

An aerial photograph of a white lighthouse situated on a grassy cliffside. The lighthouse is a tall, slender tower with a lantern room at the top. Below the lighthouse is a small, dark-roofed building. The ocean is visible in the foreground, with waves breaking against the shore. The sky is a deep blue, and the overall scene is serene and coastal.

Deloitte.

Risk Intelligence Series
Issue No. 8

The Risk Intelligent Approach to Outsourcing and Offshoring

Audit . Tax . Consulting . Financial Advisory .

This publication contains general information only and Deloitte & Touche USA LLP and its subsidiaries are not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte & Touche USA LLP and its subsidiaries, its affiliates and related entities shall not be responsible for any loss sustained by any person who relies on this publication.

Table of Contents

Preface	ii
Outsourcing and Offshoring Defined	1
Key Drivers of O/O Initiatives	1
Why Risk Intelligent Outsourcing and Offshoring?	2
The Risks Are Real – and Undermanaged	2
The O/O Lifecycle	3
Major Risks at Each Stage of the Lifecycle	3
How Do You Address the Risks at Each Stage of the Lifecycle?	5
Stage 1: Strategic Assessment - <i>Rightsizing the Deal</i>	5
Stage 2: Business Case Development - <i>Build a Solid Foundation</i>	6
Stage 3: Vendor Selection - <i>It Now Means Something Different</i>	7
Stage 4: Contracting - <i>Striking the Deal</i>	8
Stage 5: Service Transition, Delivery & Post-transition Management - <i>After the Deal is Signed</i>	9
Stepping Up Your Game	10
Final Thoughts	10
Test Your Organization’s Risk Intelligence for O/O Initiatives	11
Contacts	13

Preface

This publication represents the eighth installment in our series on Risk Intelligence. The concepts and viewpoints herein build upon those discussed in the first whitepaper in the series, *The Risk Intelligent Enterprise™: ERM Done Right*, as well as the subsequent titles. You may access the previous whitepapers in the series free of charge at www.deloitte.com/RiskIntelligence.

Unfettered communication is a key characteristic of the Risk Intelligent Enterprise. We encourage you to share this whitepaper with the board and senior executive team at your company. The issues outlined herein will serve as a starting point for the crucial dialog on raising your company's Risk Intelligence.

The Risk Intelligent Approach to Outsourcing and Offshoring

In recent years, many companies have increased their use of and dependence on outsourcing and offshoring (O/O). These arrangements present both risks and rewards to the organizations using them.

But outsourcing and offshoring need not be a roll of the dice. There are steps you can take to minimize the risks and maximize the rewards at every stage of the O/O lifecycle. These steps will carry you down the path toward Risk Intelligent outsourcing and offshoring, and will help reduce the chances that you'll experience an undesired outcome — an “Oh! No!” moment — during your O/O initiative.

O/O Defined

For the purposes of this paper, the term “outsourcing” describes contracting with an external service provider to perform specific functions or processes, including:

- information technology outsourcing (ITO) – application development, maintenance, production support, etc.
- business process outsourcing (BPO) – call centers, human resources, accounting, etc.

Outsourcing vendors perform a back-office or front-office function, in contrast to the traditional vendor role of supplying materials. O/O vendors act more as business partners providing services on behalf of your organization. They are, in effect, an extension of your company, a business relationship sometimes referred to as the “extended enterprise.”

In this paper, “offshoring” refers to relocating one or more processes or functions to a different (and usually lower cost), foreign location, including “captive” shared services facilities. Various business models fall under the definition of O/O; see graphic, “Offshoring/Outsourcing Business Models,” for some representative examples. Regardless of the business model used, offshoring benefits may include lower labor or operating costs and other advantages. Offshoring also introduces risks that exacerbate those of onshore outsourcing, including the

availability of qualified talent; geopolitical risks; and risks arising from foreign cultural, language, and infrastructure issues.

If you're an executive or manager in a midsize to large organization, you almost certainly have a stake in the success of one or more O/O initiatives. Your role may involve responsibility for decisions, management, monitoring, governance, or operational dependence on the initiative. Whatever your role, you can benefit by considering a Risk Intelligent approach.

