Q Management Inc

February 27, 2009

Consulting Group: T.S.D. Scott, MBA, CMA; Jason Chan, MBA, CMA

A GUIDE TO SELECTING QUALITY INSPECTION SERVICES FIRMS

Contents

INTRODUCTION

This document is presented to assist decision-makers in the process of identifying and selecting a Quality Inspection Service provider(s). A criteria matrix is provided for quick reference. There is also a background overview describing the competitive environment of Quality Inspections Services to provide the reader with a deeper understanding of the selection criteria.

SELECTION CRITERIA MATRIX

Selection Criteria	Outcomes (see Key below)
5+ continuous years of third party validated systems/controls (ISO/TS)	1 & 4
Disclose related parties/businesses/organizations	1 & 4
Described Internal Metrics and outcomes	1, 2, 3 & 4
Performance management controls	1, 2, 3 & 4
Describe approaches to internal learning and growth	1, 3 & 4
Functional support staff supporting the order management cycle	1 & 4
References	1, 2, 3 & 4

Key: When selecting a Quality Inspection Services firm the customer should be searching for a firm that will provide the following outcomes:

1. ***Sustaining professional support***
2. Positively and ***ethically reflects*** the customers' ***vision and values***
3. ***Respects all stakeholders*** including the customers' customers and suppliers
4. Is committed to delivering ***responsive, effective and efficient services***

BACKGROUND: COMPETITIVE OVERVIEW

COMMODITY CHALLENGE

A commodity may be described as "...a generic, largely unprocessed, good that can be processed and resold...grains, metals, and minerals. They are generally traded in very large quantities..."[i] Commodities are characteristically priced according to supply and demand influences as well as transportation costs; they are otherwise undifferentiated. At first glance, many view Quality Inspection Service activity as a simple commodity, perhaps seeing an easy unit of measure such as a general labor hour. This is not unusual as there are very few immediate visual differentiators from an Inspector provided by a Quality Inspection Service provider compared to a general laborer. The actual value created by the Quality Inspection Service provider is imbedded in the overall management of the inspection activity throughout the entire order management cycle. These include:

- Systems and infrastructure to respond to service requirements
- Taking over the challenge from the customer or host and managing the activity
- Documentation/Reporting - relevant and timely
- Employing robust standards for effectiveness control

Once this value is delivered, the rewards of responsiveness, effectiveness and efficiency are apparent and well appreciated by customers/hosts. Consider a service provider that offers services for 25% less per hour but requires 30% or more resources to complete a task or, perhaps more concerning, incurs other cost pressures including demands on customer/host management and/or rework. It is not the unit price (for

example price per Inspector hour) but the total project cost (including host/customer distraction, inefficiencies and rework) that truly represents the value of the service provided.

NUMEROUS COMPETITORS – WHY?

There exist numerous Quality Containment firms competing for business in support of the automotive manufacturing supply chain. The vast number of companies is a result of two primary drivers:

1. ***Low barriers to entry***.
    - This enables less sophisticated entrepreneurs with limited capital, experience and/or knowledge to ***"start-up"*** Quality Inspection companies

2. ***Underestimating the need for relevant infrastructure*** (systems and processes required to administer, support and deliver sustainable Quality Inspections services to a high standard).
    - Perception that delivering Quality Services is a simple business model whereby entrepreneurs simply charge customers more than it costs for an inspector
    - Perception that since capital equipment (such as assembly line/process cells/heavy equipment/tooling etc) is not required then this type of business model is simple (and inexpensive) to execute
    - Therefore a perception that delivering Quality Inspection Services is a source of ***"easy money"***

WHO STARTS THESE FIRMS?

There are typically three types of entrepreneurs who attempt to start-up Quality Services firms:

- Former managers/employees of a Quality Inspection Services firm.
- Former managers/employees of automotive manufacturing firms.
- Management of ancillary services firms supporting the automotive OEM industry such as logistics firms, employment agencies, and/or packaging firms.

These participants are lured into this sector of the automotive industry because of the two above described drivers (low barriers to entry and the expectation of *"easy money"*).

