or the desired outcomes they are looking for from the gainsharing plan or model. This helps them to decide which kind of measures should be used in a certain situation. Also when companies are developing a gainsharing plan, companies need to identify the cost structure. By doing that it is easy to find out where the most of the money is spent. If, for example, most expenses come from raw material the emphasis should be in cutting the raw material use and costs. On the other hand, if the labor is found to be the most expensive cost, then the emphasis should be naturally in labor productivity

measurements such as productivity per man hour, less scrap and rework costs. (Imberman, 1993)

Imberman (1993) states that “the most important element of any gainsharing formula is simplicity.” This is important so that the people who are involved are able to understand what is measured, how the gains are shared when new innovations are introduced. Additionally, the simplicity is a key to avoid any kinds of arguments and interpretation problems. The measurements and the constants are often formed based on the historical data so in order to do that companies must have records. This means that companies need to take time to review the old data and form forecasts of the upcoming costs and expenses.

Lastly, even though the gainsharing model is implemented and gains are shared between outsourcing parties, the employees need to be involved. This means that there needs to be some kinds of incentives for the employees to share their ideas of innovations. Sometimes the gainsharing model is integrated with the continuous improvement programs. It should be always assured that the employees are educated and they know and accept the idea of gainsharing. (Imberman, 1993)

The structuring of gainsharing model is a vital phase. When planning the gainsharing model for the use of service provider and service receiver, it needs to be assured that the model is appropriate and in balance for the use. This means that the model should motivate the parties to work as wanted and increase the appropriate and desirable behavior within both parties. Also the model should be simple, easy to understand and leave no interpretation possibilities, which would easily lead to arguments. (Goel 2008)

When the gainsharing model is functioning properly, it should lead to a win-win situation. That is obviously very important as it is the only way that both parties engage themselves to strive to reach the targets and desired outcomes. This also ensures the risks, investments and rewards are distributed fairly between the members. Both parties should be committed to the gainsharing model and take part on innovating new ideas and implement them. The goal is that everyone profits from the model. (Goel 2008) In the gainsharing contract it should be defined and agreed how the financial benefits will be shared. Also a mechanism

should be introduced that clarifies risk ownership allocation and investment responsibilities. (Kapadia 2010)

When investments are made, the typical arrangement is that the investing party should recover first before the gainsharing is put to use. The need of investment normally takes place when a new technology is needed for example. The investment is recovered when the money has been recouped in the form of savings or cost cuts. When the success of gainsharing model is evaluated, the focus should be on tangible and quantitative measures. This way it is easier to calculate the real gains and decided the share that each party should be getting. Simultaneously, possible arguments related to qualitative outcomes and their value are avoided. (Goel 2008)

Lastly but as importantly the gainsharing period for service provider should be decided. When the gain is realized, normally there is agreement made in advance which states the time that the service provider gets a part of the gain. This can be, for example, six months or a year depending on the agreement. In the end the service receiver gets the whole gain to itself. (Goel 2008)

### **5.3 Barriers to gainsharing success**

Many studies argue that gainsharing agreements between service provider and service receiver are not the straight path to success. (Kapadia 2010; Goel 2008) Many factors impose impediments to successful gainsharing. These impediments are often related to the 10 ailments to successful outsourcing relationship explained in second chapter of this paper. One of the factors might be poorly structured contract. When the contract is not in balance and does not have a clear mechanism for risk- and reward-sharing, there is a huge potential for failure. Both parties need to see the contract beneficial and fair. (Kapadia 2010) The other potential factor might lie on the relationship between the partners. As it was mentioned earlier, strong relationship and mutual trust are essential factors. If the partners do not trust each other, the less likely they are taking any sort of risk that are many times needed. This complicates the information sharing and transparency which are vital for a successful gainsharing arrangements. Additionally, the strong relationship poses a

common ground to share the innovation ideas, discuss about them and naturally implement them. (Kapadia 2010) Capabilities poses a risk for successful gainsharing also. If the service provider does not have experience of the customer's industry and the technologies, processes and solutions related to it, it can be difficult for the provider to come up with anything innovative. (Goel 2008)

Digrius and Koenig (2006) share their ideas, why gainsharing is not used in outsourcing contacts. They list five impediments for the successful gainsharing contracting. They are:

1. Size of the financial results. If the value of the savings is marginal, the service provider is more likely to accept the traditional fixed-fee contracts.
2. A lack of measurable and auditable benefits.
3. Non-existent tracking mechanism. This is very important in order to follow and monitor the success of the innovation projects.
4. Contradictions in business cultures. There must be a win-win mentality, a tolerance of risk, flexibility and trust.
5. Lack of an experience. Digrius and Koenig (2006) claim that "Buyers need to have experience in contracting for large, complex services."

#### **5.4 Gainsharing for incenting innovation in outsourcing relationship**

As it has been mention before the incentives are needed in order to generate innovations in outsourcing relationship. In the innovation survey conducted by Lacity and Willcocks (2014), gainsharing at a project level is found to be the most effective incentive program for innovation between service provider and service receiver. The other options that were available in the survey for the respondents (service providers, customers (outsourcers) and advisors) were innovation funds, invest days and special governance for innovation. Almost 80 % of respondents agreed that gainsharing on innovation was the most effective way to contract for innovation. The main reason for that is that it provides gains for both parties. In the gainsharing arrangement the provider is given a share of the profits meanwhile the customer's performance is improving.

Even though the survey revealed that the gainsharing is seen as the best and most efficient option, still only 40% of delivered innovations used gainsharing. Frequently the contracts between service providers and customers did not include gainsharing clauses. There were also instances where the gainsharing was included in the contract but it was never exploited. According to the survey, gainsharing did, in spite of all, generate very promising and efficient results to some of the customers. Lacity and Willcocks (2014) explains that these mixed results are derived from the use of gainsharing in different levels: at a project level and relationship level.

Using gainsharing at the project level proved to be the most efficient way. This means that the gainsharing arrangements are negotiated for one project at a time. In this instance, the savings or improvement are more easily evaluated and measured lowering the level of uncertainty simultaneously. (Lacity and Willcocks 2014)

When the goals are set for the overall performance of the relationship and the results are evaluated, for example, yearly, it means gainsharing is used in the relationship level. The results of using gainsharing at a relationship have not been very encouraging based on the Lacity and Willcocks (2014) survey. One major issue that respondents reported was the problem of setting targets. The service receiver felt that the targets were often set too low and it was not real fear of not reaching the targets for the service provider. Sometimes it is difficult for the parties to agree on the conditions and a baseline performance measures. That has led to abandoning gainsharing even though it has been agreed on the contract. Also the interpretation of gainsharing clause has caused argument between parties. (Lacity and Willcocks 2014) This is a sign that the negotiations for the gainsharing arrangements have to be well planned and the terms carefully examined before adding gainsharing clause in the contract.

In the beginning of an outsourcing relationships it is typical that it takes some time before the new innovations are introduced and the service receiver's performance increases. Actually it is found that performance might even decrease in the beginning before the it gets stabilized. So even if the gainsharing arrangements and innovation clauses are agreed in the contract it does not mean that the success starts on the spot. Lacity and Willcocks

(2014) introduce a process the call “AIFI- Acculturating, Inspiring, Funding and Injecting”. This AIFI- process is recommended to be implemented in order to incent innovation.

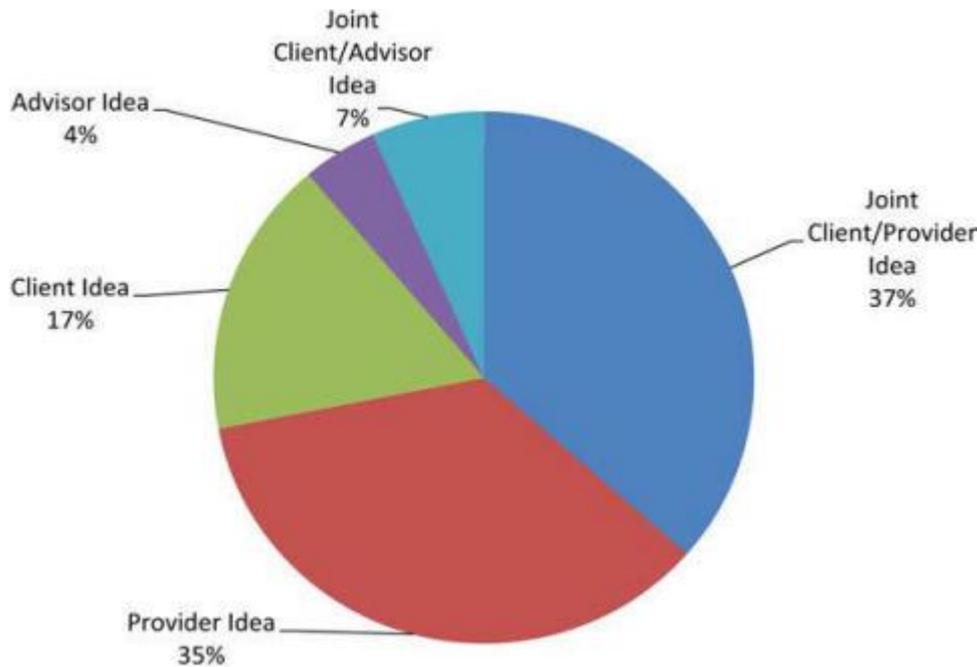
#### **5.4.1 Acculturation**

Acculturation is very important especially in offshoring outsourcing cases. It means that two cultures merge and formulate one cohesive culture. The cultural differences tend to be more significant when the parties in outsourcing relationship are from different countries. These cultural differences can pose risk to successful relationships and thus they should be managed carefully. This is called” a cultural distance management” and it is used to learn, to accept and to adapt to different cultures. (Lacity and Willcocks 2014)

An example of two cultures merging would be a service receiver notifying special holidays that are relevant for the provider’s culture. Another example would be service receiver using servicer receiver’s colors and logo in their office or warehouse. The key point is that the both of the parties accept and strive to develop a culture where innovations are desired and rewarded. (Lacity and Willcocks 2014)

#### **5.4.2 Inspiration**

The goal of gainsharing is ultimately that both parties in outsourcing relationship would simultaneously bring new innovation ideas to the table. According to the Lacity and Willcocks (2014) it is typical that the parties think that their own part of being innovator is more significant for the relationship. Below the figure 4 shows how the ideas of innovations are divided according to the survey.



