



Business briefing series

20 issues on outsourcing and offshoring

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All information is current as at November 2011

First published December 2011

This communication provides general information which is current as at the time of production.

Published by:

The Institute of Chartered Accountants in Australia

Address: 33 Erskine Street, Sydney, NSW 2000

Ernst & Young

Address: Ernst & Young Centre, 680 George Street, Sydney

20 issues on outsourcing and offshoring

First edition

National Library of Australia Cataloguing-in-Publication entry

20 issues on outsourcing and offshoring/Institute of Chartered Accountants in Australia, Ernst & Young.

ISBN: 978-1-921245-90-9 (pbk.)

Contracting out.

Offshore outsourcing.

Institute of Chartered Accountants in Australia.

Ernst & Young.

Business briefing series.

658.4058

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Business briefing series



20 issues
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Today's global business system, characterised by market liberalisation and free trade, has opened the world to Australian businesses.

Outsourcing and offshoring are viable options for many organisations looking to grow their operations and networks, but there are many aspects to consider in determining whether this is the right choice.

20 issues on outsourcing and offshoring is designed to help businesses make that decision. It explores how best to weigh up options available, how to set up the processes, and issues to consider when transitioning to new arrangements, such as governance, business continuity and feasibility.

The decision to outsource elements of a business is often complex, and this publication aims to break down the components of the process and enable business leaders to make a seamless, cost-effective transition.

This publication is the sixth in the Institute's Business briefing series, which offer business leaders and financial professionals simple, clear guidance in overcoming the challenges associated with an evolving economic climate.

The Institute has partnered with Ernst & Young on the production of *20 issues on outsourcing and offshoring*, and I trust the content is both insightful and informative for those considering or evaluating their sourcing options.



Rachel Grimes FCA

President

Institute of Chartered Accountants in Australia



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Introduction

The market for outsourcing and offshoring services has changed dramatically in recent years. What was an emerging phenomenon with great potential is now a natural element of corporate services.

The value proposition and measures of success for outsourcing and offshoring operations is evolving. Leading organisations look to harness value beyond cost reduction through consolidation, automation, and labour arbitrage to more commercial benefits including accessing and building capability, scalability and flexibility to support business strategy.

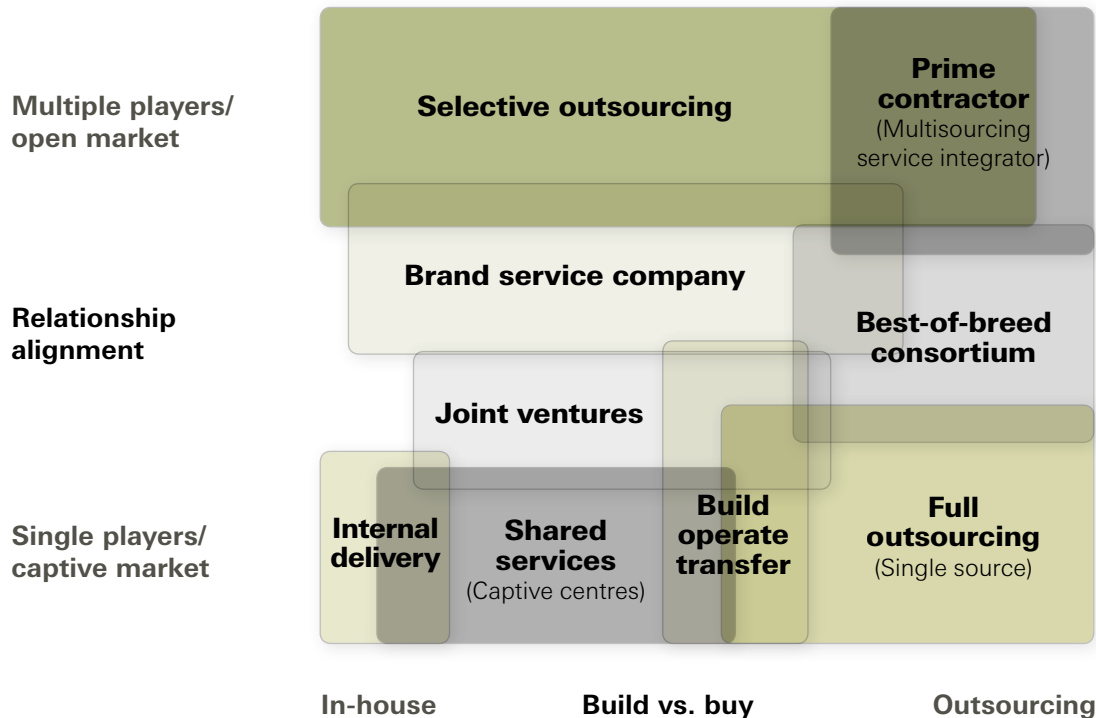
Today, technological advances, together with trends in privatisation, globalisation and deregulation, are encouraging the emergence of alternatives to traditional business models (Illustration 1). Organisations employ

a broad range of service delivery models and techniques, including offshoring, outsourcing, selective and hybrid models for core and support functions. The scope of activities within an organisation’s value chain that can be performed offshore has grown as we continue to see new types of services being handled remotely and across borders.

Are your organisation’s support services a cost burden or a competitive advantage; a tactical necessity or a strategic weapon? A well-developed outsourcing and shared services delivery model that is appropriate for your organisation can leverage capabilities, reduce cost and increase agility to deliver sustainable business value.

Illustration 1 – Emerging alternative sourcing models:

The IT Sourcing Strategy Space and the Nine Sourcing Models



Source: Gartner, Inc., *How to Put Sourcing Models into Action to Address Business and Market Dynamics*, March 23, 2011.

Illustration 2 – Top outsourcing trends



As the benefits of these models are realised and implementation capabilities are refined, the cost and performance gap continues to grow between organisations that have adopted these strategies with those that have not.

Consequently, the outsourcing and offshoring industry has grown significantly as its use becomes more widely accepted. While the global financial crisis (GFC) caused uncertainty and a softening in market demand in 2009, the current economic climate is generating demand for selective outsourcing and offshoring.

International Data Corporation (IDC) forecasts the worldwide demand for business process outsourcing services for the five key functions (customer care, finance and accounting, human resources, human

resources processing and procurement) will grow steadier in 2012 (Illustration 3). IDC expects 2011 data to reflect slower growth due to intense contract negotiations and other market conditions that include customers reducing discretionary spend and new delivery models such as platform business process outsourcing¹.

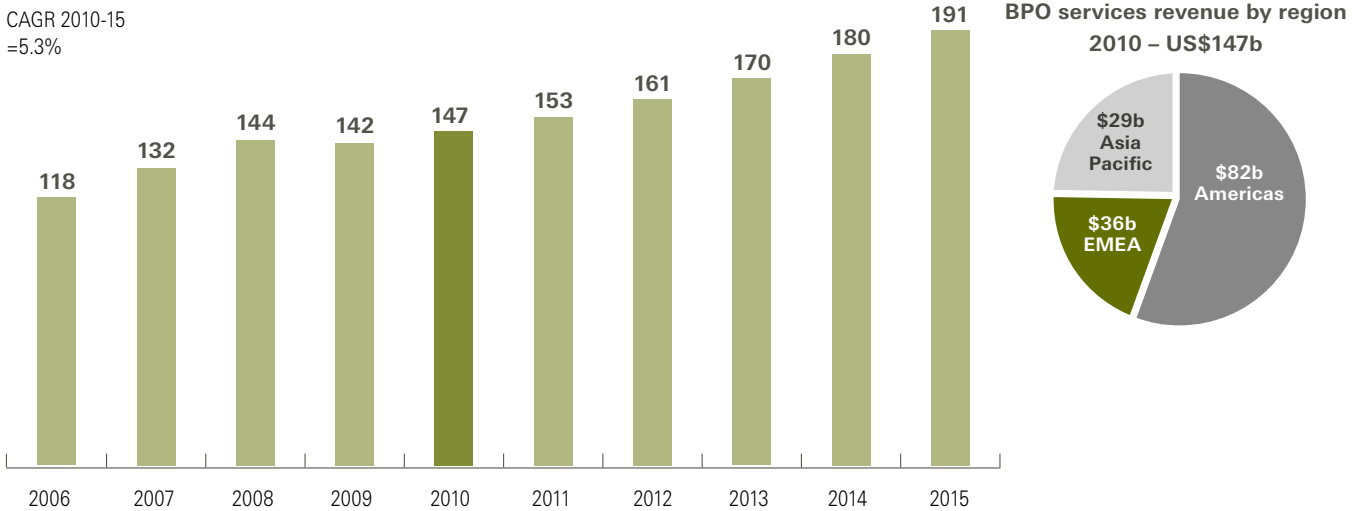
As the issues surrounding development and implementation of a successful sourcing strategy are complex, the majority of sourcing projects are executed with the support of a sourcing advisor or intermediary. The greater the complexity in a sourcing project in terms of scope of services, geographical footprint or scale, the greater the likelihood the deal will be advisor led².