Key Drivers of O/O Initiatives

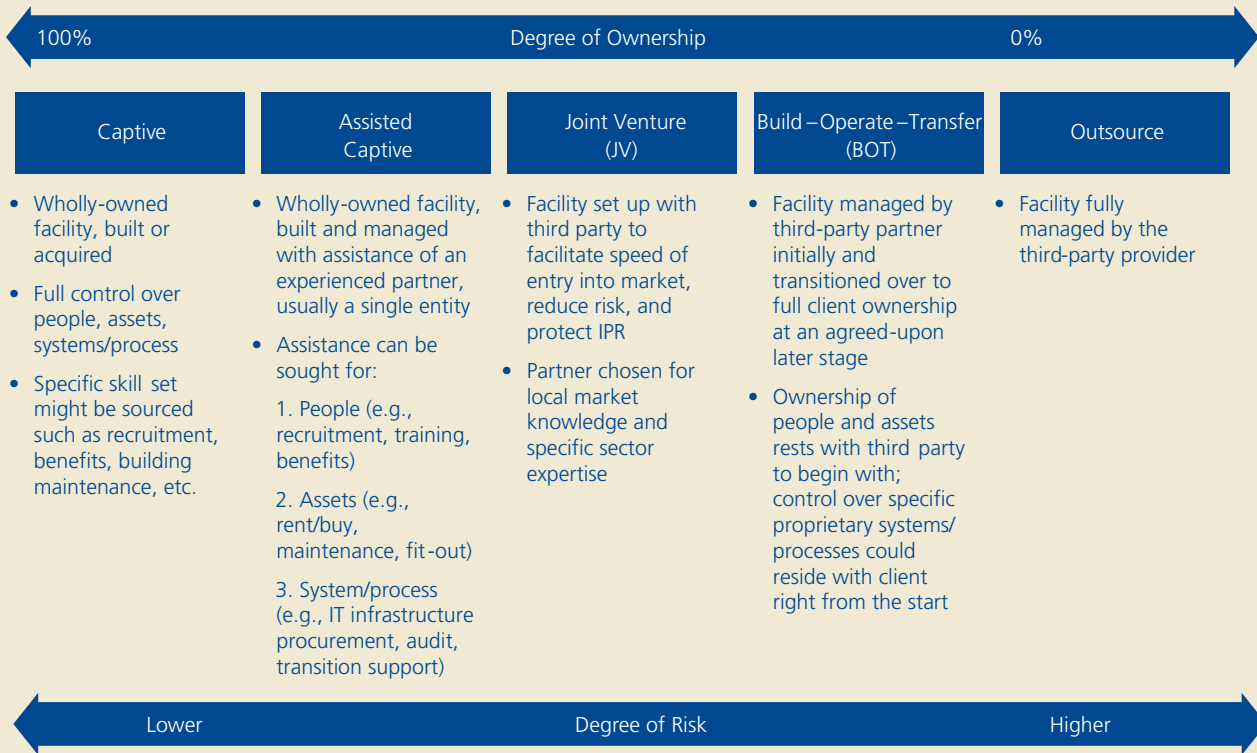
Organizations employ O/O to create additional shareholder value, primarily by seeking to:

- reduce operating, development, sales, or other costs
- focus more on core competencies
- tap vendors' best practices and innovations
- increase flexibility and scalability of operations
- gain access to human capital
- fuel global growth by gaining a foothold in a growing economy.

O/O initiatives usually deliver some combination of these benefits — but rarely to their full potential and often with increased risk to the organization. If not managed well, those risks, both internal and external to the company, can adversely affect the business performance of the entire organization. For example, a Deloitte Consulting LLP survey noted that a significant number of surveyed companies expressed disappointment with their outsourcers' overall ability to provide continuous process and technology improvements.¹

1. “Why Settle for Less? Deloitte Consulting 2008 Outsourcing Report.” Deloitte Consulting LLP, December 2007.

Offshoring/Outsourcing Business Models



Copyright © 2008 Deloitte Development LLC. All rights reserved.

Why Risk Intelligent Outsourcing and Offshoring?

Risk Intelligence, our philosophy and approach toward risk management,² consists of practices that:

- account for the full spectrum of risks in business decisions and activities
- cut across “silos” to provide an integrated, organization-wide view of risk
- consider upside opportunities as well as downside possibilities
- identify, avoid, mitigate, detect, and report on risks in comprehensive, cost-effective ways
- provide a common language and context for risk management
- allocate risk management resources based on the importance of the threats and opportunities.

2. See *The Risk Intelligent Enterprise: ERM Done Right* and related titles at www.deloitte.com/RiskIntelligence

Such practices are particularly important — and often lacking — in O/O initiatives. This paper shows one way to approach O/O decisions, employing Risk Intelligence at every stage of the sourcing lifecycle.

The Risks Are Real — and Undermanaged

The basic risk in any business endeavor is that it will fail to deliver the intended value. By that measure, many companies face serious O/O risks. In a Deloitte Consulting LLP outsourcing survey,³ 30 percent of participants stated they were dissatisfied or very dissatisfied with their outsourcing arrangement. Additionally, 39 percent of the respondents had terminated an outsourcing contract, transferring the contract to a different vendor.

3. “Why Settle for Less? Deloitte Consulting 2008 Outsourcing Report.” Deloitte Consulting LLP, December 2007.

Moreover, several growing trends have increased O/O risks:

- Companies now rely on third parties and offshore entities, not just for specific projects and back-office functions, but more often for core business processes.
- Increased competition for global talent has contributed to shortages of qualified local talent, which requires a company to focus on its human capital strategy to optimize quality and cost of services.
- Regulatory developments have increased exposure to liability for malfeasance or misfeasance; in some cases, senior management and the board can be held accountable for non-compliance associated with third-party operations.
- Piracy, security breaches, and theft of information can erode the value of brands, intellectual property, and other intangible assets, in which companies have more heavily invested in recent years.
- A more volatile political environment in some popular offshore locations increases the risk that unrest, terrorism, or related developments will threaten the value of products and physical assets, as well as create a climate of instability precluding effective and efficient operations.
- Third-party suppliers may morph into de facto partnerships, albeit without the analysis, reporting, and control that typically characterize true partnerships.