START-UP PHASE – "ARTIFICIAL COMPETIVENESS"

Start-up firms characteristically capture initial business (the ***Beta host or client***) through pre-existing relationships with former customers (if previously employed by a Quality Inspection Service firm), former colleagues (if previously employed by a manufacturing firm) or existing customers (in the case of ancillary service firms). Generally speaking initial business is conducted in a favourable (perhaps uncompetitive) environment as errors and omissions are tolerated by host manufacturers (especially if the costs of services are incurred by the beta host's vendors) and the entrepreneurs enjoy initial (but limited) success. Often the initial

business is “won” by the start-up firm through a lower price bid (i.e. $0.50 – $1.00 less per inspector hour) – usually, due to pre-existing relationships or knowledge, the start-up firm has perfect information on incumbent service providers’ pricing which empowers the incrementally lower price bid approach. This incremental lower price also serves to induce decision-makers to accept the start-up firm as a viable replacement.

During this start-up phase new entrants may also be supported by their beta hosts (the first to permit them work) in more substantial ways. The beta host often exhibits a natural tendency to support and nurture the new entrant through various actions that may include:

- Sharing/benchmarking activities/approaches utilized by other service providers,
- Coaching and mentoring,
- An increased tolerance for errors and omissions, and/or
- Direct assistance in capturing additional business.

It is in this context that the Start-up is, in fact, competing in an artificial environment. With a supportive beta host, a sophisticated and professional start-up firm will reinvest the rewards of initial success. This reinvestment prepares the firm with the required depth of infrastructure to continuously grow and improve in preparation for what will soon be discovered as a competitive marketplace. Those “fast learner” start-up firms quickly discover that delivering Quality Inspection Services presents significantly more challenges then first anticipated. The learning curve is usually steep as the previously concealed challenges associated with operating this type of enterprise are revealed. These challenges typically emerge throughout a myriad of functional areas including:

- Finance and Administration, (financing, billing, receivables, payables)
- Human Resources – (training, performance management and control)
- Quality Management (ensuring services delivered to consistently high standard)
- Information Technology – productivity support
- Legal (contracts, documentation and insurance)
- Marketing (operational and strategic fitness)
- Operational Excellence (capacity management, resource management)

Not unlike other types of businesses, challenges with any or all of these ancillary activities will distract many Quality Inspection Services firms and significantly impact their sustainability.

REWARDS OR REINVESTMENT – WHAT HAPPENS TO THE MONEY?

It is the sophisticated and professional management team that will build an organization with strong functional core assets to mitigate the challenges that emerge across all functional areas in a Quality Inspection Service provider. The supporting functional staff must be oriented to ensure all functional activities are focused on enhancing the delivery of the core service offering. The value that a strong support team provides is revealed in the execution of the service offering. Capital reinvestment is also continuously needed to support core service delivery performance. Investment in employee training and development, coupled with a robust service quality management

system, is tantamount to deliver continuously higher standards of service and ensure competitiveness. Investment in information technologies is also required to integrate shared learning and growth, improve productivity and foster innovation.

It is the incurious "start-up" firm that will simply reap the rewards from the initial success - distributing these rewards to shareholders with little capital reinvested into the firm to build infrastructure. The initial (although small) success experienced in an artificially competitive environment deceives unsophisticated managers to believe their early perceptions of "easy money" were prophetic. Eventually these firms either learn to reinvest or run out of nurturing beta opportunities and fail.

GOING CONCERN OR GOING BROKE?

After initial start-up the successful Quality Inspection Services firm will need to grow to capture more business opportunities and reinvest the rewards of growth to continuously develop personnel, infrastructure and technologies. The aim is to constantly improve service performance from the customers' perspective and thereby significantly improve competiveness. When supporting a limited customer base or small geographical area, merely the presence of the firm's "service champion" or founder will positively impact the standard of service in the local area. However, as a firm grows to encompass a larger customer base and greater geographical reach, this influence is spread too thin and quickly becomes irrelevant. The presence of a champion or founder in many locations is unrealistic. To evolve from the "start-up" to the "going concern" phase sophisticated participants will create infrastructure and technologies that enable robust yet flexible support systems. The support systems serve to ensure premium service performance standards are achieved and will foster an attitude of innovation to continuously improve Operational Excellence (service quality/productivity/efficiency).

GROWTH STRATEGY OR CREATING ANOTHER START-UP?

There are two approaches to expansion.