1. IDC, *Worldwide and U.S. Business Process Outsourcing Services 2011–2015 Forecast*, Doc # 228081, May 2011.

2. Source: Forrester *Sourcing Professionals Can Use Advisory Firms To Help Architect Healthy Deals*, March 2008.

Illustration 3 – Steady growth forecast for 2012 and beyond

Worldwide Business Process Outsourcing Market – \$US Billion



Source: IDC, Worldwide and U.S. Business Process Outsourcing Services 2001-2015 Forecast, Doc # 228081, May 2011.

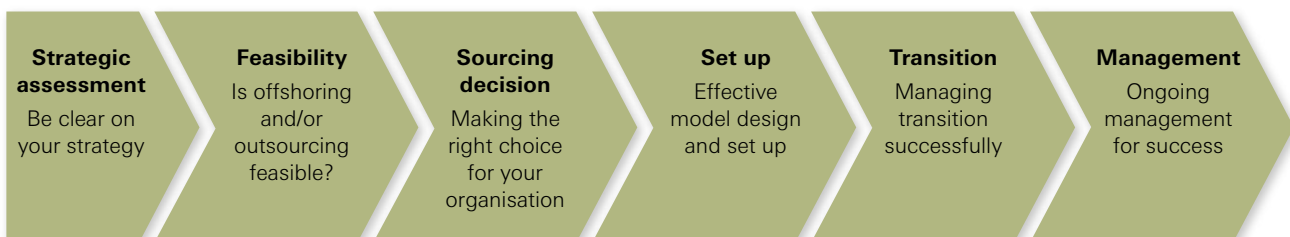
While specialised intermediaries provide services in support of specific stages such as supplier selection and contract negotiation, sourcing advisors can provide support across the entire sourcing lifecycle in areas such as:

- Research and training
- Sourcing strategy and feasibility
- Outsource and insource process management
- Solution development and business case
- Supplier selection and evaluation

- Service level agreement development and contract negotiation
- Program management and transition support
- Relationship management.

This paper, *20 issues on outsourcing and offshoring*, focuses on the key issues organisations should consider in making sourcing decisions. The issues discussed are grouped under six key stages of the sourcing lifecycle and are observed regardless of industry or the scale and scope of activities being sourced.

Sourcing lifecycle



Strategic assessment

1. Source to support your business strategy

- Does outsourcing or offshoring align with your business strategy?
- Has a sourcing strategy been established?

Traditionally, the motivation for offshoring or outsourcing was to cut costs. However, today the decision is influenced by more strategic factors. To be competitive, organisations need to drive innovation, enable growth and increase flexibility. Offshoring or outsourcing activities can help organisations become more flexible and adaptive and react faster to changing markets. Before considering offshoring or outsourcing options, you need to ensure such a strategy aligns with your overarching business strategy. For example, organisations with an aggressive growth strategy may

need a flexible sourcing option that can scale as the business grows. Those companies that do not carefully test alignment may find themselves incurring new costs, frustrating customers and losing market share.

Sourcing decisions are often made tactically and in isolation from long-term business strategy. Organisations should establish a sourcing strategy as an element of wider business strategy. This provides a frame against which tactical sourcing decisions can be made (Illustration 4).

Outsourcing and offshoring can have a significant impact on your business. Many companies have undertaken it successfully however there have been failures. Having a clear picture of what you are trying to achieve will help set your sourcing strategy and objectives. This will then help you decide whether or not offshoring or outsourcing is right for your business.

Illustration 4 – Aligning sourcing strategy to business strategy



- An organisation's functional strategy and sourcing strategy need to be fully aligned to the overall business strategy
- Both the functional strategy and corporate sourcing strategy will be used to drive an aligned and effective functional offshoring/outsourcing outcome
- The functional sourcing strategy will be implemented through lifecycle planning and detailed phase-by-phase activity planning - this will be carried out on a cross functional basis if appropriate.

Feasibility

2. Gather facts on current performance

- Do you know what your current processes look like and cost?
- How does current performance compare to other organisations?

It is important to have a solid foundation of facts on the current state of processes and gaps to better practice. This will offer essential input to investigating sourcing options and impacts, skillfully negotiating sourcing arrangements and making sound sourcing decisions.

A review of current operations and a baseline analysis across processes should be performed to ensure current performance and costs are understood. This can be a high-level review initially to identify the opportunity, but will require detailed analysis using a consistent, proven approach to build a solid business case and achieve buy-in to the sourcing solution. A current state assessment will create a baseline for assessing future operational performance and benefits and typically comprises collation or development of process flow documentation, activity logs, systems, organisation

charts, roles and responsibilities, performance measures, and a RACI (Responsible, Accountable, Consulted, Informed) framework across key processes or operations. The ability to capture this provides valuable information in its own right and will demonstrate the need for a sourcing solution.

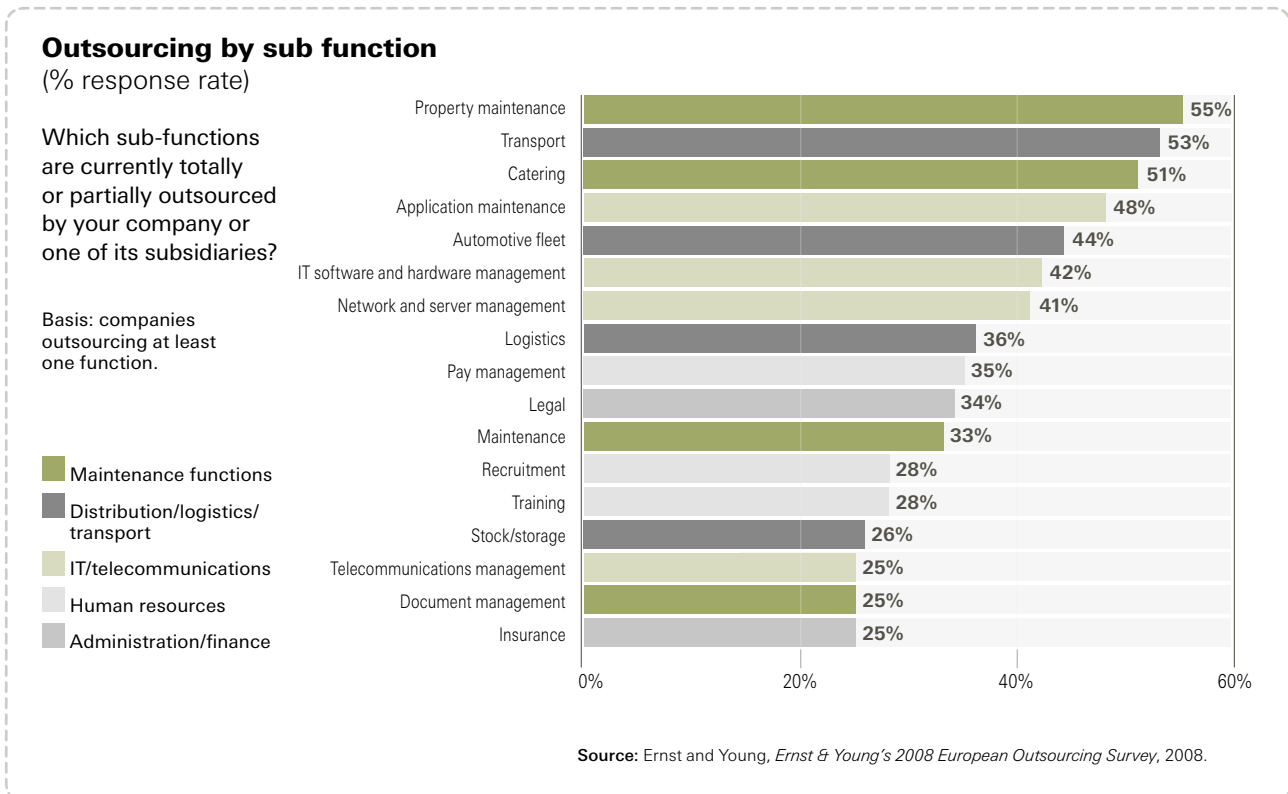
It is crucial to understand your key activities, how often they occur and who manages the outputs. Knowing the activities, complexities, frequencies, relationships and interactions will help you to understand how current activities could fit into the future solution and start to provide the foundation of material for a transition plan.

Performance measures should be developed if these don't already exist, to support the development of expected service levels of the future provider.

This approach will help to ensure you make sourcing decisions based on solid research and facts, and ultimately enable the success of the strategy to be assessed.

There are a number of different functions that organisations can choose to outsource. The diagram below shows the most commonly outsourced functions (Illustration 5).

Illustration 5 – Which functions are outsourced?



3. Assess qualitative and quantitative benefits

- Has a robust benefit and risk assessment been completed?
- How will sourcing enable you to focus on the strategic direction and/or growth of the organisation?

The ability to reduce costs is the most significant advantage of outsourcing and offshoring, yet outsourcing can achieve benefits way beyond simple cost savings. Improving effectiveness is a close second motivator for sourcing arrangements today. The GFC highlighted the need for organisations to build agility and capability more quickly in back, middle and front office functions. Organisations looking to expand or divest should look at how sourcing can quickly enable the benefits of that strategy to be realised.