To deal with such complex and dynamic risks, companies must employ a holistic risk management approach to guide sourcing decision making throughout the O/O life cycle.

The O/O Lifecycle

The O/O lifecycle is a sequence of decisions and tasks that move the initiative forward. Each stage of the lifecycle presents risks that you can address with specific tools, techniques, and mitigation tactics.

The stages of the O/O lifecycle are:

1. **Strategic assessment:** Deciding why, how, and in what form O/O may support your business strategy, and whether internal capabilities can support the initiative.
2. **Business case development:** Analyzing expected cost savings and other financial and operational benefits of the initiative.

If you're an executive or manager in a midsize to large organization, you almost certainly have a stake in the success of one or more O/O initiatives.

3. **Vendor selection:** Choosing a vendor according to criteria related to the strategic assessment and the business case.
4. **Contracting:** Negotiating a contract that captures the needs and expectations of both parties, and addresses compliance and risk factors identified in the previous three stages.
5. **Service Transition, Delivery & Post-transition Management:** Managing the migration, or initiation, of the service in the vendor or offshore location. Monitoring the ongoing performance and risk of the relationship according to the contract and service level agreements (SLA), as well as for the attainment of strategic objectives.

Major Risks at Each Stage of the Lifecycle

Although we associate specific risks with specific lifecycle stages, — those risks and stages are interconnected. That is why risk must be evaluated early in the lifecycle in an interconnected, Risk Intelligent manner. It is essential to identify and prioritize risks at the first two stages the strategic assessment and business case development. Subsequent phases can then focus more on risk assessment and mitigation than on identification. Indeed, most failures to manage O/O risks stem from inadequate risk identification early in the lifecycle.

Major Risks at Each Stage of the Outsourcing/Offshoring Lifecycle

The following are examples of significant risks associated with each stage of the O/O lifecycle. This list is intended to be a representative, not comprehensive, sample. Many other risks may arise in addition to these cited.

Stage 5: Service Transition, Delivery & Post-transition Management

Lack of formal transition planning, governance oversight practices lead to low service levels, cost overruns, and other outcomes that erode value.

Stage 4: Contracting - Contract provisions covering service levels, incentives, contingencies, vendor personnel, security, privacy, price protection, and termination are missing or faulty. Provisions for measuring key SLAs are not in place.

Stage 3: Vendor Selection

Failure to develop vendor selection criteria that contemplate outsourcing objectives and risks, and failure to exercise thorough due diligence.

Stage 2: Business Case Development

Incorrect outsourcing assumptions, for instance regarding projected cost savings, payback period, or investment needed to build governance, measurement, and validation capabilities

Stage 1: Strategic Assessment

Outsourcing objectives not aligned with overall business strategy

Based on our experience, the following are examples of significant risks:

Strategic Assessment: Outsourcing objectives not aligned with overall business strategy

Business Case Development: Incorrect outsourcing assumptions, for instance regarding projected cost savings, payback period, or investment needed to build governance and management capabilities

Vendor Selection: Failure to develop vendor selection criteria that contemplate outsourcing objectives and risks, and failure to exercise thorough due diligence.

Contracting: Contract provisions covering service levels, incentives, contingencies, vendor personnel, security, privacy, price protection, and termination are missing or faulty.

Service Transition, Delivery & Post-transition Management: Inadequate transition planning causes suboptimal knowledge transfer and poor change management, and, perhaps, risk of losing key personnel. Lack of formal governance oversight practices lead to low service levels, cost overruns, and other outcomes that erode value.

It is essential to identify and prioritize risks at the first two stages—the strategic assessment and business case development.

How do you address the risks at each stage of the lifecycle?

Get a Fix on the Risks

Aligning risk management with the O/O lifecycle enables you to account for the interactions among the life cycle activities and to identify, assess, prioritize, and mitigate O/O risks at the right stage. Companies tend to overlook a number of key risk management considerations, including the need to:

- **Stage 1:** Account for strategic alignment and inherent risk exposure in the sourcing decision, and to assess gaps in resources, processes, capabilities, and culture needed to support execution.
- **Stage 2:** Factor costs and expected efficacy of risk mitigation and ongoing management into business case development, and to track business value realization.
- **Stage 3:** Leverage the vendor selection process to manage operation and compliance risk exposure proactively.
- **Stage 4:** Develop contracts that address performance, compliance, and global delivery risks.
- **Stage 5:** Plan adequately for the transition and manage change. Align the sourcing governance program to the parties' visions, provide vendor oversight, and continuously improve the process.

On the following pages we examine each stage of the lifecycle and these Risk Intelligent steps in more detail.