**Note:**  $n = 189$  respondents

**Figure 6. The source of innovation ideas. (Lacity and Willcocks 2014)**

As it is seen, the innovation ideas are most often created jointly or by the service provider. In few cases advisors or consultant are used to come up with new innovations. Ideas that are created in collaboration between the parties usually take place during the innovation meetings, invest days or forums. The service provider clearly has bigger role in creating innovation ideas. That makes sense since the service provider often has the knowhow and expertise of the area of business it is operating on. (Lacity and Willcocks 2014) In logistics outsourcing, the source for innovation ideas is rarely from advisor or consultant as the service provider is often a party who has the knowledge and capabilities to enhance the service receiver's performance.

### **5.4.3 Funding**

Funding is frequently needed. Especially when the new technologies are deployed, investments need to be made. The decision of which party should invest, can be one of the factors that defines how the gains are shared and in which ratio. The participation on creating innovation ideas depends often on the incentives. Especially the service provider needs to recognize the benefits of bringing in new innovations to enhance the customer's

processes. The table 1 below illustrates how the innovation ideas are funded according to Lacity and Willcocks (2014).

	Provider's idea	Client's idea	Joint provider/client idea	Total	
				Number	Percent
Provider-funded	35	4	16	55	36
Client-funded	13	12	5	30	20
Jointly-funded	14	14	39	67	44
Total	62 (41%)	30 (20%)	60 (39%)	152	100

**Table 1. Source of innovation ideas and funding. (Lacity and Willcocks 2014)**

#### **5.4.4 Injection**

In high performing outsourcing relationships innovations should be desired and stimulated. With the innovations comes the need of change. When the new processes or technologies are introduced, there is a clear need to change the old ways and adapt the new ways to conduct processes more efficiently. That is why it is necessary to manage the change in a customer's behalf. It is well-known that change creates resistance and in order to tame this resistance, the employees, teams and the units have to understand the impacts and benefits of the change and the desired outcomes. If the change management is not done properly, there is a risk that innovations will not take place. Ultimately the service provider might see innovation creation unnecessary and stop wasting time and effort on it if the service receiver is constantly refusing the ideas and not willing to change.

### **5.5 Measuring Gainsharing**

Measuring gainsharing is very relevant to this study as the goal of this study is to create gainsharing model prototypes that would work in a logistics outsourcing context between the service provider and service receiver. However, as the Agrawal et al. (2005) clarifies, very few studies deal with measuring gainsharing. This research gap seems to be true still today as the extensive literature view that has been made for this study finds very little information about the matter.

Agrawal et al. (2005) identify one method to measure gainsharing between companies in outsourcing IT –context. Agrawal et al. (2005) writes “the fundamental premise of the

method adopted by researched companies relies on parameters (cost projection) materialized in flexible budgets and standards for each operational cost center established by the “joint team”. In the paper, four steps are introduced that needs to be taken to build the parameters. These steps are:

1. Planning of the original budgets
2. Revision of the original budgets
3. Counting of the actual expenses
4. Comparison of the actual expenses with constants in the revised budgets

In the first step, all the quantities and the values of the needed resources are estimated for each volume level and cost center. In the revision step these values and quantities are reformed and updated. These revised budgets form a base for the comparison that is made in during the fourth step. In the third step the actual expenses in a certain time period are counted and finally they are compared with constants in the revised budgets. After the fourth step, the measurement of gainsharing is possible as it is easy to clarify the difference between estimated costs and actual costs.

There are few premises that need to be possible in order to be able to measure gainsharing properly. These premises are:

- The results should be measured against previously specified parameters
- The efforts involved in various actions that are undertaken should be reflected
- The goal is to generate performance improvement
- The measurements should be objectively measurable, expressed in financial terms and mutually acceptable to the parties.

In conclusion, in order to deploy gainsharing arrangements, there must be historical data available. If there is not, some work study including measuring process times and defining financial values for the process is required. In logistics outsourcing context, it can be recommended that the parties have some type development tool in order to calculate the potential savings of the development projects.

## **5.6 Gainsharing in outsourcing contract**

Feng (2009) states that “Under a gainsharing contract, a vendor and a client originally negotiate a target price and a gainsharing ratio for a particular product.” In the logistics outsourcing context this “product” is often a service or an activity. For instance, if a service provider is managing customer’s warehouse, this activity could be a picking process. Each time the service provider’s employee picks products from the warehouse and sends them forward, the service provider is getting paid. In the end of the month the service provider sends an invoice to its customer (outsourcer) that is comprised of the amount of picks made during that month. Gainsharing steps in when this activity process, for example picking, is being improved. If the picking time is halved due to new innovations, technology or something else, it is obvious that the cost of picking will decrease as well and capacity (amount of deliveries per day) will increase. The sharing of these cost savings depends on the gainsharing agreement that the parties have in the contract.

The painsharing should also be considered in the contract. Ackerman and Van Bodegraven (2011) emphasizes the other side of the gainsharing agreements. The gainsharing will not function correctly if the painsharing is not added in the contract. This means that the service provider will be penalized if they fail to offer the promised savings or development. Sometimes the costs might increase due to external factors such as inflation in prices of electricity, materials or labor. These types of situations should be considered in the gainsharing agreement. The gainsharing price is robust because the price can be changing depending on the savings, innovations and the cost overruns. (Feng 2009) Below is an example of gain/painsharing in a target cost contract created by the Defence Material Organization.

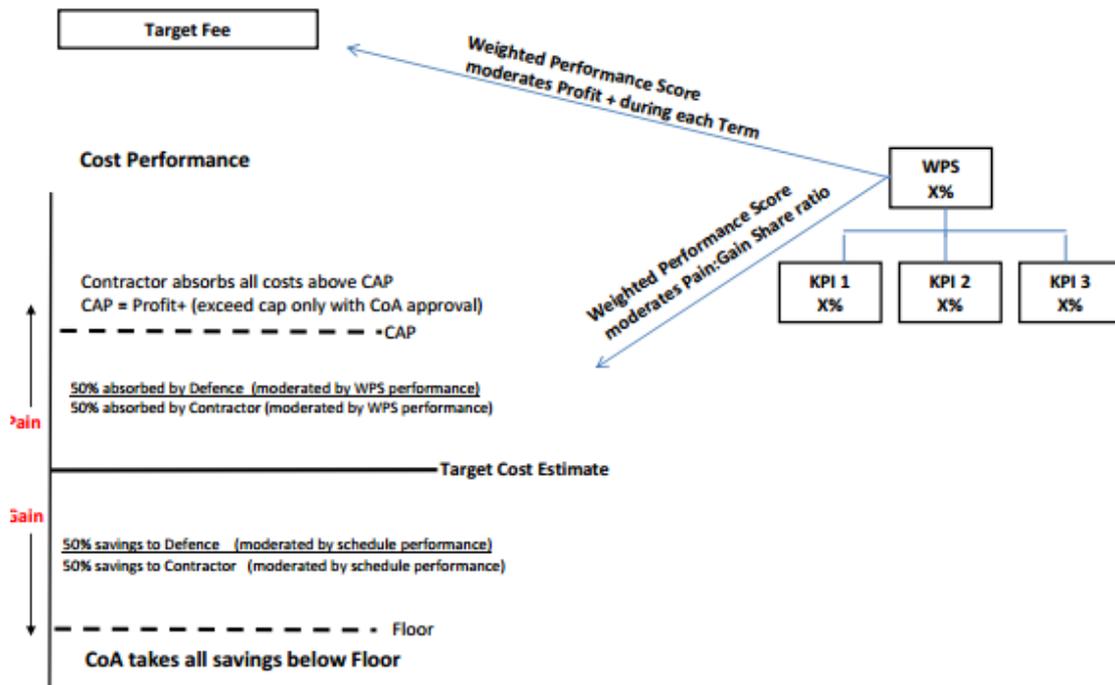


Figure 7. Example of gain/painsharing in a target cost contract. (Defence Material Organisation 2010)

The target cost contract has been introduced previously in this paper. Basically in the Figure 7 the financial and operational performances are integrated. The companies have set a target cost and chosen key performance indexes which they follow periodically. In this example the service provider (contractor) and service receiver share the gains and the pains to a certain limit on an agreed ratio which is 50 %- 50 % in this instance. If the limits are exceeded, the service provider gets the rest of savings or absorbs the exceeded costs or, in other words, cost overruns. (Defence Material Organisation 2010)

Typically, companies need to agree on four common elements when negotiating on gainsharing arrangements. These elements are:

1. Baseline
2. Performance target
3. Reset horizon
4. Sharing mechanism

The baseline is based on the historical data concerning the performance level. The measurements are formed by using this data and desired goals and targets are compared to these measurements. The most suitable measurements are decided and agreed by the both parties in outsourcing relationships. It is vital that the data is visible and available for the both parties. (Charles 2005) An example would be, when a price for picking service in warehouse is calculated. First the average time of one picking activity shall be measured and then the price calculated based on the time and other relevant factors.

The performance targets are also set together. The service receiver should have a clear vision of the desired outcomes and these should be discussed and shared with the service provider. The set goals should be distinct so that the arguments and interpretation issues are avoided. In some gainsharing arrangements the profit is shared when these desired outcomes are achieved. (Charles 2005) The performance target could concern the time needed to execute a picking activity. For example, the outsourcer could set a target to cut the time by 10% from the baseline time in order to execute more picks per day.

Reset horizon means an agreed point of time in future when the service provider and the service receiver re-think the gainsharing arrangement. Often this means changing the conditions, resetting the targets or even abandon the agreement. (Charles, 2005) When considering the previous picking example, it is obvious that the picking time cannot be decreased infinitely.

