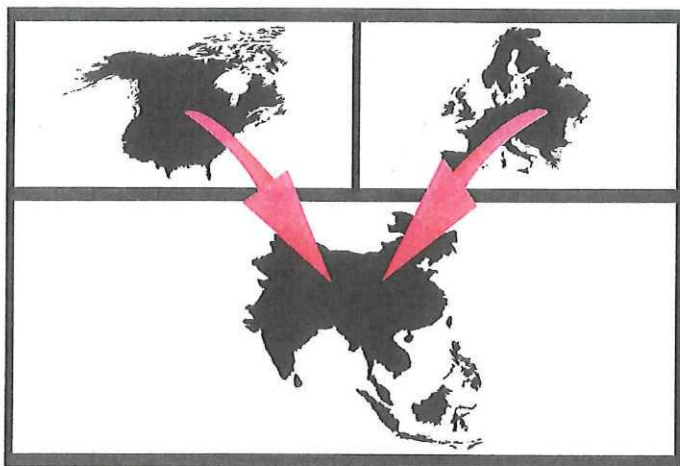


BY MUAZZIN MEHRBAN



Outsourcing is expected to continue rising as companies attempt to restructure operation and reduce costs. But successful outsourcing depends on an exhaustive process, and it is vital that companies undertake vigorous due diligence of any potential service providers before entering into a binding agreement. This need has been accentuated by scandals such as the one involving Satyam in India – a popular outsourcing destination – which means that the industry now needs to restore confidence in the market.

Despite the drop in confidence, the opportunity to reduce costs by outsourcing operations remains attractive to many companies, especially those in the retail, IT and financial services sectors. Companies view outsourcing not only as a way of reducing costs, but also as an important part of their long term growth. Clearly, there are numerous advantages to a strategy involving outsourcing. “The ability to obtain access to new technologies and methodologies without large up-front capital expenditures also continues to be a key driver,” notes Jason Haislmaier, a partner and co-chair of the IP, Technology & Media Group at Holme Roberts Owen LLP. “As the current economic climate continues to provide companies with additional financial leverage over providers, the increased ability to actually lock in broader business benefits at these reduced costs will almost certainly play a role as well.”

Indeed, cost is not the only consideration for a well-run business. Gaining a business advantage through discovering new innovations will remain a key driver for outsourcing, especially while the global crisis prevails.

A realistic approach

However, in order to successfully shift key business functions overseas, companies must fully understand their current objectives. An organisation must identify the individual performance standards that it hopes to maintain in outsourcing, as well as the corresponding risks. According to Dan Burge, a Partner and Head of Outsourcing at Denton Wilde Sapte LLP, there is no ‘one size fits all’ solution. “But there are common characteristics to an effective outsourcing strategy,” he points out. “Perhaps most importantly, there has to be a clear commercial vision which has been carefully modelled and championed at a senior executive level. Allied to this should be the creation of appropriate internal governance structures – with executive sponsors to ensure that issues can be swiftly identified and escalated and that there is a ‘root and branch’ fostering of the commercial vision throughout the relevant functions.” Ultimately, balance is the key to successful outsourcing. A company must remember to retain sufficient resources to oversee the relationship with the new provider while reducing their internal infrastructure elsewhere.

Unfortunately, this does not often occur, and it is clear that the majority of companies need to refine their approach to outsourcing. Andras Kohli Gurovits, a Partner at Niederer Kraft & Frey, believes companies should have parameters in place to measure the success of outsourcing companies. “Organisations should specify realistic strategic goals as well as realistic, specific benchmarks and short-term objectives against which the outsourcing provider shall be measured,” he says. This will allow companies to both correct mistakes and enhance positive practices. “The outsourcing customer has to ensure that it retains the ability or right to define the technologies, and the right to implement required or desirable changes over time,” adds Mr Gurovits. Also, an efficient strategy should include an efficient measurement of service qualities as well as an effective termination plan, allowing for a smooth transition back to the provider once the outsourcing process has finished.

In terms of selecting an outsourcer, companies should scrutinise potential targets individually to establish the best fit. Long term considerations, such as cultural fit, are as crucial as short term aims such as expertise and track record. “Key factors to investigate are a sound financial basis of the outsourcing provider, a sound track record demonstrating expertise and know-how of the outsourcing provider in the relevant areas, references from other customers in the same industries, interviews with and background checks of the designated key personnel of the provider that shall be allocated to the project, as well as thorough internal due diligence of the organisational function to be outsourced,” recommends Mr Gurovits.

The need for thorough due diligence has heightened recently, with companies keen to minimise risk levels across their operations. But Mr Burge warns there is a limit to how accurate and up-to-date records can be. “We are therefore increasingly seeing organisations supplement traditional methods of financial due diligence by adding mechanisms to outsourcing structures, which seek to mitigate counterparty solvency risk going forward. At the project level, it is prudent to undertake due diligence to understand how the supplier will be able to make a reasonable profit while still ▶▶

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delivering the services to the required quality and timescales," he says. This will provide a good indication of whether the supplier will be able to sustain the outsourced operations. If the supplier is unable to make a profitable return, it is likely that the quality of the service or the product will diminish as a result. To supplement this, client companies are advised to perform continuous diligence throughout the contract.

