

EMPLOYING BUSINESS IMPROVEMENT
TECHNIQUES TO IMPROVE
PERFORMANCE AND REDUCE RISK
IN SERVICES OUTSOURCING

Ronan McIvor



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EMPLOYING BUSINESS IMPROVEMENT TECHNIQUES TO IMPROVE PERFORMANCE AND REDUCE RISK IN SERVICES OUTSOURCING

by
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FOREWORD

Services outsourcing has become a common feature in the global economy. However, whilst outsourcing offers the potential to reduce costs and improve performance it is not without risk. This research project develops a practical framework in which business improvement techniques can be employed to improve performance and reduce risk in various stages of services outsourcing.

The project involved an initial review of existing literature on services outsourcing and this has been published separately on the ICAS website under the title “What do we know about services outsourcing?”. This identified a lack of a structured framework for integrating business improvement techniques into the outsourcing process. In-depth case study research was then conducted with four very different organisations that had been applying business improvement techniques at various phases of the outsourcing process.

As a result of this analysis a practical framework was developed by the author and is presented in this report, together with illustrations from the case study organisations. Both the benefits and challenges of applying business improvement techniques are also discussed and potential strategies for overcoming those challenges are suggested. The report concludes with a number of considerations for those involved in or currently considering services outsourcing.

This project was funded by the Scottish Accountancy Trust for Education and Research (SATER - see page 41). The Research Committee of The Institute of Chartered Accountants of Scotland (ICAS) has also been happy to support this project. The Committee recognises that the views expressed do not necessarily represent those of ICAS itself, but hopes that the framework will provide a practical aid to those considering or already using services outsourcing.

Allister Wilson
Convener of ICAS Research Committee
March 2013

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Finally, the Research Committee and the researcher are grateful for the financial support of the Scottish Accountancy Trust for Education and Research, without which the research would not have been possible.

EXECUTIVE SUMMARY

This research project involved developing a framework which employs business improvement techniques to improve performance and reduce risk in services outsourcing. The framework was developed from carrying out in-depth analysis of a number of organisations that have been employing business improvement techniques in the outsourcing process. The framework provides a structured approach for organisations integrating business improvement techniques into the outsourcing process. The framework is illustrated in Figure 1 on page 7. Case illustrations are also presented which provide insights into the implications of applying business improvement techniques in outsourcing practice.

The report highlights how business improvement techniques can improve performance through delivering cost savings; increasing service quality; and eliminating inefficient processes. It is also shown how business improvement techniques can reduce risk through deriving clearer requirements for vendors; developing effective performance measures for contracting purposes; retaining important knowledge; and understanding the causes of poor performance prior to outsourcing. However, the report also highlights the challenges of applying business improvement techniques in outsourcing including: comparison difficulties across organisations in the areas of cost analysis and benchmarking; resistance to standardisation; lack of internal skills; and enhancing the strategic role of the retained function.

The report presents a number of important considerations for those involved in or considering outsourcing:

- **Business improvement techniques can be employed to understand internal performance prior to outsourcing.** Such analysis is important in the case of processes that are critical to competitive advantage, as outsourcing can lead to a loss of skills in strategically important areas. Moreover, business improvement techniques can be employed to reduce process complexity and process inefficiencies prior to outsourcing.
- **It is essential to standardise as many processes as possible to achieve the benefits of outsourcing.** Incorporating too many exceptions to standards, and making frequent changes to requirements in the outsourcing process is likely to create complexity for the vendor and limit the potential for performance improvement.
- **Organisations have a number of sourcing options to improve performance and reduce risk in outsourcing.** These sourcing options include: improve performance and retain the process internally; improve performance internally prior to outsourcing; and outsource and allow the vendor to improve performance.
- **Business improvement techniques are important for determining requirements from outsourcing.** This involves considering issues, such as: the level of process improvement required; the level of specific client requirements; and the type of outsourcing relationship required. Understanding and documenting processes will help in communicating requirements and allow the vendor to meet the required performance levels more quickly.
- **A change management strategy is important for winning the support of people impacted by business improvement techniques.** Building relationships through involvement in decision making and communication will help create greater ownership of new processes and obtain buy-in from staff.
- **Relational and formal contracting should be employed as complements when applying business improvement techniques.** Strong inter-personal relationships between the client and vendor are important for resolving difficulties and creating flexibility in outsourcing. In addition, a formal contract is essential for dealing with issues that cannot be resolved via relational mechanisms alone.
- **A broad set of skills and management capabilities is required to apply business improvement techniques.** As well as requiring skills in contracting and vendor relationship management, the client requires skills in business improvement tools. External expertise should be sought to address any skills deficiencies.

In addition to the illustrations provided within this report, further detailed illustrations from the case studies organisations are published separately on the ICAS website at: www.icas.org.uk/mcivor.

The literature review, undertaken in the preliminary stage of this project, entitled *What do we know about services outsourcing?*, is available online at: www.icas.org.uk/mcivor.

1. BACKGROUND

Services outsourcing has grown as organisations have been transferring responsibility for entire functions, such as human resources, finance, customer contact and information technology (IT) services, to external vendors. Organisations are looking to specialist vendors to reduce costs and achieve performance improvements. However, the potential for performance improvement has to be considered along with the potential risks from employing external vendors. Organisations have to consider risk factors, such as the level of specific investments with the vendor, performance measurement difficulties and the inclusion of contractual safeguards to allow for uncertainty and changes in requirements. Increasingly, organisations have been employing business improvement techniques to transform performance and at the same time reduce risk in services outsourcing arrangements.

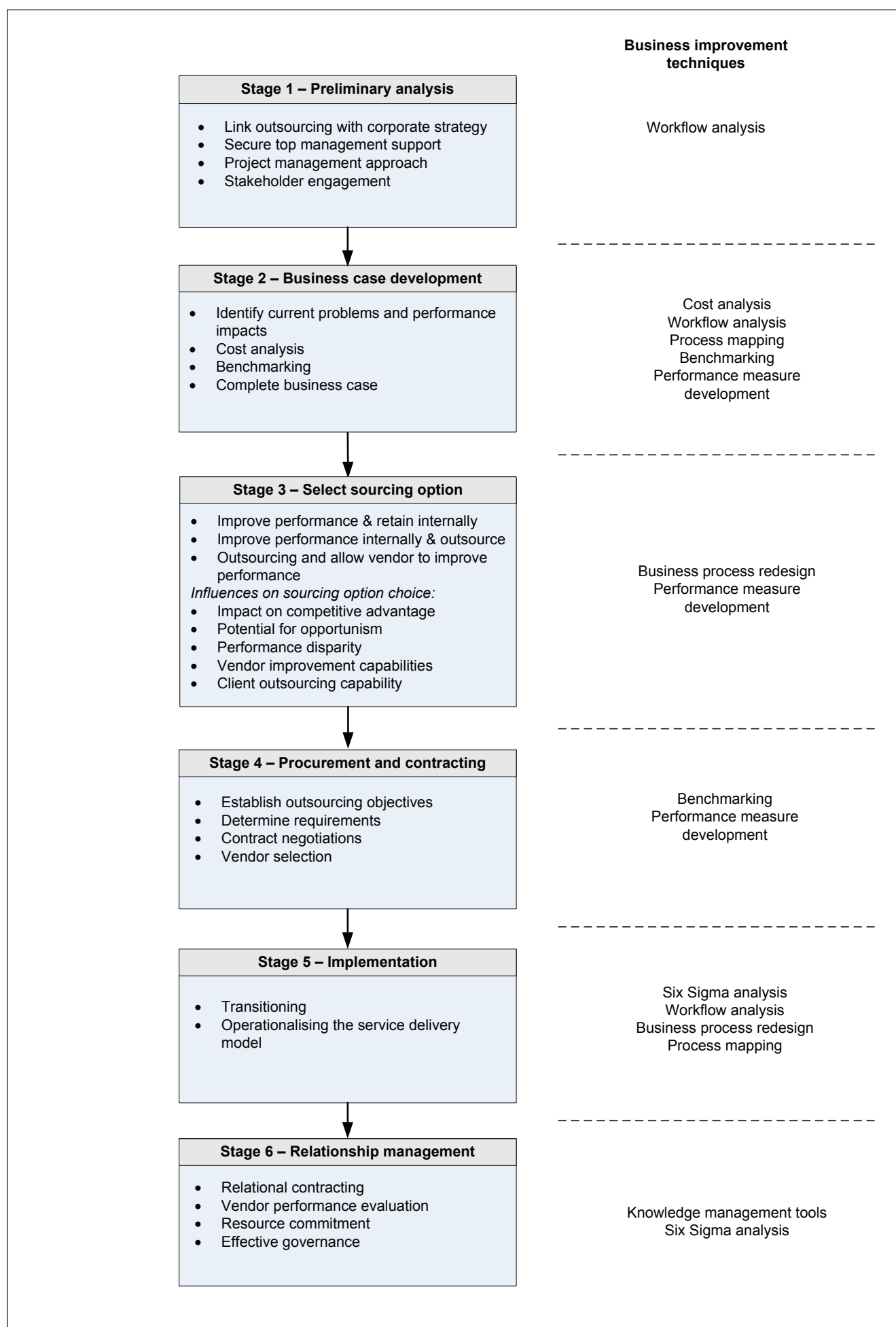
This research has developed a practical framework for understanding how business improvement techniques can be employed to improve performance and reduce risk in services outsourcing arrangements. This framework can be used by practitioners who are currently involved in or considering outsourcing. The framework was developed from carrying out research with four organisations which had been working closely with vendors in applying business improvement techniques in outsourcing arrangements. Appendix 2 provides further information on how the research was carried out. The research focused on the following organisations and outsourcing processes:

- Public sector organisation – large scale human resource outsourced shared services arrangement.
- Financial services organisation (FSO) – the evaluation of outsourcing of mortgage processing.
- Software company – the outsourcing of revenue processing for its Europe, Middle East and Asia territories.
- Management consultancy organisation – the outsourcing of facilities management services.