Stage 1. Strategic Assessment - *Rightsizing the Deal*

When you assess your O/O initiative in light of strategic business goals, you can evaluate how the initiative will support — or perhaps not support — those goals. This assessment also positions you to define the capabilities you need in a service provider, select the right provider, and specify required service levels. To put yourself in that position, you must first look ahead to the major decision points and risks at each stage of the lifecycle. Then, you should assess your sourcing model choices and your internal resources and capabilities to support and monitor the initiative. This early point in the process is the most appropriate time to align your business objectives with the sourcing risks and required mitigating actions.

In the process, be sure to answer two essential questions:

- What inherent risks will result from our sourcing decision? These risks will be driven by the nature and scale of the services being outsourced or offshored, and they must be managed in the subsequent phases.
- What is the adequacy of our internal processes, resources, and capabilities to support the proposed sourcing strategy? Companies that lack the necessary capabilities are likely to fail.

Downside Possibilities:

If O/O objectives do not align with the business strategy, or if risks are not properly identified and mitigated, the initiative will not support — and may even undermine — that strategy. The problem is far from rare. A Deloitte Consulting LLP survey⁴ asked 300 executives what they would do differently with respect to their outsourcing arrangements; 39 percent said they would better define and align their business goals with the outsourcing initiative.

In some instances, this misalignment can scuttle the entire outsourcing initiative. For example, the same Deloitte Consulting survey found that 50 percent of companies that said they were dissatisfied or very dissatisfied with their largest outsource contract wound up bringing the function back in house.

Upside Opportunities:

Appropriate strategic assessment minimizes the ad hoc O/O decisions that result in a patchwork of mismatched initiatives. The assessment shows how related and unrelated O/O efforts support the organizational strategy and enables you to address any weaknesses. A rigorous strategic assessment enables a more holistic view of outsourcing that advances the agenda beyond just cost savings and eliminates redundant or overlapping initiatives. In this way, you may also solve the most common O/O limitation, which is to realize cost savings *and nothing else*. You may also avoid potential future issues stemming from inadequate capabilities and resources to manage the initiative. Another upside is optimal allocation of resources to sourcing objectives and better performance during the contract period, which enables you to outperform competitors who are also outsourcing/offshoring.

4. "Why Settle for Less? Deloitte Consulting 2008 Outsourcing Report." Deloitte Consulting LLP, December 2007.

Keys to Risk Intelligent Strategic Assessment:

Decide what you want to accomplish at the strategic level, and then decide if and how O/O will help you achieve it. An O/O initiative can support the business strategy or simply solve a short-term problem. The key is to align your choice of vendor, contract terms and conditions, and internal processes and capabilities to support your short- and long-term objectives, whatever they may be.

To create an environment that encourages a Risk Intelligent strategic assessment:

- integrate your company's formal sourcing strategies and formal business strategy
- match your organization's sourcing vision and sourcing capabilities; invest in the development of internal resources or acquire external expertise to build essential internal capabilities
- systematically build risk mitigation into downstream sourcing lifecycle activities, including vendor selection, contracting, service transition, and ongoing operations.

Stage 2. Business Case Development - *Build a Solid Foundation*

A sound business case follows logically from the strategic assessment. It begins with assumptions relevant to your business goals and should extend beyond operational cost savings. An O/O initiative typically includes goals to increase flexibility; to improve technical, operational, and process management skills; to reallocate internal resources to more value-generating activities; to cut product development cycles and improve marketplace "nimbleness"; to expand capabilities; and, ultimately, to increase competitiveness and add shareholder value.

A specific business case for an O/O initiative must fully consider project management, communications, HR, legal, finance, and other costs directly related to the transition, which many analyses fail to do. The business case must also accurately consider ongoing governance and management costs, which many companies underestimate.

Downside Possibilities:

Many companies — 38 percent, according to a 2005 Deloitte Consulting LLP study⁵ — have paid additional or hidden costs for services they initially believed were included in their contracts. Incorrect assumptions regarding items such as cost savings and payback period have also contributed

to suboptimal O/O decisions. These problems occur when companies fail to accurately identify all relevant costs of the current operation or to think through future processes and governance structures. In addition, most companies omit a comprehensive risk analysis and thus underestimate risk mitigation costs. These trends have continued since the 2005 study, as demonstrated by the 2008 Deloitte Consulting survey that found that 63 percent of respondents did not use a business case/strategy assessment in developing their outsourcing initiatives.⁶

Upside Opportunities:

When a business case is based on validated assumptions, you can rationally compare O/O options, and decide whether to outsource the function at all. You can save significant sums of money by heading off bad decisions at this stage, which, admittedly, can be difficult if others in your organization have made a commitment to outsourcing or offshoring. Yet if you cannot make the business case for an O/O decision, you are actually making the case for an alternative. So avoid potential losses and allocate your resources to more-productive initiatives.

Keys to Risk Intelligent Business Case Development:

Start by assessing your organization's governance structure and the resources required to oversee and interface with O/O operations. While you're at it, conduct a complete risk analysis to identify, prioritize, and evaluate the risks and potential mitigation responses — and calculate the costs of risk measurement and mitigation. The key to a robust business case development is a formal method of identifying the benefits and total cost of outsourcing, and using adequate due diligence to validate assumptions. It's also useful to categorize expenditures into one-time and ongoing costs.

