



White Paper

---

# Import vs. Domestic Sourcing:

*Poor accounting systems significantly contribute  
to the US trade imbalance*

Industry Leading Cases Studies

Jack Haedicke  
Arena Consulting

September 2008

# Import vs. Domestic Sourcing

*Poor accounting systems significantly contribute to the US trade imbalance*

There is a better way to make intelligent and well-informed decisions about whether to source products domestically or to import. Management accountants have an important role in those decisions. This paper is a must read for manufacturing, distribution and retail executives who are grappling with these very difficult and important decisions.

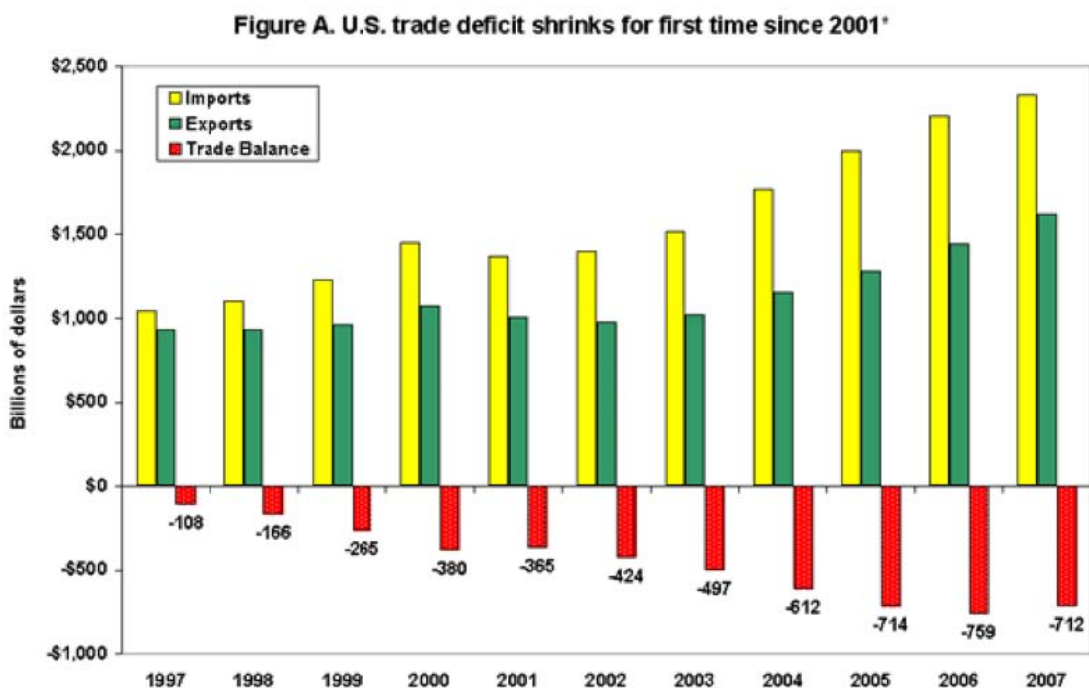
This is not a whitepaper about theory. It is about the hard realities being faced by the United States regarding its trade imbalance and the methodologies being used by some of our country's most notable firms to deal with outsourcing. The paper ends with a practical example from such a firm.

This does not mean that all products should be sourced domestically. However, sourcing decisions should not be made lightly, and should be based on the best possible information.

To put the issue into perspective, we first need to understand why outsourcing has become such an important issue for the United States.

## “Free Trade” Isn’t Really Free

Lou Dobbs and CNN aside, the situation with the United State trade deficit is bleak. As illustrated below, the deficit has grown at a compounded annual growth rate of 21%....with no immediate end in sight.



\* Balance of Payments (BOP) Basis.  
Source: U.S. Census Bureau, Foreign Trade Division.

There was some minor improvement in 2007, but it was due to the combined effects of appreciation of the Euro and other currencies over the past five years, and the initial effects of a U.S. slowdown. The numbers for August 2008 show that the imbalance is again growing with a record \$62 billion trade deficit in what is clearly a stagnant US economy.

According to the Economic Policy Institute, in 2007 the U.S. trade deficit exceeded 5.1% of GDP, an amount considered unsustainable by the majority of economists.

***“Why all the concern? Don’t imports assure that we, as Americans, are able to obtain products cheaper?”*** On the surface the answer is “yes”, but the reality is that the US is losing huge portions of its manufacturing base. Manufactured imports are responsible for the bulk of the U.S. trade deficit. The manufacturing sector lost 3.3 million jobs between January 2001 and December 2007, including 200,000 jobs lost in 2007 alone. More than 32,000 U.S. manufacturing establishments closed between 1998 and 2005.

