Advisory Services
Outsourcing

How an integrated global approach can lead to sourcing success*

*connectedthinking

PricewaterhouseCoopers

September 2008

Embracing the era of collaborative resources.

Globalization is driving unprecedented changes within the business world.

As companies expand internationally, new sourcing options and fierce economic forces drive them to rethink how they deliver services to customers and respond to competitors.

Even companies without global reach have new options. Many of these organizations are re-evaluating their sourcing strategies with an eye toward capitalizing on the increasing availability of service providers worldwide.

In this environment, many organizations are moving away from the traditional approaches of outsourcing “non-core” or overhead functions and retaining “core” functions in-house. Indeed, the very definitions of the terms are shifting. In an era of globalization, some functions traditionally considered non-core are essential to the business and can provide a competitive edge. For instance, for a global distribution company, attracting and retaining suppliers around the world are core competencies, so an efficient accounts payable process—traditionally a non-core function—could be a prerequisite for success.

For global companies, the more relevant sourcing question has become: *How can we deliver services better, faster, and cheaper?*

Developing a global business and sourcing strategy is fraught with complexity, as highlighted in PricewaterhouseCoopers’ 11th Annual Global CEO Survey, released in January 2008 at the World Economic Forum in Davos, Switzerland. Of more than 1,000 CEOs surveyed worldwide, 70 percent characterized developing a global strategy as “moderately” to “extremely” difficult.

Many are turning to suppliers for help, but not just in reducing costs. According to PricewaterhouseCoopers’ survey, companies are forming collaborative relationships with their suppliers—stressing joint ventures and entrepreneurial creativity. Sourcing relationships are evolving away from vendor and buyer into partnership.

In this new model, organizations face a range of sourcing options, from shared services to hybrid models. This publication suggests differing approaches to a sourcing strategy.

As a first step, PricewaterhouseCoopers recommends evaluating the sourcing options and considering how each aligns with a company’s strategic vision for the next three to five years. What processes and operations could be consolidated? Is there enough critical mass in certain processes to justify an investment in a shared services center?

Executive managers must take part in the selection process, because the sourcing model will have a major impact on global operations and future performance. Success depends on using some type of detailed governance model at the strategic, program and operational layers of the organization.

Choosing the right sourcing model is a challenge, but those who succeed can gain a competitive advantage.

An in-depth discussion

Taking a tour of sourcing models.

A variety of sourcing models are available to global organizations, from onshore shared services centers to offshore joint ventures to hybrid solutions that include both captive facilities and outsourced functions. Choosing the right model—one that allows the organization to achieve operating efficiencies on a global scale and deliver services better, faster and cheaper than its peers—can be a powerful competitive differentiator.

Shared services (captive model)

Shared services, or the captive model of sourcing, consolidates dispersed resources performing similar functions within one or more centers owned by the company. They serve multiple internal customers with similar needs. The shared services center (SSC) is the internal service provider for the organization.

The shared services model has key advantages. It ensures standardization and complete control over work processes, and it protects the organization's intellectual property (IP). It also necessitates performance metrics, which strengthen management of the business.

On the other hand, setting up an SSC typically requires a significant initial investment. It also creates staffing challenges, because the existing workforce may have to be supplemented or replaced by workers with more specialized skills.

The success of an SSC also depends on a strong brand and corporate reputation, which are essential to woo internal customers and attract and retain employees (particularly in countries such as India where the demand for workers exceeds supply).

Outsourcing

Outsourcing is the contracting of work, previously performed in-house, to a third party. Ideally, companies leverage outsourcing relationships to deliver a faster go-to-market strategy and build a more flexible and scalable service delivery model.

Whether pursuing outsourcing, shared services or a hybrid strategy, organizations have three options when choosing a location for business processes:

- **Onshore**—Within the organization's home country.
- **Offshore**—Outside the home country.
- **Nearshore**—Close to the home country (in terms of physical distance and/or time zone). Nearshore locations typically are countries that offer a lower-wage workforce but have economic, political, language, or other links to the home country.

Where to Source?

Figure 1: Identifying the Optimal Sourcing Model

Pros	Cons
Shared Services (Captive)	
Ensures standardization and complete control	Requires high initial investment
Protects intellectual property	Requires strong brand and reputation
Creates a metric-driven organization that strengthens management	Creates staffing challenges
Outsourcing	
Enables collaboration with reputable global service providers	Sacrifices a degree of control
Leverages proven technologies	Requires intensive effort to build and maintain relationships
Moves to variable cost models	Weakens intellectual property protection
Hybrid	
Distributes risks and financial burdens between parties	Increases administrative and legal complexity
Ensures internal control over high-value activities	Creates added business and cultural challenges
Protects intellectual property under the new entity	Poses regulatory challenges around issues such as sharing of confidential client data

Within the realm of outsourcing, two models are becoming more prevalent: Build-Operate-Transfer and Joint Venture:

Build-Operate-Transfer

Under this model, an organization/customer outsources the construction and operation of a service center to a provider. After operations are stabilized, the provider transfers the assets and operations back to the customer.

This is a viable option for organizations that meet one or more of the following criteria. These organizations:

- Do not want to make a major investment in building operations;
- Do not have the skills and knowledge to build a captive center;
- Lack knowledge of local laws and culture of the country in which they will deliver services; and/or
- Lack the initial critical mass to justify the investment of financial and management resources in building a captive center.