A Risk Intelligent business case would also:

- review successes and failures of your previous O/O decisions, and those of competitors
- validate financial, operational, and other assumptions, for example, regarding savings achieved by peers
- project one-time and ongoing costs accurately, including the cost of risk measurement and mitigation.

5. "Calling a Change in the Outsourcing Market: The Realities for the World's Largest Organizations." Deloitte Consulting LLP, April 2005.

6. "Why Settle for Less? Deloitte Consulting 2008 Outsourcing Report." Deloitte Consulting LLP, December 2007.

Stage 3. Vendor Selection - *It Now Means Something Different*

It's natural to blame the vendor when things go wrong. However, many problems can originate in your own organization, especially in cases where your company has not clearly articulated its objectives and expectations — and has failed to validate the same. If you don't address these foundational issues, the probability of a bad outcome rises substantially.

Vendor selection is, of course, a milestone stage of the process that helps make all your plans and projections real. But as tempting as it may be to fast-track the selection, the urge should be resisted. First, make sure you have attended to stages one — strategic assessment — and two — business case development. Then, be certain to carefully work through the selection process, with no shortcuts.

Significant problems can arise when companies give vendor selection short shrift. This usually stems from predetermining the vendor at the outset or choosing only on the basis of costs or relationships. It's also the result of requests for proposals (RFPs) that omit requirements and expectations from the strategic analysis and the business case — a common occurrence. Diligent vendor selection can represent the difference between disaster, failure, success, and phenomenal success.

Downside Possibilities:

Inadequate due diligence can lead to suboptimal — and risky — O/O relationships, as can mismatches between outsourcing objectives, significant risks, and vendor selection criteria. Indeed, 44 percent of companies in the Deloitte Consulting LLP study⁷ found that their vendors ultimately did not have capabilities required to deliver expected quality levels and cost savings. Of course, selection of the wrong vendor often creates the need to repeat the whole process in order to select the right one. The 2008 Deloitte Consulting survey⁸ found that 35 percent of respondents said they would spend more time on the service provider selection process if they could go back to the beginning of their initiative.

Upside Opportunities:

If you exercise due diligence regarding vendors' capacity, capabilities, and resources, you maximize the chances that the initiative will deliver on all expectations, smoothly and consistently, for years to come.

Keys to Risk Intelligent Vendor Selection:

Remember that once you enter into an outsourcing arrangement, your vendor's risks essentially become your own. Even if you legally transfer risk to the vendor, accountability remains with you. Thus, your due diligence process should, to the extent possible, assess vendors' risk management capabilities as well as operating, management, and reporting

**Vendor selection is, of course,
a milestone stage of the process
that helps make all your plans
and projections real.**

capabilities. This assessment includes the vendor's operational readiness to begin delivering services and its ability to comply with contract terms *and* regulatory requirements in all relevant industries and jurisdictions.

A sound selection process would also generally include:

- deliberation at the entity level of your organization rather than an ad hoc, "silo-style" selection by business units
- RFPs with clearly defined performance requirements and techniques for security, recovery, audit, and control
- validation of initial assumptions, review of operating and quality assurance capabilities, and sensitivity analysis of proposed pricing
- assessment of vendors' business continuity plans, given the proliferating sources of risk to operations (See "*Risk Intelligence in the Age of Global Uncertainty*" at www.deloitte.com/RiskIntelligence)
- exit and switching strategies.

Your internal auditors can play a critical role in assessing the service provider's internal controls during due diligence and throughout the outsourcing agreement. Of course, internal audit's access may be limited in a pre-contract situation, as some companies will be reluctant to hand over the "keys" prior to a formal engagement. Nonetheless, you should attempt to obtain sufficient access to information to attain reassurance regarding the service provider's system of internal control.

7. "Calling a Change in the Outsourcing Market: The Realities for the World's Largest Organizations." Deloitte Consulting LLP, April 2005.

8. "Why Settle for Less? Deloitte Consulting 2008 Outsourcing Report." Deloitte Consulting LLP, December 2007.

Items to be assessed include:

- **Service provider's control environment and governance structure**
 - ✓ Does the vendor have a code of conduct and expectations similar to your company's? Is it adhered to?
 - ✓ Are the vendor's structure, competencies, and experience adequate to provide the required services?
 - ✓ Does the vendor conduct periodic risk assessments that consider factors affecting services provided to the client?
- **Service provider's security, privacy, and business continuity practices**
 - ✓ Is a comprehensive information security control architecture in place based on the client's control requirements and vendor's risk assessment?
 - ✓ How are the security policies and guidelines communicated? How is the operating effectiveness of the controls validated?
- **Service provider's operational delivery processes**
 - ✓ Are service delivery processes thoroughly documented? Are roles and responsibilities between the company and the vendor clearly defined?
 - ✓ Are adequate controls in place to cover service level agreement reporting and billing?
 - ✓ Are change management, incident management, and issue escalation and resolution processes formalized?
- **Service provider's human resources practices**
 - ✓ Are hiring, compensation, training, and termination practices adequately controlled and compliant with local laws? Are they philosophically aligned with your own company's practices?
- **Your own Vendor Risk Management (VRM) program**
 - ✓ Do you have a formalized VRM program?
 - ✓ Does the program consider relevant risks under a global delivery model?
 - ✓ Are service provider risks periodically monitored based on risk ranking?

