PwC Advisory
Performance Improvement

How to succeed in outsourcing through strengthened governance*

Table of contents

Situation p. 2

Although the number of companies pursuing strategic outsourcing initiatives continues to rise, studies reveal that as many as half of these investments fail to return the benefits executives expect. There are a broad range of contractual, operational, political and cultural risks that can derail an outsourcing initiative quickly and many executives struggle to manage this uncertainty. While there are different explanations for outsourcing failures, they each can be traced back to a fundamental lapse in managerial oversight and control — in effect, to a failure in governance.

Our perspective p. 8

The most effective way to manage outsourcing risk is to adopt a rigorous approach to outsourcing governance, and to do so well before any contracts are signed and authorization to begin services is conveyed to third-party providers. To be effective, a governance model needs to address governance at strategic, program and operational levels. One of the best ways to translate a governance model into performance is to create a strategic steering committee and establish centralized outsourcing governance offices, or “centres of excellence.”

Implications p. 14

To establish a more robust governance structure, start early in the planning process by defining a three-tiered governance model and by identifying all of the individuals whose participation is critical to the project’s success. These individuals should be chosen carefully and should include stakeholders in both the outsourcing organization and the vendor’s organization. Centres of excellence should be created at both the enterprise and operational levels.

Situation

The failure rate of outsourcing initiatives is high and risks continue to mount.

Despite its popularity, outsourcing can be an enormous challenge for many executives. Forrester Research estimates that failure rates for outsourcing initiatives range from 25% to as high as 50%.[1] In fact, in a recent survey conducted by PricewaterhouseCoopers and the Economist Intelligence Unit (EIU) and focusing on senior executives in financial services companies worldwide, only half the respondents pronounced themselves satisfied with offshoring's overall impact.[2] When asked to identify the leading reasons for their dissatisfaction, executives cited four factors: the misalignment of business and outsourcing objectives; poorly defined project scope and service requirements; inadequate training and knowledge transfer; and a high staff turnover rate.

Most senior executives are not blind to the risks of outsourcing, but they often think that these risks will be addressed during their due diligence review. Some recognize that critical risk factors change continuously, but they are often persuaded to approve outsourcing initiatives that lack an effective risk management process because they are under pressure to achieve the business benefits of outsourcing. Others simply don't know how to manage such complexity.

1 Forrester Research, "Adaptive Sourcing: Outsourcing New Paradigm" (January 2006).
2 PricewaterhouseCoopers and Economist Intelligence Unit, "Offshoring in the Financial Services Industry: Risks and Rewards" (2005).

Many executives struggle to determine how best to manage the broad portfolio of risks that can derail an outsourcing initiative including:

Political and country risk: As companies conduct an ever-increasing amount of international business, executives encounter political issues that can take even the most experienced business manager by surprise.[3] The July 2006 bombing of commuter trains in Mumbai, India, is just one example of a country-specific event that raises complex questions about how risks to personnel and business continuity in politically sensitive offshore locations should best be measured, assessed against other location-specific issues, and mitigated if possible.

Contractual risk: Many outsourcing contracts aren't specific or flexible enough to accommodate changes in the business environment, or can't be cost-effectively enforced in a foreign jurisdiction. Some components of this risk can be addressed in advance by ensuring that outsourcing contracts are informed by the successes and failures of other companies seeking similar results from an outsourcing strategy. But just as often, the opposite is true; executives can be tempted to view a well-drafted contract as a proxy for effective risk management.

Operational risk: Operational or performance problems, such as sub-par or declining levels of service quality, unexpected cost overruns, or business interruptions, are common risk issues. These risks are much greater when companies and vendors do not share a clear understanding of required service levels or when performance monitoring and management is weak or inadequate. Unanticipated changes to taxation and transfer pricing regimes can undermine outsourcing performance as well. And escalating wages can offset anticipated cost benefits, especially in the most popular outsourcing markets. Other operational risks include difficulty retaining top employees in offshore markets and ensuring the security of client data or intellectual property.

Cultural risk: The risks associated with cultural differences between home and offshore environments are often overlooked until problems surface. These can include language problems, differing communication protocols and work-related standards, practices, and behaviors that may not be understood or effectively engaged by both the company and service provider. Differences in time zones can also introduce lags in addressing concerns before they become major issues or responding to windows of opportunity before they close or are leveraged more quickly by other companies.

These risks can be particularly difficult for executives to manage because many companies engage in outsourcing simultaneously along multiple channels, through a series of largely uncoordinated outsourcing initiatives specific to individual regions, business units, or functions. Such a fragmented approach often leads to the high costs and inefficiencies associated with duplicative management processes and can prevent management from gaining the benefits of an enterprise perspective on outsourcing — such as better negotiating leverage with vendors and the ability to make sure that an overall outsourcing strategy exists to align each outsourcing initiative with the company's business objectives. A fragmented approach to outsourcing also obscures service provider visibility into the company's goals. Without a clear understanding of the client's objectives, providers cannot demonstrate agility and flexibility in adapting to changes in the client's business environment, or contribute to the company's goals by suggesting new solutions or business models.