Surveys show organisations are using outsourcing and offshoring as a strategic tool to enable growth, support changes of direction and leverage available resources more quickly (Illustration 6). The labour savings from global sourcing can be substantial, however only form part of the bigger picture that also encompasses improvements in quality through specialist skills, improved delivery quality and increased flexibility. While a number of service providers are perceived to be simply low cost providers of commoditised services, others are fully appreciated for the access they provide to skills unavailable in-house and producing high-quality work products.

Additional reasons why organisations outsource:

- Release of cash from the transfer of assets
- Access to leading-edge technology without capital investment
- Ability to transfer risk to the service provider
- Desire for flexible and scalable solutions that support growth or divestitures
- Drive to focus more on core processes and business activities
- Delivery of continuous improvements in process effectiveness and efficiency
- Leverage of scarce resources.

The business case, benefits and risk assessments need to be robust. There are a number of challenges in quantifying the business case including lack of visibility about the current functional costs or lack of data where information and technology is not well integrated.

The sourcing decision should carefully identify and assess these qualitative as well as quantitative benefits and may require review of the business case criteria and decision process to ensure the optimal conclusion is reached. The following provides an indication of the range of benefits organisations typically achieve in outsourcing and offshoring:

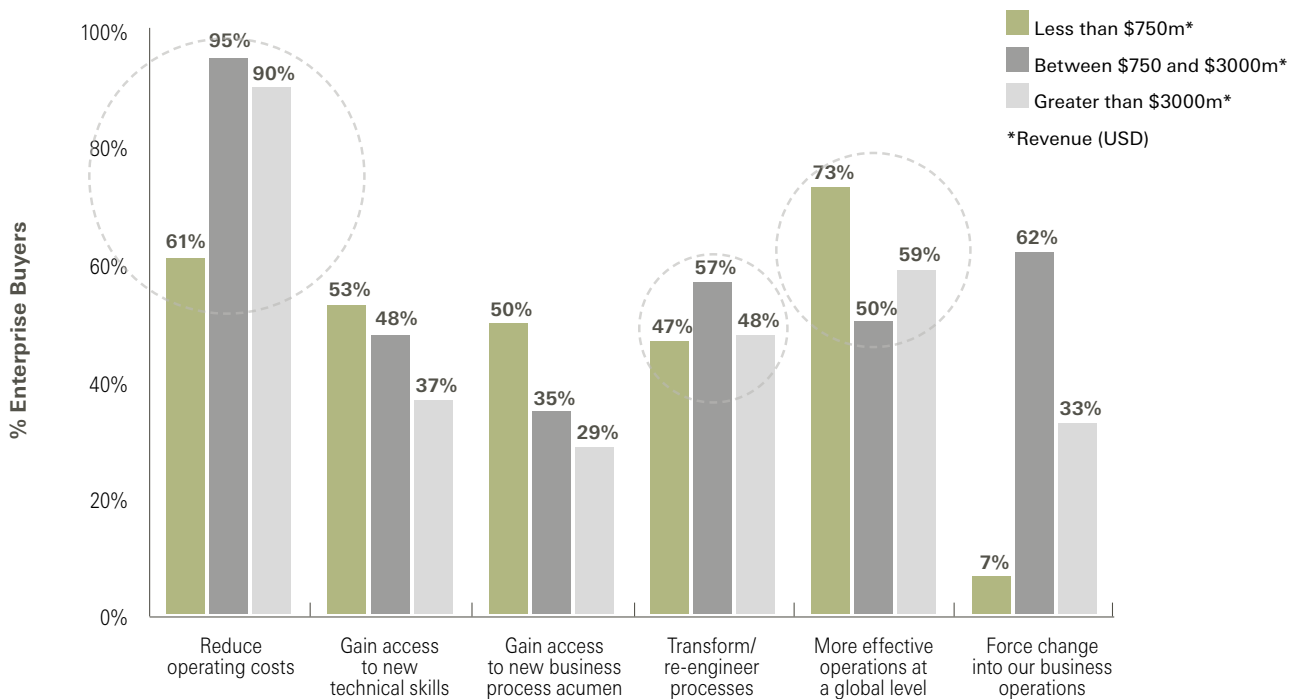
Quantifiable

- Reduced operating costs (estimated 20-55%)
- Labour arbitrage (estimated 10-30%, reducing cost per head by moving to a low cost location)
- Productivity and process improvement (estimated 5-15%, process excellence and IT enablement to improve cycle times, lower cost and increase quality)
- Reduced overheads (estimated 5-10%)
- Improved working capital (through the sale of assets and/or facilities to the vendor)
- Reduced capital commitments
- Improved quality.

Qualitative

- Improved service delivery (access to world class processing)
- Stronger control environment (improved controls through process simplification and focus)
- Platform for transformation (leverage the transformation capabilities of the vendor)
- Improve focus on core capabilities (retained staff can focus on 'value-add' activities)
- Improved relationships with customers and suppliers
- Access to talent.

Illustration 6 – Key business drivers for business process outsourcing for organisations
(by \$US revenue)



Source: HFS Research, *Outsourcing: a symptom of a failing education system?*, April 2011.

4. Don't move until your organisation is ready

- Is there (executive/senior management/internal) support or appetite for an offshore model?
- Have processes been improved sufficiently to offshore?

During the feasibility stage, the likelihood of obtaining critical executive support should be considered and tested. If the organisation has offshored processes or outsourced niche activities previously, there is a precedent that could work for or against the support needed for a successful business case. If the organisation has not offshored or outsourced processes in the past, it will take considerable time and effort to

engage stakeholders in building the business case and actively sponsoring the implementation. Legitimate stakeholder support will result in a clear endorsement of the sourcing strategy and commitment to delivering the outcomes. The many tactical decisions to be made and the challenges that will inevitably arise are easier to navigate if support and shared understanding is developed upfront.

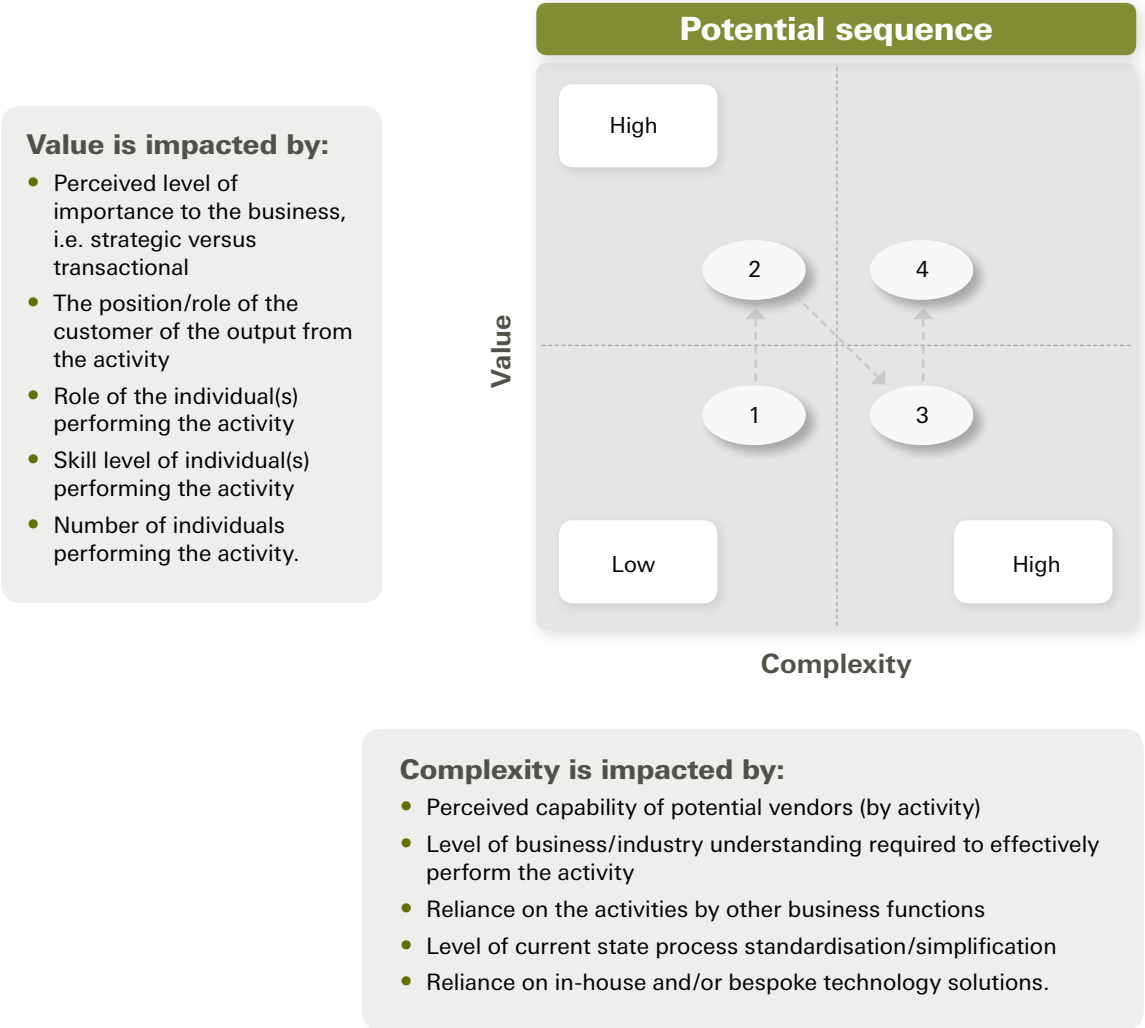
To supplement the business case, organisational readiness for an offshored or outsourced model should be assessed to determine capability to absorb what can be a significant change. A review of the social and political factors should be conducted particularly for customer-facing processes, as this may impact the sourcing options to be considered.