Appendix 3 provides a more detailed background to the case organisations and the outsourcing processes analysed.

Analysis of these outsourcing processes, along with a review of the literature¹, was used to develop the framework that integrates business improvement techniques into the outsourcing process. This framework is shown in Figure 1 and demonstrates how business improvement techniques can be employed at various stages in the outsourcing process to improve performance and reduce risk.

Figure 1 A framework for employing business improvement techniques in services outsourcing



2. A FRAMEWORK FOR EMPLOYING BUSINESS IMPROVEMENT TECHNIQUES IN SERVICES OUTSOURCING

This section presents in detail the stages involved in the framework as shown in Figure 1. Case illustrations from the organisations that participated in the research are introduced to illustrate the outsourcing framework in practice². In particular, the illustrations highlight the benefits and challenges of applying business improvement techniques in outsourcing practice.

Stage 1 – Preliminary analysis

Prior to fully committing to outsourcing there is often preliminary analysis where an organisation begins to consider the most appropriate sourcing option for improving performance. This preliminary analysis will have a number of important elements:

- **Link outsourcing with corporate strategy** – the need to consider outsourcing can often arise for a number of reasons. These include corporate restructurings, poor performance in a business area or enhanced capabilities of vendors. Where outsourcing is being considered it should support the corporate objectives of the organisation.
- **Secure top management support** – top management support is necessary for analysing whether outsourcing is appropriate and winning support for the most appropriate sourcing option. Senior management should ensure that the functions and employees cooperate and provide the necessary information to ensure that an effective outsourcing decision is made.
- **Project management approach** – a project management approach should be applied to the outsourcing process, which will involve a number of elements (Meredith and Mantel, 2006; Levene, 2005). A team should be formed with representation from each functional area likely to be affected by outsourcing. The team should also include additional expertise in areas such as business improvement, change management, procurement and contracting. The team leader should be regarded as a champion of the outsourcing decision and would normally be a senior person from the function most directly impacted by outsourcing.
- **Stakeholder engagement** – stakeholders are individuals, or groups of individuals, who are either directly or indirectly involved in the project, and have a vested interest in its successful or unsuccessful conclusion. The project team should consult and communicate with stakeholders impacted by outsourcing throughout the project.

Stage 2 – Business case development

A fundamental building block of the outsourcing decision is the development of a business case. The risks and complexity of outsourcing means the business case should contain a logical and convincing justification for proceeding with outsourcing. A key aspect of business case development for the outsourcing decision involves determining whether an organisation can achieve superior performance levels internally in business processes on an on-going basis. Many organisations assume that because they have always performed the process internally, then it should remain that way. In many cases, closer analysis may reveal a significant performance disparity between their internal capabilities and those of vendors and competitors. Organisations considering outsourcing must rigorously evaluate their capabilities in relation to both their vendors and competitors. This analysis can assist in revealing weaknesses that need to be addressed – either through internal improvement or outsourcing – to become more competitive. The following sections outline a number of important elements of business case development for the outsourcing decision along with how business improvement techniques can be applied.

Identify current problems and performance impacts

An in-depth analysis of the current problems with the process and associated impacts on performance should be carried out. This will involve analysing documentation, interviewing staff in the affected functions and attempting to understand the causes of poor performance. Many organisations mistakenly rush into outsourcing without attempting to understand the underlying causes of poor performance. This creates significant difficulties when organisations outsource such processes. Organisations assume that external vendors can provide processes at a higher performance level than internal functions. Often, vendors cannot meet client performance expectations as a result of problems that were present in the process when it was performed internally. Prior to outsourcing, organisations should have an understanding of the key measures that indicate performance in a process relative to vendors or competitors (Aron and Singh, 2005).

Cost analysis

Cost analysis involves assessing the relative cost position of the client in relation to both vendors and competitors in a process. The major cost drivers associated with a process should be identified. For example, cost drivers associated with customer service

processes include labour rates, location of facilities, number of customers served, sales per customer and service levels offered. Cost drivers differ across organisational processes. For capital-intensive processes the major cost drivers are likely to be the cost of equipment, whilst for highly labour-intensive processes, the major driver of costs is labour rates. At a general level, there are a number of drivers of costs that impact upon the relative cost position of an organisation relative to vendors and competitors including factor costs, economies of scale and experience (McIvor, 2005). Illustration 1 outlines how the FSO analysed costs in mortgage processing for outsourcing purposes.

Illustration 1 - Cost analysis at the financial services organisation

The financial services organisation (FSO) undertook cost analysis of mortgages processing both internally and with one of its European sister operations. An example of how costs were analysed is shown in Table 1.

Table 1 Mortgage processing cost analysis

	Sold at branch	Sold outside branch network	Totals per annum	Sister organisation
Direct costs (£'000)				
Staff (total)	3,464	1,782	5,246	5,469
Marketing	231	118	349	
Procurement & Legal Fees	558	288	846	
Other	n/a	n/a	n/a	
Total costs	4,253	2,188	6,441	5,928
Income (net) (£'000)				(not available)
Mortgage	10,303	2,975	13,278	
Insurance	249	0	249	
Total income	10,552	2,975	13,527	
Surplus of income over expenditure	6,299	787	7,086	
Number of products sold	7,896	3,882	11,778	31,500
Average revenue per product sold (£)	1,330	766	1,150	n/a
Average cost per product sold (£)	540	566	550	188
Average margin per product sold (£)	790	200	600	n/a
Number of staff	51	25	76	n/a
Mortgages processed per staff member per annum			155	175
Turnaround time			14 days	7 days

Notes

1. The figures have been altered in the interests of confidentiality and the sister organisation's figures have been converted from Euro to Sterling.
2. Staff costs include the salaries of staff at branches and at Head Office, plus any overtime payments. Overtime is counted as a direct cost as it is a necessity.
3. Procurement and legal fees are deemed to be a central cost. For convenience, they have been allocated in Table 1 on a proportional basis, i.e. products sold.
4. The breakdown of costs, such as marketing and procurement and legal fees, were not available for the sister organisation. However it had another category, 'other', which might include these costs.

Illustration 1 - Cost analysis at the financial services organisation (Cont.)

Table 1 shows that on average it was costing the FSO £550 to process a mortgage application. When the FSO compared the average cost (£550) of processing a mortgage application with one of its European sister organisations, it found that the average cost per product sold was far smaller at £188. The sister operation benefited from economies of scale through processing a greater number of mortgages and was more heavily automated. In addition, the operating costs of the FSO were excessively high which was having a detrimental impact on its profit margins. The lower half of Table 1 provides details of the productivity and efficiency of the two different sets of staff. There was considerable difference between the speed of processing mortgages, with the sister organisation being significantly faster (7 days as opposed to 14 days) due to its automated processes. However, despite the automation employed by the sister organisation each member of staff only processed 20 more mortgages per annum (a difference of 13%).

However, a number of limitations were found with this analysis. The information provided for both the FSO and the sister organisation and also for the FSO's internal and external operations (i.e. outside the branch network) were not always directly comparable. The FSO did not use well-known methods to analyse costs when providing the financial figures and it was difficult to get a complete picture of costs. For example, marketing was classed as a direct cost, yet most organisations would class it as an indirect cost or overhead. Furthermore, there were a number of gaps in the information. The legal and procurement costs for the financial services organisation were not broken down and were allocated between sold at branch/sold outside branch on a pro rata basis, which may not have been totally accurate. No revenue costs were provided for the sister organisation and it was not possible to calculate average revenue per product sold or average margin per product sold.

Benchmarking

An important element of understanding performance in outsourcing involves benchmarking relative performance along a number of dimensions including quality, flexibility and service. Analysis along these additional dimensions is important given the experiences of organisations that have embarked upon outsourcing primarily on the basis of costs. Initial analysis may reveal that a vendor possesses a lower cost position, whilst at the same time being weaker in areas, such as quality and service. Benchmarking is a valuable approach for assessing an organisation's performance relative to potential vendors and competitors. There are a number of the critical aspects involved in benchmarking for outsourcing purposes.

- ***Select benchmarking approach***

This involves deciding who should undertake the benchmarking exercise. An organisation can either use internal staff alone or involve external consultants to assist with the benchmarking exercise. A team should be formed to carry out the benchmarking of the processes under scrutiny. This team should be composed of both personnel involved in the outsourcing decision, such as senior management, as well as representatives from the function under scrutiny.