If we don’t have a strong manufacturing base we won’t have people that can afford to buy these products, no matter what the price.

***“Hold on ...aren’t the lost manufacturing jobs replaced by “higher value” employment in the U.S.?”*** Tell me what those jobs are. Customer service? Try calling AOL or Travelocity for some help (you’re calling India). Software engineering? Also being outsourced to India. The answer is that the “high value” jobs in the U.S. are being outsourced almost as quickly as manufacturing jobs.

**So much for the theory of “free” trade.** What happened to a country that prided itself in the annual investment and improvement in the productivity of its workers? Does it really make intuitive sense that it’s more profitable to manufacture or source products from China simply because of lower labor rates when labor has become a lower percentage of the total cost of production, the international supply chains are so long and the cost of transportation rises every day in direct relation to the cost of oil?

***What has led to the current levels of trade imbalance?***

**Our trading partners aren’t really partners...and the US Government does little to protect us.**

Our trading “partners” such as China provide government-backed subsidies that have allowed steel production to increase by more than 170% between 2000 and 2005 and another 20% in 2006, while exports of Chinese steel to the U.S. more than doubled in 2006. The Chinese government holds a controlling stake in its steel industry. The government owns 100% of eight out of the ten largest steel manufacturers and owns a majority of the 19 top steel producers.

The subsidy issue extends from making steel to processing it. As IMT pointed out in

December 2007, the U.S. found that Chinese pipe was subsidized by an average rate of 16.59 percent.

There is only one way to resolve this. Our government must enact and enforce policies that truly support free trade through the WTO (World Trade Organization). The government's inaction in this regard over the last eight years is frightening.

It is also important to note that China currently holds \$506 billion of US Treasury Bonds.

**It is easy to blame Wal-Mart....and totally unfair to do so.**

With the exception of Costco, Wal-Mart has the lowest supply chain expense of any major retailer in the United States. Their operating expense as a percentage of revenue is 16% of sales compared to their competitor's average of 26%. By implementing the best supply chain technologies and practices available they have created value and a cost advantage of 10%. They then they pass that cost savings to consumers in the form of lower prices.....and consumers flock to their door.

This is the way it is supposed to work. They make money by being efficient. This used to be the American way.

Yes, they are so large that they wield huge influence over manufacturers. People have reported that Wal-Mart now comprises over 30% of Procter and Gamble's sales volume in the soap category. Clearly, when Wal-Mart speaks manufacturers listen. It is a long flight to Bentonville for a manufacturer making a sales call when they know that their whole financial year is on the line.

But would you as a consumer have it any other way? Wal-Mart's value proposition to consumers is lower prices. Period. It certainly isn't a pleasant place to shop. Would you have them subsidize one manufacturer just because they produced product in the United States? This won't work because Wal-Mart's competitors will hardly be so altruistic and you, as a consumer, will most certainly go to the store that has the lowest prices. Wal-Mart could not change even if they wanted to.

Of more concern is the manufacturer's reaction to this constant pressure for lower prices.

**Most, but not all, manufacturers take the easy way out.**

It is quick and easy to outsource production to China. Why not?

*"As a CEO I am driven by quarterly numbers, and if I don't hit them, I'm gone. Labor is cheap in China. That will reduce my total cost and increase my profitability. Besides, everyone else is sending production to China. They must know something that I don't. I need to do the same to compete." CEO, Large Manufacturer*

Compared to Wal-Mart and their long-term investments in technology and supply chain

practices, **decisions to outsource production overseas are usually focused on making money by doing what is expedient rather than by being efficient.** The rapidity with which manufacturers are seeking this expediency is akin to lemmings following one another off a cliff.

There are other problems with outsourcing. What is the impact of passing our production technologies to countries that are, in reality, our competitors? What is the longer-term impact on this country's loss of manufacturing base?

Companies like Procter and Gamble understand this cost, and the vast majority of their production remains in the US. **P&G works collaboratively with Wal-Mart to reduce total supply chain cost (production, distribution, selling) with the goal of reducing selling price to consumers though increasing efficiency and effectiveness.** There should be more companies like them.

Investing for the long term in the technologies, supply chain practices and cost accounting to make our production processes more efficient is hard work. It takes will in an era of quarterly numbers. It takes vision and, as much as anything else, **it takes good numbers on which to make decisions.**

## The Role of Management Accountants

**The issue is that the vast majority of U.S. accounting systems do not capture all of the costs associated with outsourcing. So, what are cost accountants doing?**

It is called standard costing. Standard costing focuses on material and production variances within the manufacturing process. It is what management accountants were taught in school and it is what outside auditors expect to see. The work is hard and tedious. The problem is that it doesn't capture all of the costs associated with importing products, most of which have nothing to do with the manufacturing process.