Executing offshoring or outsourcing arrangements requires specific skills in negotiating, managing the transition and major change, managing risk and managing functions or processes remotely. Where offshoring or outsourcing has not been completed previously, this can prove challenging, and will always take more effort and resources than anticipated. It may require new hires or external support to execute well. The learning curve on offshoring or outsourcing is steep, however organisations learn quickly from each

transaction and quickly build capability that can be readily applied to new opportunities.

Consideration should also be given to the maturity of the processes considered for offshoring or outsourcing. Processes that are broken or fragmented and rely on the skill and experience of current staff to operate smoothly can be difficult, risky and costly to offshore or place with an outsourcer. Experience shows that organisations prefer to conduct some initial process improvement before placing offshore, as Illustration 7 indicates.

Illustration 7 – Example of readiness assessment for offshoring or outsourcing a process



Sourcing decision

5. Scale matters

- Is your organisation big enough to take advantage of outsourcing/offshoring?
- Can a third party outsourcer provide the scale you don't currently have?

A common question asked is, 'at what scale does outsourcing or offshoring make sense?' Scale does matter as there are substantial upfront costs involved in establishing an outsourced/offshore service delivery centre which need to be recouped through the benefits delivered. Often, where the business case is marginal for an in-sourced solution, a third party provider can provide scale via its multiple client service model and by having made the upfront investment cost to establish the operation (e.g. real estate and technology infrastructure). With these factors in mind, the case may be better to outsource to a third party provider, even after allowing for their margin, rather than offshore internally.

It is important when assessing scale to consider the scope of processes and the expected growth of the business. Scale may be achievable for a multi-process/function solution but not for a single process and while the immediate case may be marginal for the current business, when growth projections are factored in, including potential expansion of operations (e.g. across Asia) the case can very quickly turn from negative to highly positive. Accordingly, organisations should forecast the expected scale in short, medium and long-term timeframes. Scenario analysis on the impact of scale (or lack of) is also highly valuable.

Scale is an important consideration. It is critical to understand and factor in both potential scope of function and business growth considerations while also considering whether an outsource provider can enhance the value proposition by leveraging its additional multi-client scale advantage.

Example:

An Asian airline undertook an assessment of the business case associated with moving selected finance processes across their global network to a consolidated lower cost solution, utilising delivery centres in India and China. While the scope of process in some countries was comparatively small and did not produce a viable case on a single country basis, the sum of the parts made sense. When the comparison was made between the internal and external provider, the numbers showed that the best leverage of scale could be achieved through leveraging the scale of a major established global business process outsourcer via their existing facilities.

6. Don't outsource a problem

- Which activities are appropriate to be outsourced and which should be kept in-house?

There is clear value in understanding the state of current processes and considering transformation in-house before outsourcing. Importantly, the condition of existing processes to be outsourced needs to be understood to assess whether it is best to 'shift then fix' or the reverse, 'fix then shift'? Increasingly, organisations are investing in a degree of fixing processes first, to capture full value and ensure that they are not simply outsourcing a problem. Following the current state assessment, it is worthwhile to develop a broad strategy for the processes and identify any quick wins that can be achieved in-house and onshore before handing over to an offshore or third party provider, particularly where local business knowledge and capability is needed to drive the change. Further processes should be reviewed for opportunities to automate the process to achieve significant cost reduction and efficiencies, which may alleviate the drivers for outsourcing.

Processes that require significant transformation or investment to fix may have a stronger case to outsource than those in better shape, particularly where the skills and technology required to transform them are not currently held in-house and a provider can offer a faster route to wholesale change.

Irrespective of the approach taken, it is vital the processes retained within your organisation are fixed and the touch points with the outsourced, and offshored processes are well defined to work effectively. Onshore investment will be required to improve processes for retained activities, technology and different skills. The end-to-end governance of the process, discussed in issue 17, is also important to define accountability for process improvement and the role of the organisation versus the provider in addressing wider structural problems and tactical process issues.

7. Don't chase labour arbitrage

- Will labour cost advantages erode over time?
- What other benefits should you be looking for?

Typically labour arbitrage alone can deliver cost improvements in the order of 10-30%, however there has been recent concern as to whether rising costs of labour in emerging economies will quickly result in erosion of benefits through offshoring. Recent research showed that labour costs for IT and process outsource providers in key offshore markets, including India and China, are increasing on average by 8 to 11% per year, representing around half the inflation levels that have been commonly reported³.

This suggests offshore outsourcing suppliers have been making inroads to control rising labour costs. Everest research suggests the arbitrage opportunity for US companies (a reasonable comparison to Australia/New Zealand) can be sustained for 18-25 years with Asian markets, such as India, China and the Philippines.

One advantage which third party providers can offer is access to an existing or planned network of service delivery centres allowing for the ability to shift work across their centres more easily than internal delivery options as the economics change from location to location. The key to securing this benefit is flexibility in terms negotiated in the sourcing contract, which can provide some protection to rising labour costs in locations that become 'the go-to destination' for offshore services.

While labour cost benefits are expected to remain a key driver for some time, all cases for offshoring

and outsourcing need to factor in benefits beyond labour arbitrage including better spans of control in management layers, infrastructure consolidation and avoided IT investment costs as well as the critical factor of service improvements. Sensitivity analysis around the labour costs should be a standard part of the business case analysis to understand at what point reduced labour arbitrage changes the decision.

For organisations with existing offshore arrangements, close monitoring of the economic conditions of current and alternative service centre locations should be maintained to pre-empt any negative trends and take advantage of opportunities to review the sourcing location or service provider contract.

8. One solution does not fit all

- What sourcing strategy will best meet the needs of your overall business strategy?
- What information is available to identify main trends, key players and aid your decision making?

There is no 'one size fits all' solution to sourcing and so a robust sourcing strategy and solution design is required to ensure that the decisions you make will ultimately serve to meet the needs of your organisation's overall business strategy. There are many service models an organisation could adopt and it may be appropriate to adopt more than one service model. Regardless of the sourcing approach you take, meticulous planning and investment of management time and unwavering commitment from all key stakeholders are required through all stages from feasibility, pre-contract, set-up, transition and steady-state operations.

Approaches to outsourcing and offshoring are varied and solutions for a range of different functions have been implemented successfully. Less common now are examples of organisations that outsource entire functions in one go. Carefully considered due diligence for each process should be carried out, particularly when outsourcing involves selecting offshore locations. Evidence suggests that many outsourcing initiatives fail to deliver the anticipated value and often, the reason for these failures stems from the lack of a clear and

3. Everest Research Institute, Sustainability of Labour Arbitrage, 2009.

explicit sourcing strategy, a lack of definition around how the various parties in the sourcing arrangement will work together to drive improvements and a lack of understanding of the impact this will have on the functions not included in the sourcing arrangement. For example, if outsourcing the accounts payable function, consider:

- Should the sourcing model design and decision criteria be focused on cost reduction or quality improvement (or both)?
- What will be the role of the provider versus the organisation in driving process changes and needed investment in technology?
- What will be the impact on the procurement processes that are not part of the sourcing arrangement?