The fourth element, sharing mechanism, addresses the sharing ratio of the potential gains or losses. In addition, it includes splitting the investment responsibilities. The gains and losses might be divided equally 50-50 or they may be shared based on more complex formula. Often the ratio depends on the investing and innovative party. For example, if the investing and innovative party is the service receiver, they would get the more benefits and bigger share of the achieved savings. On the other hand, if the innovations and investments are made by the service provider, the service provider might get a bigger share of the gains, let's say 75% for a certain period of time. It's important to bear in mind that in the gainsharing arrangement, the time period in which the gains are shared are also mutually agreed and ultimately the gains are often moved to the service receiver. (Charles, 2005)

## **6 DEVELOPING GAINSHARING MODEL PROTOTYPES WITH THE CASE COMPANY**

The gainsharing model variations were first created based on the literature and by interviewing the case company's employees. The model variations were introduced to several customers who shared their opinions, issues and experiences about the gainsharing. The models were developed further based on customer's expectations. One of the gainsharing models will be tested with one key customer. The testing itself will be done in future and not within the limits of this thesis. The gainsharing model will be coded to the case company's extranet where it is usable for the case company and its customers. The further studies and analyzes of its functionality shall be conducted later after the testing, but are not part of this thesis.

### **6.1 The business environment**

As it has been mentioned before, the case company operates in logistics outsourcing environment as service provider. The gainsharing model variations that are created in this study are planned to be used between the case company and its key customers. So in order to take the customers' perspectives into account, few of them are interviewed. The chosen customers are labeled as key customers and there are assigned key account managers in the case company who are responsible for managing the business relationships daily. These key customer companies are Finnish OEMs. The outsourcing contracts have been valid for years and over the years the relationships have deepened and the parties know each other very well. This naturally means that there is a high level of trust between the parties and the communication and information flow is relatively smooth in most cases. The collaboration has stabilized and over the years somewhat extended.

The chosen key customers have outsourced part of their warehouse operations and processes in various locations in Finland to the case company. The operations include inbound, internal and outbound logistics procedures such as receiving goods and materials, packing, shipping and outdoor material handling. Additionally, in few instances, the case company is responsible for procuring packaging materials from the subcontractors named

by the customer and producing certain wooden packages. In some locations, the case company offers also assembly, documentation and archiving services. There are hundreds of the case company's employees working in the customers' manufacturing sites and warehouses. The employees are responsible for accepting the deliveries, moving the parts and products to the shelves in the warehouse, picking and packing and sending the final products and parts forward and so on.

In order to deliver the services, the case company is responsible for managing the human resources in these locations. This means that the case company ensures that there are correct amount of workforce and they are trained and they have the appropriate know-how to execute the work tasks as required. The case company also plans, manages and develops the processes and operations. The case company has introduced continuous improvement philosophy for its employees in these locations in order to identify the potential development targets in the key customers' operational environment. The gainsharing has been mentioned in the outsourcing contracts and it has been discussed but it is yet to be taken into use.

## **6.2 Motivation behind the plan**

As it has been mentioned in the introduction, the customers are craving for transparency and better understanding of the expenses and potential savings. Obviously a service buyer expects the service provider to develop and improve the processes and bring savings through new innovations. To enhance the operations is one of the main reasons of outsourcing. For the case company gainsharing arrangement is a way to ensure that there are benefits available for them from the development and innovation projects. The financial savings for the service receiver are also part of the case company's value proposition, contract and they are consistently expected by the customers. The case company has implemented one gainsharing model with another key customer before and it has proven to be useful tool for the company to increase profits, enhance the processes and strengthen the relationship and collaboration with the customer. Also the interviews with case company's employees revealed that the service provider sees gainsharing as way to keep customer satisfied. Normally a strong and functional relationship should be

established with the service receiver as the contracts made by the case company and its customers are often valid only for three-to-five years. In order to assure that the collaboration continues and the new contract are to be made in future, strong relationship, flexibility, continuous improvement and satisfied customers are indispensable for the service provider. Nowadays, in almost all of the outsourcing contracts the case company signs with the customers, the gainsharing is mentioned, but in most cases the arrangement has not been executed yet and the gainsharing contracts have not been signed.

Creating functional gainsharing model for the use of the companies is a way deepen the relationship, improve the collaboration and enhance the innovation and development projects. With the gainsharing arrangements there are incentives for the both parties continuously develop the processes as the potential savings, quality improvements and such, are creating monetary profits for both parties. The goal of gainsharing model is to illustrate how the potential savings can be fairly divided between the parties. Naturally the share one party gets depends on the gainsharing agreement and the model that is in use.

### **6.3 Prerequisites for gainsharing arrangement**

Before signing the gainsharing contract, adopting gainsharing arrangement, creating a gainsharing plan and introducing the model, companies need to recognize the prerequisites for gainsharing. The gainsharing between companies can be an expensive arrangement as it often requires that both parties are involved and committed to it. Thus, the involvement costs are high. Due to this fact companies need to agree the size of the project when gainsharing is adopted. The projects that bring marginal changes and savings are not worth to take into consideration. But if there are major potential savings, both parties need to be involved and the gainsharing should be adopted. In addition, mutual benefits should be available on each project in order to gain mutual satisfaction.

The case company introduces developments via two channels; floor-level innovations and innovation projects including gainsharing. To come up with the floor-level innovations, the case company has introduced continuous improvement ideology which includes the employees. Basically the idea is to encourage the employees to introduce their ideas of

improvement and reward them by doing so. The innovation projects including gainsharing are the ones that have the major saving potential but simultaneously they need time, effort, negotiations between parties and resources to implement them. Often the ideas for innovations come from the employees also.

Ultimately the goal of the gainsharing is to create a win-win situation and the sentiment behind this is that the benefits achieved by developing and innovating together are bigger than the benefits the companies would get by working individually. In the worst case scenario, the companies would try to induce benefits by working against each other. It should be kept in mind that one model does not necessarily work in every situation. The model shall be customized depending on the customer and the business environment where it is designed to be used. The model itself has to be simple to use and easy to understand. It should not raise any interpretation issues. Success is more likely when companies work together and there is a standardized process for gainsharing. If there are constant arguments of who did what, the collaboration might be restricted and some impediments for success might pop out. This is why it is important that there is a database and IT-systems that support gainsharing and where the ideas and the process can be recorded and followed.

The interviews with the case company' staff have revealed that there are various issues that companies need to consider before adopting gainsharing. It is imperative that there are enough of information and data available for the companies in order to come up with new innovation ideas and develop the processes. The transparency is vital. Both parties should have an access to a database where they are able to check and follow the development ideas, projects and their progress and the expected savings. This can be done by integrating IT- system between the service receiver and service provider. Currently the case company is often lacking important information such as the customer's production plan, incoming deliveries and forecasts. There is no proper data about the quantities, timetable and products. In addition, the case company does not have accurate information about the incoming batches and deliveries from the suppliers so they could be prepared to accept and receive them. This has led to problems in planning of the resources concerning correct amount of workforce, packaging materials and so on. At the moment, in some locations, the employees are often waiting for work tasks and this creates unwanted waste. This is

waste is obviously expensive for the case company. In other words, the case company is constantly struggling to plan the resources accurately.

To improve the information flow, the case company needs to illustrate the benefits of it to the customer. In order to reduce the waste in this situation, the case company needs information and data about the production plan, products, quantities and incoming batches. Additionally, the innovation ideas and concerns about the quality, such as reclamations and packing mistakes and other feedback, should be shared. Naturally there must be incentives for the customer to do so. As with the better planning the company is able to allocate resources and do the work more efficiently, they could offer the customer price reductions, but still improve their profit margin by cutting these waiting times that have been appearing currently in one of locations the case company is operating in. Also the customer needs to be convinced that by sharing the information and data, the case company can more efficiently enhance the processes. There are other benefits available for the service receiver also. For example, the case company may improve the material management and identify products and materials that are staying in the warehouse long times and unnecessary capital have been committed to them. Also the enhancement of the processes may impact positively on the delivery times and such and these developments improve the customer satisfaction. Such development can even be utilized in customer acquisition.

Prerequisites concerning the gainsharing model should naturally be considered also. In order to calculate the potential savings, there is often a need for a development tool, which can be used to realize the savings. This tool can be, for example, the PFEP (Plan for Every Part) which is used to measure the work times. The work time, for example, a second can be given a financial value by using this PFEP tool. Many development projects are related to decreasing the times needed to execute a certain process, such as picking or packing process. Many examples of these will be given later on in this paper. The PFEP is not only a development tool and sometimes is it not needed. For instance, some projects only require that there is historic data available. For example, a project related to designing new package in order to cut down the shipping costs, need only the data of the current costs which can be compared to new costs after the new package is introduced. In order to use gainsharing, the benefits achieved from the development project should always be given a

financial value. Additionally, the parties have to agree, how these financial savings are shared. The interviews conducted for this study, indicate that the savings should be shared via the transaction price. But this is not that simple every time. For example, there are situations, where the case company has introduced innovations on the package that have potentially saved 100,000 €/year shipping costs for the service receiver. The important question in these sort of situations is how is the case company rewarded? When introducing such innovations, this have to be kept in mind and should be agreed when making the gainsharing contract. If the case company is designing and producing the packages, the savings could be shared in the price per package. Other option would be the transaction price for the packing activity that could be increased for a certain period of time in order to reward the case company for the innovation. The main point is that there needs to be incentives for the case company to bring these sort of innovation ideas to the table.

The case company uses various pricing models depending on the customer. In one case, there is only one transaction price used which is related to the end product the customer is manufacturing. In this instance, the case company get paid a fixed amount by one product. So the amount of money the case company gets per day depends on the amount of end products produced per day. Then there are other examples, where the case company gets paid by different activities. For instance, there is a transaction price for a picking activity, packing activity, assembly and so on. Sometimes the price for packing activity depends on the package which can be a normal cardboard box or a special wooden package designed for a certain product. It is important recognize the pricing model that is in use with the customer when implementing development projects and allocate the savings to the right transaction price.

