

The Issue: Why and How Outsourcing Management and Governance is Critical to Outsourcing Success

by Stan Lepeak, Managing Director, Research
 Mike Beals, Managing Director, Outsourcing Management Technologies
 Liz Campbell, Managing Director, Outsourcing Management
 Lee Ann Moore, Vice President, Marketing

Organizations undertaking information technology and business process outsourcing (ITO/BPO) typically are very focused on “doing the deal.” This involves finding and assessing service providers, determining geographies from which to source services, developing contracts, defining service levels, and a myriad of other tasks. Yet, arguably the hardest part of outsourcing occurs after the deal is done: undertaking the transition and performing ongoing outsourcing management and governance (OM/G). OM/G is a critical and fundamental - but often misunderstood and sometimes neglected - component of any ITO or BPO effort. Outsourcing management and governance is a key element through which organizations that have undertaken outsourcing efforts can strive to maintain the “intent” of the deal. But what exactly is OM/G, what does it do, and what does a good OM/G operating model look like?

The Details

Why Outsourcing Management and Governance?

Outsourcing management and governance (OM/G) is all about preserving and enabling the “intent” of an outsourcing effort, the reason an organization chooses to outsource selected processes. The overarching objective of the outsourcing effort often is to reduce costs while also enabling process improvement and transformation. The intent of the deal impacts everything from the structure of the contract, to the type of client-service provider relationship, to the design of the governance operating model.

OM/G is manifested in the people, processes, supporting tools, and third-party support services that collectively enable an organization to achieve the intent of the outsourcing deal. Through years of experience, EquaTerra has identified six key capabilities that enable outsourcing management and governance success. These capabilities can be categorized further and mapped to the balance that companies continue to manage – risk mitigation against desires for value realization. These categories are highlighted below:

Risk Mitigation

- Finance and commercial management: The ability to ensure contractual obligations are being met by both parties and verifying the invoice reflects the service quality received and provisioned
- Compliance management: Ensuring effective compliance with regulatory, safety and privacy requirements
- Issue and problem management: Appropriate mitigation of issues and resolution

Value Realization

- Change and program management: Manage demand for services as well as leverage and focus service provider capabilities
- Service quality management: Create optimization through standardization, defined performance and satisfaction levels
- Communication management: Business requirements, relationship alignment

Examples of activities:

- Ensure delivery of expected cost savings
- Ensure market pricing for services
- Institutionalize process improvement

Despite the importance of ongoing management and benefits delivery to outsourcing success, many organizations struggle to implement successful OM/G programs. There are many reasons for this:

- Under-investing in OM/G resources. Many organizations undertake outsourcing to reduce costs and are reticent to adequately fund OM/G efforts.
- Not planning for OM/G early enough in the outsourcing evaluation process.
- Underestimating the challenges, skills and resource requirements for OM/G efforts.
- Assuming that existing staff possess the skills and experience required to perform OM/G activities. This is often not the case, at least initially, or without additional training and education and possibly adding new staff with more outsourcing experience.
- Assuming the service provider account team will provide all the necessary governance to manage the agreement.

The impact of not implementing effective outsourcing management and governance can become significant. As indicated in Figure 1 below, there are many ways that the value leaves the organization. Left unchecked, this can approach 10-15 percent of the outsourcing contract value.

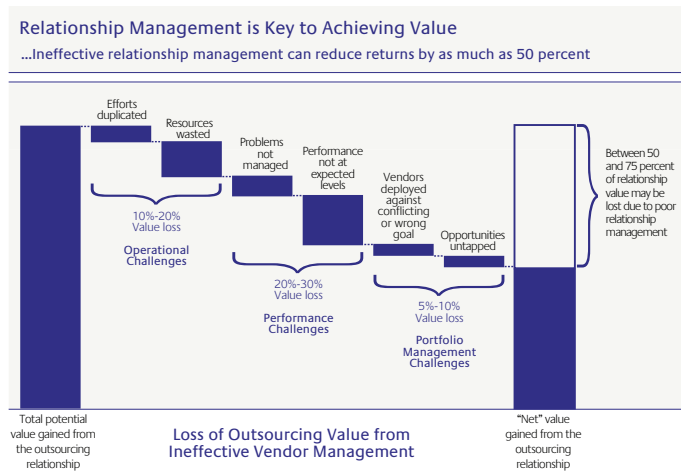


Figure 1

What is OM/G?