Issue one: standard costing almost completely focuses on the manufacturing process. It does little, if anything, to measure and assign any of the support costs associated with that same production process. It is typical that none of the support costs illustrated in chart 1 (see next page) are ever captured. This has obvious impacts on the decision to source production overseas.

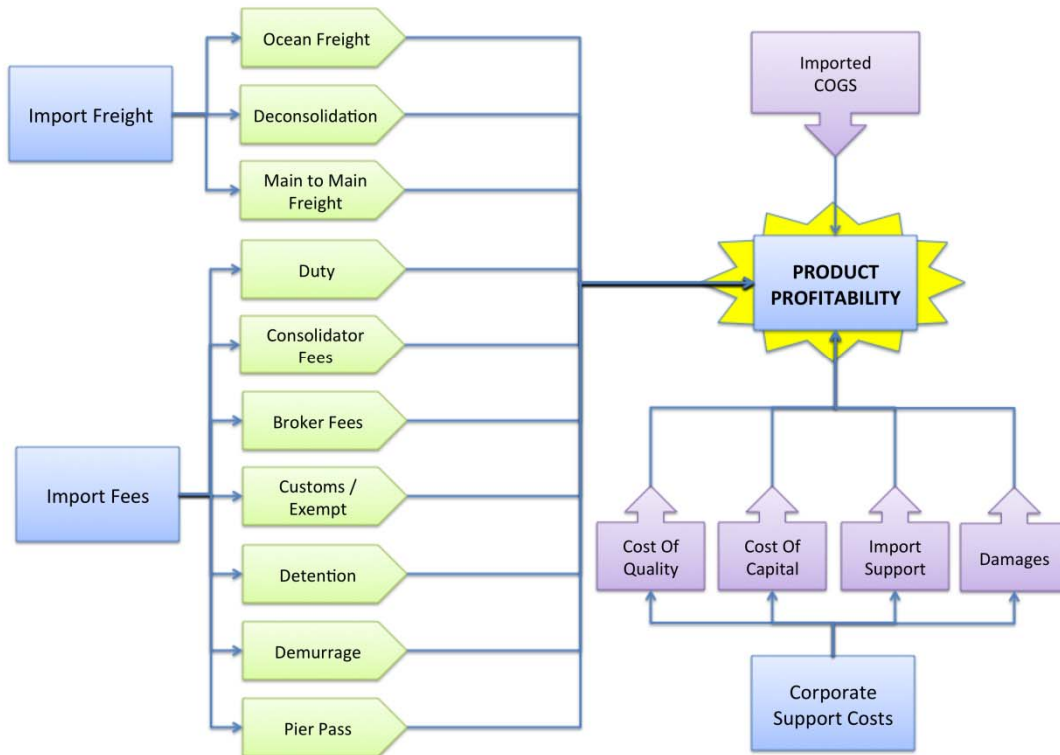
Issue two: support services, transportation and overhead have become a much larger percentage of the total cost of manufacturing than when standard costing was first devised in the 1920s. Under standard costing, support costs are usually pooled and spread evenly across all products, giving little or no visibility to the different levels of support required by domestically sourced or imported product.

**Isn't sending production overseas an easy decision to quantify?**

If we were to ignore the significant long-term impacts of outsourcing US production mentioned above, (which even a good cost accountant can't quantify), off-shoring production would seem to be a fairly straightforward decision. **It would seem to be a simple tradeoff between lower labor expenses and increased transportation costs.**

Oh, that it were so simple.

**Chart 1 - Illustrating the supply chain expenses of imported product**



As shown in chart 1 above, it is a lot more difficult (and by association, a lot more costly) than one would first believe.

**Import Freight** – Import freight consists of the following key activities: ocean freight, deconsolidation, and main-to-main freight. This is the process of shipping containers to the U.S. port of entry, opening the container and hand palletizing the load by product, and then shipping those pallets to distribution centers across the country. From there, product is shipped to retail stores. Obviously, in an era of escalating oil prices this is an expensive process and contains several more steps than would be taken through domestic sourcing.

**Import Fees** – It's a long list of fees that are paid at every step of the process. Many of these fees are the legitimate cost of doing business overseas, while many are sources of revenue for the local taxing authorities. Almost all import fees are avoided when sourcing domestically.

**Corporate Support Costs** – Corporate support costs are a large and growing proportion of the cost of imported product. It begins with engineers being far away from the source of production, includes the cost of capital invested in an extremely long supply chain, and ends with quality control and damages that are often not known until the container is opened at the port of entry.