Experts have also agreed that businesses often underestimate the importance of risk management when outsourcing, despite the threat of disruption to services. To this end, Mr Haislmaier advises companies to take a multi-layered approach when structuring outsourcing contracts, so they can compensate for risk across multiple circumstances. "Contracts that rely only on the ability to terminate in the case of a service level failure or other breach are usually insufficient to avoid the disruption of service that can often accompany the breach. Contracts should enable a company to identify early indications that a breach may be likely to occur and provide them with the ability to take action before the breach actually occurs and disrupts service," he explains. Fluctuating credit ratings, changes in service levels and early security breaches are all examples of indicators that can serve as a warning. When faced with such issues, a contract should be flexible enough to allow a company to respond quickly. Responses could involve detailed reporting on performance or even inspection rights. If the situation gets worse, clients should have the right to suspend exclusivity and payments or even terminate the outsourcing relationship.

Contractual, legal and regulatory issues

Although issues such as incorrect procedures and missing deadlines can arise from poor internal operations at the outsourcer, the lack of governance and direct control from the parent when outsourcing can make it difficult to address these issues. "Additionally, there are 'novel' risks which outsourcing can introduce to a particular function," adds Mr Burge. "For example, outsourcing may give rise to regulatory risks, if a regulator has a special regime for outsourcing or if the outsourcer will undertake activities offshore. Equally, the involvement of a third party may introduce competition or confidentiality concerns," he says. Again, a well drafted contract can help to address and lessen the risk attached to such concerns.

This will require numerous documents, as well as complex liability, relief and governance provisions, to ensure the customer is covered in the event of outsourcing failure. "The outsourcing agreement should typically consist of a main contract body that sets out the basic legal terms and conditions," explains Mr Gurovits. "The main body should be supplemented by exhibits defining details of operational and technical topics – applicable to the full scope of the outsourcing project – that may change over time, as well as specific service agreements providing the relevant terms for the various services to be provided," he adds. Furthermore, depending on the location of the outsourcer, the contract framework should contain country-specific terms and conditions regarding its assets and employees.

In addition, Mr Haislmaier advises that the responsibilities and payment obligations of the outsourcer under the outsourcing contract should be well defined. "This includes defining detailed specifications for key services and establishing clear and measurable performance levels for those services – all with the aim of ensuring that the provider is obligated to perform the services as intended by the company and the company is obligated to pay only for those services it actually uses," he says. Ultimately, the contract should cover the key commercial aspects of the deal, ensuring the outsourcing customer will have its requirements fulfilled without incurring additional costs or paying for services it does not require.

There is also the issue of the legal framework, which should consider bargaining positions, commercial objectives, insurance programmes and the nature of the outsourced function. A solid legal framework is vital to the outsourcing process, but its presence does not guarantee success. Indeed, experts have highlighted a major problem with the lack of continuity after a deal is signed. According to Mr Burge, this can often impair the effective-

ness of the process from the outset. "Typically, advisers and key business personnel will move onto fresh projects after a deal is signed. As a consequence from 'day one', there can be a profound lack of understanding from both parties about what each is supposed to do and what rights each has," he says. To counter this, organisations are taking it upon themselves to make sure contractual agreements are implemented at operational level. This includes producing and distributing employee manuals, as well as holding post-deal meetings with staff. In addition, change management is key and should not be overlooked. Without a change management team, a company could lose out on commercial benefits because the conduct of its outsourcer does not align with the conduct agreed in the contract.

Effectively managing an outsourcing relationship requires both parties to be able to react to changes in both their own businesses and the wider economy. "This includes the ability to adjust the scope of services to address changes in the company's business or markets. It also includes the ability to respond to broader changes in technology, legal and regulatory issues, service performance benchmarks, and pricing structures," explains Mr Haislmaier. It is also vital is that either party is able to deal with both expected and unexpected changes without disrupting its operations. To ensure this is possible, particularly given the fluctuating state of the economy, Mr Haislmaier advises companies to consider creating an option to trigger a periodic renegotiation of the agreement, enabling them to adjust the scope of the contract as changes in their business may require them to do so.

Finally, companies with outsourced operations should have an efficient dispute resolution procedure, minimising the threat to operations. "Dispute resolution measures may include establishing various escalation steps that allow for dispute resolution on various corporate levels, and appointment of external experts that shall solve the issue or at least propose possible solutions following quick and efficient procedures, should the parties fail to solve the issue between themselves," explains Mr Gurovits. Without such measures in place, the fallout could be significant for both the outsourcer and the company itself.

Provided that a company can minimise the associated exposures, outsourcing can prove to be a highly effective way of reducing costs and opening up to overseas innovation. However, a poorly governed outsourcing process can give birth to a mismatch in expectations between suppliers and customers, which could prove detrimental for the operations outsourced. To this end, due diligence, combined with a well-drafted contract and continuous oversight are essential. ■