- ***Analyse the process***

From an outsourcing perspective, it is important to analyse the process under scrutiny to understand the process, complexities, performance problems and process inter-dependencies (Van der Vegt *et al.*, 1998). Process analysis assists with providing a benchmark against which improvement can be measured. The level of analysis will depend upon the impact of the process on competitive advantage. In the case of a process deemed to be of critical importance, it is necessary to conduct extensive analysis to determine the sourcing options in terms of either internal improvement or outsourcing to an external vendor. This more extensive analysis will involve carrying out a number of tasks including identifying the people and their roles in the process; determining the role of vendors in the process; and mapping and documenting the process by interviewing relevant people involved in the process and analysing organisational documents and reports. Process maps can be used to compare performance across organisations to identify areas for improvement. As a result of mapping the process a key outcome is the identification of performance metrics. This is necessary since before comparing performance with external vendors, a clear understanding of internal performance is required.

- ***Identify potential partners***

Once processes have been analysed and understood, suitable benchmark partners should be found. Based on the mapped processes and the metrics developed, the development of a partner profile can assist in identifying companies carrying out similar processes. In the context of outsourcing, the most competent vendor of the process is likely to be a valuable benchmarking partner. Information from vendors can be much more readily obtained than from competitors, who are likely to have a natural reluctance to share commercially sensitive information.

- **Collect and analyse data**

Effective benchmarking involves ensuring that the right information is collected and then analysed. The first phase involves designing a questionnaire based on the partner profile. The benchmarking questionnaire should be based on a clear, formal agreement and understanding about what data and information is to be collected and shared. Rules need to be agreed with the partners in relation to the level of access to and use of confidential information. As well as a questionnaire, internal reports, site visits and interviews can be carried out with key staff within the partner organisation. Illustration 2 outlines how the FSO conducted benchmarking for outsourcing purposes in the case of mortgage processing.

Illustration 2 – Benchmarking and outsourcing at the financial services organisation

The first step in benchmarking involved an analysis of the internal mortgage processing unit. A process mapping exercise was undertaken, which involved interviewing staff, observing work practices, developing workflow charts and identifying potential performance measures for benchmarking purposes. The financial services organisation (FSO) identified a number of companies to benchmark including one of its sister operations and a specialist mortgage vendor. A three-tiered benchmarking process was adopted, which identified benchmarks at the strategic, operational process and sub-process levels as illustrated in Figure 2. It can be seen from strategic level indicators in Figure 2 that the most critical strategic indicator was related to the speed of mortgage application processing. This strategic indicator was further analysed at the operational process and sub-process levels to illustrate how the benchmarking exercise was carried out.

Step 1 - Strategic level indicators

The strategic level indicators were broadly based on critical success factors (CSFs) identified by the FSO from its corporate strategy. These CSFs included factors such as lower processing transaction costs, improving customer added value and understanding better customer needs. For purposes of evaluation at this stage, the performance of both the sister organisation and external vendor were subjectively quantified using a 1-10 scale, with each unit on the scale equating to 10 percentage points. For example, where one of the entities processed mortgage applications twice as quickly as the FSO, the score would be -10, as it was 100% slower than the benchmarked organisation.

Step 2 - Operational process level

At the operational process level the strategic factor of processing mortgage applications quickly was broken down into five process measures. The sister organisation and external vendor were quicker in all areas that were measured. This is shown in Step 2 in Figure 2. For example, they were 25% and 27% quicker, respectively, when it came to sanctioning applications.

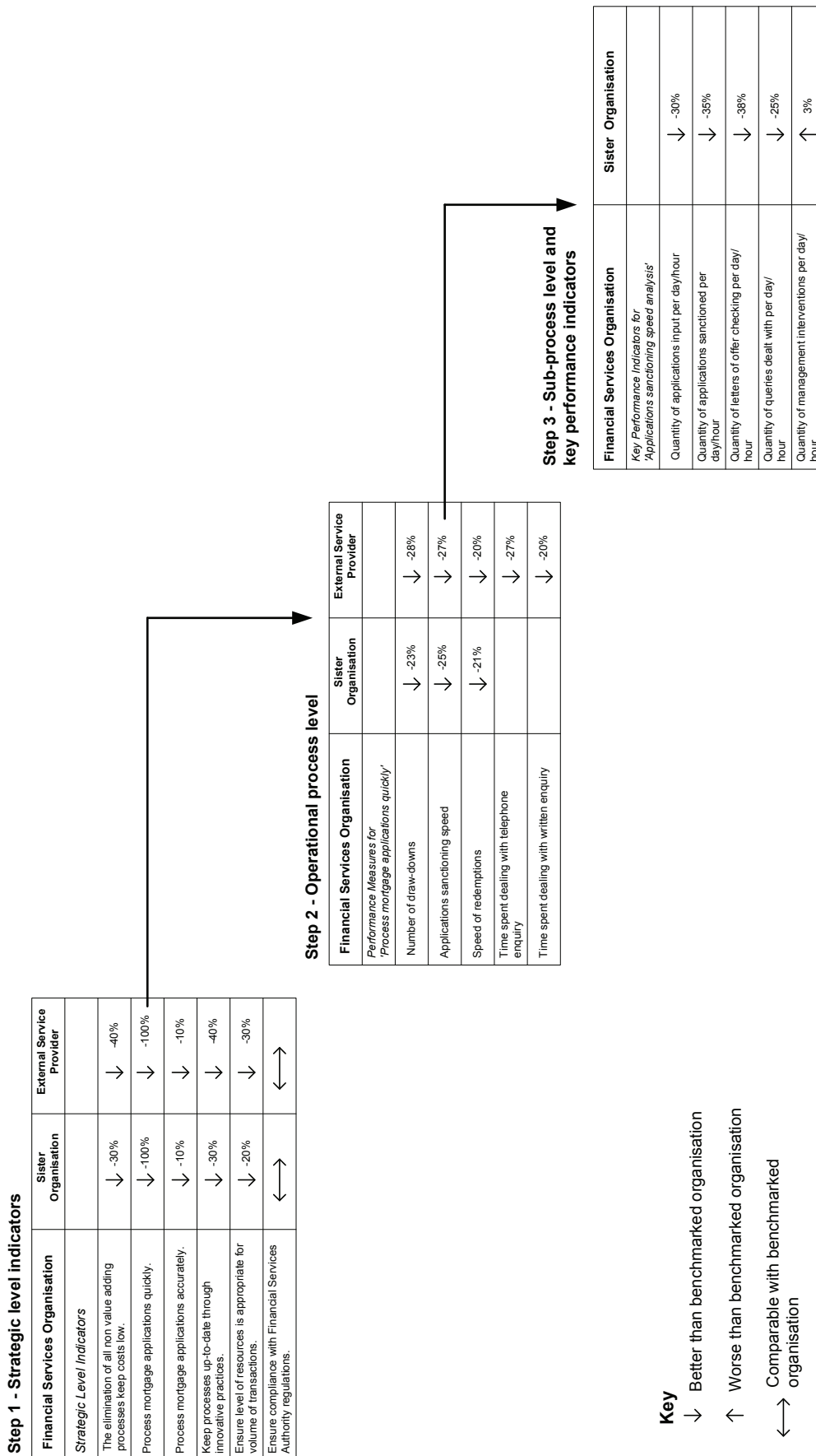
Step 3 - The sub-process level and key performance indicators (KPIs)

The next stage compared the FSO with KPIs at the sub-process level. The measures identified in Step 3 in Figure 2 relate only to the performance measure 'application sanctioning speed' since this was highlighted in Step 2 as the poorest overall performer. It should also be noted that the external vendor would not divulge information on metrics at this level of detail and only those for the sister organisation are indicated. Apart from one area, quantity of management interventions per day/hour, the sister organisation outperformed the FSO, being over a third quicker in two areas.

The FSO used this analysis to further understand performance weaknesses and how they should be addressed. In the case of its sister operations, it found that the operational performance levels were better and they also invested more resource in information technology. In relation to the specialist mortgages vendor, it found that it invested a considerable amount of resource in information technology and had considerable experience in offering mortgage processing services to other leading UK FSOs. Their systems were capable of dealing with customised mortgage profiles, with a range of different rest periods, interest profiles, repayment plans, early settlement and flexible features. Senior management also found that the vendor had clearly defined processes and provided detailed performance measures that it was using with its major clients.

Illustration 2 – Benchmarking and outsourcing at the financial services organisation (Cont.)

Figure 2 Benchmarking at the strategic, operational and sub-process levels



Stage 3 – Select sourcing option

The analysis from the previous stages will have revealed valuable insights into how performance can be improved in the process and highlight a number of sourcing options with associated benefits and risks. Rather than having to outsource a process it may be possible to improve performance and retain the process internally. This option offers a number of benefits in the form of control of the process internally, attaining all the benefits of the improvement initiative and avoiding the risks of dealing with an external vendor. However, potential risks of retaining the process internally include failure to achieve the required performance improvement due to a lack of internal resource and skills and failing to leverage the specialist capabilities of vendors. Where it has been decided to outsource the client has the options of either improving performance in the process internally prior to outsourcing or transferring the process to the vendor and allowing the vendor to improve performance during the outsourcing contract.