- Establishment of autonomous business units
- Scaled Growth with centralized core infrastructure to improve scope/reach

The Autonomous Business Unit Approach

- Advantages:
  - Responsive to local customer needs
  - Tailored to local activity
- Disadvantages:
  - Replicated fixed costs/overhead
  - Unable to enjoy economies of scale savings with infrastructure costs
  - Lack of shared knowledge from centralized core business activity with respect to lessons learned, continuous improvement, productivity & efficiencies.
  - Lack of integrated support to those customers needing support in diverse geographical locations

- Tendency for localized negative "drift" from original performance standards

Scaled centralized approach

- Advantages:
  - Integrated support from all functional areas:
    - Operational Excellence
    - Service Quality Management System
    - Finance/Administration
    - Human Resources
    - Marketing
    - Information Technology
    - Legal
  - Shared learning for sustaining innovation in quality/productivity
  - Diminished unit infrastructure/overhead costs & allocation
  - Structure & control to prevent negative localized "drift"
- Disadvantages:
  - Local responsiveness/tailoring
    - This will be mitigated with a firm possessing robust yet flexible service support systems – a requirement for any relevant participant

Figure 1, Performance Ratios Comparison

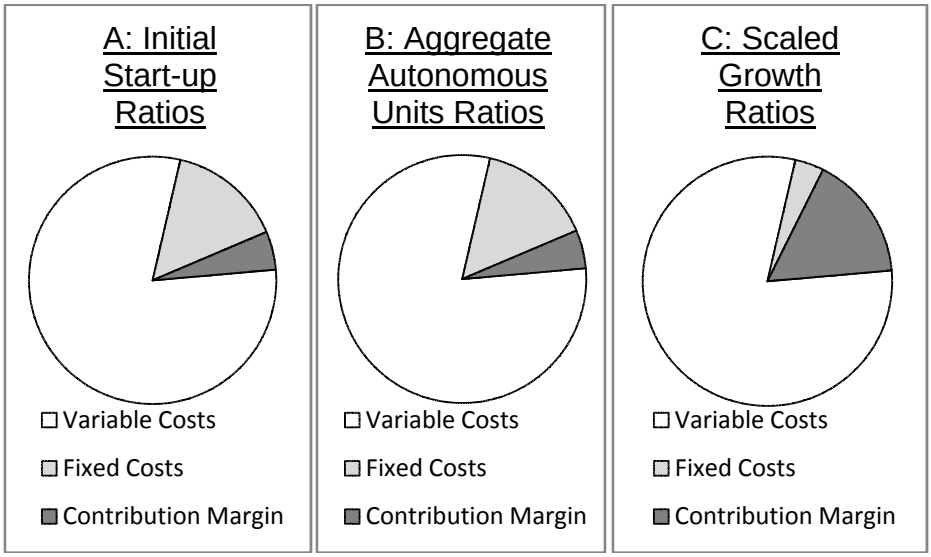

Figure 1, the above graphs illustrate the relevant advantage Scaled Growth (C) provides compared to growth utilizing Autonomous Business units (B). With Scaled Growth (C) the contribution margin ratios improve considerably thereby providing significantly more capital to reinvest in infrastructure and systems supporting Operational Excellence. Despite the aggregate growth in revenue the Autonomous Units (B) provide there is no improvement in contribution margin ratios

The autonomous business unit approach to expansion provides intimate and locally responsive organizations however this approach is fraught with challenges to sustainable competitiveness. There are two primary challenges to this approach:

- Replicated infrastructure overhead or fixed costs
- Absence of integrated shared innovation

The replicated fixed cost hampers long term growth due to the proportionally lower profit margins available to reinvest into infrastructure (and other management systems) for performance improvement. This is further exasperated since each autonomous unit has its own infrastructure overhead to support thereby significantly reducing incremental reinvestment.

The absence of centralized and integrated systems for shared innovation is also detrimental to competitiveness. The likely outcome is independent business units evolving at varied paces and in different directions. Whereas centralized/integrated systems serve to transfer lessons learned and innovations throughout the organization. This approach promotes Operational Excellence among all regions of the organization and eliminates the likelihood of repetitive experiences in errors and omissions.

The power of scaled growth in the centralized expansion model is especially relevant in generating capital for reinvestment. Clearly the centralized infrastructure proportionally reduces overhead in relation to revenue compared to the autonomous business unit growth approach. The outcome is more capital to allocate to infrastructure and systems supporting continuously improving Operational Excellence.

THE COST LEADER TRAP

The Cost Leadership Strategy enjoyed success long before Harvard Professor Michael Porter described it in his 1980 work[ii]. However, as clearly described by Porter, to be successful this strategy usually requires a considerable market share advantage or preferential access to raw materials, components, labour, or some other important input. Without one or more of these advantages, the strategy can easily be mimicked by competitors. Wal-Mart is the successful cost leadership example often cited. It is Wal-Mart's vast array of retail stores (infrastructure) coupled with a sophisticated inventory management technology that support this success. Wal-Mart, through purchasing power, can demand from its suppliers lower prices than any other relevant competitor.