One more prerequisite should be taken into account. The service receiver should only take advantage of gainsharing when the relationship profitable. There are examples, where the prices have been pushed so low that the service provider is hardly making any profits. In these sort of situations, the company should rather try get rid of the contract and the customer than introduce gainsharing arrangement.

#### 6.4 The gainsharing process in logistics service context

In this part the typical gainsharing process and the steps are explained in very simple way. In reality these steps may take a lot of time due to the negotiations between the parties, potential need for investments and planning the responsibilities and so on. The steps need to be examined carefully and the parties need to agree on many things before the actual development idea is to be executed. The figure 5 illustrates the typical gainsharing process.

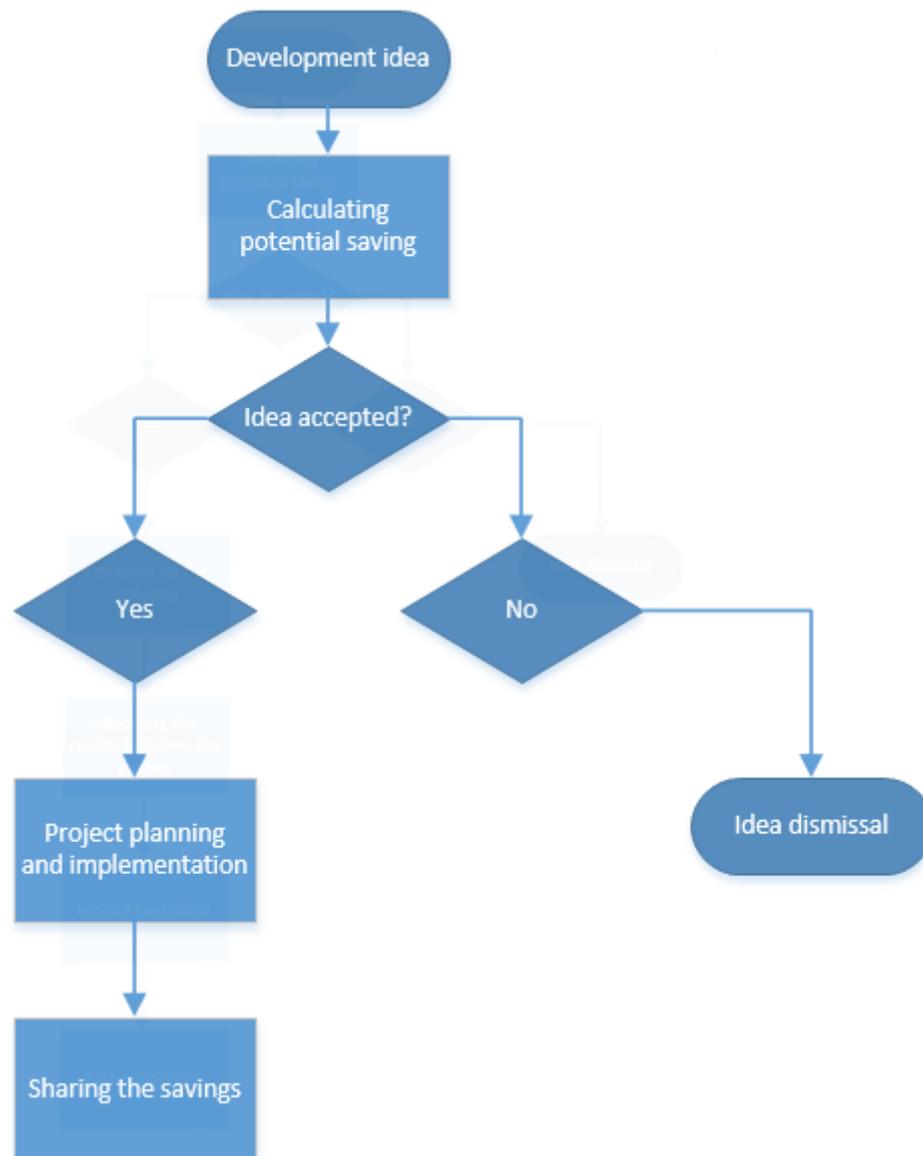


Figure 8. The gainsharing process

The whole process begins with the development idea that has been introduced by a party that can be the case company or the service receiver. Also the idea can be mutually invented. The parties go through the development ideas in a regular meetings that may take place every month or so depending on the case. All the relevant information should be given and the details about the project explained and recorded. Every innovation idea should always be recorded so that there is always information available how the idea was born and where did it come from. In this phase it is also good to recognize whether the project needs monetary investment or not. Additionally, when the idea is taken into consideration, it should be assessed whether the idea is possible to implement, what are the potential risks and how should they be taken into account and are the right measures available. For example, the risk can be apparent, when the outsourcing contract is ending and there is no agreement about the future. In this sort of situation, it is very risky to implement developments that require investment that have a long repayment period. Other example would be if there are large deviations in the estimated volumes. This obviously could potentially prolong the repayment of the investments and decrease the calculated savings. If the parties decide to move on, the potential savings should be calculated next. This is an important phase in order to assure that there are real “gains” available. The calculating process requires data. Often, in order to have the data, some work study should have been made previously or it shall be made before the next step can be taken. The most important thing is that there is some type of development tool and the proper measures available so that it is possible to calculate the potential savings and, in the end of the project, the parties are able verify the savings. This tool can be, for example, PFEP which is in the case company’s use. By using PFEP, the case company is able to measure the potential savings of the development project related on the work times. Frequently, the development projects have an impact on the working time in certain point of process. This may concern packing or picking time, or receiving and unloading trucks and so on. For example, if a new innovation idea concerns improving the packing process, it should be identified how the new innovation reflects on the packing time. Let’s say that average packing time has been 60 seconds and by implenting this new innovation idea, the time is expected to decrease by 10 seconds. The financial value is needed for this 10 second reduction. If the transaction price has been previosly 10 € / packing activity, the potential saving would be  $1/6 \times 10 \text{ €} = 1,67\text{€}$  / packing activity. If the montly average is 1000

packing activities, the savings would be 1670 €/month which would be substantial amount of money.

It is important to keep in mind that not every project need PFEP- tool. Sometimes the development projects might be more straightforward and all that is needed are correct measures and historical data. An example would be re-designing of the package that would save space and thus, decrease the shipping costs. The benefit of gainsharing is that the service provider has incentives to develop such thing also. Even though these savings would go straight to the customer's pocket, in gainsharing, the service provider should be awarded also.

After the potential savings have been calculated, the idea shall be accepted or not. Even though the development idea will not be implemented, it should be recorded. The interviews revealed that there have been cases, where the other party has come up with an development idea but the other party has not accepted it. Then after a year or two the same idea has been introduced again and accepted. In some gainsharing models the party who introduces an idea is rewarded and this means they might get bigger share of the savings. If the idea is accepted, the next step is to start planning the project and implement it. This phase might take days, months or years depending on the size of the project. In some projects the planning takes months but the implementation takes only days. Normally the outsourcing parties have agreed on who is responsible for what in this phase. Obviously the planning or implementation can be done in collaboration. This often depends on the gainsharing model that is in use. The interviews made for this study revealed that the case company is often the party who is responsible of planning and implementing these development projects. If the project needs investment, it can complicate and slow down the progress of the project. Naturally correct and precise calculations shall be conducted regarding the amount of money needed for the project and to define the repayment period.

When the project is implemented, the actual gainsharing begins. The first step is to recover the investments. It means that if investments have been made, the investing party gets the "gains" for themselves as long as they have recovered the money. Here is an example: The service provider introduces new technology. The investment is 10,000 € that has 12

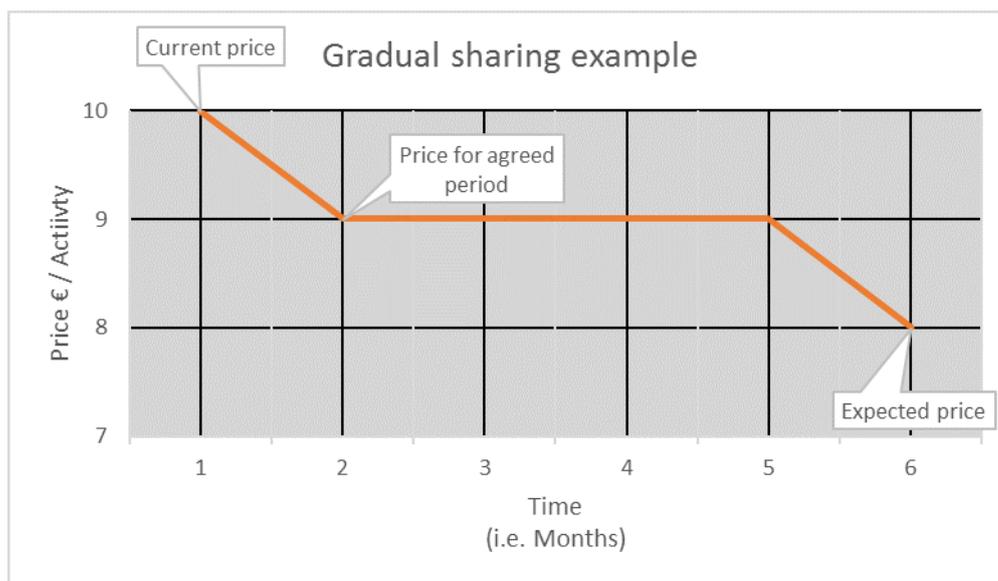
months repayment period with interest. After the implementation the transaction price for the activity stays as normal for the next 12 months, until the investment has been recovered. After that the gains will be shared on an agreed ratio. Let's say the agreed ratio has been set 50-50, the transaction price has been 10 €/activity and the saving is 0,90 €/activity. After that the transaction price is decrease by 0,45 €/ activity to 9,55 €/activity. The potential savings should always be shared by decreasing activity prices, not by sharing calculated amount of saved money between parties.