Improving performance internally prior to outsourcing offers the client a number of benefits including retaining internal knowledge of process improvements, deriving clearer requirements and performance measures for the vendor and therefore reducing the level of dependence on the vendor in the outsourcing contract. However, the client may lack the necessary resource and business improvement capabilities to improve performance internally and therefore has to rely on the vendor for performance improvement. Outsourcing and allowing the vendor to improve performance during the contract means the client benefits from reallocating scarce internal resource and accessing the specialist business improvement capabilities of vendors to improve process performance. In some cases, vendors can deliver significant performance improvements. However, this option leads to a greater dependence on the vendor, loss of important knowledge of the process and the need for significant experience and skills to manage the contract and relationship to ensure performance improvements are delivered.

There are a number of dimensions that influence the choice of each sourcing option and benefits associated with each sourcing option as shown in Table 2.

Stage 4 – Procurement and contracting

A key aspect of this stage involves determining clearly what is required from outsourcing. This involves establishing clear objectives in areas such as service quality and cost, as well as determining detailed requirements at the process level. This serves as an important starting point for entering into negotiations with potential vendors and communicating clearly client requirements to vendors. The final vendor selection decision will be made on the basis of the vendor's ability to meet these requirements and allow the client to achieve the overall outsourcing objectives. The issues are outlined below.

Establish outsourcing objectives

The absence of clear objectives can create difficulties in managing the outsourcing process in a number of areas including vendor selection, selecting the most appropriate outsourcing relationship, drawing up the contract and managing performance in the outsourcing relationship. Typical outsourcing objectives include reducing costs, enhancing service quality and obtaining higher levels of service in the provision of the process. The objectives established will reflect the underlying motives for the organisation considering outsourcing. In many cases, organisations outsource with the objective of obtaining higher quality service at a lower cost from external vendors. In this case, the key objectives will provide valuable direction for managing the outsourcing process.

Table 2 Suggested ideal conditions for each sourcing option

Dimensions that influence sourcing option choice	Improve performance and retain internally	Improve performance internally prior to outsourcing	Outsource and allow vendor to improve performance
Impact on competitive advantage	Process has a significant impact on competitive advantage.	Process is important to competitive advantage.	Process has limited impact on competitive advantage.
Potential for opportunism ³	High potential for opportunism from outsourcing.	Possible to reduce opportunism by improving performance and re-designing the process. The improvement effort will create a better understanding of the process and allow the client to better specify requirements to the vendor prior to outsourcing.	Possible to manage the potential for opportunism by adopting an appropriate relationship strategy, such as relational contracting.
Performance disparity	Client has the capabilities and resource to improve performance in the process and build a sustainable position that is difficult to replicate.	Client has the capabilities to improve performance in the process prior to outsourcing. However, post-outsourcing the capabilities of the vendor means it can deliver further performance improvement.	Client does not possess the capabilities or resource to improve performance. Vendors can deliver significant performance improvement through greater experience and specialisation.
Vendor improvement capabilities	External vendors do not possess the required capabilities to deliver the required performance improvements.	Although the client has the potential to improve performance initially, vendors possess stronger process improvement capabilities to deliver further and sustained performance improvement over time.	Vendors have far superior process improvement capabilities.
Client outsourcing capability	Client has a lack of experience in managing outsourcing arrangements where significant performance improvement is required.	Client has a lack of experience in outsourcing arrangements where the vendor is responsible for driving all the process improvement effort.	Client has extensive experience with complex outsourcing arrangements in areas such as formal and relational contracting and implementing governance arrangements.
Benefits	<p>Retain control of a process that has a significant impact on competitive advantage.</p> <p>Avoid vendor opportunism potential associated with outsourcing.</p> <p>Client obtains all the benefits from the performance improvement efforts.</p>	<p>Client can attain some of the benefits of the improvement efforts prior to outsourcing.</p> <p>Client can reduce potential for vendor opportunism by redesigning and improving process prior to outsourcing.</p> <p>Client can leverage the superior capabilities of a vendor to further improve performance during the outsourcing relationship.</p>	<p>Client can focus scarce internal resource on areas where it can build superior performance positions.</p> <p>Leverage the superior process improvement capabilities of vendors.</p> <p>Potential to build a strong relationship with the vendor and deploy vendor capabilities in other parts of the organisation.</p>

Determine requirements

This involves determining what is required from the vendor and involves dissecting the process involved to determine the skills and resources required to perform the process. At the most basic level, this will include a specification of the process the vendor should provide to the client. This will involve determining the interdependencies between the outsourced process and other internal and outsourced processes. Where the interdependencies are clearly understood, it should be possible to derive effective performance measures for the outsourced processes. However, the greater the number of process interdependencies then the more difficult it will be to specify performance measures at the outset of the outsourcing arrangement. In addition, performance measures may have to be amended where the requirements of the client change during the relationship. In summary, determining the requirements involves addressing some of the following questions:

- Does the client need a vendor that can deliver the highest level of performance in the process?
- Does the client need a vendor that can transform performance in the process?
- Does the client require standard processes that can be sourced in the supply market, or is the process highly specific to the needs of the client?
- In the case of highly specific requirements, does the client wish to develop a long-term, collaborative relationship with the vendor?

Contract negotiations

Contracting will involve the client and vendors specifying the services provided by the vendor throughout the contract. Formal contracts have an important role to play in driving performance improvement in outsourcing arrangements (Poppo and Zenger, 2002). Formal contracts are often incomplete in outsourcing arrangements where performance improvement is required, as each party cannot fully specify future actions and the client often has highly specific and complex requirements. Despite these challenges, formal contracts should be as complete as possible to mitigate potential risks. For example, the vendor has to incur higher learning costs in understanding client processes and the client has to incorporate provisions to prevent the loss of proprietary process knowledge. The outsourcing contract should include: service level agreements (SLAs), benchmarking clauses, warranties, penalties for poor performance, asset transfer, price and payment terms and conditions for contract termination. A key aspect of the contracting process will involve establishing performance measures and standards. Performance measurement is an important element of driving performance improvement via formal contracting. Measuring service levels allows the client and vendor to assess where improvement efforts should be targeted and allow them to monitor the costs and benefits of performance improvement.

Vendor selection

Some vendors offer lower cost services through scale economies and lower labour costs, whilst other vendors offer specialist business improvement capabilities to transform performance in a range of business processes (Mani *et al.*, 2006). In this environment, the vendor selection process is both complex and challenging for the client. The critical task of vendor selection involves evaluating carefully whether a vendor can meet client requirements and this involves answering some of the following questions:

- How does the vendor achieve lower costs in the service, for example, through lower labour rates or experience?
- How quickly can the vendor deploy its capabilities to meet the client's required performance levels in the process?
- What specialist capabilities does the vendor possess that enable it to transform performance in the process?
- Does the vendor have a track record of managing and motivating people to deliver high performance?

Feeny *et al.* (2005) have developed a valuable framework for evaluating vendor capabilities in outsourcing (Feeny *et al.*, 2005). This framework includes three dimensions that are now discussed in the context of vendor selection:

- **Delivery competency** - refers to how well the vendor can respond to the client's requirements for operational services on a day-to-day basis. Consideration should be given to the scope and complexity of the vendor's services including levels of costs, quality, robustness and flexibility. The client should be confident that the vendor can meet the minimum performance standards throughout the contract.
- **Transformational competency** - as well as meeting the operational requirements of the client vendors should have the ability to improve service performance in areas, such as cost, quality and functionality. Some vendors possess specialist capabilities

for delivering radical change and improvement. However, this is an area where vendor capabilities can differ significantly and careful evaluation is required.

- **Relationship competency** - refers to the willingness of the vendor to develop a collaborative relationship where the client and vendor goals are aligned and risks and rewards are shared equally. Although the client may negotiate the best price at the beginning of the contract, once the contract is signed the vendor may seek greater control and build switching costs into the relationship. Therefore, the client should assess carefully whether the vendor is willing to develop a collaborative relationship.

Illustration 3 outlines how the software company analysed the delivery, transformational and relationship competencies of the chosen vendor when it moved to the new outsourcing arrangement.

Illustration 3 – Vendor capability analysis at the software company

Vendor capability analysis involved the software company developing a sourcing strategy that involved clearly defining its requirements from the outsourcing arrangement and then selecting a vendor that would meet these requirements. Once it determined its requirements it was clear that the software company needed a vendor that possessed significant business improvement capabilities and had experience of offering these services to other clients. A global outsourcing vendor was selected and the delivery, transformation and relationship competencies of this vendor were considered as outlined below:

- **Domain expertise** – the vendor had extensive experience and knowledge in revenue processing with its other clients. The vendor was expected to automate many manual elements of the processes and use its knowledge management capabilities to retain knowledge and limit the effects of employee turnover. In addition, the vendors would acquire specific process knowledge from the transferred employees.
- **Business management** – analysis of the vendor and consultations with some of its major clients had revealed that the vendor had the capabilities to meet the required service levels. The vendor had sufficient capacity and skills to deal with the increasing requirements of the software company. It also offered a number of standard processes in revenue processing that it provided to other clients. Through benchmarking the client was careful to ensure that the vendor would make a fair margin during the contract. This was viewed as important to allowing a performance improvement culture to develop in the relationship.
- **Behaviour management** - the vendor had the capability to develop staff through a training programme and offered a career progression structure. This was important in the case of transferred employees whose morale was low and performance was suffering as a result. The vendor had a track record of training, managing and motivating people.
- **Technology exploitation** – the vendor had a track record of deploying IT to improve performance in the processes involved. In addition, it was anticipated that the vendor would quickly deploy its capabilities in IT to meet and improve service levels. This would also allow the software company to reduce capital expenditure in IT.
- **Process re-engineering** - this was a critical consideration for the software company and the selected vendor possessed specialist capabilities in business improvement techniques, such as Six Sigma. Significant skills were necessary for removing inefficiencies, reducing complexity and improving process performance.
- **Planning and contracting** – in the contracting phase the vendor put forward a number of plans on how costs could be reduced and service performance improved in the processes involved. Agreement was reached in the contract on how the benefits of such improvements would be shared.
- **Governance** - the vendor had experience of working with large clients in a range of outsourcing arrangements and operated a number of sourcing arrangements for managing relationships. The vendor had a service review board that defined, tracked and evaluated performance. This involved having reporting mechanisms to ensure that the relevant personnel in the client and vendor were properly informed and there were procedures for expediting and dealing with problems.
- **Leadership** – the software company identified strong leadership and resource commitment in the vendor hierarchy and project teams. However, this was an area that could not be fully assessed until further into the contract with the vendor.