Joint Venture

Under this model, an organization jointly creates and operates a new Shared Services Center with the service provider.

Joint ventures are optimal for organizations whose strategy is to deliver services in new markets, where they have no physical presence. It can also work for companies that want to deliver services in vertical markets, domestic or international, in which they lack experience and require a partner with industry knowledge.

Identifying the Optimal Sourcing Model

That said, joint ventures are difficult to manage because they require organizations to give up some degree of control. The relationship between the organization and the service provider must be very strong for a joint venture to succeed. Regardless of the model, outsourcing generally brings three advantages:

It enables collaboration with reputable global service providers. It leverages existing, proven technologies, eliminating the need to invest in new IT systems. And it moves the organization toward a more transparent, variable cost model whereby the service provider charges per transaction rather than a flat fee. Using this variable cost model is also less expensive than building an SSC that, within a certain range of transactions, will incur the same overhead regardless of the volume of business.

On the downside, outsourcing requires an organization to surrender a degree of control and to invest a great deal of time building and maintaining the relationship with the provider (which effectively increases the cost). Outsourcing also weakens the protection of IP rights, because the provider could modify the outsourced processes and technology to create and market its own model.

Hybrid model

Globalization's complexity is driving many organizations to evolve toward a hybrid sourcing model, which combines shared services for certain functions or locations with outsourcing for others. For instance, it may not be worth the investment for a US-based company to build a shared services facility to process accounts payable in Europe. But in the United States, a larger customer base could justify the investment.

The hybrid model is becoming prevalent in organizations with SSCs that are moving up the value chain (e.g. focusing on higher value activities like planning and forecasting vs. general ledger entries). As these SSCs become more skilled, they outsource an increasing number of low-value processes, such as data entry or invoice imaging. They then have the ability to take on higher-value activities for which the organization wants to retain control, such as budgeting and forecasting.

As is true of the models described above, the hybrid approach also has pros and cons. One advantage is that the model disperses the risks and burdens between the parties. In addition, it helps an organization retain internal control over, and IP protection of, high-value activities at the SSC.

On the other hand, the hybrid model increases administrative and legal complexity because of the need to manage multiple organizations and sourcing models. This generates added business and cultural challenges. Finally, the hybrid model poses regulatory challenges, such as sharing of confidential client data.

Our Perspective

An optimal sourcing model can help the organization align the operations with the business drivers and help the organization achieve its strategic vision. To succeed, organizations must view sourcing from a global perspective and form collaborative relationships with their suppliers.

In our experience, companies often pursue sourcing strategies in isolation —for instance, to reduce costs in a particular business unit, product line, or geographic location—without considering their overall strategy and goals. Such a narrow approach limits opportunities to maximize the benefits of strategic sourcing. Organizations can achieve much greater efficiency, cost savings, and additional benefits by taking a broader view of the organization and applying a systematic approach to sourcing, as illustrated in the chart on the following page.

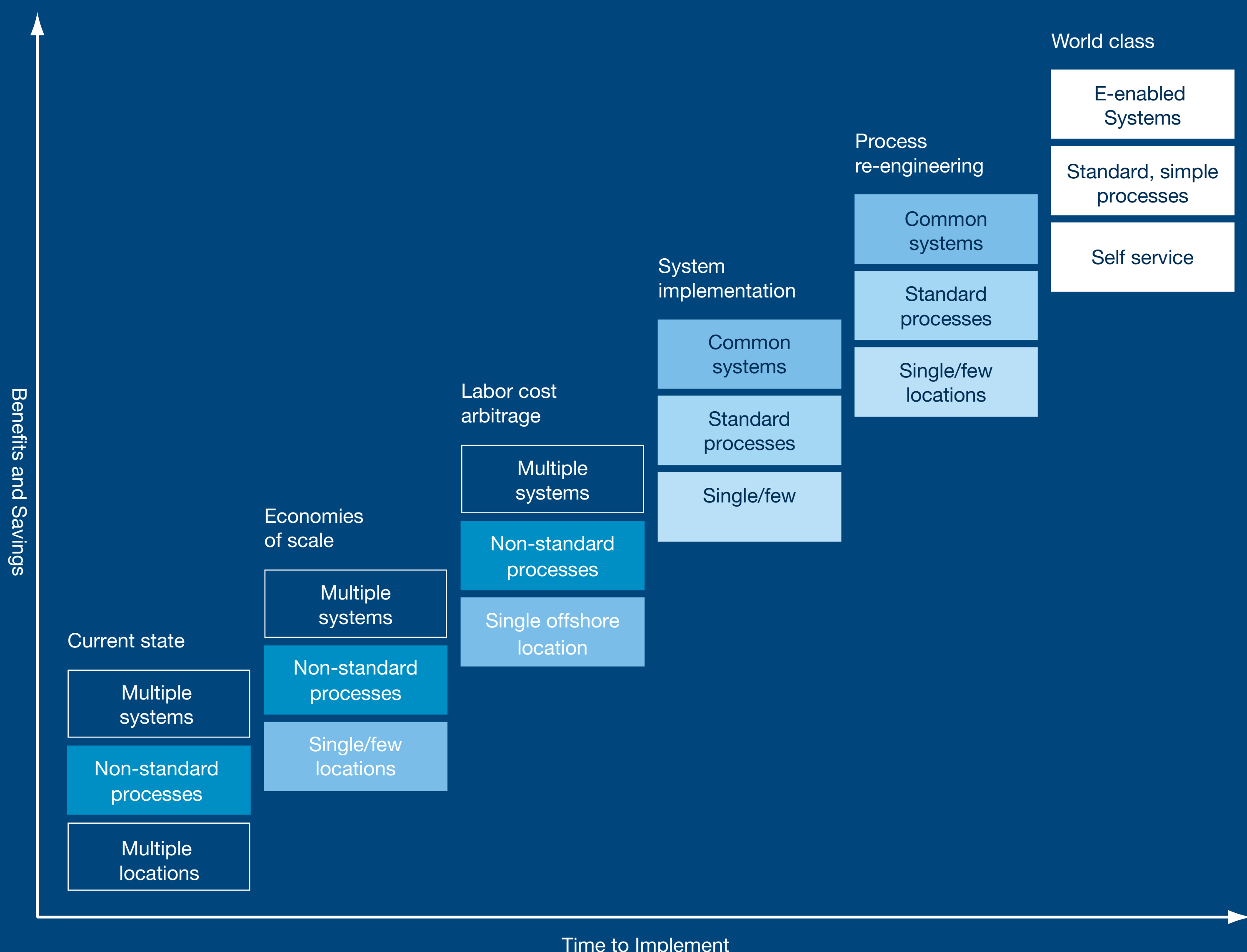
PricewaterhouseCoopers believes an effective collaboration allows both customer and supplier to share the benefits and costs of the relationship. For instance, a supplier that generates cost-saving improvements for a customer should retain a reasonable portion of each dollar saved over some baseline amount. In addition, suppliers should share in the ownership of ideas they generate. In one case, a customer barred a supplier that developed a method to improve technical support from using it anywhere else. Fortunately, the customer relented, realizing that allowing the supplier to co-own its improvement ideas would make the supplier more likely to bring new ideas to the table.