How the gainsharing works actually between the service receiver and service provider depends on the gainsharing model that is in use. Not always the agreed ratio is 50-50 or even fixed. It can actually depend on the project and the responsibilities that the parties have on it. It is also good to keep in mind that when the calculations are made about the potential savings, they are made based on estimated volumes by using historical data and forecasts. So it is important to add clause that deals with the potential changes on the volumes. If there is an investment of 50,000 € made and the volumes decrease suddenly by half, the repayment period of the investment will be longer than expected. In addition, when the investment is discussed, the parties should acknowledge that the time used in the planning and implementing the development project can be seen as an investment, especially if the project takes months. In order to give value for the used time, parties need to agree price for an hour. Previously there have been instances where the time used in planning and implementing has not been taken into account. A development project has taken place and the service provider has been responsible of planning and implementing the idea without getting any extra reward by doing so. This obviously decreases the service providers financial benefits as the resources used for the project are not free.

## **6.5 Post assessment of a development project**

The post assessment of a project is phase that the parties should be taken account in certain situations. Frequently, it takes time to verify the real achieved savings. For example, a new process is introduced and it requires employees' training. During the implementation phase, most likely, only part of the staff is involved. Later on, the whole staff will be trained. Often the gainsharing has begun before the training is completed and the new

transaction price relies on the calculations and assumptions that have been made during the project. This is why it is important to set a time frame when the work study is conducted again and the real benefits realized. The post assessment is not required for every project. In the project that requires training of the employees, it would make sense to involve the post assessment in order to find out the real gains. Additionally, in these sort of situations, it would be sensible to share the “gains” gradually. For example, a development project is calculated to save 4 €/activity. The gainsharing ratio is 50 % - 50%. The current price is 10 €/activity. There are still some uncertainties related to the real savings and the success depends on how well the employees adopt the new method of working. Then the parties could agree to share 50 % of the estimated savings which would be 2,00 €/activity, so both parties would get 1 € savings per activity. The training is expected to take four months and after this period new work study is conducted and the real savings confirmed. The figure 11 below illustrates this situation.



**Figure 9. Gradual sharing example**

This way potential miscalculations and their influence on the service provider’s profits would be avoided. Sometimes it can be very expensive and difficult for the service provider if the calculations and estimations go wrong and the savings are not realized. Additionally, the post assessment is a good idea when there is a notable investment involved. The repayment period is normally defined by using the historic data, volumes and forecasts. When the post assessment is done after a certain period, the parties can

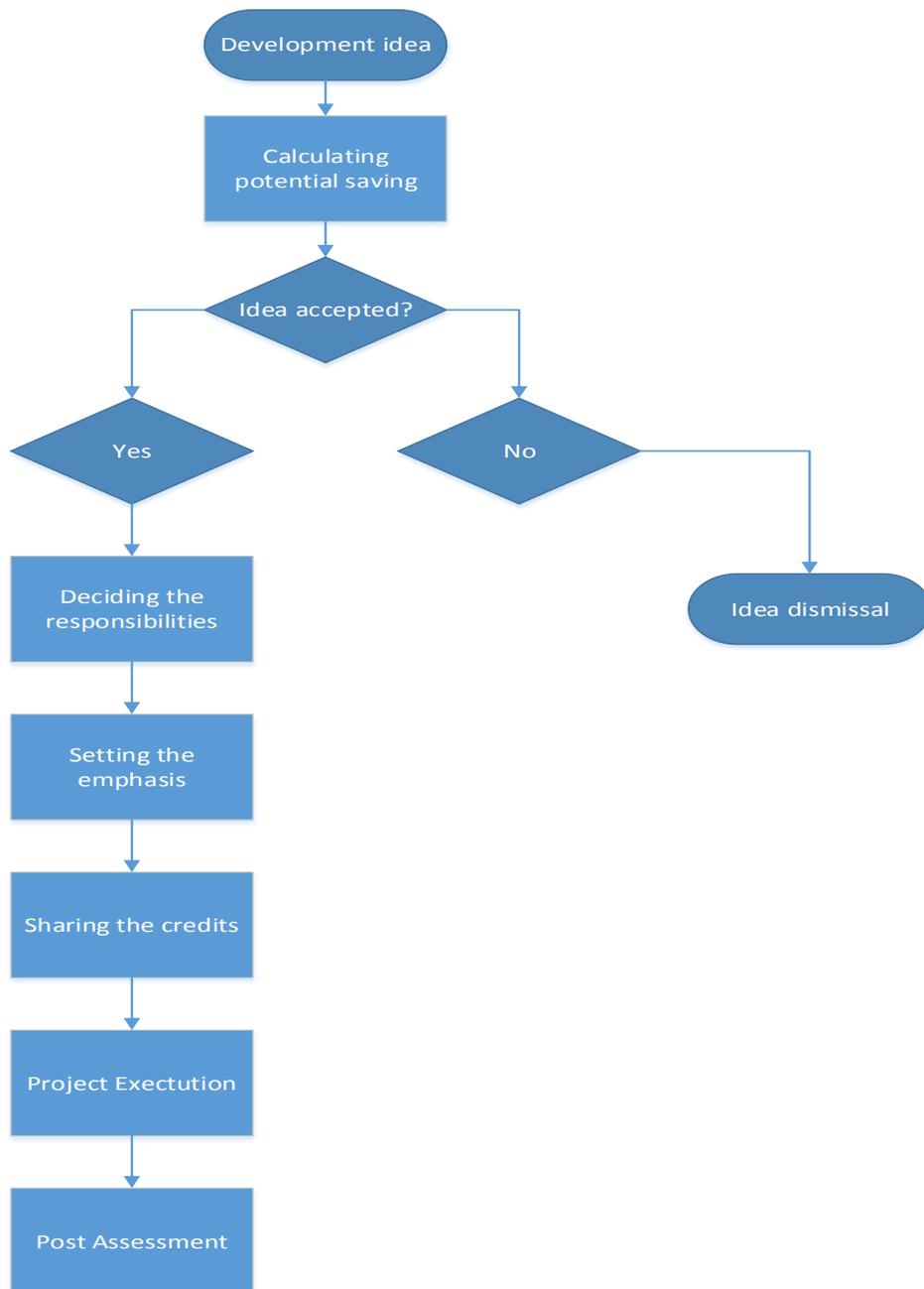
assure that repayment period has been set correctly. If there have been big changes on the demand and volumes, it will most likely have an effect on the repayment period as well and the period may be redefined when necessary. For example, the parties have assumed that the demand will be 10,000 products/year, but after 6 months the demand has only been 2,000 products and the forecasts indicate that the sales volume will not reach 10,000. Then the parties can extend the repayment period so that the investor will recover the investment.

## **6.6 Gainsharing model variations**

Here five different variations of gainsharing models are introduced. The model variations have been developed based on the literature and interviews with case company's employees. These models were later shown to the case company's customers and their opinions and views were asked about the variations. One of these models will be customized based on the customer's requirements and tested later. To be able to conduct the tests, the proper development tools and measures have to be available. The gainsharing model prototype will be coded in the case company's Extranet where it will be available for the case company and its key customer. The testing is not part of this thesis.

### **6.6.1 Variation A. Project-based gainsharing model**

A project-based gainsharing model means that the gainsharing ratio is decided for every development project individually. How the "gains" or savings are shared depends on the responsibilities that each party has on certain development projects. The process is illustrated in the figure 6 below.



**Figure 10. The gainsharing process in project-based model**

The beginning of the process is the same than explained in the previous chapter. The idea is introduced, the calculations are done and the project is either executed or dismissed. If the idea is taken forward, the next phase is to share the responsibilities each party has it in the project and set the emphasis on the parameters, which are ideation, planning, implementation and investment. To decide how the gains are shared and in which ratio

depends on the responsibilities that the parties have. The following steps are next to be taken:

1. Decide who is responsible of what in the project.
2. Enter the weights on the variables which are ideation, planning, implementation and investor. 100 credits are available to share between these variables.
3. Share the credits between the parties
4. See the gainsharing ratio

In the first step, the parties negotiate who plans and implements the project. If the project requires investment, the responsible party is decided. Additionally, the ideation is taken into account. Altogether 100 credits are split between variables depending on the importance and the time and resources needed by the variable. For example, sometimes the planning process takes a lot of time and the implementation process is very straightforward and takes little time. This means that emphasis should be on the planning variable and it should be given more credits than the implementation variable. The emphases obviously depend on the case. These emphases shall be decided together with the other party. The emphasis what the investor gets depends on the size of the investment made. Naturally, there is a difference if the investment is 10,000 € than when it is 100,000 €. It is important to remember that if investments are required, they are always recovered before the actual gainsharing begins. It can be recommended that the ideation variable is given 10 credits maximum. This relates to the fact that often the parties can have different views on the party who came up with idea. In order to avoid unwanted arguments, the idea should not be given too big emphasis. The table 2 and 3 below illustrates the sharing of the 100 credits.

Variable	Emphasis	Service provider (%)	Service receiver (%)
Ideation	A	$X_1$	$Y_1$
Planning	B	$X_2$	$Y_2$
Implementation	C	$X_3$	$Y_3$
Investor	D	$X_4$	$Y_4$
Final share	= 100 Credits	= $A \cdot X_1 + B \cdot X_2 + C \cdot X_3 + D \cdot X_4$	= $A \cdot Y_1 + B \cdot Y_2 + C \cdot Y_3 + D \cdot Y_4$

**Table 2. Example of the project based model table**

The second step consists of sharing the credits or points between the members. For instance, imagine that the implementation process is give 30 credits. These 30 credits will be shared between the service provider and the customer depending on who is responsible for it. If the case company takes care of the implementation they will get these 30 credits. If both parties attend equally the points will be split 50 % - 50 %. If the service receiver is responsible for implementing the innovation, they will get the 100 % of the credits which is in this case 30 credits. As mentioned earlier, very often the case company is responsible for planning and implementing the development projects. With this model, it is also awarded for doing that, which has not necessarily been the case earlier. When the development project is being planned, it requires time, data, work study and engages resources. The table 3 below is an example of setting the emphases and sharing the credits between the parties.