Stage 5 – Implementation

Once the contract is signed with the vendor the next stage is implementation which involves transitioning client assets to the vendor and operationalising the new service delivery model and going live with the services.

Transitioning

Transitioning involves transferring the processes and associated equipment, staff and knowledge to the vendor. There are a number of factors, outlined below, which can increase the complexity of the transitioning phase:

- **Number of service users** – the number of service users in the client will increase the transitioning time. Where they are from different client functions it is likely that their needs will be different, thus requiring greater attention.
- **Number of transferred staff** – it will take time to manage the transfer of staff from the client to the vendor operation. As well as dealing with changes to staff terms and conditions, motivation and morale issues have to be considered in order to ensure the vendor can improve performance.
- **Characteristics of the process** – where the service requirements are complex and highly specific to the needs of the client, it will take time for the vendor to understand and meet the required service levels. Alternatively, where the services involved are highly standardised with low levels of complexity, the vendor can quickly get up to speed with the process through experience developed with other clients.

Additional important factors in transitioning include client experience with outsourcing and resource allocation. As with any phase of the outsourcing process, there is a high correlation between outsourcing experience and success in transitioning. Where the transitioning phase is not managed effectively, it is likely that any problems that existed when the process was performed internally in the client will still remain. For those involved in transitioning, they must be aware that operationalising the processes will require a significant amount of work, with problems likely to arise in the initial phases of service delivery. The transitioning team leaders should ensure that staff in both the client and vendor work together to resolve any problems and foster realistic expectations of vendor performance amongst service users. As well as dealing with staff terms and conditions, another important aspect of managing the transfer involves transferring knowledge to assist the vendor with operationalising the processes. The client should identify staff with key knowledge that should be transferred to ensure the smooth transfer of the service to the vendor.

Operationalising the service delivery model

This involves getting the processes ready for operational use by service users in the client organisation. There are a number of important aspects to this process including: redesigning and testing new processes; forming a client-vendor team and assigning responsibilities for managing the relationship; and developing and implementing mechanisms for tracking service performance. The sourcing option chosen will influence the complexity of operationalising the service delivery model. Where an organisation has opted to improve performance prior to outsourcing it will attempt to carry out much of the improvement tasks prior to outsourcing to a vendor. This is likely to involve the organisation analysing and redesigning processes prior to transfer to the vendor. This analysis can create a better understanding of the processes involved, allow the organisation to better specify its requirements and determine performance measures for performance management during the contract.

Alternatively, where an organisation has opted to outsource and allow the vendor to improve performance significant attention will be given to redesigning processes and dealing with organisational change issues. Moreover, where there is a significant IT component much of the effort will go into coding and automating the redesigned processes. Organisations have to give careful consideration to organisational change issues during implementation as employees can potentially resist signing up to redesigned processes and new ways of working. These difficulties are further exacerbated where an organisation has opted to outsource and allowed the vendor to lead the improvement initiative. Outsourcing can have a negative impact upon the job security and loyalty of employees even when they retain their positions in the outsourcing organisation. Illustration 4 outlines how business process redesign was implemented in the case of the HR shared services arrangement. It highlights some of the strategies pursued to address employee resistance and ensure a standardised approach.

Illustration 4 – Business process redesign at the public sector organisation

Analysis for the business case revealed significant process duplications and inconsistencies in interpretation of corporate HR policies in areas such as absence management. Differentiating between processes that should remain in the HR department and those moved to the shared services centre was challenging. There was a risk that HR staff would try and retain processes in departments and hold on to their own specific way of performing certain processes rather than agree to the adoption of standard processes applied across all departments. However, the project team believed that effective management of this process would yield a number of significant benefits. Outdated and idiosyncratic work practices would be eliminated and significant costs would be reduced via standardisation of duplicated activities into the shared services centre.

Process mapping was an integral part of the business process redesign process. Throughout this exercise, idiosyncratic work practices associated with certain departments were removed. The project team adopted a number of practices to gain the support of departments in this exercise. The commitment of employees at both corporate and departmental level was obtained through involving relevant staff in the design of the new arrangement through full involvement in the design workshops. In addition, buy-in to the necessary changes was achieved through demonstrating the benefits of standardising the process.

Despite this emphasis on consultation and engagement a number of difficulties arose. As well as departments misinterpreting some corporate policies, a number of policies had to be changed as a result of outdated procedures or a lack of consistency. Updating these policies involved protracted renegotiations with a number of stakeholders including unions and this caused delays. Members of the project team admitted that they should have been stronger in their approach and tried to make corporate policies more robust prior to standardisation. For example, it was acknowledged that there was some success when clear leadership and authority was applied to deal with departmental resistance revolving around their having to relinquish long-held HR practices. However, there was a view that too many exceptions were included and that senior staff should have been more forceful in driving a standardised approach.

Stage 6 – Relationship management

The formal contract describes the institutions put in place to govern the relationship, whilst relationship management involves implementing these institutions to ensure that value is created and sustained in the relationship. Often in the initial phases of the outsourcing arrangement the client and vendor will have to jointly address teething problems when going live with the new service delivery model. However, once the relationship becomes established the client and vendor should work together to ensure that performance improvement is realised. There are number of important aspects of relationship management to ensure performance improvement and risk reduction in services outsourcing.

Relational contracting

Relational contracting is essential for performance improvement in outsourcing arrangements. It involves a longer-term collaborative client-vendor relationship. In driving performance improvement, both firms must adopt a relational contracting arrangement because it emphasises the mutual trust, shared risks and rewards, commitment and joint action needed to make such a close relationship work (Mani *et al.*, 2006). Relational and formal contracts are important complements for driving performance improvement. The presence of detailed contractual clauses, service levels and non-performance penalties along with relational practices, such as joint problem-solving, flexibility and trust, will lead to greater collaboration in the outsourcing arrangement. There are number of relational facilitators of performance improvement in the outsourcing arrangement.

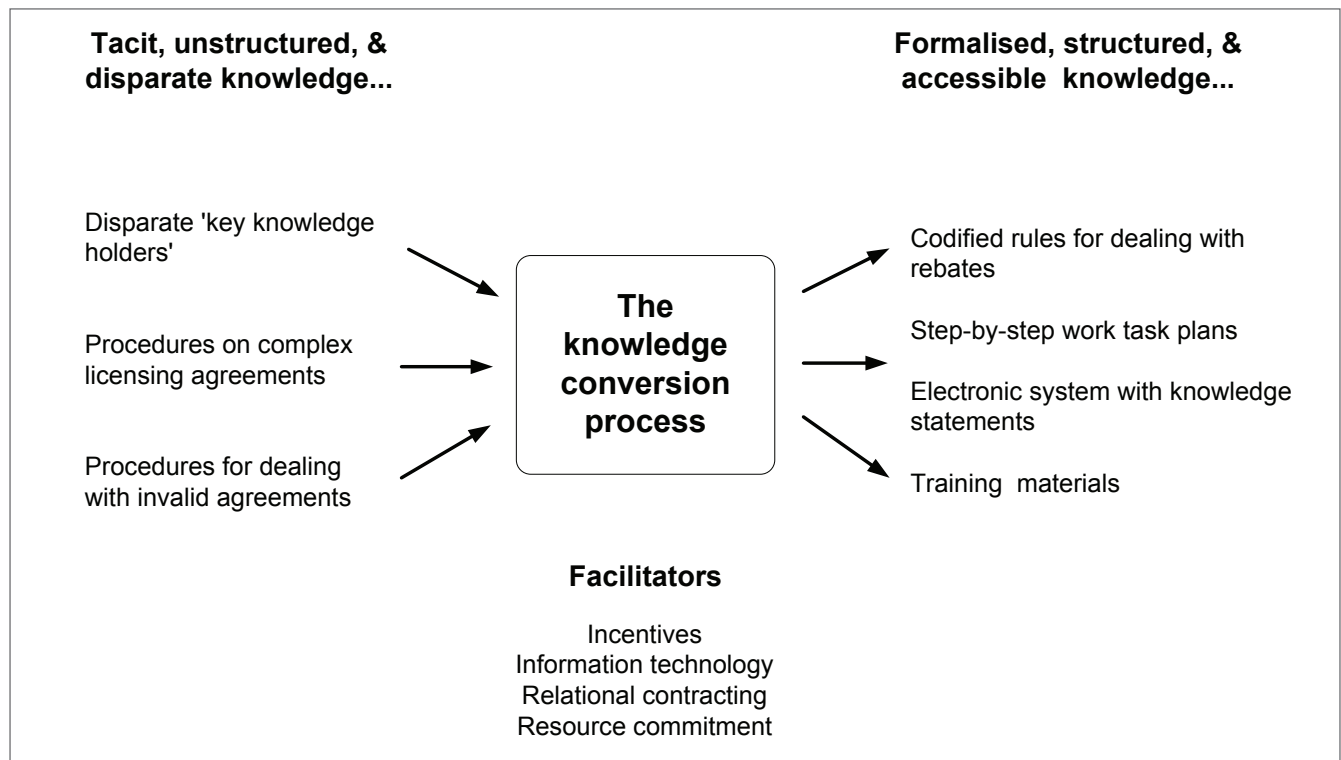
- **Trust** is an important driver of collaboration in relationships as it enhances performance, decreases the costs and complexity of negotiation and reduces conflict. Trust will encourage the sharing of information and lead to a high degree of effort on not only routine tasks but in dynamic responses to new situations (Sako, 1992).
- **Knowledge-sharing** involving regular patterns of interactions that facilitate the transfer and integration of knowledge is another relational facilitator. Knowledge sharing can create new knowledge and ideas where the client and vendor share and use knowledge to exploit each other's capabilities (Grant, 1996). For example, the vendor can develop knowledge of the client's business processes and contribute ideas and develop plans for improvement.
- **High mutual dependency** in the form of highly specific asset investments by both the client and vendor is a further relational facilitator. Rather than using relational contracting to pre-empt opportunism in the presence of high dependency on the vendor, relational contracting can be used to gain complementary skills by tapping each party's capabilities to create value and improve performance (Madhok and Tallman, 1998).