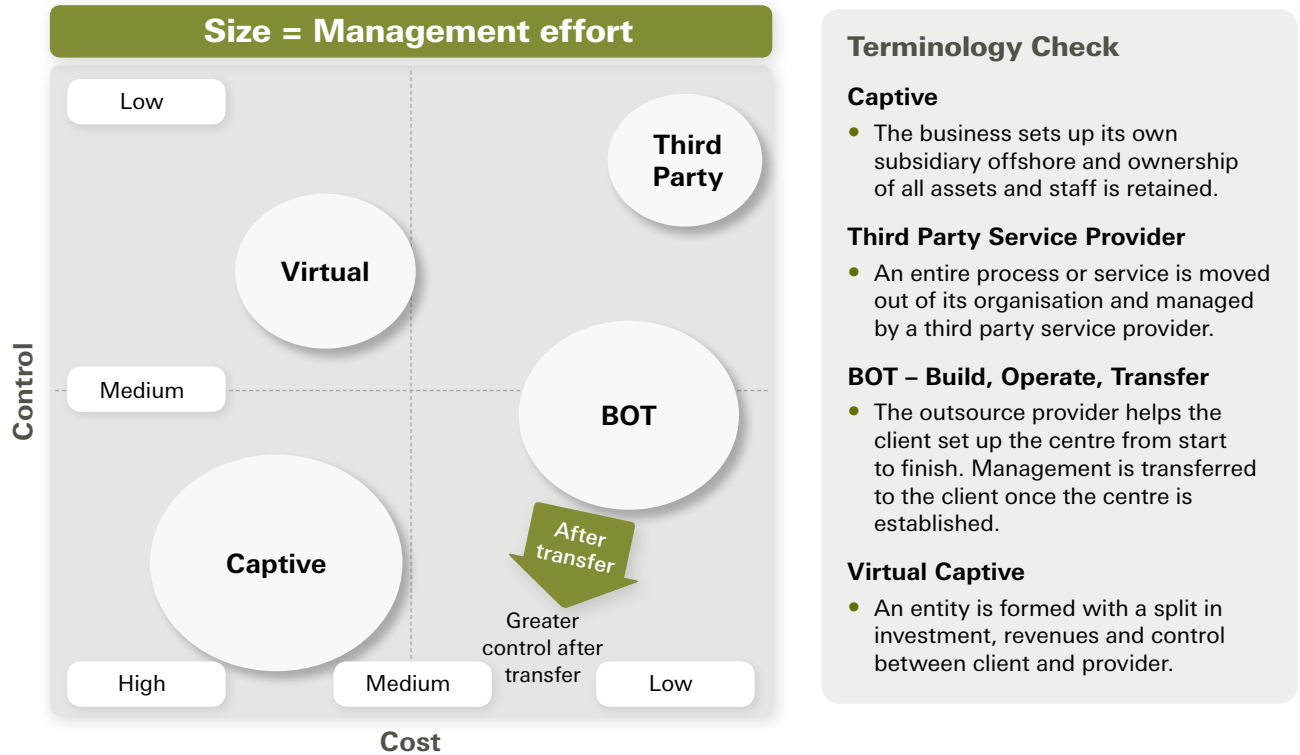
At an early stage, it is important to develop a view of the experiences of other companies and the possible outsourcing relationships that are available. Gaining an appreciation of the characteristics of each and developing a preferred model or models going forward will inform decision making regarding partner selection and other key sourcing decisions down the track. As the sourcing arrangement matures, it should also be reviewed to determine if it is still appropriate. Some organisations, for example, establish offshore captive centres for processes, but shift to outsourcing once they have optimised those processes to their best capability.

The table below shows the offshoring models adopted by Australia’s big 4 banks (Illustration 8).

Illustration 8 – The offshoring landscape in Australian banking: different strokes for different folks

Bank	Offshoring/Outsourcing Models	ITO	Business Process (Core)	Business Process (Support)	Knowledge process
Bank 1	<ul style="list-style-type: none"> • Arrangements with three vendors in India • In 2007, international payments roles were offshored to India • Over 350 back office roles have now moved offshore across both core and support processes. 				Third party provider
Bank 2	<ul style="list-style-type: none"> • Early 2008 outsourced part of its human relations function to India • Offshoring of back office processes was put on hold in 2006 but is currently being reconsidered. 				Third party provider
Bank 3	<ul style="list-style-type: none"> • Has an agreement with third party provider for outsourcing back office processes to Bangalore. 				Third party provider
Bank 4	<ul style="list-style-type: none"> • Has had a captive centre in Bangalore since 1989 • The captive centre currently employs 1,100 roles in IT services and 400-500 roles in back office and support functions, including Accounts Payable and MI system management 				Captive

Illustration 9 – Cost and control profile for alternative sourcing options



There are no clear rules around which processes should be offshored or outsourced, however a robust assessment using agreed criteria such as the cost to implement and the level of control sought over a process provides a simple rule of thumb to sourcing processes (Illustration 9). Organisations should develop their own sourcing decision criteria which incorporates both internal and external factors. The table below summarises the benefits of alternative sourcing options that can be considered.

Comparative benefits of outsourcing and offshoring

	Onshore	Offshore
Captive	Maintain direct control of the customer experience	Ability to grow and scale, maintain direct control, while leveraging labour arbitrage
Outsourced	Transfer risk, secure investment in significant improvements, deliver improvements quickly	Rapid access to low cost locations and agreed performance improvements

Set up

9. Smart and simple service level agreements

- In the service level agreement, are accountabilities clearly defined and clearly assigned?
- Are the service level objectives balanced and complimentary, with realistic targets set?

An effective service level agreement (SLA) is one that defines precisely what needs to be managed by whom and to what standards. It uses unambiguous language, unarguable metrics and employs robust measurement systems. It is a collaborative process between client and service provider designed to ensure both succeed.

SLAs should be kept simple to ensure there is a clear focus on what is important to the client. A SLA is typically made up of service level objectives (SLOs) – a good guide is five operational objectives and two commercial objectives per process. This is heavily dependent on the complexity of the process being outsourced.

SLOs should be balanced and complimentary. When targets are set too high, costs spiral. Benchmarks should be used to ensure targets are appropriate. Accurate forecasts ensure workload is resourced correctly to meet the SLO. SLOs should be explicit about what is measured, how it is measured, and over what period.

Typically performance should be reviewed monthly with weekly reporting, however the SLA should include triggers for exceptions. SLAs drive minimum acceptable standards. Use contract terms to drive over achievement through service bonuses or credits.

Example

A SLA defines precisely what needs to be managed by the outsourcer or service centre.

Take, for example, a call centre outsourcing contract based on cost per call minute. Historically clients would have tried to drive their outsourcer to achieve Average Handle Time objectives (AHT – Call Duration), to keep costs as low as possible.

A SLO based on First Call Resolution (FCR) drives a focus on call quality; however this also drives down call volumes by reducing the volume of repeat calls, a cost containment objective.

Keys to successful SLAs

- Avoid light touch management
- Pick the right KPIs
- Trap errors early
- Manage change
- Listen
- Audit.

Set up issues specific to offshore captives

10. Choose the right location

- Do you have the requisite local knowledge of the preferred location to consider all relevant factors?

There are a number of typical key considerations for any location decision, including skills and language availability, available infrastructure, labour cost and inflation, political and country risk. Organisations should seek input from advisors with current local expertise and knowledge of these issues.

Careful analysis of the incentives for investment in the location should be undertaken, as this can significantly impact the business case and have unforeseen consequences in the future. Declining cost savings in some locations due to wage inflation and increasing significant establishment costs mean that the economics for a chosen location can change from one year to the next. The AT Kearney Global Services Location Index shows there is considerable annual movement in the rankings of location highlighting the need for access to current information and detailed sensitivity analysis on the business case to narrow the list of viable location options (Illustration 10).

A factor sometimes overlooked is the data stewardship restrictions of moving processes offshore to a preferred location. For example, regulatory restrictions, freedom of information laws, legal issues and potential risks

to intellectual property may restrict data transfer arrangements. If these data stewardship issues are not effectively managed, data security could be compromised.

The choice of location should also consider the cultural factors that will enable a positive working relationship between the captive centres and the overall business. An appreciation of the effort required to build the desired culture should be considered upfront as this is often the key difference between a successful transition and operation from an unsuccessful one.

Downstream impacts from location choice

- **Proximity** – closer proximity enables more frequent travel between local management and the offshore captive centre
- **Training** – delivery of training face to face is impeded by distance, but can be addressed through other mechanisms, such as video-conferencing
- **Business momentum** – the business will interact more efficiently and effectively with the offshore captive if there are common business hours
- **Legal system** – the legal system of the country of choice will determine the ability to enforce contract terms
- **Privacy Laws** – the ability to protect data and information is impacted by local privacy laws.

Illustration 10 – Location analysis

	Financial attractivity	People skills and availability	Business environment	Total score	Change in rankings 09-11
1 India	3.11	2.76	1.14	7.01	0
2 China	2.62	2.55	1.31	6.49	0
3 Malaysia	2.78	1.38	1.83	5.99	0
4 Egypt	3.10	1.36	1.35	5.81	2
5 Indonesia	3.24	1.53	1.01	5.78	0
6 Mexico	2.68	1.60	1.44	5.72	5
7 Thailand	3.05	1.38	1.29	5.72	-3
8 Vietnam	3.27	1.19	1.24	5.69	2
9 Philippines	3.18	1.31	1.16	5.65	-2
10 Chile	2.44	1.27	1.82	5.52	-2
11 Estonia	2.31	0.95	2.24	5.51	5
12 Brazil	2.02	2.07	1.38	5.48	0
13 Latvia	2.56	0.93	1.96	5.46	14
14 Lithuania	2.48	0.93	2.02	5.43	5
15 United Arab Emirates	2.41	0.94	2.05	5.41	13
16 United Kingdom	0.91	2.26	2.23	5.41	15
17 Bulgaria	2.82	2.82	1.67	5.37	-4
18 United States	0.45	0.45	2.01	5.35	-4
19 Costa Rica	2.84	2.84	1.56	5.34	3
20 Russia	3.20	2.48	1.07	5.34	13

Note: Weight distribution for the three categories is 40: 30: 30.