Variable	Emphasis	Service provider (%)	Customer (%)
Ideation	10	100 %	0 %
Planning	40	50 %	50 %
Implementation	30	50 %	50 %
Investor	20	100 %	0
Final share	= 100 Credits	$(10 \cdot 100 \%) + (40 \cdot 50 \%) +$ $(30 \cdot 50 \%) + (20 \cdot 100 \%) =$ 65	$(10 \cdot 0 \%) + (40 \cdot 50 \%) +$ $(30 \cdot 50 \%) + (20 \cdot 0 \%) =$ 35

**Table 3. Example of setting the emphase and sharing the credits**

Table 3 illustrates how the credits could be shared. So in this instance, the variables have been given emphases which can be seen in table 3. The share the service provider gets is  $100 \% \times 10 \text{ cr} + 50 \% \times 30 \text{ cr} + 50 \% \times 30 \text{ cr} + 100 \% \times 20 \text{ cr} = 65$ . In this example, the case company has been the party who has come up with an innovation idea. The planning and implementation will be done in collaboration with the customer. Additionally, in this instance, there is a need for an investment and it has been given 20 credits' emphasis. The investing party is the service provider and they will get these credits. This would mean that the potential saving created by this project would be shared 65 %- 35% for the service provider's favor.

As the weights are given to the variables and the credits shared between the parties, the gainsharing formula is decided. The required measures are dependent on the project that is being implemented. So for every innovation project, a set of measures is chosen so that they are relevant to the case. Thus, it is important that the relevant data is available or if not, the needed work study shall be conducted. This work study might be part of the planning process. The goal is to find out the current value for the needed measures, for example, average packing time for certain product and compare it to time after the development project is finished.

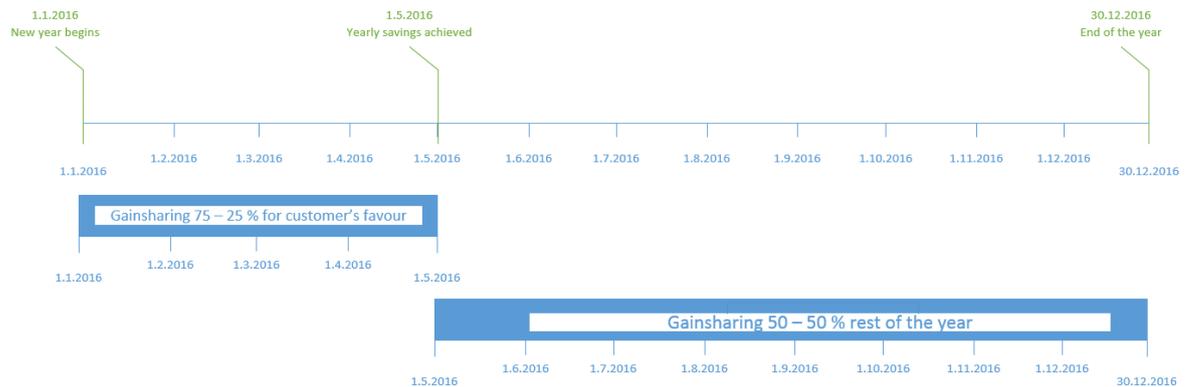
This project-based model is designed especially for the big development projects. The model itself is bureaucratic and need both parties' commitment and involvement. Also the negotiations for setting the emphases, sharing the credits and making the needed

investments can be expected to take time. Thus, it should not be used when the project is expected to bring small savings, such as less 10,000 €/year. This model, as the others as well, is tied to the transaction prices and when the potential savings are calculated, it should be estimated how the project influence on the price. The positive side of this model is that it motivates the parties to collaborate and participate in the project. The last step in the figure 6 which is the post assessment will be explained later in this paper in its own chapter.

One remark related to the project-based model is that sometimes it can be difficult to estimate the required time and the “value” of each step of the project. Thus, the setting of the emphasis on the variables can be difficult task before the project is implemented. In this case, the parties may decide the responsibilities of each party. For example, the service provider is behind the idea and it gets 100 % of the agreed points from that variable. The planning and implementation is done mutually 50-50 %, so the points will be split between the parties. The investing party is the service provider and it get 100 % of the points given to the investment variable. Basically this would mean that certain party or both would take responsibility of the planning and implementing process. Additionally, the parties would agree on the investment. The setting of the emphasis and the sharing of the points would take place just after the project is executed.

### **6.6.2 Variation B. Yearly price decrease first, then equal sharing**

The case company promises yearly savings for the service buyer in an outsourcing contract. Usually these saving are stated in certain percentage of the transaction price, for example, 3-5 % decrease per year. In this gainsharing model variation, the gains would be shared 75- 25 % until these yearly savings are reached. After that the gainsharing ratio would be 50-50 % the rest of the year. The timeline below illustrates this model.



**Figure 11. Timeline example.**

In this model the previously explained characteristics are valid. Thus, a development tool is needed and the savings are shared via transaction prices. The monitoring of the development should be done monthly in this model. This model fits best when the development project does not require big and expensive investments.

### 6.6.3 Variation C. Balance scorecard model

This variation of gainsharing model is related to balance scorecard and it can be seen as relationship-based model. Basically in this model, the companies choose a group of measures which they follow periodically. These measures can be related to financial performance, internal processes, customer and learning and growth. Normally the measures are chosen regarding to the desired outcomes and targets. So first it is important to ask the service buyer “What benefits are you looking for?” or “Why are you outsourcing?”. In addition, it is good idea to think about the cost structure and choose the measures depending on where the most capital is committed. The service receiver can set targets for development on certain areas of operations. In this model, the service provider is mostly responsible for developing and innovating new solutions. Again, in many cases, the yearly price decrease is promised in the contract and they will take place anyway, even if the savings have not been achieved. This model works also best when the development project does not require big and expensive investments. In this model, the painsharing clause can be added easily. If the performance drops significantly without a proper reason the parties might agree a penalty for the service provider. However, it should be kept in mind that in some cases the yearly price decrease is agreed on the outsourcing contract

which are given regardless how much development and savings have been achieved during the year. The table 4 below illustrates an example.

Measurement	Historical Average	New average	Difference	Financial saving	Influence on transaction price
Picking time, seconds	100	90	10	0,50 € / pick	?
Cost per package	5 €	4,50 €	0,50 €	0,50 €	?
Reclamations / 1000 deliveries	10	5	5	5000 € / year	?
Need for overtime work, h /month	50	25	25	3000 € / month	?

**Table 4. Example of Balance scorecard measurements**

It needs to be assured that the historical data is available for all the chosen measures. If not, some work study needs to be conducted in order to establish the measure. Additionally, some kind of development tool is needed in order calculate the financial benefits of the developments. In other words, for example, it is vital to know what the 10 seconds decrease means financially or how much a reclamation costs on average for the service receiver. In this gainsharing model, the potential savings achieved by the development of the measure are shared via transaction price. It can be recommended that the companies choose limited amount of measures which they follow.

The measures are examined periodically, for example, every 6 months or once in a year. The development of the measures is discussed and their influence on the transaction price calculated in the meetings. If the results indicate improvement and real savings have been achieved, the transaction price is decreased. The gainsharing ratio shall be agreed between the parties when the gainsharing contract is to made. Here is an example to illustrate this model: The parties have set target to enhance the picking process. In a yearly meeting, they go through the set measures related to it. The service receiver has introduced new innovation on the picking process and they have been able to save 10 seconds per pick. By

using their PFEP tool they can find out the financial value for the 10 second decrease and calculate the monetary savings. Let's say the saving is 0,50 €/pick and the transaction price has been 5,50€. This 0,50 € saving is shared between the parties on an agreed ratio, which could be in this case 50-50. So the new price for a pick would be 5,25€.

#### **6.6.4 Variation D. Equal share model**

In this gainsharing model, the gainsharing ratio always 50-50. The investments are always recovered before the gainsharing begins. This model requires that both parties are involved and committed to the development projects. The time used in the development project is seen as an investment if it exceeds 100 hrs. The value €/h shall be decided so that the financial value of the time investment can be defined.

Example. Service provider recognizes a need for IT- development that would save 0,40 € saving per incoming delivery. The service provider is the investing party. The development costs are 10,000€ including 200 hours of planning and implementing procedures and the procurement of the needed system. After the implementation the transaction price is kept the same until the mutually agreed repayment period is over. After that the price is decreased by 0,20 €/ each incoming delivery. In this model the previously explained characteristics are valid. Thus, a development tool is needed and the savings are shared via transaction prices.

#### **6.6.5 Variation E. Idea rewarded model**

One option is that the party that comes up with the innovation idea gets always a reward. For example, the first six months the shares would be divided 75-25 % in favor of the party how came up with idea. After the six months the ratio would be 50-50 %. If there is a need for investment, it will be recovered first before the gainsharing begins. The time used for the planning and implementing the project is seen as an investment if it exceeds agreed period of time, for example, 100 hours. Here again, a value for an hour shall be decided.

This model would obviously motivate the parties to innovate even more. The problem in this model, is that the service receiver might introduce dozens of ideas while hoping to decrease the prices substantially. This potentially causes a lot of work for the service

provider as it has been mentioned that the service provider has the development tool which is used to calculate the potential savings of a development project. Thus, it is important to carefully evaluate the potentiality of the idea in the meetings before starting to calculate the savings. Otherwise the service provider might be overwhelmed with the accumulated innovation ideas.

## 6.7 Results of the interview

Three of the case company's key customers were interviewed. The five gainsharing model variations were introduced to the customers and the customers were given an opportunity to comment and state their opinions about model variations. Additionally, the key customers were asked about their experiences of the collaboration between the companies and their expectations and views about gainsharing. The frame of the interview can be found in end of this paper (Appendix 1.) Below in table 5 the customers are briefly introduced. All of the customers are large Finnish OEMs.