Although suppliers should benefit from the ideas they generate, contracts should not be lopsided. This often happens in long-term contracts that include automatic cost-of-living increases for suppliers. Process improvement clauses should balance such contract provisions by guaranteeing the customer a minimum in annual cost improvements (typically 8 percent, which generally is achieved by eliminating certain resources needed early in the relationship).

As new providers enter the market and sourcing relationships become more complex, many organizations move toward shorter-term contracts; today, a three-year contract with an option to renew for two more years is typical. Such an approach allows organizations to test the waters before making a longer-term commitment. A spirit of collaboration is more likely to lead to a successful long-term relationship.

Figure 2

A systematic approach


World class
E-enabled Systems
Standard, simple processes
Self service
Process re-engineering
Common systems
Standard processes
Single/few locations
System implementation
Common systems
Standard processes
Single/few
Labor cost arbitrage
Multiple systems
Non-standard processes
Single offshore location
Economies of scale
Multiple systems
Non-standard processes
Single/few locations
Current state
Multiple systems
Non-standard processes
Multiple locations
Benefits and Savings
Time to Implement

Gaining leverage on a global scale

Regardless of whether a company does business internationally, it can take advantage of globalization to source its operations more efficiently and cost-effectively. PricewaterhouseCoopers advocates looking at processes across the organization to determine areas for improvement, while keeping the three- to five-year strategic vision in mind. Such an approach enables consolidation of certain operations across geographies and business units to boost efficiency.

By viewing sourcing from a global perspective, a company broadens its options for how and where to source an activity or service in the fastest, and cheapest way, creating a competitive edge. The need to think and act globally should drive any company reviewing its sourcing options.

A holistic sourcing approach allows some of world's leading organizations to globally distribute and manage their work in the most effective, efficient and inexpensive ways. This is difficult for competitors to replicate, because it requires an in-depth understanding of how the organization operates.

Consider the example of Li & Fung, a giant in the apparel industry that enjoys enormous competitive advantage even though it manufactures no clothing. Rather, the Hong Kong supply chain manager coordinates a global network of suppliers that design, produce, and deliver apparel to European and US markets.

Each time Li & Fung orchestrates the creation of a new product, it assembles a unique set of suppliers among the thousands to whom it is loosely coupled. If a process is delayed or a contractor fails to deliver, the company can quickly plug other suppliers into the system. Viewing its organization as a collection of services offered by a wide variety of service providers has kept Li & Fung at the top of its industry for decades. And it presents a significant challenge to competitors. In the coming years, such a services-oriented approach will be essential for companies that aspire to become “global orchestrators,” coordinating vast networks of suppliers and partners to deliver products and services to the marketplace.

In addition to a global approach to sourcing, alignment of the sourcing model with the organizational strategy is important. Misalignment substantially increases an organization’s risks and may result in failure. For example, if a supplier in Beijing must wait for a check to arrive from Boston, site of accounts payable, the supplier relationship may be strained or lost, and the performance of the core business could ultimately suffer.

What this means for your business

Making the best choice.

As a first step in choosing a strategy, consider the models described above and how each model could help you reach your corporate goals within three to five years.