3 PricewaterhouseCoopers and Eurasia Group, "How Managing Political Risk Improves Global Business Performance" (2006).

When you take a broader look at these issues, it’s clear that at the heart of almost all of them is a fundamental lapse in managerial oversight and control — in effect, a failure in governance.

Our perspective

Outsourcing governance must extend across the enterprise and reach deeply into each initiative's day-to-day operations.

Making governance work is a challenge that eludes many companies. From an outsourcing perspective, we see companies struggling with this issue in almost all of the industries we serve. Many of our clients report chronic obstacles in trying to apply outsourcing governance objectives practically, efficiently, and continuously on a day-to-day basis, not just across their enterprise but also deeply within each of their outsourcing initiatives. They tend to encounter difficulty analyzing risks as well as in moving beyond assessing risks to managing them. They often find out too late in the outsourcing process that monitoring without a framework to implement controls and parameters that trigger action is merely an exercise in gathering information, not an effective approach to governance or risk management.

One of the best ways to gain control is to establish a formal governance structure — a model that enables the centralized management of risk, quality, and compliance over all of the company's outsourcing-related service, competency, or functional delivery groups (see pages 12-13). To deliver sufficient strength-in-depth, this model needs to address governance at three levels: strategy, program management, and operations.

Strategic governance

Companies need to align outsourcing engagements with business objectives, risk management imperatives, and critical resources while also ensuring that individual initiatives are on track as planned. These activities are typically exercised by a strategic steering committee (SSC) whose membership includes senior leaders and account managers from both the client and provider organizations.

The SSC carries out its duties in oversight and control primarily by establishing centralized governance offices, or centres of excellence (CoEs). Whether physical or virtual, these CoEs — one at the enterprise level and several at the program and operational levels — help the SSC address strategic tasks such as conducting aggregated cross-enterprise risk analysis, developing standardized service level agreements (SLAs), and managing vendor relationships at an enterprise level while engaging the various service delivery organizations at the program and operational levels.

Through these centres of excellence and other channels, the SSC builds healthy relationships between executives in the client and provider organizations by providing a structured forum for communication and decision-making while also conducting joint-company reviews to monitor the progress of initiatives, plan for their subsequent phases, and address any problems before they disrupt operations.

Program governance

To ensure the vision and objectives established by the SSC are met at a program level, companies need to establish a program governance organization which will undertake performance monitoring, coordination, and improvement initiatives. The program governance organization should include key managers representing the project management office; the company's governance, risk, and compliance function; the solution architecture team; and the business process engineering group, as well as the vendor's account management and program teams. This group creates the delivery organization and defines the processes and technologies needed to facilitate operations. It also identifies and addresses risks associated with the program and coordinates support from additional sources such as the company's HR, administration, and finance functions.

Operational governance

The company should form an operational governance organization comprised of project management teams from both the company and vendor. This organization should be formed and charged with 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. It conducts these tasks primarily through the operational centres of excellence (O-CoEs), which, depending on the client organization's circumstances, can be organized by function, region, or competency.

A practical, well-structured governance model

	Senior Management Team **Strategic steering committee**	Program Management Team **Program Governance**	Program Management Team **Operational team**
Company	Business sponsor Relationship management team	Project management office Relationship management teams Governance, risk, and compliance Solution architecture and process engineering	Project management office Project managers Quality assurance
Vendor	Delivery management team Account management team	Project management office Account management teams Delivery management team Solution architecture and process engineering support	Project management office Project managers Quality assurance and testing

Implications

Establish a comprehensive governance framework as early as possible in the planning process.

To realize the desired benefits from an outsourcing initiative, corporate sourcing executives, business process planners, and key internal users or stakeholders need to ensure that the initiative is guided and directed by a practical approach to governance. Here are some suggested steps to create an outsourcing governance model, including guidance on setting up a strategic steering committee, enterprise centre of excellence, and operational centres of excellence.

How to create an outsourcing governance model

Establish leadership and structure the mission

Identify an executive sponsor or sponsors as well as key members of the strategic governance and planning team. Define the charter, roles, and responsibilities of the strategic governance team.

Determine the initiative's scope and validate its objectives

Decide whether the outsourcing or offshoring initiative will be organized in terms of business units, functions, processes or services, or geographical regions. Then develop the business case and carry out an analysis of feasibility, risk, and cost to validate the scope and targeted benefits.

Assemble resources

Define the program governance and operational governance organizations and task these teams with developing a comprehensive outsourcing project plan. This plan should address each of the following key elements or processes of the governance model in detail, including defining roles and responsibilities: (a) establishing a strategic steering committee; (b) identifying governance, risk, and compliance practices; and (c) establishing a project management office.