Illustration 5 outlines how relational contracting was necessary for applying knowledge management tools in the revenue processing outsourcing arrangement for the software company and the vendor.

Illustration 5 – Knowledge management at the software company

Under the previous outsourcing arrangement, high employee attrition rates meant that important knowledge in revenue processing was lost. Additional costs were therefore incurred with recruiting and training new employees. Changing rules for licensing agreements and rebates were not updated. The whole area of revenue processing had become increasingly dependent upon a number of key individuals with tacit knowledge built up over a number of years - referred to as key knowledge holders. Therefore, the software company and the vendor put in place a strategy for managing knowledge as shown in Figure 3.

Figure 3 Knowledge management strategy



The first part of the strategy involved gaining a fuller understanding of the processes and rules for processing revenue. This assisted with identifying important unstructured and disparate knowledge that had never been formalised. Working with 'key knowledge holders', the vendor began to formalise and document the most important knowledge. Much of this exercise involved working with the software company to document the rules for licensing agreements and rebates. There were a number of facilitators of this strategy as shown in Figure 3. Incentives were offered to key knowledge holders to ensure they shared knowledge, which involved linking the knowledge management strategy with the performance and bonus structure of the relevant team. This motivated individuals to share their knowledge with other less experienced individuals in the team and allow it to be documented as it would enhance the overall performance of the team. Information technology was used to codify and store much of the unstructured and tacit knowledge gathered from the key knowledge holders. Rules for dealing with rebates were codified and stored electronically.

Managing knowledge was a continuous process and required a relational contracting arrangement. Formalising and documenting knowledge involved both formal and informal interaction between staff in both organisations. The software company changed its rules for licensing agreements and rebates, which often had knock-on effects for stored knowledge. Codified and stored knowledge that was affected by these changes had to be updated, or deleted in some cases. Moreover, when the software company introduced new products or upgrades, it worked closely with the vendor to communicate clearly licensing agreements, rebates and the relationship with its existing product portfolio. The vendor convened monthly forums with each team to ensure that knowledge was kept as current and as accessible as possible.

Vendor performance evaluation

The need for performance improvement means that the evaluation of performance should be a joint endeavour, with both the client and vendor attempting to identify and deal with the causes of poor performance in any areas. As both the client and vendor are responsible for the success of the relationship, the focus should be on performance improvement. This focus on improvement not only centres on cost reduction but also can encompass any performance area, such as service, flexibility and responsiveness. There is also an onus on the client to effect performance improvements. The client may attempt to achieve improvements in its own internal operations that can assist the vendor in meeting the required performance levels. Moreover, pursuing a relational contracting arrangement will involve the client and vendor working jointly over the long-term to improve performance levels and meet each other's expectations.

There should be flexibility in the performance measures and measurement systems introduced to reflect the dynamic nature of many outsourcing arrangements. A flexible approach to performance management is important, particularly in an outsourcing arrangement that is characterised by highly complex client requirements and uncertainty. Although the client should specify as much detail as possible at the outset, it is often difficult to fully specify all the requirements and performance levels for the entire outsourcing contract. In complex outsourcing processes it is not possible to fully specify all requirements and performance measures during the contracting phase, therefore, changes will often be required during relationship management.

Resource commitment

It is critical that both the client and vendor have the necessary resources and skills to analyse and understand performance. There are a number of influences on the level of resource commitment. The complexity of the client's requirements will influence the resource required. Where the client's requirements are highly complex and specific, both the client and vendor have to commit substantial resource to deal with any difficulties and performance problems. For example, visits by personnel from both the client and vendor to their respective facilities are essential in creating a mutual understanding of each other's needs and capabilities. In addition, the strategic importance of the outsourced process is an important influence on resource commitment. In the case of strategically important processes, the client will have to commit considerable resource to working with the vendor to improve performance. Achieving performance improvements in such processes has the potential to differentiate the client from its competitors. Illustration 6 outlines how the consultancy organisation applied a Six Sigma approach to improve performance in its facilities services outsourcing arrangement.

Illustration 6 – Six Sigma and performance improvement at the management consultancy

The organisation had outsourced facilities services such as catering, security, building maintenance and office concierge, to a number of vendors. Internal employees accessed these services through a help desk via email or telephone. The key role of the help desk was to log queries or problems and redirect these to the appropriate vendor for resolution. However, this outsourcing arrangement was not operating effectively and performance reporting between the help desk and vendors had shown significant performance misalignments. In some areas the helpdesk was reporting achievement of between 40% and 60% completion against SLAs, whilst vendors were reporting between 80% and 90% completion against SLAs. This had created tensions in the relationship between the vendors and the management consultancy and dissatisfaction amongst employees on service quality. The management consultancy decided to address these problems by applying the Six Sigma approach and applied the Define-Measure-Analyse-Improve-Control (DMAIC) cycle.

Define

This phase involved deciding on the scope of the project. It involved: gaining an understanding of the processes involved in facilities services; workflows between processes; functions affected by facilities services; the linkages between the vendors; and the help desk and internal employees. It also involved working with key stakeholders from facilities services, procurement, helpdesk managers, service users and vendors.

Illustration 6 – Six Sigma and performance improvement at the management consultancy (Cont.)

Measure

This phase involved collecting data, mapping and establishing current performance in the process. A key part of this phase involved gathering data from a number of sources including performance data from the helpdesk, recent SLA data from the vendors and summary information on performance metrics agreed in the initial contract. The analysis revealed that only two metrics were used by the helpdesk to dynamically measure performance against specification:

- Respond by time – measures the time between a service request being logged by the helpdesk and assigned to the appropriate vendor.
- Resolution by time – the time taken for the vendor to resolve the service request.

The respond by time metric added little value as it only considered how long it took to assign the problem to the vendor and did not measure whether the problem had been solved which was of critical importance to the service user.

Analyse

This phase involved using the performance data gathered and analysing in-depth the processes involved in order to identify the problems and associated causes. A number of areas had considerable performance problems including, for example, building maintenance which experienced the lowest performance with a 50% resolution within the SLA. Moreover, there were significant variances in monthly service requests across a number of areas and no effort had been made by the client to forecast requirements to allow vendors to better schedule resources to meet requirements. In relation to the problems identified, service users were not given a reliable indicator of the time it would take to resolve any service problems they logged with the helpdesk and in some cases were contacting helpdesk staff directly for updates. It was suspected that helpdesk employees were not collecting the required information on the service request and in some cases were assigning the service request to the wrong vendor which reflected poorly on the performance of the affected vendor. A major problem identified was that over 50% of the categories of problems recorded in the helpdesk system were not included in the contract.

Improve

The objective of the improve phase was to develop more consistent problem categories, better performance metrics and integrate these changes into the contract. Developing new and redesigning existing problem categories involved working with key stakeholders, such as helpdesk employees, procurement, service users, managers of functional areas affected and external vendors. Each of these stakeholders was allowed their input into the development of the problems profiles through participation in workshops in order to limit the likelihood of resistance from those affected by the changes. Two hundred and fifty three new problem profiles were developed along with appropriate performance metrics and estimated resolution times for problems. Once these problem profiles were agreed the contracts were amended accordingly in consultation with vendors. Training was provided for helpdesk employees and additional support was put in place to deal with queries during the early stages of implementation.