Following are a few general questions to help start the conversation:

- Will the sourcing model accommodate your growth expectations and flexibility requirements?
- Are you willing to commit to the model for the time required to generate an acceptable return on investment?
- What impact will the model have on your industry and competitors? Will it help you to gain a competitive advantage?
- Will the model enable your organization to balance critical current and future needs?
- Does your existing workforce have the skills to implement and manage the new sourcing model? If not, do you have the resources and commitment to recruit and retain a new workforce with the requisite skill set?
- What impact will the sourcing model have on employee morale? Is there a significant risk of losing key people if you choose to implement the model?

Gain a thorough view of your current “as is” organization

Answering strategic questions—such as those above—will help you to begin narrowing your sourcing options. The next step is to gain a holistic view of your current, “as is” organization in order to identify those processes that potentially could be sourced differently. Following are a few suggested questions to explore as a starting point:

- Where within the organization can sourcing improve process effectiveness? What automation, innovations and process improvements could be utilized across the organization?
- What processes and operations could be consolidated to achieve greater efficiency? For instance, if some business units already have an outsourcing relationship or shared service model, perhaps other units could leverage those operations. The resulting increase in standardization and economies of scale could bolster the organization’s bottom line.
- Is there enough critical mass in certain processes to justify an investment in one or more SSCs or to gain the interest of a reputable service provider? If not, can critical mass be gained by on-boarding multiple business units to the new sourcing model?
- Is there potential to gain additional economies of scale in outsourcing if IT and business process outsourcing are bundled together?
- How fragmented is your technology landscape? It is easier to support a shared services model if an organization has consolidated IT platforms rather than multiple systems and platforms. Many organizations consider outsourcing if the investment to upgrade/consolidate technology is high.

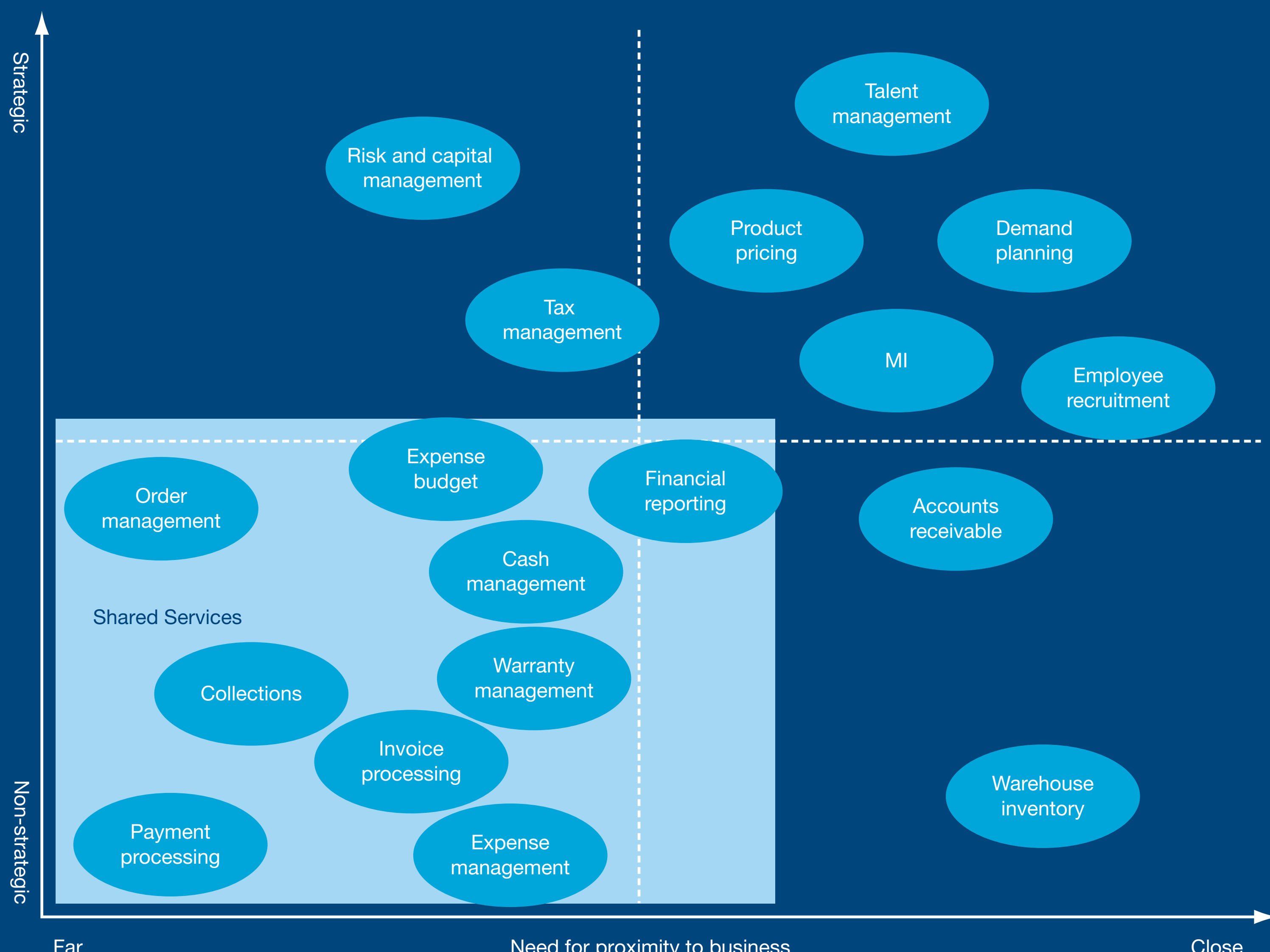
As noted earlier, many organizations no longer follow the traditional approach of outsourcing non-core functions and retaining core functions in-house. Rather, they analyze each function to develop the appropriate sourcing option. The evaluation of outsourcing opportunities must be a focused, methodical process that considers the impact on the business and the need for proximity to the organization, as illustrated on page 21.