Source: AT Kearney, *Global Services Location Index*, 2011

11. Price to drive behaviour

- Does your organisation understand the true cost of services you are moving offshore?
- Will your pricing structure drive the behaviour your organisation is seeking to achieve?

The objectives for the sourcing arrangements should be front of mind when setting the pricing structure. Cost reduction is most likely the primary incentive for offshoring, therefore an organisation should be clear about this aim and develop a pricing arrangement that drives behaviour in both the centre and on the local demand side that builds scale and encourages efficiency improvements.

The desired behaviours to encourage include:

- Transferral of further activities and volume to the centre
- Adoption of enabling technology
- Adoption of standardised processes
- Reduction in waste and unnecessary activity.

To enable price comparability, prioritisation and a 'mature' definition of services, the function needs a reasonably accurate picture of the current true cost of operations or services and what is driving the current cost structure. The pricing regime can then be set once the efficiency improvement objectives, strategy and roadmap are established.

There are a range of options for pricing the services of an offshore captive operation, and various mechanisms within the model will drive behaviours, including basing pricing on:

- Headcount in the centre dedicated to the service or business unit
- Current total cost or unit cost of services, less the targeted cost reduction from improvement initiatives
- Unit cost to serve based on an assumed level of volume, with unit cost reductions as volume increases.

To prevent initial high costs, the total cost to the organisation should be managed so that the costs incurred in the offshore captive are offset by a reduction in the in-country team of its tasks, resources and allocated budget. Choosing to operate the offshored captive as a cost centre or a profit centre also drives the pricing regime and the motives of the centre

management. The performance management framework for the centre needs to balance cost and profit objectives with quality of service and minimum service standards.

As the offshore captive matures, the pricing model should evolve also. Typically organisations begin by establishing the centre as a cost centre, transferring budget for services from the business units to encourage participation. Cost reductions are built into budgets and passed on to the business unit as they are achieved. Over time, the centre may adopt a more commercial, unit-based pricing structure to compete with outsourcers where the business unit's participation in the centre is not mandated.

Phased pricing models

The shared services centre for a well-known Australian organisation actively building scale in its centre recognised it would need an accurate projection of costs and budget required to sustain current service levels and invest for future growth.

The shared services centre was set up as a profit centre with the pricing mechanism designed to foster continuous improvement.

In developing a pricing framework that was fair, transparent and flexible, the entity developed a phased pricing model:

- Phase One – During transition, services were priced on a full cost recovery basis. This model ensured all costs relating to client activity were fully recoverable by the shared services cost centre
- Phase Two – Post transition, services were priced at a fixed fee based on a capped usage of services, with additional volume billed on a per transaction basis. A service rate card would be established for pricing drivers to discourage high costs and differentiate between services.

The phased pricing model approach supported the strategy to reduce costs over time.

Set up issues specific to outsourcing

12. Select the right outsourcer for you

- Is the outsourcer's culture conducive to building a trusted working relationship?
- Does the outsourcer have a proven methodology that aligns to your preferred long-term strategy?

Considerable effort is usually invested in choosing the right outsourcer. It is important to ensure the outsourcer selection process has the right focus on matters that experience shows will ensure a long-term successful partnership.

Bigger is not necessarily better when it comes to outsourcer selection. It is critical to build a sound understanding of the specific tools, processes and methodologies that the outsourcer will apply in transitioning, managing and improving the functions they will inherit. However, the factors that will make the partnership successful are the team and processes the outsourcer will apply to your organisation specifically.

In selecting a vendor, organisations should conduct a rigorous and disciplined selection process that supports valid comparison of vendor proposals. In addition to price, the long list of selection criteria must do the following:

- Assess vendor effectiveness in understanding and addressing your sourcing objectives and longer term strategy in their service offering
- Demonstrate commitment to strong relationship management with clients, with value placed on trust, proven proactive communication and effective issues resolution
- Illustrate organisational cultural fit - does the vendor organisation incite confidence in a constructive and confident working relationship including clear lines of accountability
- Have a clear proposed performance management framework
- Propose transitioning arrangements and risk mitigation strategies
- Outline onsite vendor visits and references.

Once the contract is in place it is difficult, although possible, to transition processes out. The vendor should reliably demonstrate how they will identify and drive process improvements over time, so that the arrangement continues to deliver value beyond what can be achieved if the processes were retained in-house or switched to another provider.

13. Contract for the long term

- Does the contract contain detailed operational conditions that could be better managed in the service level agreement?
- Does the contract include adequate termination and exit clauses?

In establishing an outsourcing arrangement, it is critical for the outsourcing entity to remember that the main mechanism for day to day management of the outsourcing relationship will be documents other than the contract, such as the SLA. These documents are typically more flexible in nature, leaving the contract to manage non-negotiable aspects. An outsourcing entity should use the contract to outline any strict, definitive requirements they have including guarantee of required skills, data security meeting legal, regulatory and ethical requirements, minimum service standards and risk management.

Negotiating a contract with a vendor is often an intense process that requires skill and experience. Given the objective is to build a long-term partnership, a negotiation process that becomes combative rather than conciliatory and rigorous could be a sign of things to come.

Outsourcing entities should build into the contract mechanisms for benchmarking and market comparability with penalties in place for breaches of minimum acceptable service standards and performance levels. These provide clear guidance and focus for the service provider and a basis for negotiation during contract reviews.

The contract should also provide adequate contract review points and termination and exit clauses given the difficulties organisations have found in winding back an outsourcing arrangement without incurring significant cost, risk, loss of capability and loss of knowledge. For example, does the contract provide for access on exit to assets, maintained process documentation and performance measurement information? Does the contract provide for how a termination of the arrangement will be communicated to minimise any public relations and brand issues that may arise?

Be specific about the minimum service standards that are expected of the vendor, and put in place the appropriate monitoring controls to monitor not only activity, but outcomes.

Example:

Consider a scenario in an outsourced accounts payable function where incorrect invoices from a supplier are rejected if they are non-complying. The supplier continues to re-invoice, without the underlying issue being resolved between the vendor and the supplier. This results in the supplier making demand for payment of all outstanding fees within 24 hours, placing a stop on supply and causing significant operational issues and unnecessary costs. The contract with the vendor and service level agreements should clearly outline minimum expectations of the vendor regarding not only efficient execution of the outsourced process, but the proactive management and notification of issues with outsourced processes that impact upstream or downstream operations beyond the service provider's responsibility.

For Practitioners

The Accounting Professional & Ethical Standards Board (APESB) plans to issue a guidance note on outsourced accounting services in 2012. Guidance will be provided to members of the professional accounting bodies who are in public practice, covering both providers of outsourced accounting services, and utilisers of such services. More information will be available on the APESB website: www.apesb.org.au

Transition

14. Communicate, communicate, communicate

- Is there a clear plan for communicating the sourcing decision and transition arrangements?
- Is there a service user guide in place?

One of the most common difficulties experienced in setting up outsourcing relates to staff, as demonstrated in Illustration 11 below.

Fear of the unknown can lead to staffing issues at either the client or vendor end of the sourcing arrangement. For the client, there may be an employee backlash and unwanted attrition with fears of job losses and internal reorganisations. On the vendor side, staff problems may arise due to the lack of physical proximity to the client, which may make staff relationships more challenging to maintain.

Suggestions for effective communications

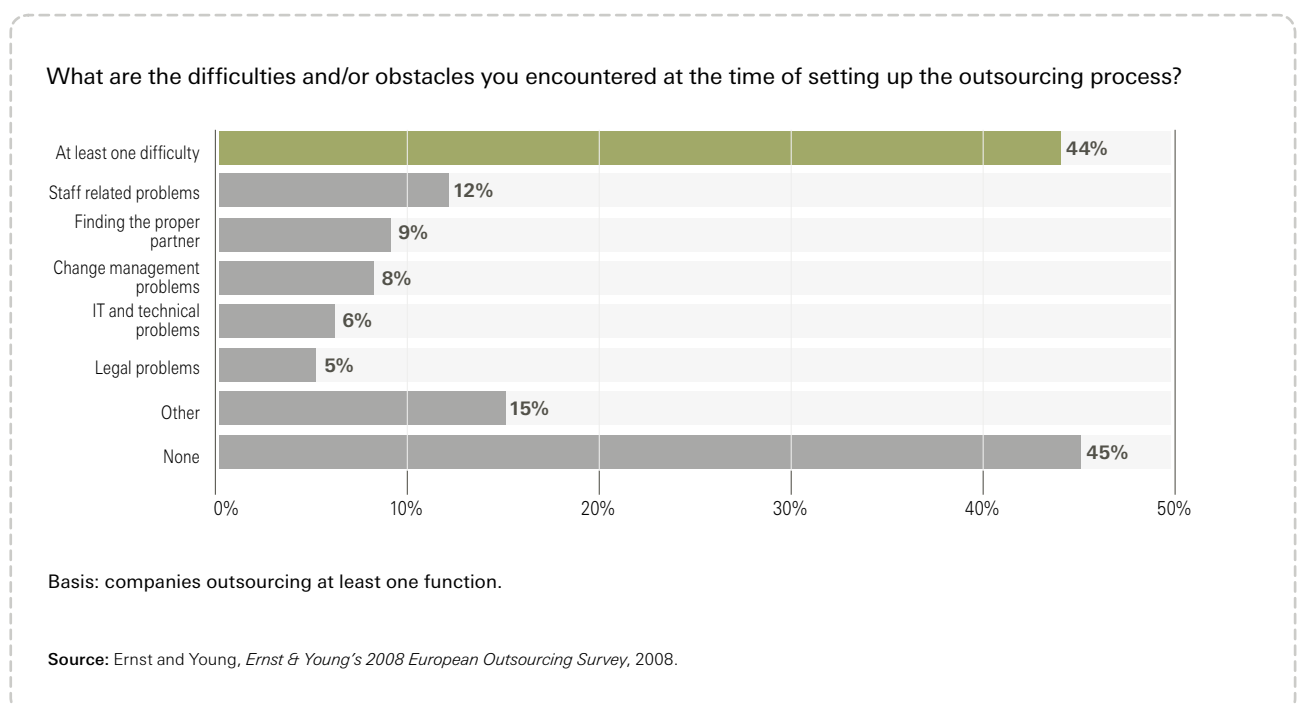
- Develop an internal and external staff relations and communication strategy
- Initiate measures to improve work atmosphere in the captive and/or retained organisation
- Carefully handle transfer of roles to service provider.