EquaTerra has developed a proven approach for ensuring that companies achieve the intent and value of the outsourcing transaction. EquaTerra created its OM/G methodology based on years of managing outsourcing relationships, understanding that the goals of the organization and the service provider must remain aligned for long-term success. The critical components of the approach follow – relationship management, the operating model and commercial management.

Relationship Management

Major ITO or BPO efforts are more akin to a joint venture (or a marriage) than a procurement transaction or simply buying external services. For this reason it is critical that buyers focus on the overall relationship with the service provider and not just the commercial (e.g., meeting service level and contract T&Cs) aspects of deals, though the commercial elements remain important. Buyers with weaker service provider relationships may find, for example, that service levels are being met but the original intent of the deal is not. Additionally, much changes over the life of the contract, including the buyer’s needs, the outsourcing market, and what defines best practices in terms of performance and cost. It is critical, therefore, that both the buyer and service provider can adapt and respond to these changes.

It is also important for organizations to understand the true intent of the deal and the type of outsourcing relationship they seek. The type of relationship (outlined in Figure 2) will drive the OM/G commitment required to achieve the desired outcome. Figure 2 below illustrates the continuum of outsourcing relationship types between the organization and the service provider, from transactional to partnership. As you move right on the continuum, the complexity and OM/G requirements increase. Therefore, the investment needed increases. In addition, the skill set required expands from simple commercial management to include joint planning and more sophisticated change management.

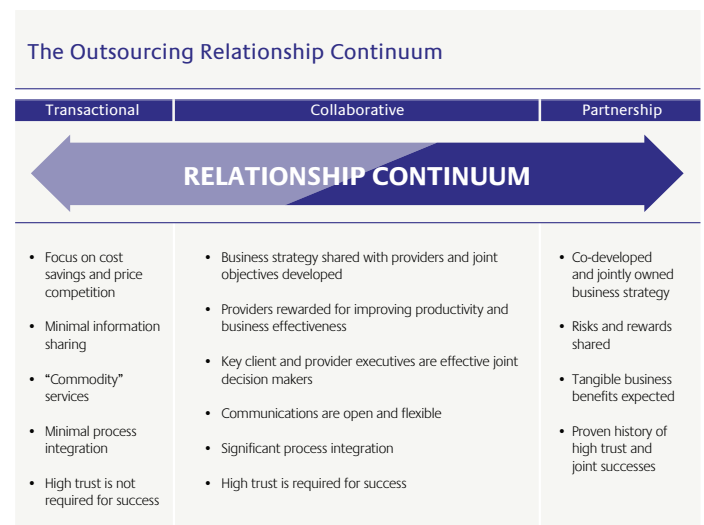


Figure 2

Disappointment and dissatisfaction often occurs when a buyer expects a more collaborative or innovative relationship, yet does not make the investments to support and enable that level of improvement or change. Frustration can result when the parties are focused on a partnership or transforming critical business processes, but the underlying relationship is not built on trust or each party is aligned with its own objectives. Understanding the type of relationship sought and making sure the requirements to achieve that type of relationship are clearly understood by the provider and outsourcing organization are critical to establish an operating model that drives the value for all parties.

An outsourcing buyer often assumes the provider relationship is working, basing that decision on interpersonal relationships versus evaluating the six critical elements that form the basis for developing trust and an effective relationship model. As many outsourcing transactions have a transformational component, we find that most organizations often misunderstand these critical components of an effective outsourcing relationship:

1. Cultural compatibility
2. Inter-dependence
3. Performance
4. Attitudes and assumptions
5. Joint alignment
6. Value

In evaluating your relationship, it is critical to measure these components. It will test alignment between you and your provider, create a framework for assessing your relationship, and ultimately yield a more productive dialog with your service provider. When evaluating an outsourcing relationship, we often see organizations limiting their assessment to what is in the contract. More often, they need to perform a full relationship health assessment to test and measure continued effectiveness of the relationship.

Top Tip: Don't wait until the ink is dry to evaluate the desired type of relationship with your service provider. Use these six relationship components as part of the evaluation process and openly communicate your expectations.

OM/G Operating Model

Highlighting and emphasizing the importance of relationship management in an outsourcing effort helps define and does not diminish the importance of the operating model or managing the commercial aspects of the transaction. In designing its operating model, an organization needs to:

1. Define the type of relationship desired (see Figure 2).
2. Define the guiding principles of outsourcing management.
3. Develop the processes, structure, staffing and funding unique to its requirements to ensure sustainable value through effective outsourcing management.