A PricewaterhouseCoopers client wanted to adopt a common technology platform and set of processes worldwide, to increase visibility and improve management control while reducing costs. After an external analysis failed to make a business case for outsourcing, this Fortune 500 Company decided to develop a global shared services model and to implement a shared services center (SSC) in Europe. Simultaneously, management decided to outsource its problem-plagued accounts receivable function in North America for the next two years, until a new North American SSC could absorb the work.

The client projects it will reduce costs by 35 to 40 percent through the opening of the European SSC. The new SSC offers greater visibility into the company's finance and accounting functions across Europe, which in turn will streamline compliance processes and provide more timely information to management. The European center also provides a foundation for the company to consolidate its accounting and finance functions throughout the world, increasing efficiency and further reducing costs.

Figure 3

Focused outsourcing opportunities


Strategic
Non-strategic
Far
Need for proximity to business
Close
Shared Services
Talent management
Risk and capital management
Product pricing
Demand planning
Tax management
MI
Employee recruitment
Expense budget
Order management
Financial reporting
Accounts receivable
Cash management
Collections
Warranty management
Invoice processing
Payment processing
Expense management
Warehouse inventory

Unfortunately, it's challenging to gain a holistic view of highly decentralized organizations. Business units that operate with a high degree of autonomy have little incentive to identify areas of leverage outside their organizations. In such cases, corporate leadership should drive the initiative for a global sourcing strategy. For this top-down approach to work, corporate executives must define the value proposition for the business units, whose leaders will want to know how such an initiative would affect their bottom line and risk profile.

By taking a holistic approach to evaluating processes, you can gain perspective on the activities that lend themselves to external sourcing versus retention in the business. As an example, the figure on page 25 indicates the value and complexity of various financial processes. Processes that are low in value and complexity are the most obvious candidates, but many organizations could benefit by outsourcing more processes.

For instance, most organizations would agree that it makes sense to outsource transaction services, but many are reluctant to outsource decision support services, because they don't want to lose control over decision-making. In our view, these services are good candidates for outsourcing; the organization does not have to outsource decision-making, just the financial analysis that supports decisions. We believe that corporate processes, such as tax management, budgeting, planning and forecasting, are examples of functions that may not be appropriate candidates for outsourcing, because of their complexity and high value to the organization.

Select the optimal sourcing model

Once you gain a holistic understanding of your operations and how they could be improved, the final step is to select the optimal sourcing strategy. When determining which sourcing model will align with the organization's three- to five-year vision and overall strategy, following are some key factors to consider:

Global tax considerations

Evaluate the tax implications of sourcing in various locations. For instance, in addition to exploring the potential for doing business in low-wage countries, consider the generous tax incentives that high-cost countries such as Switzerland offer, which may offset the incremental expenses.