Control

A number of measures were put in place to monitor the performance of the new arrangement. A daily analysis of all service requests logged was undertaken, which highlighted any communication issues and facilitated immediate intervention to resolve issues that arose. Analysis of the first month of operation had revealed that output from the helpdesk recorded around 86% of service request achieved within the SLA (compared with around 50% under the previous arrangement) and the vendor system reported around 91%. Whilst this was regarded as a significant improvement from the previous arrangement it was still felt that an ongoing improvement initiative should be continued to gain further improvements.

Effective governance

Effective governance is necessary for controlling and managing the outsourcing arrangement to ensure performance improvement is achieved. Governance should consist of a set of structures and mechanisms to ensure the following issues are addressed:

- Ensure that the outsourcing arrangement is aligned with the outsourcing objectives;
- Formal mechanisms for measuring and improving vendor service performance;
- Ensure that the necessary resources are provided to improve service performance; and
- Ensure that the role of the retained function is enhanced as a result of outsourcing.

In the context of performance improvement the governance arrangement should have the following mechanisms in place:

- To decide what areas performance improvement initiatives should focus on;
- How performance improvement initiatives should be implemented; and
- How the client and vendor should share any of the benefits of improvement.

A performance improvement board composed of client and vendor staff should be formed to evaluate and select any performance improvement initiatives proposed by either the client or vendor. The selection of any proposed performance initiatives will depend upon the skills and resource required for implementation and potential financial benefits. Where a performance improvement initiative has been approved, a project team should be established and composed of staff with the required skills from both the client and vendor. The performance improvement board should review and track the progress of the improvement initiative to ensure the objectives are achieved. The formal contract may have mechanisms, such as gain share clauses, to ensure any benefits of performance improvement initiatives are shared equally. However, in many instances the presence of relational contracting aspects such as trust and personal relationships, can be an effective way of agreeing how benefits are shared equally. Effective governance is also important for transforming the strategic role of the retained function. Key aspects of attempting to achieve this transformation include: implementing the staff training and development strategy; meaningfully engaging with stakeholders affected by the changes; and addressing change management issues, such as employee resistance to the new changes. Illustration 7 highlights a number of the challenges encountered in enhancing the strategic role of the retained function in the case of the outsourced HR shared services arrangement.

Illustration 7 – Enhancing the strategic role of the retained function at the public sector organisation

Senior management were attempting to effect an attitudinal change and transform the retained HR function into a customer-service and strategically oriented function. A number of strategies were pursued to try and achieve this transformation. Implementing the changes required a training and development programme, which involved developing new skills and competencies in the HR professional both at corporate and department level. HR professionals at both director and management levels undertook development courses in areas, such as business partnering⁴, change management and project management. HR staff in departments that were not willing to move towards a business partnering role were offered redeployment opportunities. Expertise from the specialist HR consultancy was employed to advise HR departments on how to change their bureaucratic structures to become more customer-focused and act as a strategic partner delivering value-added services.

Despite these strategies some difficulties arose which meant it was difficult to reinforce the changes in the role of the retained HR function. There was evidence of attitudinal resistance to the new arrangement amongst retained HR staff. Many HR employees had difficulties with the decision to outsource. The outsourced shared services centre was in effect replacing long accepted HR roles in the organisation and even though there was goodwill on the part of many HR professionals, there was some reluctance to embrace the new HR service delivery model.

Some retained HR staff were also resistant to the business partnering role and viewed it as quite an alien concept. Some HR staff viewed it as something of a fad, whilst others resisted the concept because it took them out of their 'comfort zones'. However, there was a more positive view amongst some senior departmental managers regarding the changes to HR and evidence of the changes being reinforced where more constructive relationships with business partners had been forged with certain areas of the organisation. Some business partners fully understood the visions and embraced the concept. A clear implication which emerged in the interviews was that HR business partners had to work extremely hard to gain credibility and respect to allow the business partner role to take root and flourish. Senior HR managers were aware of this issue and encouraged business partners to play such a proactive role where they solved problems and built constructive and trusting relationships with line managers.

3. BENEFITS OF APPLYING BUSINESS IMPROVEMENT TECHNIQUES IN SERVICES OUTSOURCING

Based on the experiences of the case companies this section outlines the benefits of applying business improvement techniques in services outsourcing.

Performance improvement benefits

The case companies have shown how the application of business improvement techniques can be applied to improve performance in outsourcing arrangements. Achieving cost savings was a key motive for the organisations studied when outsourcing and applying business improvement techniques was important to achieving this. An organisation can enjoy cost savings through eliminating out-dated and idiosyncratic work practises, standardising and outsourcing processes to vendors, as shown in the outsourced HR shared services case. Although there were challenges in standardising HR processes through the application of business process redesign it achieved cost savings through reducing duplication and redeploying staff to other parts of the organisation.

The case study findings have also shown how business improvement techniques can be employed to improve service quality during an outsourcing contract. The facilities services outsourcing case provides an illustration of how Six Sigma tools were applied to improve service quality. Applying the Define-Measure-Analyse-Improve-Control approach in this case showed how the consultancy organisation and vendor worked together to understand the current problems and design an effective solution for improving service levels. Designing the new solution involved working with key stakeholders, such as helpdesk employees, procurement, service users, managers of functional areas and vendors. The revenue processing case provides a further illustration of how business improvement techniques can improve service quality. Prior to applying knowledge management tools the vendor was taking too long to resolve complex queries because they were highly dependent on a number of key individuals that had highly specific, tacit knowledge that had been built up over a number of years. Applying knowledge management tools allowed the software company and the vendor to formalise, document and share important knowledge with employees across the operation, which allowed them to resolve complex queries more quickly.

A key motive for outsourcing for all the companies studied was that it allowed them to focus scarce internal resource on their core business and leverage the specialist capabilities of vendors. In the case of the outsourced HR shared services arrangement it opted for the outsourced shared services arrangement because it allowed it to outsource non-core, transaction intensive HR tasks. It worked with the vendor in applying business improvement techniques to redesign and automate transaction-intensive HR tasks. This then allowed the organisation to focus on strengthening the capabilities of the retained HR function. In the revenue processing case the software company was facing pressures from corporate level to reduce the total cycle time for processing revenue and dealing with customer queries. It therefore redesigned the entire revenue processing operation and selected a specialist vendor that had extensive skills and experience in revenue processing. It was anticipated that this would allow the software company to focus internal resource on building relationships with its key clients.

Risk reduction benefits

The case studies have shown a number of ways in which business improvement techniques can be used to reduce risk in outsourcing:

- The mortgage processing case provides an illustration of how business improvement techniques can be applied in the evaluation phase of the outsourcing process. Benchmarking was employed to understand internal performance in mortgage processing relative to vendors. When it was found that vendors could process mortgages more quickly the initial reaction was to outsource the mortgage processing operation. However, the FSO realised that it possessed the business improvement capabilities internally to improve performance in mortgage processing, thus avoiding the risks of outsourcing.
- The outsourced HR shared services arrangement illustrates how business improvement techniques can be applied in the contracting phase of outsourcing. It lacked the internal skills in performance measurement in contemporary HR service delivery. This was regarded as an important skills deficit as it needed to establish a baseline performance measure to assess vendor performance during the contract. Clients often enter into outsourcing contracts with no effective performance benchmark and therefore have no means of assessing vendor performance or knowing whether the vendor is delivering better performance than when the process was performed internally. Therefore, the project team employed external consultants to assist with developing KPIs and SLAs, which facilitated the development of a baseline position to measure performance in the contract.

Business improvement techniques can be employed to reduce the likelihood of poor vendor service quality by reducing opportunism potential in the outsourcing process. The revenue processing case shows some of the ways in which the software company applied business improvement techniques to reduce the potential for opportunism⁵.

- **Asset specificity** - process mapping tools were used to map out and understand the processes, identify inefficiencies and complex inter-dependencies. Clearer process definitions meant clear lines of responsibility could be established between the processes involved. Business improvement techniques were employed to reduce interdependencies and, where possible, reduce specific process requirements to deploy standard processes offered by the vendor.
- **Knowledge loss** – knowledge management tools were employed to derive clear task specifications and licensing agreement rules which could be stored electronically and clearly documented. This exercise assisted with training and limited the impact of employee turnover and knowledge loss.
- **Performance measurement** - clearer process definitions and better understood interdependencies led to improved performance measurement. The adoption of a formal approach to documenting process changes in the outsourcing arrangement meant that performance measures were kept relevant and, where necessary, amended or removed.
- **Uncertainty** - the software company simplified the licensing variants and rules for rebates, which reduced uncertainty for the vendor.

The case findings have highlighted a number of ways in which business improvement techniques can mitigate strategic risk. Strategic risk refers to the loss of critical skills and knowledge in an outsourced process. In the mortgage processing case, benchmarking and in-depth analysis of mortgage processing allowed it to better understand the causes of poor performance and address them through a business improvement programme. This type of analysis also assisted in understanding how vendors perform processes and in many cases achieve superior performance positions. A common risk of outsourcing involves organisations outsourcing processes that have traditionally caused problems. In some cases such processes can have a significant impact upon competitive advantage. Understanding the causes of poor internal performance and vendor performance can mitigate this potential risk. Developing a relational contracting relationship with the vendor can help to protect against losing important knowledge and also help to develop knowledge that can lead to better performance. For example, through adopting relational contracting the software company worked with the vendor employing knowledge management tools to formalise and retain important knowledge on licensing agreements. In the case of facilities services, adopting a relational contracting arrangement allowed the consultancy organisation to work with the vendor to redesign the structure of the facilities services model.