	Outsourced processes	Title(s) of the Interviewee	Preferred model
<b>Customer 1</b>	- Internal logistics incl. all the processes	- Logistics manager	- Equal sharing model
<b>Customer 2</b>	- Packing services - Shipping	- Logistics Manager - Purchasing Manager	- Balanced scorecard model
<b>Customer 3</b>	- Packing services - Shipping - Procuring - Assembly - Documentation - Archiving	- Logistics Manager	- Equal sharing - Balanced scorecard - Idea reward

Table 5. Customers interviewed

Based on this small sample, it seems like gainsharing is not very well-known concept within Finnish OEMs. The people interviewed did not have previous experiences about gainsharing and they were not able to give examples of the models. Most of them had heard about the concept and recognized the idea. The opinions concerning gainsharing and the customer's participation in the development of the processes varied.

The simplicity of the model was clearly an issue that were expected by the customers. This supports the observation made from the literature. The simplicity is a key to make the gainsharing arrangement to function properly. In addition, it allows the parties to avoid situations where the interpretation issues might arise. If the model that is in use is complicated, it often compromises the parties' willingness to use it and take advantage of gainsharing.

The customer 1 wants to see the parties as partners that are innovating and developing the processes together and sharing the benefits fairly between the companies. The confrontation in the relationship should be avoided. It is clear that this customer has high expectations about gainsharing and they are prepared to be part of the developments. Two of the customers chose balanced scorecard model as their favorite. In this gainsharing model the responsibility for development is theoretically mostly carried out by the service provider. The customers were asked about the willingness to invest and to share data and required information. All of the customers replied positively and showed their willingness. Only customer 2 was suspicious when asked about the willingness to invest and rather allowed the case company to recover the investments through transaction price increases.

The author observed that there is a need for improvements within the data and information sharing. There is definite need for Key Performance indexes that the parties can follow and compare the development. In few cases, the case company is not currently able to plan its resources efficiently which stems from the lack of data concerning production plan, incoming batches, products and so on.

When asked about the different models the customers were not able to give any major improvement ideas. This naturally stems from the lack of experiences. The gradual sharing

was widely seen as a good idea for situations where the savings are uncertain. The customers proposed that few different kind of models could be used in the relationship. For example, the simple equal sharing model for the projects that bring average savings and the project based model for the project that require more planning, resources, investment and are expected to bring substantial savings. Each customer had their favorite models and indicated that the models could function in the relationship. The savings first model was seen a bit confusing due to the differences in the contracts. The case company has different contracts and pricing models with the customer and obviously the savings first model would function only with the customer who are promised yearly price decreases. The saving first model can also create administrative problems for the parties as the monitoring of developments and their influence to the transaction prices shall be done accurately.

One feature that was pointed out by the customer 3 concerned the time seen as an investment. The customer pointed out that it can be very difficult to calculate the hours used for the project and this is obviously true. In this sort of situation, the calculation of the used time need to be done carefully and truthfully. It is clear that this might cause some extra work for the developing party to keep track of the time used. The trust in the relationship should be apparent. Additionally, the customer pointed out that definition of the value for an hour can be difficult task.

When asked about the outsourcing relationship with the case company and the history of the developments the customers had different views. The customers 1 and 2 seemed to be satisfied on the relationship and the developments that have taken place. On the other hand, the customer 3 indicated that things could have been done better and more development projects should have been executed, but added that the problem was not only the case company. Customer 3 explained that various ideas of potential developments had been discussed but often “forgotten”. One reason for the this was that the development ideas were not recorded. In the gainsharing arrangement it is vital that there are proper database and IT-systems where the ideas can be recorded, monitored and tracked.

## **6.8 Painsharing and risk-sharing**

In the model variations the risk- and painsharing is not considered thoroughly. However, this is something that the parties need to think about when negotiating about gainsharing. Especially it is advised to consider painsharing when the development project is seen risky and require investments. The literature suggest that service receiver often expects there to be some sort of arrangement and agreement related to the projects that did not work out and the goals were not reached. One system that has been pointed out in the interviews is the bonus vs penalty system, where the service provider is given targets they should reach within certain period. If the target is reached or even exceeded, the service provider gets awarded based on the agreement. If the targets are not reached, the service provider will face a penalty that has been agreed before the project. This feature could be easily added on balanced scorecard model.

Also the painsharing should consider the possible cost overruns. For example, the parties may agree the share the possible cost overruns to the certain point. If the limit is exceeded the service provider might have to take the responsibility of the rest. This obviously depends on the agreement that the parties have. It should be kept in mind that the costs might increase due to external factors such as inflation in prices of electricity, materials or labor. The sort of situations should also be considered in the contracts.

## 7 DISCUSSION

In this chapter the author describes few remarks and introduces options concerning gainsharing that could be taken into account when considering to deploy gainsharing arrangements with a customer. As a result of this thesis, five different gainsharing model variations have been introduced. The models have been named. The names of the models are:

1. Project-based model
2. Yearly savings first model
3. Balanced scorecard model
4. Equal sharing model
5. Idea rewarded model

The model development has been proven to be complicated and time-consuming process. In this paper, the goal for the author has been to keep the model variations as simple as possible, so that the procedures related to the certain model are understandable, easily adopted and tested with the customers. Especially in the contract-making process every single variable that is on the model has to be taken into account and agreed on. The more complicated the model is, the more work and details should be taken into account in the contract also. To convert the visual and numerical model into a written contract can be a complicated and sensitive process. Even though the simplicity is often emphasized in the theory, sometimes more complicated models might be required.

Previously, the post assessment of the development project has been introduced meaning that for some development projects it may be difficult to estimate the potential savings before the project is executed. Thus, it makes sense to conduct work study after certain period of time after the project in order to find out the realized savings. The work study is frequently conducted by the service provider and thus, the service receiver might react suspiciously towards it. In the end, there is a room for errors or distortion when conducting it. Here again, the trust between the parties need be to in place and the service provider needs to explain and illustrate the methods they are using in order to get the results. If it is possible, the measures used to identify the development should be chosen based on data

that is already available in IT-systems. This ensures the transparency and the balance. The projects that require work study also relate to the graded gainsharing that has been introduced shortly before. Basically the idea with the graded gainsharing is to keep the gainsharing sustainable. If the savings are shared right after the development project and they are based on the calculations that have been done before the project, there is a risk available that the calculated savings have not been realized and thus, it can become expensive for the service provider. It can be recommended that especially in the development projects where the potential savings are uncertain, the gainsharing is done gradually meaning that the parties agree to share, for example, 50 % of the calculated savings for a certain period of time, then conduct a work study and verify the savings and share the rest of the savings.

For the case company, the author suggests that gainsharing arrangements should be used with profitable customers. It is a good idea to offer gainsharing arrangements for the key customers which typically have a lot of potential processes and operations that the case company could be involved in. Taking advantage of the gainsharing arrangements in the relationships which do not bring profit to the company can be problematic. As it has been mentioned, the gainsharing can be an expensive and resource-consuming arrangement and thus, it can get risky and very unprofitable for the service provider to introduce such arrangements. Gainsharing should be used only in development projects that bring quantitative benefits because that is the only way to identify a financial value for the development. The qualitative development is as important but it frequently raises interpretation issues and lead possibly to arguments. The realization of the financial value may be very difficult. The qualitative development can be seen as a part of the service provider's normal business and a mean for the case company to remain in the market, keep its position and to improve customer satisfaction.

One thing that could be added or developed beside the gainsharing model is a development cost sharing model. Basically, this model would be used when the projects are set to bring these qualitative improvements which are difficult to measure financially. Both parties should make an estimation about the potential benefits that the project would bring to them and set a value for the project. The 'gains' are not really shared but each party commits

itself to the cost of the project based on the speculation of the benefits it will bring to the party.

Frequently in the theory concerning gainsharing, it is said that the gainsharing period should be decided in advance. It is uncertain whether the contracts used as an example in the articles included yearly price decrease as the case company often has with its customers. An example of the gainsharing period is when it is agreed that the savings are shared for example, 50 % - 50 % for one year and after that the service receiver gets the benefits. The author of this paper has come into conclusion that this should not be the de facto standard in the logistics outsourcing context at all. The de facto standard should rather be based on the sentiment that whoever develops and innovates better solutions should be rewarded by doing so. Other procedures and policies should be agreed separately. The service provider's share of the savings can be seen as the "piece" that allows it to create new innovations and developments continuously. If the benefits are always moved to the service receiver after certain period of time, the service provider's resources for the development are eventually exhausted. The sharing of the achieved benefits or savings of the gainsharing projects should rather be based on the responsibilities and burdens the parties have on a project such as the investment, implementation, planning and the ideation. Frequently the service provider promises yearly price decrease for the service receiver. Thus, the savings achieved through development projects bring often extra savings for the service receiver. The yearly price decreases are given anyway to service receiver and they ensure that the savings that are achieved from the development projects eventually are moved to the service receiver. Through gainsharing projects, the service provider can ensure that the decreases are given, but also that their business stays profitable. Thus, based on this study, the gainsharing period should not necessarily be defined. An example would be when the 1 €/activity savings have been achieved by a development project. The savings are agreed to be shared 50 % -50 %. So the transaction price decreases 0,50 €/activity. In theory this decrease would last certain period of time, for example, 6-12 months and the after the period the price would lower another 0,50 €/activity so that the service receiver would get the benefits for themselves. The author's suggestion is that the price should be decreased only once and the whole benefits would not be transferred to the service receiver. This way the price decrease

would be easy to agree on in the contract and in addition, both parties would be able to forecast the cost structures more efficiently.

Within the limits of this research paper, the gainsharing model that have been developed are just prototypes and require testing and possibly further development based on the feedback and experiences. In the case company, the key account managers, the management and other employees who are responsible for operative implementation of the gainsharing models are probably the best sources of information when considering the functionality of the gainsharing model. Also these sources have the knowledge about the current state of the relationship and developments that have taken place before gainsharing. When the potential savings are being calculated, these sources work as speculative validators who have the insight whether the calculated savings can be achieved or not. Additionally, the customers' opinions should be valued and heard. The further studies could be conducted concerning the repayment of the investments made for the developments. In reality, there might be various development projects being implemented simultaneously and they all might impact on the same transaction price. How to manage these sort of situations? This needs more research and practical field test studies.