**Loss of Intellectual Capital** – As a country, we have long competed with the world by being more efficient and effective than our competitors. How can we do that when production is owned by another country? How do we improve a process that we no longer own? Do we really believe that we can protect this intellectual capital and that it will not be available to our next competitor that asks for it? This is, perhaps, the largest cost. Even the best management accountant cannot quantify the impact.

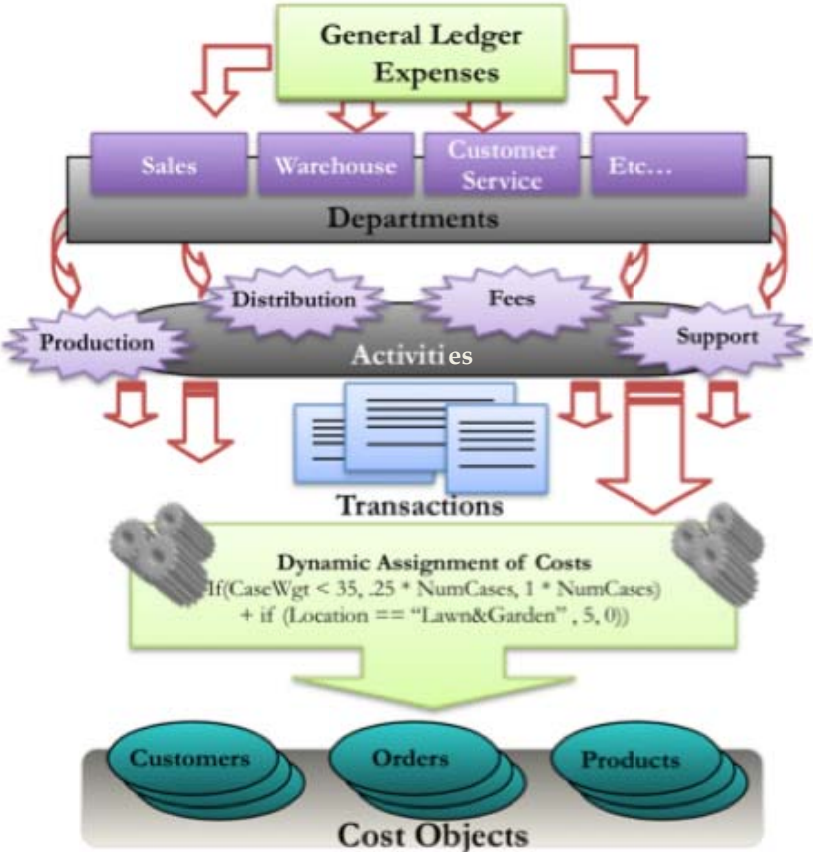
**We need to make management accountants relevant by capturing and assigning these costs to the products we produce and distribute.**

The key to this issue is in a simply designed and implemented system called activity based costing (ABC). A detailed description of how ABC works is beyond the scope of this whitepaper. However, as illustrated in chart 2 (on the next page), it begins by identifying the steps, or activities in the supply chain; all the activities, not just those in production. These activities include all the support costs, fees and transportation expenses illustrated in chart 1, along with the COGS that result from either importation or domestic sourcing.

Once identified, activities are costed by assigning the expenses of the general ledger to each activity, just like it is a business within a business. Once expenses are assigned to activities, the activities are then assigned to the customers, orders and products that uniquely absorb them. If an item does not absorb a cost, it does not get assigned one.

In other words there is no global spreading of costs. If certain costs are created by importing products, those costs will be identified and assigned only to the imported products. Domestic products would not be assigned any of these costs.