It is essential that an outsourcing decision is announced properly and the organisation does not rely on the service centre or vendor to provide all communication. A joint communication strategy for key stakeholders including affected staff that provides regular, proactive, open and honest information is good practice. The form of communication is also important in communicating complex messages in simple ways. A range of techniques should be adopted that command attention, maintain optimism and communicate measures clearly, for example, newsletters, emails or roadshows.

A 'service user guide' is a key tool to put in place early during the transition that outlines how things will operate in the new model, who to go to, who is responsible for what, what they can expect from the offshore or outsourced centre (and how to best interact with them (e.g. generic email addresses, contact numbers, etc). Explaining this guide to staff is a key lever in developing understanding of how things will work.

Illustration 11 – Outsourcing setup difficulties

(% response rate)



15. Manage the detail

- Is there a seasoned program management team in place?
- Is there enough support from key stakeholders?

The transition phase is often the most challenging part of the outsourcing and offshoring processes. New people need to be recruited and trained, a customer orientated and process improvement culture needs to be developed, an office needs to be equipped, communication lines and document flows need to be redirected, processes need to be standardised, networks and systems access need to be arranged, and people need to be redeployed or made redundant. It becomes even more complex if processes are transformed at the same time as the transition.

The transition requires a seasoned program manager with practical experience in transitioning processes to an outsourcer or to an offshore centre, supported by a team of strong project managers that drive coordination and discipline into the project plan. A common failure is insufficient resources and rigour dedicated to communications, change management and performance management. Small details can cause issues and impact the success of the transition – for example, failure to establish service user guides, lists, meeting rooms or catering facilities can impact the transition. A detailed implementation plan and rigorous adherence to it can ensure such matters are properly addressed. Key stakeholders across the business, IT and other areas must be fully engaged, briefed and involved in transition planning.

One area that often impacts the success of the sourcing arrangement is the effectiveness of IT issue management. The sourcing arrangement can generate a significant volume of IT issues such as slower systems performance, IT security, provision of systems access to offshore staff, establishing IT infrastructure (networks) and managing firewalls that need sufficient planning and resources to address and enable smooth operations. This often requires a dedicated onshore resource to ensure issues are anticipated and resolved quickly and minimise operational downtime. The service provider may point to technology issues as the root-cause of poor service levels, which can be difficult to assess independently. Establishing systems performance monitoring processes is important to gather facts and manage these issues quickly and effectively.

A detailed 'go live' checklist should be maintained covering all aspects of transition management in detail.

An example of the high-level contents of a transition checklist includes:

Business readiness

- Process documentation complete and communicated
- Roadshows complete
- Knowledge transfer complete
- Process and application training complete
- Roles and responsibilities documented and communicated.

Technical readiness

- Systems testing complete
- New functionality and data conversion tested
- Data backup complete
- IT issue management resources in place.

Supplier readiness

- Confirmation of 'go live' from suppliers received, demonstrated through a Letter of Comfort.

Project readiness

- Benefits realisation plan and benefits tracker prepared
- HR processes for realignment completed.

Facilities

- Location 'go live' plan in place
- Facilities made ready for staff relocated and/or new staff – peripheral equipment ready
- Contact centre tested.

Service levels

- Service KPIs and management responsibilities in place
- Reporting mechanism in place.

Contingency

- Functional contingency plan/disaster recovery plan in place.

16. Ensure business continuity

- Are sufficient measures in place to prevent knowledge loss?
- Has sufficient business continuity planning been conducted?

It is essential to establish a transition schedule that balances early benefits, momentum, credibility and risks. If multiple locations and/or business units are in scope, a phased approach is rarely taken. Instead, processes and locations are transitioned in waves. As all the process documentation needs to be established during the first wave, a longer timeframe should be allowed for this particular wave and staffed with the most experienced people. Once the processes are transitioned into the new centre, newly recruited staff can be trained in the centre itself on live processes. When recruiting a large number of people, there will always be some that don't work out. As people need to go through a learning curve, it makes sense to overstaff a little during the early waves. This not only reduces the risk of issues in the start up phase, but also ensures there is enough capacity to deal with issues when they occur.

Detailed documentation of processes and provision of training is essential to avoid loss of key knowledge. Typically, process maps should clearly show the responsibilities of all parties. If process maps, desktop procedures, service level agreements and operating level agreements are inter-linked, it becomes a powerful training and reference tool.

During transition, there is often one opportunity to get the process right, with serious disruptions impacting the credibility of the change if the first time is unsuccessful. Detailed business continuity planning and transition planning are critical. To minimise the transition costs, outsource providers have developed creative, alternative methods for knowledge transfer, however work shadowing or face-to-face training are clearly the most effective. To potentially reduce transition costs, the 'train the trainer' concept can be successfully applied. It is also worthwhile to consider providing post 'go live' support in the centre from a limited number of key individuals.

To maintain clear direction in the face of inevitable challenges during transition, it is important that high level leadership continually supports the transition, offshore strategy program and program management. Equally, it is important to face reality when the transition is running off course and requires rethinking. Encouraging a culture of openly raising issues is essential to avoiding disasters early.

Management

17. Maintain good governance

- Are the roles and responsibilities of all key parties clearly defined and understood?
- Is governance being maintained beyond the transition phase?
- Are there adequate risk assessment and control frameworks in place?

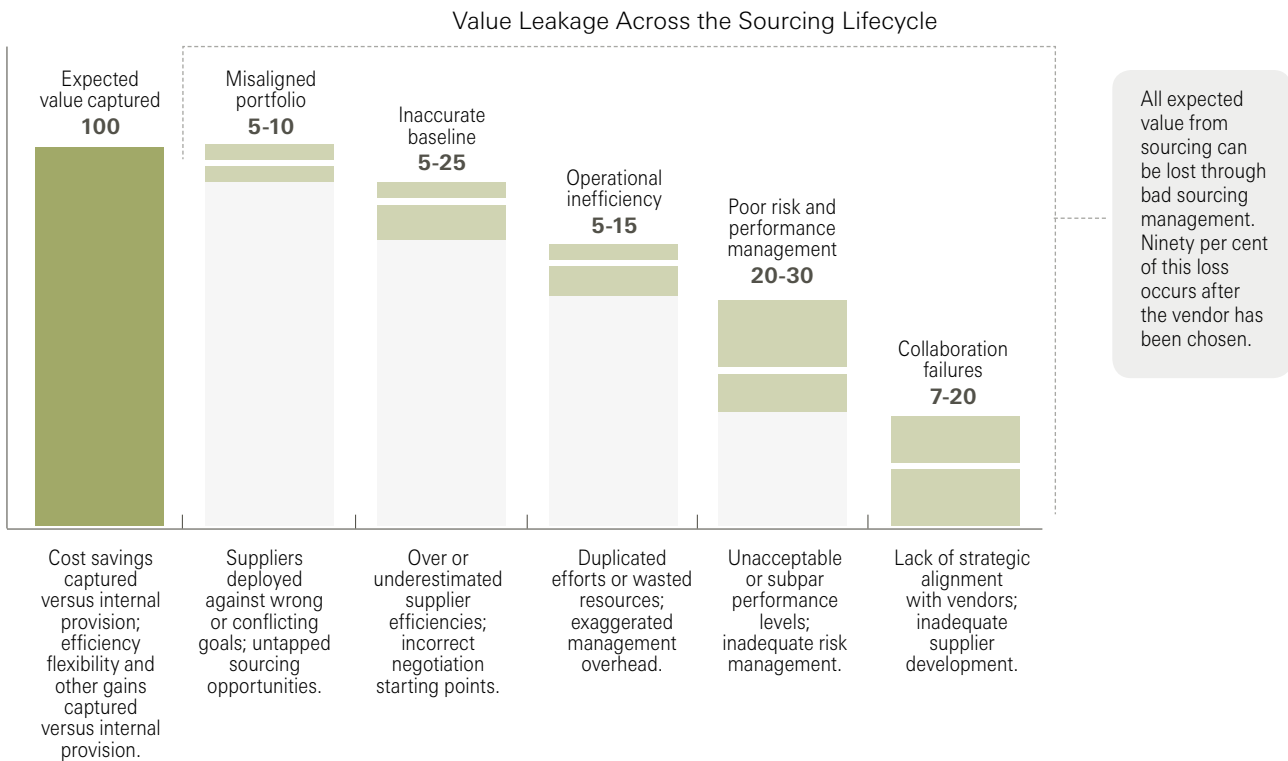
Service delivery is critical to the success of a service provider. Understanding customer requirements and monitoring the ability to meet those requirements over time is important to building a trusted relationship between each party. The governance approach drives the relationship between the parties and provides a framework for communication and a process for decision making, the delivery and breadth of services, and the mechanism for driving and measuring performance. Poor risk management, performance management and collaboration failures are the most common areas where value is lost in the sourcing arrangement (Illustration 12).