Stage 4. Contracting - *Striking the Deal*

After the key deal points have been nailed down and risks identified, contracting should be a relatively easy exercise. That's the payoff for the effort and due diligence expended in the first three stages of the process. During those early stages, a draft contract will often have been prepared (at least in outline form), setting the stage for a mutually advantageous relationship. The contracting stage is not the time to fix a poor strategic assessment or a questionable vendor selection; unfortunately, it is a fairly common mistake for companies to try to do so.

Downside Possibilities:

Missing or inadequate provisions regarding (among other things) service levels, incentives, transition management, vendor personnel, security, privacy, contingency plans, price protection, "audit clause," and termination can leave you with little leverage down the road. However, contracts can also be so rigid that it becomes difficult to amend them even

Elements of a CRC Program

An effective contract risk and compliance program consists of links, processes, structures, and interactions with external partners to realize value and manage risks in business relationships. It's a formal program of setting objectives and measures of success, monitoring performance and risks, and establishing ownership and accountability for personnel for both parties.

Core activities in an effective CRC program include:

- clarifying business objectives, risks, controls, and benefits for each business partner
- creating a common understanding of compliance and noncompliance with contracts
- validating the accuracy of information reported by business partners
- performing risk assessments and control reviews of business partners.

Specific requirements and activities will, of course, vary by industry, but the basic intent and function of a CRC program remains the realization of value and management of risk. See "*More Than a Matter of Trust: Managing Risk in Extended Business Relationships*" at www.deloitte.com/us/crc.

if conditions warrant a change. Good-faith negotiation and a mutually rewarding contract can decrease these risks. Forty-nine percent of respondents in the 2008 Deloitte Consulting survey⁹ wished that they had done more to define realistic service levels that aligned with their business goals and objectives.

Upside Possibilities:

Clearly defined contracts, along with service level agreements or balanced scorecard provisions, enable both parties to clearly set expectations and allow for understood monitoring of one another's performance under the contract. This sets the stage for transparency and cooperation rather than secrecy and corner-cutting. Clear, fair contracts are also essential to a useful contract risk and compliance (CRC) program throughout the ongoing relationship.

Keys to Risk Intelligent Contracting:

Ideally, the parties should view contracting as the cement that binds a mutually rewarding, ongoing relationship. The parties should develop contracts with a view toward the formal CRC program under which the contract will be administered. (If your company does not have a formal CRC program, now is the time to start developing one.) Risk Intelligent contracting really depends on the quality of the provisions and metrics in the contract and the means of monitoring performance under them, and that depends on getting the previous three stages right.

That said, there should be clearly defined security and control requirements based on the nature and configuration of the sourcing relationship as well as existing standards, policies, and procedures. Companies that try to insert control requirements late in the contract stage, or worse, after the contract is signed, often find this difficult and costly.

In addition, Risk Intelligent contracting calls for:

- performance criteria and SLA metrics linked to business value
- mechanisms to manage variations in volume as well as cost increases, decreases, ceilings, and floors
- defined payment terms, currency, and exchange rates
- checklists of legal, regulatory, contract, and insurance requirements and clearly stated implications of non-compliance
- right to validate the performance of the vendor in relation to the contract provisions
- contract termination and transition rights in the event either party wishes to end the relationship.

Stage 5. Service Transition, Delivery & Post-transition Management - *After the Deal is Signed*

Service Transition:

This is a critical juncture of the O/O lifecycle, and success depends on how well you've done everything up to this point. If the effort is misaligned with your strategy and rests on a faulty business case, or if you selected the wrong vendor and drew up an inadequate or inappropriate contract, a good outcome may be jeopardized. Yet even if you have done everything right up to now, you still have work to do.

Downside Possibilities:

Lack of formal transition planning undermines knowledge transfer, change management, and problem resolution — and retention of key personnel. The Deloitte Consulting LLP's study¹⁰ found that 20 percent of participants saw unexpectedly high vendor employee turnover, and concomitant erosion of the knowledge base. Worse yet, poor service transition can seriously damage your relationships with customers, employees, and other stakeholders.

Upside Opportunity:

Proper planning and management will control transition costs (and risks), set the stage for a productive relationship, and maintain the knowledge base. This stage enables you to update and streamline operations or, if appropriate, "lift and shift" an existing process or system to a third party or offshore location in a cost-effective manner.