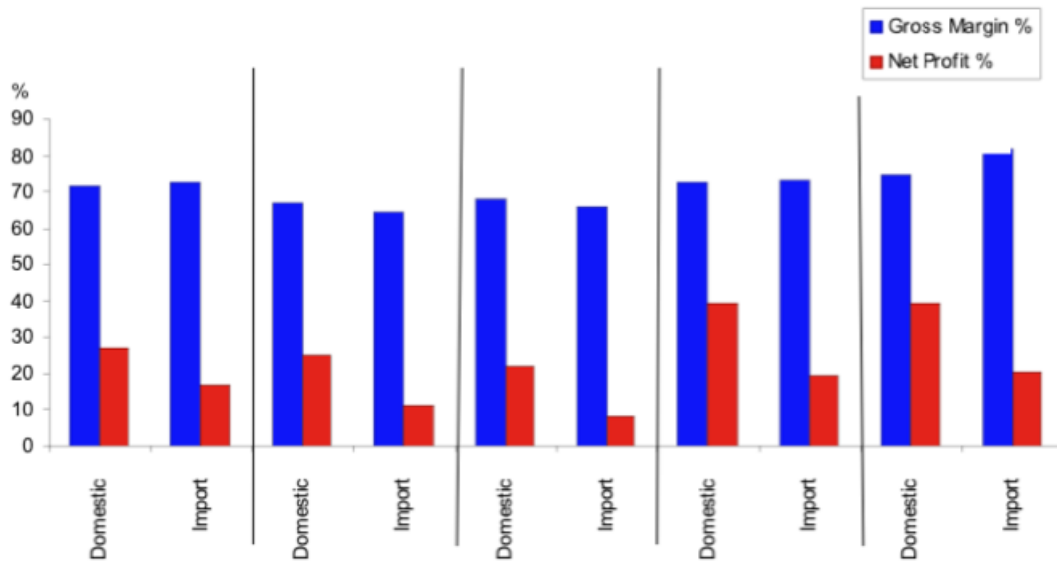
**Chart 2 - Activity Based Costing Methodology**



Source: Acorn Systems, Inc.

## The Results of an Improved System

**Chart 3** Subclass Net Profitability Comparison



### **Without good information, even excellent procurement professionals make mistakes.**

Chart 3 illustrates the results for a retailer that implemented an ABC system to capture the above-mentioned costs in five small categories. It compares the costs of sourcing domestically and overseas for similar items.

Gross margin indicates the difference between the COGS (cost-of-goods sold) and what the product was sold for. Note that COGS does not include the costs of supporting imported product. In most cases the imported product appears to have as good or better gross margin than products that could be sourced domestically.

Net profitability includes all costs of importing product (as illustrated in chart 1), captured and assigned to every item. Like items were then compared to determine whether it was better to source that product domestically or from an imported source.

The results are compelling. **Even this excellent procurement staff made the wrong decision about half the time.** Sometimes domestically sourced product should have been imported and visa versa. The savings potential for the company is huge. Without the right information as supplied by ABC, they are simply unable to make the right decision with such a long and complex supply chain.

Categories Moved To Domestic Sourcing	Revenue	Import Net Profit	Domestic Net Profit	Potential Savings
	\$13,148,543	16.9%	27.3%	\$1,365,878
\$3,252,992	11.2%	25.2%	\$456,031	
\$2,943,794	8.3%	22.2%	\$410,133	
\$1,483,292	19.5%	39.6%	\$298,363	
\$736,822	20.5%	39.3%	\$138,022	
			<b>\$2,668,427</b>	

Categories Moved To Import	Revenue	Domestic Net Profit	Import Net Profit	Potential Savings
	\$3,241,881	-0.3%	17.4%	\$575,641
\$2,419,970	24.3%	43.7%	\$470,175	
\$2,933,857	45.1%	58.7%	\$401,039	
\$2,916,570	35.7%	46.8%	\$323,121	
\$1,428,187	39.4%	52.2%	\$183,139	
			<b>\$1,953,114</b>	

**In summary**, there is a better way to make intelligent and well-informed decisions about whether to source products domestically or to import. It is through a simple and appropriately applied application of ABC. ABC also represents an opportunity to pull the management accounting profession away from standard costing and into a process of management decision making that recognizes the costs of the complete supply chain, not just manufacturing.

As important as this issue is to the long-term health of the US economy, this process won't always result in product being sourced domestically. Rather, it assures that business is awarded to those that are the most efficient and that the cost savings is passed onto consumers in the form of lower prices.

ABC assures that there's a fair playing field on which to make that decision.

## About the Author

Jack Haedicke bears the distinction of having built more activity-based costing (ABC) systems than any other single individual. As controller of manufacturing at Hughes Aircraft, he developed customer profitability models. He led the US Efficient Consumer Response (ECR) initiative while serving as director of cost accounting at Coca-Cola, and later held the position of vice president of finance and supply chain at Kraft Foods. With consulting firm Arena CG, Haedicke has built customer profitability-focused activity-based costing systems for Miller Brewing, Wegman's, Wal-Mart and Target.

Arena Consulting specializes on the interaction of cost accounting and supply chain in the areas of Return on Investment (ROI), Pricing, Collaborative Planning, Forecasting and Replenishment (CPFR), Activity-Based Costing (ABC), and Consolidation Warehousing.

### For more information

Arena Consulting Group

18418 Nicklaus Way • Eden Prairie, MN • 55347

Phone: 612-889-7151 • email: [jack\\_haedicke@arenacg.com](mailto:jack_haedicke@arenacg.com)