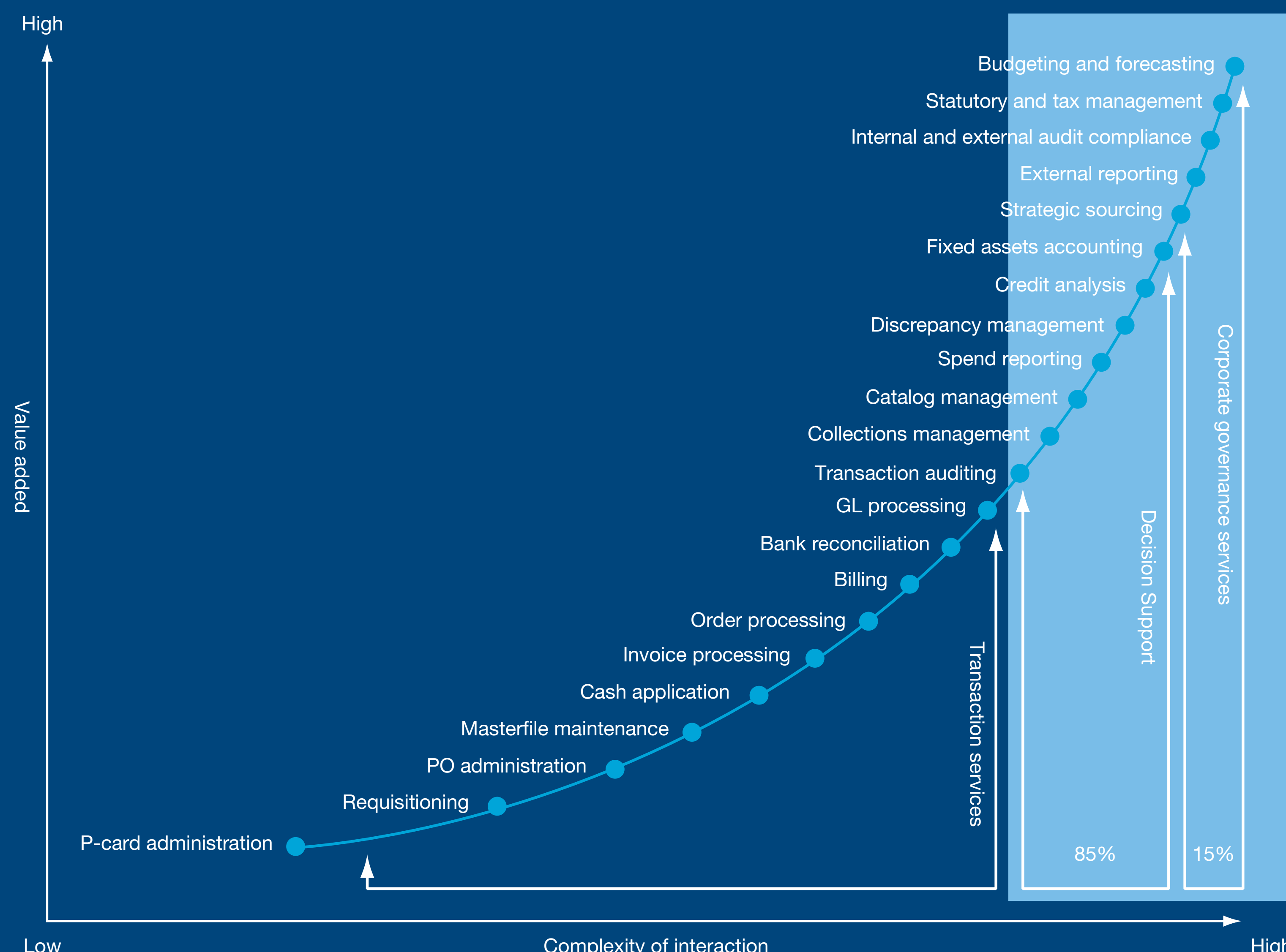
Legal and regulatory environment

Explore the legal and regulatory issues related to each sourcing model. That includes analyzing the laws and regulations of each location in which you plan to pursue a sourcing strategy.

If privacy and IP laws are lax, for instance, establishing a shared services facility could be preferable to outsourcing, because shared services will enable you to retain control over critical information. On the other hand, some countries require that a local entity own more than 50 percent of a shared services facility or equity in a joint venture, in which case outsourcing may be a better choice if you are willing to give up some control.

Figure 4

Outsourcing risks



High
Value added
Low
Complexity of interaction
High
Budgeting and forecasting
Statutory and tax management
Internal and external audit compliance
External reporting
Strategic sourcing
Fixed assets accounting
Credit analysis
Discrepancy management
Spend reporting
Catalog management
Collections management
Transaction auditing
GL processing
Bank reconciliation
Billing
Order processing
Invoice processing
Cash application
Masterfile maintenance
PO administration
Requisitioning
P-card administration
Transaction services
Decision Support
Corporate governance services
85%
15%

Geopolitical concerns

Evaluate the geopolitical risks of each country and region in which your organization operates. How stable is the political and social landscape? What is the economic forecast? Is the government involved in the international business community (e.g., a member of the World Trade Organization)? The more volatile the environment, the less appropriate it may be to establish an SSC.

Organizational restructuring requirements

Consider how much the organization will need to restructure to facilitate the sourcing model. Restructuring may include additional investments in human resources. For example, a shared services organization may require the addition of employees with service delivery skills, including account management. Even an outsourcing scenario may call for workforce restructuring to include employees with more vendor and project management skills.

Facilities and infrastructure investment

Companies pursuing shared services must take into consideration the significant investment required in facilities and in infrastructure, such as real estate, phone systems, computer management and physical security. Some local governments offer incentives to build facilities in newer cities or in older areas where the government is targeting development, which can help to defray costs.

Investing in a shared services facility, with or without government incentives, may be worthwhile if the organization has a critical mass of services to deliver and/or plans to operate the facility for at least as long as it takes to achieve a target return on investment. If there is a risk that a location might not be viable for achieving the expected return (e.g., because of rising inflation or political instability), investing in this type of infrastructure would be impractical. In that case, consider outsourcing because it requires minimal up-front investment in facilities and infrastructure and could eliminate the need to invest in security and disaster recovery, which the service provider may be able to offer.

Systems and technology investment

Will the new sourcing model require investment in new systems and technology? Outsourcing requires minimal up-front investment, but operating an SSC requires performance management, time and attendance, workforce management, ACD/IVR remote access, and monitoring tools. Additionally, the shared services model may require considerable investments to standardize and consolidate existing systems. Such investments may be particularly appropriate for decentralized organizations that plan to launch expensive transformations. These organizations can use shared services for centralizing systems control and standardizing processes before launching the initiative.

Sourcing to streamline the organizational structure. A global healthcare management company sought to reduce the cost of multiple departments by implementing a single management structure supporting all business units, consolidating service delivery in a shared services center (SSC) on a single platform, and potentially migrating service delivery to a lower cost geography.

The company asked Pricewaterhouse-Coopers to assess the benefits of a single management structure without consolidation of functions and provide a cost-benefit comparison of scenarios for establishing a regional SSC in the US, Asia, Latin America or in Central and Eastern Europe (CEE), with and without implementing a single platform solution. The client now has several alternative SSC strategies from which to choose and is weighing the related costs and benefits.