The Quality Inspection Services firm that fails to reinvest relevant capital into the infrastructure of the firm will be condemned to a slow death – likely caught in the "cost leader trap". Without reinvestment into the infrastructure and technologies to ensure the delivery of continuously improving service levels, unsophisticated firms will become uncompetitive - delivering lower service standards. This will compel a firm to lower its selling prices or be passed over for consideration. With lower prices that firm will be forced to lower input costs (especially supporting infrastructure and technologies) or deliver lower standards of service (less responsive/effective) or both. Lower pricing results in less reinvestment thereby negatively impacting competiveness and thus driving even lower pricing. This is the trap and it is a spiral that impacts unsophisticated competitors in every industry sector or marketplace in relatively the same way.

Delivering sustainably lower prices can only be achieved with reinvestment to support those activities that create and improve Operational Excellence[iii]. Cost leadership is not simply an exercise in lowering a selling price; it is about delivering high quality products and services at a lower total cost than competitors.

IRRATIONAL BEHAVIOUR OR DISTRESS INDICATORS?

Not unlike any other organization, when a Quality Service Firm is experiencing distress, often management is compelled to make decisions that are questionable in effort to survive. Indicators of internal challenges include:

- Low unit price/hour but using excessive staffing to support activity
    - Inspection activity is inefficient (slow)
    - Inspection activity has too many inspectors (excess capacity)
- Low unit price/hour but incomplete support
    - Absence of relevant work agreement that defines scope/activity
    - Weak or absence of activity reporting
    - Weak or absence of documentation of work
    - Inspection Instructions (deficient or prepared by customer/host)
    - Training logs (deficient)
    - Data reporting (deficient or belated)
    - Poor response times
    - Errors and omissions related to weak systems / management / documentation
- Loss leader pricing to host but excessive pricing to incoming suppliers to compensate.
- Ambivalence toward supplier complaints (not documented/measured)
- Complaints from suppliers to host facility (especially with respect to excess capacity/inefficient inspection activities)
- Unethical behaviour should be alarming for any customer or host. Sophisticated management readily recognizes that offering of gifts, rewards and other inducements is a strong signal that participants are uncompetitive and headed for failure. In fact the danger of this type of behaviour is exemplified by the prevalence of rules, regulations and/or policies stridently blocking the provision or acceptance of inducements.

WHY DO QUALITY INSPECTION FIRMS FAIL?

Eventually non-competitive firms will fail as the above described indicators become intolerable for the marketplace and more relevant competitors emerge. As described earlier, most of these challenges are lagging indicators of weak reinvestment into the firm to create a sustainable competitive advantage.

Weak reinvestment of capital is not limited to stand alone firms. Those Quality Inspection Services firms that are subsidiaries of parent firms such as logistics companies, packaging firms and others may also experience weak reinvestment. Often the parent firms are more focused on their core business activities and the Quality

Inspection Services subsidiary is subordinate to primary business activities. Aside from aggressive harvesting of capital by the parent, the subsidiaries needs are often overshadowed by the parent's primary business focus. During challenging times it is not uncommon for parent firms to divest non-core assets and activities and there are examples of parent firms ceasing Quality Inspection Service subsidiaries that appeared to be competitive.

CONCLUSION

With a better understanding of Quality Inspection Services firms and the environment in which they compete, decision-makers will be better empowered to make informed choices in the selection of these service providers. The unit cost is the least sophisticated metric (although the easiest metric to observe) and simply views the service as a commodity. Those low price competitors who lack Operational Excellence will deliver two possible outcomes – relatively lower standards of service (unresponsive/ineffective/inefficient) and/or irrational behaviour. A professional and sophisticated Quality Inspection Service firm reinvests in the infrastructure necessary to provide continuously improving support, while generating sustainable total cost reductions.

[i] Scott, David L. Wall Street Words: An A to Z Guide to Investment Terms for Today's Investor, Houghton Mifflin Company, 2003.
[ii] Porter, M.E. (1980) *Competitive Strategy*, Free Press, New York, 1980.
[iii] Liker, Jeffrey. *The Toyota Way*. New York, New York: McGraw-Hill, 2004.