Keys to Risk Intelligent Service Transition:

The key activities in this stage are transition planning, knowledge transfer, training, and key personnel retention. Although you may anticipate either a honeymoon period or a shakedown cruise, it's useful to evaluate outcomes during this phase against preset criteria. These criteria should include visibility into the vendor's operations and governance program, quality of the vendor's planning, adherence to deadlines and quality targets, and level of communication about problems. The SLA can potentially be fine tuned here as well. Overall, the keys to successful transitions are effective knowledge transfer and acceptance of responsibilities at an individual level; thus, this requires a proactive human resources change-management program. Many companies are ill-prepared for this stage. The Deloitte Consulting survey noted that 75 percent of outsourcing service providers stated that their clients were not well prepared to initiate their outsourcing arrangement.¹¹

9. *Ibid.*

10. *Ibid.*

11. *Ibid.*

A Risk Intelligent service transition enables you to:

- reengineer processes and systems before the transition or leverage the transition itself to reengineer them, according to plan
- monitor vendor performance and set the right expectations regarding communications and compliance through a robust CRC program
- evaluate the transition itself for “things going right” and “things going wrong,” particularly in the areas of knowledge transfer and human resources
- request — or jointly develop — a plan to correct whatever needs correction.

Delivery & Post-Transition Management:

Here is the “happily ever after” stage of the lifecycle — you hope. The productivity and benefits of the ongoing relationship depend on constant vigilance. Even O/O efforts that start off satisfactorily are prone to entropy, and only active management oversight can forestall or reverse potentially negative trends. This means monitoring the quality and timeliness of service delivery and validating continual compliance with key contract provisions, particularly those related to risk management (e.g., training and back-up plans).

Downside Possibilities:

Decreasing service levels, cost overruns, and compliance difficulties might signal the need to switch vendors or bring the function back in house. Either move represents increased costs and diversion of management attention from other matters, so it's usually preferable to try to correct such situations. But if you must move the function elsewhere, do so. Worst case scenarios include serious damage to your organization's reputation, brands, markets, finances, or legal standing.

Upside Opportunities:

When they work well, O/O initiatives deliver not only cost savings and flexibility, but ongoing two-way transfers of knowledge as well as increasing growth and profitability for both parties. Also, every successful O/O effort provides numerous lessons for the future if, and only if, those lessons are shared across the organization in useful ways. (Failed O/O projects also provide lessons, of course, but at significant cost.)

Keys to Risk Intelligent Post-transition Management:

An ongoing monitoring program to validate compliance with numerous expectations and assumptions (both hopefully contained in the contract or SLAs) should give both parties greater trust in each other and confidence that processes are operating as expected. It should also identify mutually beneficial opportunities to improve SLA metrics and customer satisfaction when you renew the contract. The governance

program must detect and report events related to non-performance and non-compliance regardless of how long the relationship endures. This occurs most reliably in the context of a governance structure with clear definition of roles and responsibilities; cross-functional integration among IT, business, compliance, security, privacy, and procurement; and balance between centralized standards and local requirements at offshore locations.

A Risk Intelligent post-deal management program will also:

- validate compliance against contract and SLA provisions periodically
- be built into a formal, centralized compliance monitoring and enforcement function and culture
- establish robust vendor risk management (VRM) programs that ensure effective and efficient ongoing vendor oversight
- assign internal audit an ongoing role in post-deal governance monitoring
- establish and enforce penalty provisions for SLA non-compliance.

Stepping Up Your Game

Taking even a few of these steps toward Risk Intelligent outsourcing and offshoring should place your O/O initiatives ahead of those of competitors. And taking more steps provides even greater benefit, because each step builds on the previous one. A lucid strategic analysis makes for a sound business case, which fosters selection of the right vendor and a complete contract. That contract — and the foregoing analysis — makes for a smooth transition and a well-managed relationship in the post-transition stage.

So, before you turn to your current or future O/O initiatives, take the test on the following page, then advance toward Risk Intelligent outsourcing and offshoring.

Final Thoughts

Outsourcing and offshoring offer many potential benefits. Yet it is worth noting that the need for management accountability remains ever present, regardless of any O/O initiative. Many tasks can be outsourced, but oversight cannot. You simply can't outsource your responsibilities away.

It's natural to think of risk management as just another cost, and, yes, it does cost money and require resources and management attention. However, given the stakes — both the potential benefits and the inherent risks — of outsourcing and offshoring today, a Risk Intelligent approach presents the surest route to realizing the maximum value of your O/O strategy. Even small steps toward that end can take you far.