Establish a strategic steering committee

Identify its members, including senior managers from both client and provider organizations. Charge the committee with the following responsibilities: (a) conducting periodic joint review to monitor key project milestones and overall performance in terms of alignment with the client organization's business and risk management objectives; (b) establishing physical or virtual CoEs; (c) enabling quick decision making to facilitate rapid issue resolution; and (d) planning for upcoming phases of the outsourcing engagement, for expansion, and for performance improvement. Also the SSC should be tasked with creating and sustaining healthy relationships both up and down the initiative's chain of command and back and forth across the lines of responsibility and accountability that align the client and vendor organizations behind a set of common objectives.

Identify governance, risk, and compliance practices

Identify and communicate key objectives, constraints, controls, risk areas, and resource requirements supporting the client organization's governance, risk management, and compliance practices. Include the key process areas and performance requirements to help guide the solution architecture and process engineering criteria, as well as the definition, monitoring, and management of service level agreements. These practice definitions should also cover how to implement mitigation strategies and conduct regular and ongoing testing for compliance. Be sure that the scope of these practices includes an effective approach to business continuity planning, disaster recovery, and information security planning and implementation.

Define risk tolerance thresholds

Specify the operating parameters and benchmarks that will identify when outsourcing-related activities and outputs have crossed risk tolerance thresholds. Identify escalation procedures and lines of accountability, as well as mechanisms to both provide incentives and enforce manager and vendor performance. Review and update these roles, responsibilities and procedures on a regular basis and ensure that training programs are in place and up to date.

Establish a project management office (PMO)

Identify and dedicate the resources necessary to support a formal PMO. Charge this office with monitoring all activity, including budgets and milestones, resource utilization levels, and both direct and accrued expenses. Also task this office with coordinating regular estimates and projections of business requirements as well as with periodic requests for approvals and authorizations and ongoing reporting and communication. The PMO should also collect metrics for SLA management and coordinate with support functions such as finance, HR, infrastructure, administration and legal.

Define the E-CoE mission

Make sure the scope of the E-CoE is truly enterprise-wide. Avoid the temptation to define the mission narrowly, perhaps for reasons related to issues such as timing and expediency, internal politics, or the challenges of establishing oversight over activities currently being conducted in many different areas of the company. Instead, insist on an E-CoE mission statement and scope of authority with appropriate vision and breadth.

Identify stakeholders and their interests

In addition to senior business unit and process managers within your organization, identify key personnel within the provider's organization as well. Also consider the needs and interests of critical third parties such as unions, regulators, or customers. At a minimum, E-CoE membership should include senior representatives from HR, IT, legal, government relations, enterprise operations, and all strategic business units.

Clarify critical tasks and activities

Typical E-CoE activities include coordinating enterprise-wide process improvement and outsourcing activities, such as assessing vendor selection criteria, compiling an approved vendor list, evaluating destination countries, developing SLA templates, developing request-for-proposal templates, writing communication plans, and performing cost modeling. Additional activities required to support outsourcing decisions include developing an outsourcing evaluation framework, a delivery model framework, and educational sourcing documentation.

Define outputs

The activities identified above should result in outputs such as a vendor candidate repository, a destination country repository, and a sourcing data repository, as well as business cases, delivery model frameworks, and sourcing tools and techniques.

How to build operational centres of excellence (O-CoEs)

Establish scope

Decide first whether the O-CoEs should be organized by process, services, function, business unit, or geographical sphere of operations. (For example, you may elect to define the O-CoEs as process-specific governance centres supporting sourcing opportunities designed to assist an individual business unit.) Then, set each O-CoE up with a clearly defined charter to champion its designated area of focus and assume responsibility for supporting initiatives approved for implementation by the E-CoE.

Define participation

Ensure that appropriate personnel are engaged. O-CoE membership should include strategic steering committee members and specific owners of the process, function, business unit, or geographic area, as appropriate. This will help the strategic steering committee facilitate communication between the business units and the service delivery groups.

Determine critical tasks and activities

Using the tools, templates, and frameworks established by the E-CoE, each O-CoE should be equipped to conduct activities such as implementing E-CoE-authorized projects; conducting service level monitoring; carrying out issue-resolution measures; customizing communication plans; and developing processes to support quality management, change management, and benefits measurement.

Define outputs

Set parameters for expected outcomes, including process-level reviews, efficiency levels, communication effectiveness, and timely issue resolution.

Making outsourcing governance work

Any company seeking the benefits of outsourcing, offshoring, or shared services assumes a complex set of risks — not just to the initiative itself but also to the organization's broader operations and objectives. As the scope and significance of these risks rise, a formal governance framework can make the difference between the initiative's success and failure. But what makes such a framework or model so effective isn't simply that it puts an outsourcing governance capability in place. Instead, it's that such a framework bridges the gap between assessing risks and managing them. This is the crucial linkage that makes governance and outsourcing initiatives succeed.

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