The author has taken an extensive look at the articles and literature dealing with gainsharing. It has proven to be difficult to find case examples of the gainsharing models used in logistics outsourcing context. Most likely originates from the companies' do not desire to reveal these models to the public. Additionally, articles about the gainsharing measuring have been proven to be difficult to find.

Traditionally the gainsharing is used to motivate the employees to improve the processes, decrease the use of material and to work smarter. Even though in this paper the gainsharing models are used between two companies, the employees working in the manufacturing sites and warehouses should not be forgotten. The improvement and innovation ideas should be expected from them as well as from the management. For example, there are case company's employees working in the customer's warehouse. If the goal is to improve the warehousing processes or to decrease defects, the employees should be involved in the innovating process and their payroll model should be tied on the developments that are

invented by them. They do not necessarily take part on the gainsharing, but there should be some other incentives for them to improve their ways of working and introduce their ideas for improvements. One other remark that could be added in the gainsharing contracts is that when the parties do not agree on the gainsharing ratio related to development project, it shall be set 50 %- 50%.

## 8 SUMMARY

The goal of the study is to offer various gainsharing model prototypes for a company operating in a logistics outsourcing. The research problem is approached by conducting extensive literature reviews on collaboration in outsourcing relationship, key account management and gainsharing philosophy. Additionally, the case company's staff and key customers have been interviewed to support the development of the model variations. Starting point is to find case examples of the gainsharing models and to identify the prerequisites for gainsharing in logistics outsourcing context. The objective is to create gainsharing models that would improve the collaboration between service provider and service receiver, enhance innovation and create savings via continuous development of the processes and operations. Additionally, procedures and instructions related to each gainsharing model variation have been created but they are not available in this research paper.

Five gainsharing model prototypes are created in this study. They work in different situations and they each have their advantages and limitations. Some of the models require more commitment and involvement, strong relationship, trust and time. The gainsharing model prototypes have been created by utilizing the literature, case company's staff's and other experts' experiences and customers' expectations. The table 5 below summarizes the model variations.

<b>Model</b>	<b>Gainsharing ratio</b>	<b>Best used</b>	<b>Problems</b>	<b>Measures</b>
<b>Project-based</b>	Based on the project	Big development projects	<ul style="list-style-type: none"> <li>- Bureaucratic</li> <li>- Heavy</li> <li>- High involvement costs</li> </ul>	Based on the project
<b>Savings first</b>	75 % - 25 % until yearly savings achieved, then 50 % - 50 %	Projects which do not require big investments	<ul style="list-style-type: none"> <li>- Both parties need to be involved</li> </ul>	Based on the project
<b>Balanced Scorecard</b>	Fixed	When the developing responsibility is moved to the service provider	<ul style="list-style-type: none"> <li>- Setting the targets</li> <li>- Too easy for service provider</li> </ul>	Based on the desired outcomes
<b>Equal share</b>	50 % -50 %	All the situations	<ul style="list-style-type: none"> <li>- Ideas not rewarded</li> <li>- Both parties need to be involved and committed</li> </ul>	Based on the project
<b>Idea rewarded</b>	75 % - 25 % for certain period, then 50 % - 50%	All the situations	<ul style="list-style-type: none"> <li>- Excess of ideas -&gt; workload for service provider</li> </ul>	Based on the project

**Table 6. Summary of the gainsharing model variations.**

The utilization of gainsharing concepts and models create added value to the outsourcing relationship. They and the potential savings ensure that the parties are constantly looking for better solutions and striving to innovate. The gainsharing is supposed to allow parties to create win-win situations where the service receiver is achieving savings through the development projects while the service provider is earning better profit margin. Typically, these development projects have a descendent impact on the transaction price that the service receiver is paying for the service provider. The transaction price might comprise of the end products that are produced daily, the certain activities that the service provider is executing in behalf of the service receiver or some other pricing model. The challenge is to define a financial value for a development. Thus, it is recommended that gainsharing involves only projects that bring quantitative development. The projects that create qualitative improvement can be seen as a necessary step for the service provider to keep the customer satisfied and themselves in the market.

There are various challenges in adopting gainsharing. The challenges might be related to the relationship that the parties have. The literature clearly insists that there are mutual respect and trust between the parties. The relationship needs to be strong and the parties should be aware of each other's capabilities and weaknesses. The desired outcomes or, in other words, the reason why the service receiver is outsourcing its operations and processes should be clearly defined. The communication and information flow should be smooth and the data-sharing is imperative so that the developing and innovating can be done. The gainsharing arrangement can be time-consuming and it need both parties' involvement and commitment.

The other challenges relate to the model that is used. There are various issues that should be taken into account when designing the gainsharing contract between the parties. First of all, the gainsharing ratio is always a matter that interests the parties. Basically, it means, how the savings achieved from the development projects are shared between the parties. In some models this ratio might be fixed, in some models it might change depending on the responsibilities that a party has in a project. Sometimes the gainsharing ratio changes after a certain period. When determining and calculating the potential benefits and financial savings of a development project, a development tool should be available. In addition,

there is a need for the historical data and measures so that the results of developments can be evaluated and compared. Often new innovations require new technology which, again, require investments. The investments made are always recovered before the sharing of the financial savings begin. To facilitate the collaboration, integration of IT-systems is often a good idea and increases the performance. When designing the model, it should be kept in mind that the more complex the model the more complicated will be the contract. This might cause trust issues. To convert a visual and numerical model to contract paper can be complex process and thus the simplicity is highly recommended. Additionally, complexity can create interpretation issues. In the literature, often the gainsharing period is defined meaning that the savings are shared between the parties a certain period of time and then moved to the service receiver. However, in this instance, the case company offers yearly price decrease for its key customers. Thus, the author does not define gainsharing period in the model variations because the savings are ultimately moved to the service receiver via these price decreases. The measures chosen to describe to development is careful process. It should be done in collaboration and the measures should be based on the desired outcomes and development project that is being executed. For example, if the goal is to improve the picking process, the average time needed to conduct a pick should be emphasized.

The selection of the gainsharing model depends on the business environment is it used and the customer. The same model does not necessarily work with every customer and every situation. Thus, it is imperative to choose the model so that it fits to the situation and the customer is ready to do its part of the deal. It needs to be evaluated how much the customer is willing to commit itself. Also for the service provider it is not necessarily beneficial to introduce gainsharing arrangements in the contract if customer does not have enough potential development targets. The gainsharing has high involvement costs and creates pressure and work for the service provider. The introduction of the gainsharing arrangements with key customers can be seen as a great idea. Additionally, it should be kept in mind that gainsharing should not be part of every development project. When the potential savings exceed a certain predefined limit, the gainsharing should be involved. The projects that bring marginal savings should not be taken into account as often the involvement costs exceed the savings achieved through these types of projects.

The transparency is emphasized when gainsharing is discussed. The information of the development and the projects should be available for the both parties where the tracking, monitoring and following can be done. The companies need to have the correct measures and data available so that the developing of the processes is possible and the parties can be assured of the development.

A few of the case company's customers were interviewed for this research. In the research point of view, it was found surprising how little the customers knew about gainsharing and there was definite lack of experiences concerning gainsharing. For the future, the model prototypes need to be tested with customers in order to find out their functionality in certain environment. The recommendation is that one of the model variations is taken into use and tested in small development project. Obviously both parties need to be involved in the testing part. The testing should be seen as learning opportunity. The improvements, changes and developments can be made based on the results and experiences gathered. For the future research, it can be suggested that the sharing of the savings within the case company or in other words, quantifying the money sharing could be investigated and explored. If a certain business unit is continuously creating innovative solutions and increasing the company's profit, it seems to be appropriate to reward them for doing that. To invest money in that business unit's work comfort could be one way. In this study the pain- and risk-sharing has been introduced shortly as well, but it can be recommended that these concepts and their integration to the gainsharing agreements should be studied further.

A well-planned and functional gainsharing model will enhance the collaboration and innovative behavior and bring benefits for the both parties. It can be concluded that in future gainsharing is a way for the case company to differentiate itself from the competitor, offer better service for the customer and thus, increase the customer satisfaction.

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## APPENDIX 1. Questions of the interview

Master's thesis interview

Vesa Siljander



*In this research the case company's customers' expectations and experiences about gainsharing are explored. The gainsharing model variations were introduced and explained to the customers and their improvement ideas collected.*

**Time and Place:**

**Name and Title:**

### **Current state and the relationship with the case company:**

1. How do you see present situation concerning innovative behavior in your facilities where the case company operates?
2. Are you happy with the developments that have taken place there?
3. Who do you think is typically responsible for the developments?
4. Have you set targets for the case company and have they been reached?
5. Are you happy with the service you get from case company?
6. Do you think the you have strong relationship? Can you trust the case company?
7. Are you comfortable of sharing information and data with the case company?
8. What could be done better?

### **Gainsharing experiences**

9. How do you understand gainsharing? What experiences do you have?
10. What do you expect from the gainsharing arrangement?

11. Why do you think you should take advantage of gainsharing in your outsourcing relationship?
12. Are you willing and able to commit yourself to gainsharing?
13. Are you ready to take part to the innovation process?
14. Are you willing to share the risks and rewards?
15. Are you ready to invest if there is a need?
16. To what extent will this type of contracting make or break the deal?
17. What kind of elements would you expect to be in the gainsharing model?

### **Gainsharing model variations**

18. What do you think about the variations?
  - a. Project-based
  - b. Savings first
  - c. Balanced scorecard
  - d. Equal sharing
  - e. Idea rewarded
19. Do you think one of the variations could work in your relationship? Which one?
20. What should be added, removed or re-considered in that model?
21. Any other suggestions or comments?