As guiding principles lay the foundation for effective OM/G, an organization should develop these principles at the outset of the relationship and then review them at least annually to make sure they are relevant to current priorities and objectives. These guiding principles, which should be shared with the service provider, will help ensure collaboration and alignment as circumstances change.

Common guiding principles might include:

1. Foster a fair and productive relationship with your provider
2. Empower the provider to provide the best service possible
3. Leverage the provider's expertise wherever possible
4. Oversee and manage the "what" and not the "how"
5. Achieve cost savings first
6. Don't duplicate the provider's responsibilities

It is critical that guiding principles should balance cost savings with investments to improve efficiency, leverage the provider's expertise, introduce innovation while maintaining a steady-state operation, etc. And, it is never too late to develop guiding principles. If these were not developed at the outset of the relationship, a mid-point in the relationship works for instituting a common framework within the relationship.

Top Tip: Develop these guiding principles collaboratively with the service provider team during the negotiations process and commit to incorporating them in the governance schedule.

As defined previously, the six key functions that serve as the balance between risk mitigation and value realization are the

foundation for the OM/G operating model. Within each of these functional areas is a set of related processes that outline the day-to-day role of the OM/G team.

1. Service Quality Management – Ensures all aspects of service quality are met, problems are resolved, and business stakeholders are satisfied with the performance and quality of the service.
2. Issue Management – Ensures issues impacting the service (regardless of cause) or the relationship are effective and expediently resolved.
3. Change Management – Facilitates anticipated business change with the service provider, including new services and transformational programs.
4. Commercial Management – Ensures the agreement is managed and the financial benefits are both tracked and realized.
5. Compliance – Ensures all applicable compliance requirements are met, internally and externally driven.
6. Communication Management – Focuses on management of key stakeholders involved or impacted by the relationship, including the service provider and other affected third-party providers.

The processes outlined in Figure 3 below complement the account management processes your service provider likely will implement. However, the focus of all these processes is what an OM/G organization needs to do and has accountability for.

Top Tip: Review our sample prioritization against the needs of your organization. Discuss the priorities, commit to a timeline for joint development and review with your service provider.

The operating model is the enabling glue that pulls together the people, processes and best practices of OM/G. It enables the six elements of OM/G, and defines the following points:

- The make-up and structure of the OM/G group, their authority and accountabilities
- The roles within the OM/G group and how they interface with other parts of the business (retained operations and business users)
- The roles and responsibilities of members of these groups relative to the service provider

Service Quality Management	Issue Management	Change Management	Commercial Management	Compliance Management	Communication Management
Service Performance Management	Escalated Operations Management	Strategic Change Management	Contract Change Management	Regulatory Compliance	Customer Relationship Management
Stakeholder Satisfaction Management	Critical Issues Management	Project Approval and Initiation	Invoice Verification and Payments Management	Internal and External Audit	Management Reporting
Service Knowledge Sharing	Emergency Management	Program Management /Transition	Service Cost Allocation Management	Safety and Security	Business Requirements Identification and Liaison
Root Cause Analysis		Demand and Consumption Management	Financial Benefits Realization Tracking and Lockdown	Data Privacy	Corporate Communications Management
			Financial Performance Reporting	Other (Client) Policies and Procedures	Relationship Alignment Review
			Benchmarking	Business Continuity	Third-party Supplier Communications
			Asset Management		

Figure 3

Go Live	D + 90 days	D + 180 days
---------	-------------	--------------

Figure 4 below illustrates the model for an engagement and the relationships between the OM/G and other parties when outsourcing arrangement(s) are put in place. In this instance, a large, multi-tower outsourcing arrangement was established.