While a consolidated shared management structure across all business units would generate significant savings and require only a modest investment, if the client chooses that option, span-of-control ratios should be reviewed, to minimize business risk. The implementation of a SSC with a single platform, either in the US or in CEE, would generate greater savings but would also require additional up-front investment and time to achieve. And while a SSC in the US would generate significant savings, much greater labor cost reductions could be achieved by implementing shared services in CEE. Implementation of any of the recommended SSC scenarios would lead to improved efficiency, greater agility, and better controls.

People/change management

People should be high on the list of criteria to consider when choosing a sourcing model. In a shared services model, the organization would have sole responsibility for recruiting and retaining employees. But no matter which model an organization pursues — including outsourcing — it will need an effective change management program to help facilitate the appropriate transfer/transition of people and knowledge and to mitigate the related risks (including the risk of losing key employees).

Time frame for benefit realization

While we advocate an approach to sourcing that looks beyond cost, saving money remains the primary reason most organizations begin shared services or enter into outsourcing contracts. Although both models require initial investments and the benefits may not be fully realized for a number of years, outsourcing is a better solution for organizations that choose to realize savings more rapidly.

Service delivery model

For organizations considering the shared services model, designing the right service delivery model is imperative. It is critical to establish independent SSCs that are not linked to any business unit. Instead, treat each business as a customer, with clear contractual relationships and service level agreements (SLAs) and a transparent cost allocation model. This will help the business units feel they are playing on a level field.

One of the most important prerequisites for a new strategy is executive management buy-in and involvement in the selection process. Whatever global sourcing model you choose will have a substantial impact on operations worldwide and may play a key role in achieving the organization's three- to five-year vision. Therefore, the C-Suite must be onboard, actively participating in the model selection and communicating to employees how the new model will support the organization's strategic vision.

Factors to consider in choosing a sourcing model

- Global tax considerations
- Legal and regulatory environment
- Geopolitical concerns
- Organizational restructuring requirements
- Facilities and infrastructure investment
- Systems and technology investment
- People/change management
- Time frame for benefit realization
- Service delivery model

Applying a global approach to sourcing

A major global pharmaceutical company had a decentralized Finance & Accounting (F&A) HR, and IT organizations with varying levels of technical capabilities and process maturities. As a result, the client was having challenges around standard reporting, and high administrative costs. In addition, the client had acquired several companies and was having problems integrating their processes and enterprise resource planning (ERP) systems. Management asked PricewaterhouseCoopers to evaluate the F&A, HR, and IT organizations with the goal of reducing costs, increasing efficiency, and enhancing control.

Following an assessment of the global F&A, HR, and IT organizations, a PricewaterhouseCoopers Advisory team recommended that the client establish shared services centers in four regions, co-locating all three functions to leverage IT and management support and thereby further reduce costs. To gain additional efficiencies, the team also recommended consolidating specialist functions in centers of expertise.

To improve the IT organization, the team recommended rationalizing ERP systems, selecting the best-in-class instances of SAP (the client had almost a dozen versions) and establishing SAP regional centers of excellence. The team also analyzed the pros and cons of maintaining ERP applications internally versus outsourcing the maintenance function and offered recommendations for supporting measurement and data mining capabilities across the organization, to make it easier for managers to access systems and generate custom reports.

For the HR organization, the PricewaterhouseCoopers team helped to select an HR business process outsourcing (BPO) provider to deliver a global HR technology solution for handling administrative activities. It also developed a design for the retained HR organization in the business units. Finally, the PricewaterhouseCoopers team worked alongside management to create an improved governance structure to manage suppliers and to formalize the relationships between business units and the shared services organization.

Today the client maintains SAP centers of excellence in Milan, Singapore, and New Jersey and plans to open four SSCs around the world. Teams from PricewaterhouseCoopers are working to harmonize processes and are assisting with site selection for the North American, Asia Pacific, and Latin American SSCs. Once the regional SSCs are established, the client expects to achieve significant cost reductions, better access to data, and greater control. Ultimately, implementation of the regional SSCs will help the client's organization to become more efficient, agile, and flexible and will make it easier to integrate future acquisitions.

Through the HR BPO relationship, the client now has more robust HR capabilities, including self-service capabilities that will enhance customer satisfaction while lowering costs.

Don’t reduce the role of governance

Regardless of the sourcing model chosen, a thorough governance model is essential for success. A sourcing relationship is not an arm’s-length transaction that you establish and then ignore. *The single biggest reason for the failure of sourcing relationships is the lack of understanding of the need for appropriate governance.*

For success, governance must occur at the strategic, program, and operational layers of the organization.

At the strategic level, the governance model addresses issues such as who will be involved in decision-making related to sourcing, how strategic committees will be formed, and how decisions will be communicated throughout the organization. At the program level, the model focuses on development of sound contractual relationships, including clearly defined service level agreements. At the operational level, it addresses day-to-day tasks such as assuring quality, monitoring service-level agreements, collecting and reporting on metrics, managing resources, sharing knowledge, and facilitating communication and collaboration.

Each layer is responsible for three aspects of governance: relationship management, change and communication management, and risk management. The three levels work together in carrying out their responsibilities. For instance, if a proposal is made at the strategic level to improve service levels, the proposed change is communicated to the program office, which assesses the risk and cost impact of the decision and communicates its findings. If the change is approved at the strategic level, the program office instructs operations personnel to implement the new SLA. The operations level is then responsible for measuring performance under the new SLA. Performance reports are communicated to the program office and to strategic management.