Effective governance also ensures that the value from the sourcing arrangement is maximised.

The governance framework needs to align to the different stakeholders impacted, including leadership teams across the organisation and offshore operation, management and the user communities to ensure the right focus and effectiveness for decision making. A good governance framework develops clear accountabilities between the service provider and the retained organisation that ensures clarity of decision making between the two parties. One example is the understanding that process ownership should remain in the retained organisation. This is important in providing a clear link to the customer and to guide future and changing requirements.

It is important to differentiate the governance of ongoing management from implementation or transition governance, as each has a different but equally important focus which should not be balanced or compromised by a common governance committee.

Illustration 12 – Why benefits of sourcing are not realised



Source: Procurement Strategy Council

18. Measure strategy effectiveness

- Are customers complaining about service cost and quality?
- Are there 'hidden complaints' such as business units completing work themselves?
- Is there satisfactory management information on the sourced processes?

Many benefits of outsourcing and offshoring are not planned to be realised as part of the transition. The strategy may have been to initially realise benefits from labour arbitrage for example, with further benefits to be realised from process standardisation and consolidation at a future stage. It is therefore important to be clear on the strategy over the medium to long term and build benefits into targets over that time horizon as the operation moves towards maturity.

Despite reasonable efforts, many service centres are under-performing compared to initial expectations. While the reasons may appear to be unique to each organisation, typical failures include:

- Formal governance processes not maintained beyond the finalisation of transition
- Process silos maintained with significant complexity
- Weak linkages developed across teams within the retained onshore function and the service provider, or within the service centre
- Processes poorly re-engineered following migration
- Business requirement changes not effectively addressed
- Planned investment is not delivered, for example, enterprise resource planning system upgrades or extension.

For many of these, a combination of effective ongoing governance and performance management that incorporates strategic intent would ensure the operation evolved in line with the original strategy.

The strategic intent for the operation should be incorporated into the performance management framework. Performance management needs to be multi-layered in terms of what is measured, the frequency of follow up and the time horizon. Effective performance management from the outset will also ensure early indications of an underperforming operation or strategy.

19. Revisit the contract

- Is the current sourcing arrangement delivering the best value in the market?
- Is the service provider driving ongoing improvements?

An extension of the overall performance management framework is the contract between service provider and customer. The contract set up typically includes a range of assumptions including the services being provided, expected improvements in service and technology enhancement. These variables can change over time and this variability provides a good reason for the contract to be reviewed on a regular basis.

A contract review provides the opportunity for both parties to discuss further strategic opportunities including:

- Additional services
- Additional locations
- Changing performance targets
- Technology changes within the organisation or the offshore operation which may change the way the parties interact
- Other changes in case of organisational restructures.

Benchmarking the service provider is common practice to provide a fact base for negotiation and also allows an understanding of both price points and differentials in the way a service is being provided, for example, web enablement.

It is also critical to understand the market environment of the service location and what dynamics may have changed from the original location analysis used in the business case. Many of the larger outsourcers use multiple locations to combat salary increases and mitigate risk.

20. Retain top talent

- Does the service centre have a clear employer brand and value proposition in the local market?
- Is there an active talent retention strategy in place for key personnel?
- What tools are in place to manage performance?

A key component of high performing service providers is effective talent management demonstrated by low turnover and a high level of trust from the business or customers they are servicing. It is important for captive operations to develop a unique, attractive culture and provide career planning and opportunities in locations where large outsourcers are based.

It is also important to remember that as the operation evolves, so does the requirement for different skills, for example, vendor management and customer relationship management. These are skills that your organisation may not have depended upon so heavily prior to outsourcing or offshoring.

A talent management strategy should be developed for captive service centres consistent with the wider organisation talent management process, however is tailored to the expectations and opportunities present in the local labour market. This means that a one-size talent management strategy does not fit all and may require significant investment to maintain localised talent practices and provide a compelling value proposition for staff.

Staff retention can be a considerable challenge in many offshore markets, where staff turnover can be as high as 30% per annum. Successful captive operations have achieved below-market turnover through development of a clear employer brand that attracts and retains quality candidates at all levels. Organisations should employ adequate staff retention strategies including:

- Offering real career progression within and outside the service centre
- Demonstrating clear performance management and rewards programs aligned to the centre's objectives
- Actively developing relationships between the centre and internal clients to maintain the centre's identity with the wider organisation.

For outsourced processes, new skills will be required in the retained organisation to manage the sourcing relationship to achieve mutual benefit and drive performance improvement. This skill set is very different to that required to manage the process in-house and may require new hires to build capability.

20 issues on outsourcing and offshoring checklist

Strategic assessment

		Yes	No	N/a
1. Source to support your business strategy	• Does outsourcing or offshoring align with your business strategy?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Has a sourcing strategy been established?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Feasibility

		Yes	No	N/a
2. Gather facts on current performance	• Do you know what your current processes look like and cost?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• How does current performance compare to other organisations?	<input type="text"/>		
3. Assess qualitative and quantitative benefits	• Has a robust benefit and risk assessment been completed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• How will sourcing enable you to focus on the strategic direction and/or growth of the organisation?	<input type="text"/>		
4. Don't move until your organisation is ready	• Is there (executive/senior management/internal) support or appetite for an offshore model?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Have processes been improved sufficiently to offshore?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Sourcing decision

		Yes	No	N/a
5. Scale matters	• Is your organisation big enough to take advantage of outsourcing/offshoring?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Can a third party outsourcer provide the scale you don't currently have?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6. Don't outsource a problem	• Which activities are appropriate to be outsourced and which should be kept in-house?	<input type="text"/>		
7. Don't chase labour arbitrage	• Will labour cost advantages erode over time?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• What other benefits should I be looking for?	<input type="text"/>		
8. One solution does not fit all	• What sourcing strategy will best meet the needs of your overall business strategy?	<input type="text"/>		
	• What information is available to identify main trends, key players and aid your decision making?	<input type="text"/>		

Set up

		Yes	No	N/a
9. Smart and simple service level agreements	• In the service level agreement, are accountabilities clearly defined and clearly assigned?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Are the service level objectives balanced and complimentary, with realistic targets set?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Set up issues specific to offshore captives

		Yes	No	N/a
10. Choose the right location	• Do you have the requisite local knowledge of the preferred location to consider all relevant factors?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
11. Price to drive behaviour	• Does your organisation understand the true cost of services you are moving offshore?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Will your pricing structure drive the behaviour your organisation is seeking to achieve?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Top 20 issues (continued)

Set up issues specific to outsourcing

		Yes	No	N/a
12. Select the right outsourcer for you	• Is the outsourcer's culture conducive to building a trusted working relationship?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Does the outsourcer have a proven methodology that aligns to your preferred long-term strategy?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
13. Contract for the long term	• Does the contract contain detailed operational conditions that could be better managed in the service level agreement?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Does the contract include adequate termination and exit clauses?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Transition

		Yes	No	N/a
14. Communicate, communicate, communicate	• Is there a clear plan for communicating the sourcing decision and transition arrangements?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Is there a service user guide in place?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
15. Manage the detail	• Is there a seasoned program management team in place?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Is there enough support from key stakeholders?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
16. Ensure business continuity	• Are sufficient measures in place to prevent knowledge loss?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Has sufficient business continuity planning been conducted?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Management

		Yes	No	N/a
17. Maintain good governance	• Are the roles and responsibilities of all key parties clearly defined and understood?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Is governance being maintained beyond the transition phase?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Are there adequate risk assessment and control frameworks in place?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
18. Measure strategy effectiveness	• Are customers complaining about service cost and quality?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Are there 'hidden complaints' such as business units completing work themselves?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Is there satisfactory management information on the sourced processes?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
19. Revisit the contract	• Is the current sourcing arrangement delivering the best value in the market?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Is the service provider driving ongoing improvements?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
20. Retain top talent	• Does the service centre have a clear employer brand and value proposition in the local market?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• Is there an active talent retention strategy in place for key personnel?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	• What tools are in place to manage performance?	<input type="text"/>		

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