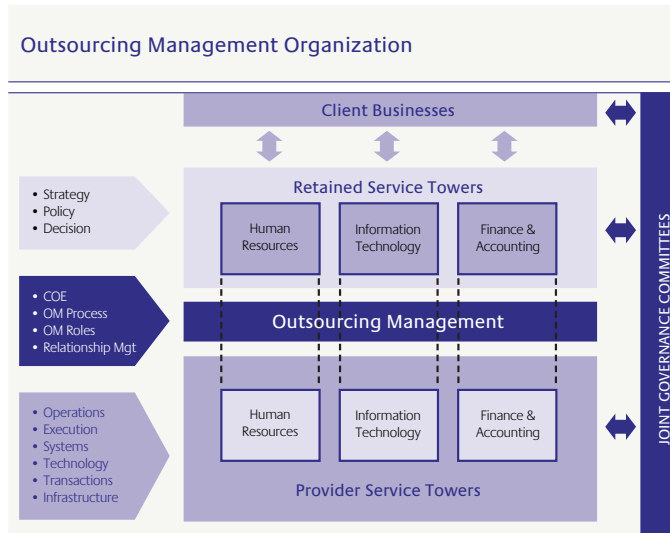


Figure 4

Many retained organizations often create centers of redundancy. These can be small or large, but regardless of size, they greatly diminish the value achieved in the outsourcing relationship. Organizations struggle with this issue more than any other. Pointing back to the guiding principles, they remain focused on the “how” element of the work being performed and revert to how the work was done in the past.

Figure 5 shows a hypothetical structure of an outsourcing management team. This diagram outlines the functional roles that make up the OM/G executive in charge of the relationship. This person may report directly to the executive in charge of the business process being outsourced – in IT, for example, this person often reports to the CIO.

The governance executive mentioned above will likely be leading a team of OM/G executives with a combination of skills and roles including commercial managers – financial, contract, compliance; relationship managers; service quality managers (likely a critical liaison to the service provider); and the program management office (potentially the PMO lead, specialists and project coordinators).

The OM/G function works early in the relationship to align the new roles within the organization to the service provider

Outsourcing Management Roles and Responsibilities

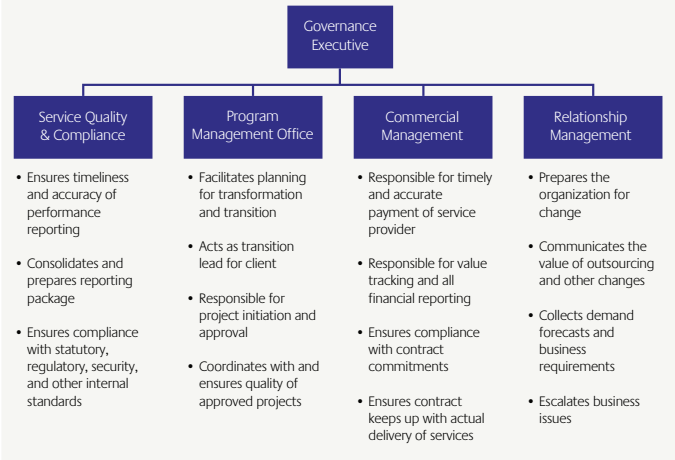


Figure 5

and the retained organization. Critical tools include the responsibility matrix and decision rights that clearly outline authority and accountability. This detailed exercise may seem simplistic but requires careful analysis and assigns critical accountability for the OM/G and the service provider teams. These organizational alignment tools serve each party well during day-to-day operations, and more importantly, when critical issues arise.

Top Tip: The skills and competencies required for OM/G may not exist within the organization. Companies often seek external hires to boost the OM/G experience of the team. Alternatively, consider team training or mentoring / coaching for specific individuals.

Commercial Management

The areas of greatest focus and scrutiny – the commercial elements of the transaction – are often over analyzed and managed as a traditional procurement versus a complex operating relationship. Commercial management is a core function within the operating model, one of the six functions mentioned previously. When managed effectively, it drives quantifiable value for the relationship.

The basics of commercial management include three types of management – contract, demand and consumption, and

financial. Contract management addresses contract-related questions and requests, ensures obligations are met by both parties, and manages any contractual changes. Demand and consumption management monitors enterprise consumption reporting and demand forecasting. The financial management component validates accuracy of all invoices, facilitates payment approval and control processes, determines cost allocations, standardizes the development of the business case and monitors and reports on financial performance.

Change management is a constant within outsourcing, yet companies often don't ensure the proper frameworks to manage change. Ideally, contract change management will become a standardized process that outlines the protocols for elements, such as who, what, where, when and how, of potential contract changes. The OM/G organization will establish how an amendment and/or agreement will be incorporated into the master agreement and will ensure the master agreement is consistent with the services being delivered. An organization should have a clear process map of the contract change lifecycle – with each suggested change documented and stored for ongoing reference.

Top Tip: Contracts are often required before the ink is dry and the agreement is put into use, points of clarification are required for language and service, etc. Ensuring this process is in place day one will help provide clarity for both parties.