Investment required

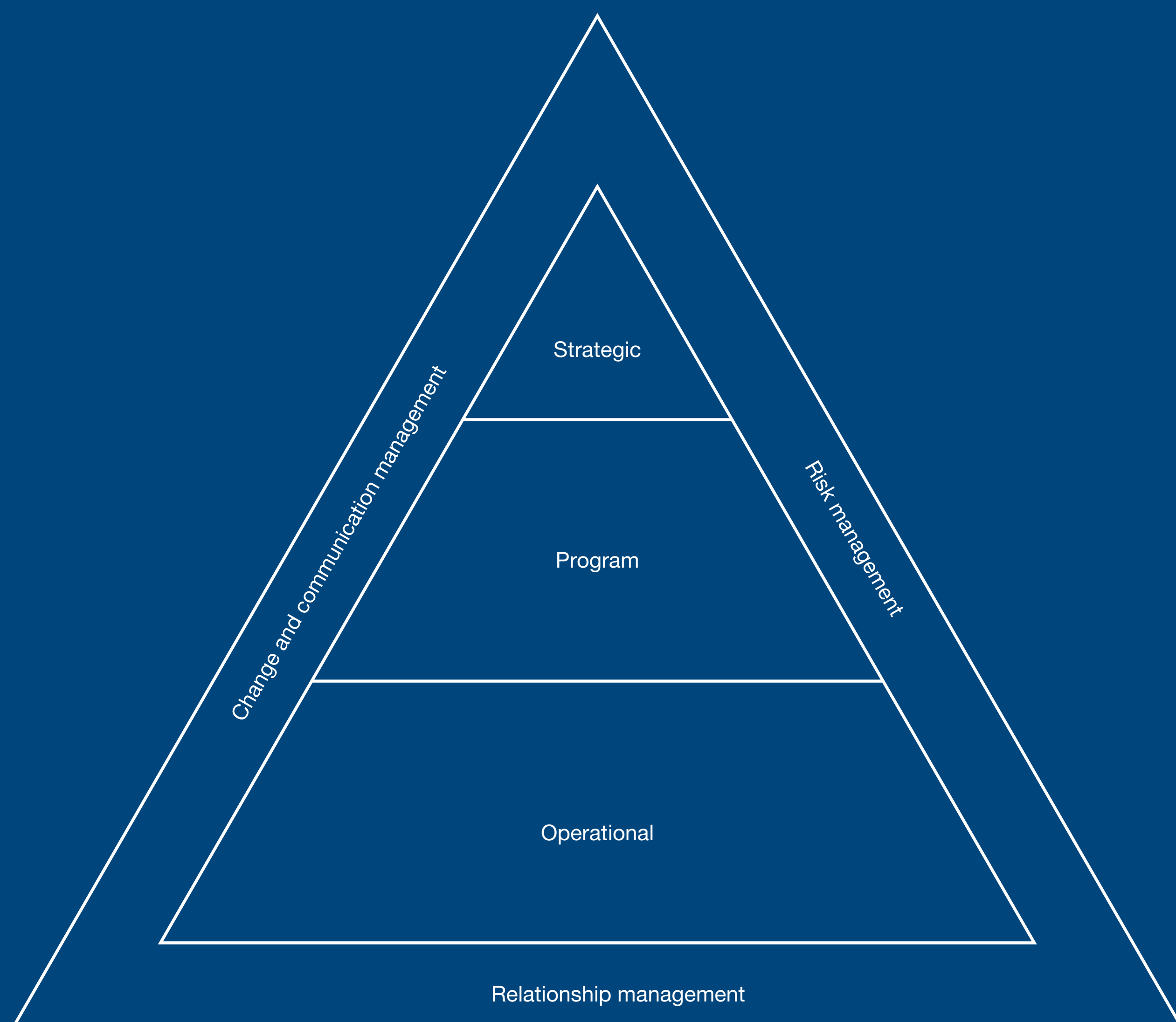
In addition to minimizing the need for governance, many organizations underestimate the cost of starting an effective governance program. In our experience, for a sourcing relationship to succeed, an organization must commit 6 to 8 percent of the value of the sourcing contract to governance. That investment covers the cost of assigning governance responsibilities to sufficient employees with experience in relationship building, contracting, and process improvement (rather than to one or two people without specialized skills that happen to be available at the moment). It also includes the cost of travel and time spent at the provider's site to gain a deep understanding of the supplier's services and to address problems that may arise.

The failure to invest sufficient resources in governance can negate the expected return on a sourcing investment. Typically, an organization spends 20 to 30 percent more in the first year of a sourcing contract than it would have incurred without the contract. That investment covers one-time cash outflows (severance payments, project costs, etc.), as well as the costs of parallel processing and disrupted processes (errors, start-up costs, learning effects, etc.) Without a solid governance structure, it will take longer to recoup that initial investment and begin to generate a positive return; rather than saving, for example, 65 percent over four years, as the original business case suggested, the company might save only 5 percent, putting the entire value proposition into question.

Any company seeking the benefits of a global sourcing strategy assumes a complex set of risks—not just to the initiative, but also to the organization's broader operations and objectives. As the scope and significance of these risks increase, a formal governance framework, with clearly defined roles and responsibilities at the strategic, program, and operational levels, can make the difference between the strategy's success and failure.

Figure 5

Governance layers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