Test Your Organization's Risk Intelligence for O/O Initiatives

- ❑ To what extent does your company consider outsourcing and offshoring initiatives in light of its strategic business goals? Does it use these initiatives basically for cost control and to solve short-term problems? Or is there a larger strategic purpose?
- ❑ Has your company analyzed its readiness to outsource? Has it assessed the gap between existing capabilities and those needed to optimize the value of O/O initiatives? Has your company addressed the gaps?
- ❑ Do you develop rigorous business cases with researched, verifiable assumptions?
- ❑ Are sourcing risk-analysis results incorporated into your vendor selection, due diligence, and contracting processes?
- ❑ Are vendors thoroughly researched and vetted? Or are they chosen mainly on the basis of costs or existing relationships?
- ❑ Are your contracts one-sided and aimed at extracting maximum advantage at the expense of vendors and partners? Or are they balanced? Do they consider and address global delivery risks in offshoring?
- ❑ Is there a separate, well-grounded transition plan for each initiative? Are those plans actually used and reviewed for efficacy?
- ❑ Does your company weave sourcing governance into the organization and its relationships? Or does it view risk management as a one-off exercise for each initiative?
- ❑ Does your company have a formal risk management frame-work to address risks at each phase of the sourcing life cycle?
- ❑ Do you establish effective risk mitigation based on risk priorities?
- ❑ Does your company have a formal contract risk compliance program? Is it applied as designed and intended?
- ❑ Does your company have a formal vendor risk management program? Do you allocate risk management resources based on risk rankings, and monitor service provider risks periodically based on a risk ranking?
- ❑ Does your company prioritize all O/O risks according to likelihood and severity? Does it allocate risk management resources to O/O risks accordingly?
- ❑ Does your company consider value-killing vulnerabilities in its assessment?
- ❑ Does your company have a risk assessment framework and a repeatable risk assessment model applicable to future decisions and deployments?
- ❑ Does your company, at the entity level, track and report its experiences in O/O initiatives and apply the lessons learned to future deployments?
- ❑ Does your company require vendors to provide regular service level management reports consistent with specified service level objectives? Are penalties for non-compliance with service level agreements established and enforced?

Contacts:

For more information on Risk Intelligence and managing outsourcing and offshoring risks, contact:

Mark Layton

Global Leader, Enterprise Risk Services
Deloitte & Touche LLP
mlayton@deloitte.com
+1 214 840 7979

David Zechnich

Partner
Contract Risk & Compliance Leader
Internal Audit Services
Deloitte & Touche LLP
dzechnich@deloitte.com
+1 408 704 4560

Peter Lowes

National Service Line Leader
Outsourcing Advisory Services
Deloitte Consulting LLP
plowes@deloitte.com
+1 212 618 4380

David Hodgson

Partner, Enterprise Risk Services
Deloitte & Touche LLP
dhodgson@deloitte.com
+1 973 602 6869

Steve Revesz

Director, Enterprise Risk Services
Deloitte & Touche LLP
srevesz@deloitte.com
+1 415 783 4311

J. Marc Mancher

Senior Manager
Outsourcing Advisory Services
Deloitte Consulting LLP
jmancher@deloitte.com
+1 203 743 1935

Kelly X. Ke

Senior Manager
Enterprise Risk Services
Deloitte & Touche LLP
xke@deloitte.com
+1 973 602 6893

Is Your Company Risk Intelligent?

See our full series of whitepapers on Risk Intelligence, including the following:



No. 1: *The Risk Intelligent Enterprise: ERM Done Right*

No. 2: *Risk Intelligence in the Age of Global Uncertainty*

No. 3: *The Risk Intelligent Enterprise: ERM for the Energy Industry*

No. 4: *The Risk Intelligent Life Sciences Company*

No. 5: *The Risk Intelligent Chief Audit Executive: Mission Possible*

No. 6: *The Risk Intelligent CIO: Becoming a Front-Line IT Leader in a Risky World*

No. 7: *The Risk Intelligent Energy Company: Weathering the Storm of Climate Change*

Visit www.deloittte.com/RiskIntelligence to download electronic copies, or contact your Deloitte professional for print copies. There is no charge for these publications.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, its member firms, and their respective subsidiaries and affiliates. Deloitte Touche Tohmatsu is an organization of member firms around the world devoted to excellence in providing professional services and advice, focused on client service through a global strategy executed locally in over 140 countries. With access to the deep intellectual capital of approximately 150,000 people worldwide, Deloitte delivers services in four professional areas — audit, tax, consulting, and financial advisory services — and serves more than 80 percent of the world's largest companies, as well as large national enterprises, public institutions, locally important clients, and successful, fast-growing global companies. Services are not provided by the Deloitte Touche Tohmatsu Verein, and, for regulatory and other reasons, certain member firms do not provide services in all four professional areas.

As a Swiss Verein (association), neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names "Deloitte," "Deloitte & Touche," "Deloitte Touche Tohmatsu," or other related names.

In the United States, Deloitte & Touche USA LLP is the U.S. member firm of Deloitte Touche Tohmatsu and services are provided by the subsidiaries of Deloitte & Touche USA LLP (Deloitte & Touche LLP, Deloitte Consulting LLP, Deloitte Financial Advisory Services LLP, Deloitte Tax LLP, and their subsidiaries), and not by Deloitte & Touche USA LLP. The subsidiaries of the U.S. member firm are among the nation's leading professional services firms, providing audit, tax, consulting, and financial advisory services through nearly 40,000 people in more than 90 cities. Known as employers of choice for innovative human resources programs, they are dedicated to helping their clients and their people excel. For more information, please visit the U.S. member firm's Web site at www.deloitte.com