Another critical component of commercial management is demand and consumption management, which is the mechanism the outsourcing organization should utilize to make sure consumption and pricing are aligned with the original agreement. Clearly, the service provider is motivated to provide additional services to meet increased demand, thus driving up total cost. It is incumbent upon the client to independently validate actual consumption and make certain the invoice is correct. That review should take a dual view – historical, making sure services have been validated by the business units, and future, identifying trends based on historical service consumption.

Top Tip: Establish regular meetings with functional operations/stakeholders to review consumption trends along with the associated impact on cost and discuss future requirements.

The service provider invoice often contains volumes of information requiring independent verification, which speaks to the need for robust financial management processes. This process enables the client to independently confirm the invoice amounts and compare them to a variety of inputs, such as contract volumes, actual volumes, unit rates, service bands, pricing components, service level credits and earnbacks, business unit charge outs, etc. It ensures the service provider invoice is accurate and consistent with the contracted services, facilitates the payment approval process, and enables the client to pay the provider in a timely fashion.

Is the relationship delivering the financial benefit sought at the outset of the transaction? Have costs gone down, were expenditures avoided? The finance manager assigned to the relationship often is responsible for measuring and tracking savings from outsourcing. Contributing factors that must be analyzed come from the controller's organization – the budget (actual and forecast), the business units, and other governance processes such as service cost allocation, financial performance reporting, etc.

In order to encapsulate all these critical components (demand and consumption management, invoice verification and payment, service cost allocation, financial benefits tracking and service performance management), each must roll up for OM/G financial performance reporting and analysis, evaluation, and communication of the financial status of the relationship and the agreement. This reporting serves the needs of the executives, process leaders and business unit leads. Other fees that might be included are any severance, transition or service taxes. These are presented so all teams can view total service provider-related charges.

How are Outsourcing Buyers Responding?

Developing and deploying the above process and organizational models is no trivial exercise. Outsourcing buyers, particularly those with an eye toward maximizing cost savings, will ask for proof that the investment is worth it and OM/G can truly preserve the intent of the deal. EquaTerra research, coupled with extensive hands-on buyer experience through its outsourcing management and governance practice, has consistently shown that OM/G investments pay off.

An EquaTerra market research study conducted Q2, 2006 found a direct correlation – up to a point – between OM/G

investments and outsourcing satisfaction. Buyers that spent 4-7 percent of the annual contract value on OM/G efforts, for example, were more satisfied than those that spent just 1-4 percent. Additionally, outsourcing satisfaction rose once buyers had completed the difficult transition process and OM/G organizations and operations were up and running smoothly (see Figure 6). Finally, buyers that undertook outsourcing to access external skills and resources or to improve process performance were more satisfied than those that were just seeking cost savings or had not clearly defined why they were outsourcing.

How are Outsourcing Service Providers Responding?

More progressive outsourcing service providers and those supporting larger and more complex deals are recognizing the value of OM/G and the importance of their client's OM/G capabilities to the success of outsourcing efforts. While service providers themselves tend to focus, and in some cases overly fixate, on the commercial aspects of OM/G, they also are increasingly sensitive to the value of relationship management. The issue for service providers relative to relationship management is its often subjective nature and the challenges associated with measuring and tracking relationship management "performance." Service providers naturally are loath to be held accountable for something difficult to measure.

The most recent EquaTerra quarterly service provider Pulse survey found service providers consistently citing governance and change management as the biggest challenge buyers face in their outsourcing efforts. Additionally, 55 percent of service providers polled said change management problems – a key element of transition that OM/G should address – are one of the biggest threats to outsourcing efforts, exceeded only by inadequate management support (cited by 59 percent of service providers).

The Advisor Perspective – Critical Points to Consider

Organizations undertaking increasingly large, multi-process area outsourcing efforts will often experience difficult transition periods and face complex and, in some cases, daunting ongoing management and governance challenges. Migrating processes and people, ramping up new operational models, launching governance efforts, and learning how to work successfully with the outsourcing

service provider are challenging tasks. Driving satisfaction in an outsourcing effort is something that takes time and effort. Buyers entering into outsourcing efforts need to keep these points top of mind, from the standpoint of how to best address the challenges of transition and the early stages of an outsourcing effort, as well as not underestimating potential early levels of dissatisfaction.

Outsourcing Satisfaction Levels

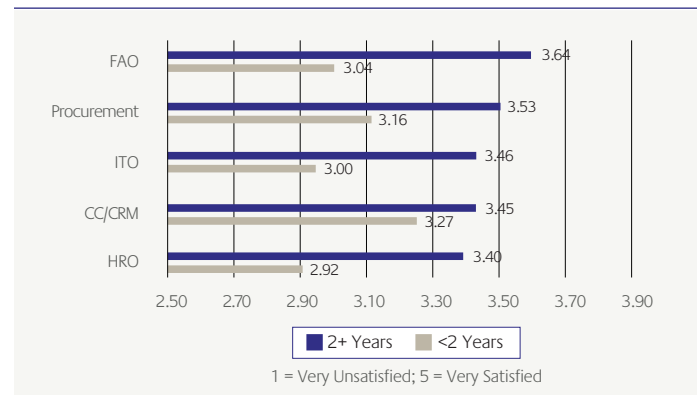


Figure 6

To this end, buyers must embrace the following positions relative to OM/G when pursuing outsourcing efforts:

- Begin OM/G efforts during the sourcing process.
- Calibrate outsourcing goals sought with the OM/G capabilities required to meet those goals and the organization's appetite to invest in OM/G capabilities.
- Define the roles and responsibilities of the OM/G and retained organization groups relative to transition and ongoing outsourcing management and governance efforts.
- Infuse the "best and brightest" into the OM/G organization and recognize the strategic importance of these roles to long-term outsourcing success.

Research indicates that almost all organizations either spend money on external tools to monitor and manage their outsourcing relationships, or develop them internally. However, it is also true that those organizations do not usually have a structured make/buy process. As described in the previous section, outsourcing relationships are very complex and contain a tremendous amount of detail. Sooner or later, OM/G organizations need tools to help them do their jobs. The question is whether they will spend six to eight months developing spreadsheets and other applications for monitoring, management and reporting. Focusing on building and maintaining tools minimizes the time and attention governance

resources can spend making proactive, informed business decisions relative to the relationship(s) they manage.

Additionally, much of the work of governance is transactional and repetitive. Activities such as consolidating and compiling performance and financial reports take a lot of time, but do not provide much value as a standalone. Automating many of these routine activities creates significant efficiencies for the OM/G organization. It also might mean that the relationship could be managed with fewer resources, thereby reducing the overall cost of governance and justifying the cost of a tool(s).

There are a growing number of Outsourcing Relationship Management (ORM) tools available on the market. With very few exceptions, these tools focus on providing functionality around one or two of the six areas governance must address. For example, service performance management and issue management are the most mature tool markets. It is important to think through what tools your governance organization needs to effectively and efficiently manage your relationships.

Conclusion

OM/G is the people, processes, supporting tools, and third-party support services that collectively enable an organization to achieve the intent of the outsourcing deal. The intent of the deal represents the ultimate goals of the original outsourcing effort as defined by key stakeholders in the buyer organization. Organizations must begin to address OM/G needs and requirements far in advance of consummating the outsourcing deal. While OM/G costs can reduce the total theoretical cost savings achieved in outsourcing efforts, these investments consistently have been shown critical to achieving any level of success in meeting outsourcing goals, either cost reduction or process improvement related. Finally, buyers must map the OM/G models and investment to the overall goals of the outsourcing effort and define a relationship model that can realistically support these goals.

About EquaTerra

EquaTerra sourcing advisors help clients achieve sustainable value in their business processes. With an average of more than 20 years of experience in over 600 global transformation and outsourcing projects, our advisors offer unmatched industry expertise. EquaTerra has in-depth functional knowledge in Finance and Accounting, HR, IT, Procurement and other critical business processes with advisors throughout North America, Europe and Asia Pacific. Our people are passionate about providing objective, conflict-free advice to our clients, which has fueled our exponential growth over the past three years. We help clients achieve significant cost savings and process improvements with outsourcing, internal transformation and shared services solutions. **It is all we do.**

If you have questions about this report or would like to learn more about how EquaTerra can help your organization address the points and opportunities discussed, please contact Liz Campbell, Mike Beals or Stan Lepeak.

- Liz Campbell, Managing Director, Outsourcing Management, liz.campbell@equaterra.com; 312 953 4891
- Mike Beals, Managing Director, Outsourcing Management Technologies, mike.beals@equaterra.com; 404 915 4022
- Stan Lepeak, Managing Director, Research, stan.lepeak@equaterra.com; 203 458 0677

For additional information on EquaTerra, please contact Lee Ann Moore at leeann.moore@equaterra.com or 713 669 9292.