4. CHALLENGES OF APPLYING BUSINESS IMPROVEMENT TECHNIQUES IN SERVICES OUTSOURCING

The findings from the case companies have highlighted the challenges of applying business improvement techniques in services outsourcing:

- **Cost analysis** - cost analysis in outsourcing is challenging for a number of reasons. Unless the client and the vendor have standardised processes, it is very difficult to derive fully objective cost comparisons. Objective cost comparisons are difficult because of different costing systems used by vendors. A further challenge involves the amount of cost data that vendors are willing to divulge due to the risks of competitors accessing such sensitive data.
- **Benchmarking** - as the case studies have shown there are a number of challenges associated with benchmarking in the outsourcing process. It is difficult to compare processes in the client organisation with those of vendors due to the presence of idiosyncratic practices and process inter-dependencies. The cause of superior performance in a certain process may be as a result of inter-dependencies between other processes that are difficult to isolate. Moreover, the lack of effective internal performance measures associated with a process makes objective comparisons difficult with other organisations.
- **Resistance to standardisation** - standardising and redesigning processes can be challenging and lead to resistance from the functions affected. Rather than being technical challenges, such as a tightly coupled IT infrastructure or vendors lacking the required capabilities, they were mainly behavioural in nature. The case of the outsourced HR shared services arrangement provides an illustration of the challenges of standardisation. Although key stakeholders were involved from departments in order to win support, there was evidence of resistance, particularly amongst line managers and HR personnel, whose co-operation was crucial to making the new arrangement successful. Some of the sources of this resistance stemmed from the fact that the shared services arrangement was outsourced and the HR function at department level had a high degree of autonomy.
- **Skills deficit** - many organisations start at a major disadvantage when entering into outsourcing contracts, as they lack the necessary skills and experience. The scale and complexity of some outsourcing arrangements means that clients lack the skills to determine requirements and a detailed outline of the service delivery model. Although vendors offer significant capabilities to transform performance, organisations still require significant in-house skills in project management, business improvement, vendor management and change management.
- **Unbundling service processes** - outsourcing service processes involves redrawing the boundaries between internal functions, processes and people. Unbundling non-core processes can adversely affect the performance of core processes. Once organisations embark on an analysis of existing systems and processes prior to outsourcing, they discover high levels of complexity and interdependencies between other processes and functions. An organisation's IT infrastructure further compounds this difficulty. In many organisations, the IT application driving the business process is highly customised and tightly integrated with the organisation's IT infrastructure including the operating systems and hardware (Hagel and Brown, 2005).
- **Enhancing the strategic role of the retained function** - it should be recognised that enhancing the strategic role of the retained function affected by outsourcing is achieved over the long term and the findings here support this view. To realise the benefits of such changes managers need to be aware that such a change will take time to be embedded and that they should prepare for the inevitable obstacles, barriers and resistance along the way. In the case of the HR shared services arrangement, the resistance to the changes brought about by the shared services arrangement stemming from outsourcing proved to be a barrier to changing the attitudes of some retained HR staff.

5. STRATEGIES FOR ADDRESSING THE CHALLENGES OF EMPLOYING BUSINESS IMPROVEMENT TECHNIQUES IN SERVICES OUTSOURCING

This section outlines potential strategies for overcoming the challenges of employing business improvement techniques in services outsourcing.

Determine requirements from outsourcing

There are a number of aspects to determining requirements from outsourcing. Existing systems and processes should be analysed and documented using business improvement techniques, which involves understanding the inter-dependencies, complexity and level of changes required in the processes involved. Efforts should be made to determine current internal performance levels and comparisons with vendor performance levels through external benchmarking should be undertaken. Determining requirements will identify the scale of the challenge and potential sourcing options required to improve performance. Where performance is marginally weaker than external vendors, it may be more prudent to improve performance internally and retain the process in-house. Where performance is considerably weaker than vendors, outsourcing is likely to be the most suitable option for improving performance. The scale of performance deficiencies will provide an indication of the vendor capabilities required to transform performance.

Supplement internal skills

Organisations can supplement internal skills through employing external consultants and recruiting people with the necessary skills and experience. Where an organisation's processes and performance measurement systems are weak, legal advice, business improvement and procurement expertise should be sought to assist with developing a robust contract that creates incentives for vendor performance improvements. As well as requiring skills in traditional outsourcing areas, such as contracting and vendor relationship management, organisations increasingly require skills in business process-redesign, knowledge management, change management and business improvement.

Stakeholder management

Outsourcing involves considerable change, particularly when it involves the redesign of organisational structures and processes. Engaging with stakeholders throughout the outsourcing process is a valuable mechanism for winning the support of powerful stakeholders and obtaining support from less enthusiastic stakeholders. Gaining the support of senior management in the initial evaluation phase of outsourcing is important for securing the necessary resource for implementation. Senior management can be used to win the support of less enthusiastic stakeholders at lower levels in the organisation. Key mechanisms for engaging with stakeholders include timely and properly directed communication and involving potential opponents in decisions and tasks throughout the outsourcing process.

Effective performance management

Prior to outsourcing, it is important to understand why internal process performance is weaker than vendors or competitors. Such analysis is important in the case of processes that are critical to competitive advantage, as outsourcing can lead to a loss of skills in strategically important areas. Moreover, the analysis may reveal that an internal improvement programme is more appropriate. Where outsourcing is considered, the client must understand how the vendor delivers better performance and how long into the contract it will take the vendor to meet the required performance levels. Managing performance throughout the outsourcing relationship has a number of dimensions. Where vendors are delivering services to client employees, the client must have formal mechanisms for measuring vendor service quality. Where employees' experiences with vendor are poor, it will lead to employee resistance and threaten the success of the outsourcing relationship. The client should put in place mechanisms to ensure that any performance problems are addressed quickly with the vendor.

Formal and relational contracting as complements

Detailed contracts are an essential ingredient for success in services outsourcing. Drafting a tight contract can act as an important complement to building an ethos of collaboration in the outsourcing relationship. A carefully drafted contract can serve as an impetus for action and performance improvement. Collaboration can be used to build flexibility into the relationship and compensate for any gaps in the contract to react to changing circumstances. Services outsourcing arrangements involve reconfiguring and changing the relationship between outsourced processes and internal processes. In some cases, it is possible to deal with these changes through re-negotiating the contract. However, collaboration can act as another important mechanism

for allowing changes to be made to processes without renegotiating the contract. Collaboration is also an important mechanism for dealing with difficulties in the early phases of an outsourcing arrangement. This is particularly important in a case where the vendor cannot meet the required service levels because the client has outsourced a poorly performing internal process without understanding the causes of poor performance prior to outsourcing.

6. CONCLUSIONS AND RECOMMENDATIONS

The findings from the research have a number of important implications for practitioners and businesses who are currently involved in or considering outsourcing.

- **Business improvement techniques can be employed to understand internal performance prior to outsourcing.** Such analysis is important in the case of processes that are critical to competitive advantage, as outsourcing can lead to a loss of skills in strategically important areas. Moreover, business improvement techniques can be employed to reduce process complexity and process inefficiencies prior to outsourcing.
- **It is essential to standardise as many processes as possible to achieve the benefits of outsourcing.** Incorporating too many exceptions to standards, and making frequent changes to requirements in the outsourcing process is likely to create complexity for the vendor and limit the potential for performance improvement.
- **Organisations have a number of sourcing options to improve performance and reduce risk in outsourcing.** These sourcing options include: improve performance and retain the process internally; improve performance internally prior to outsourcing; and outsource and allow the vendor to improve performance.
- **Business improvement techniques are important for determining requirements from outsourcing.** This involves considering issues, such as: the level of process improvement required; the level of specific client requirements; and the type of outsourcing relationship required. Understanding and documenting processes will help in communicating requirements and allow the vendor to meet the required performance levels more quickly.
- **A change management strategy is important for winning the support of people impacted by business improvement techniques.** Building relationships through involvement in decision making and communication will help create greater ownership of new processes and obtain buy-in from staff.
- **Relational and formal contracting should be employed as complements when applying business improvement techniques.** Strong inter-personal relationships between the client and vendor are important for resolving difficulties and creating flexibility in outsourcing. In addition, a formal contract is essential for dealing with issues that cannot be resolved via relational mechanisms alone.
- **A broad set of skills and management capabilities is required to apply business improvement techniques.** As well as requiring skills in contracting and vendor relationship management, the client requires skills in business improvement tools. External expertise should be sought to address any skills deficiencies.

ENDNOTES

1. The review of the literature on services outsourcing and business improvement techniques has been published separately: McIvor, R. (2013), *What do we know about services outsourcing?*, ICAS, available at www.icas.org.uk/mcivor.
2. More detailed versions of these case studies are published on the ICAS website at www.icas.org.uk/mcivor.
3. Opportunism involves the vendor shirking on responsibilities agreed in the contract with the client. Factors that influence opportunism potential include: high dependency of the vendor; performance measurement difficulties; uncertainty; and changes in client requirements.
4. Rather than deal with transactional support and routine queries, HR business partners act as consultants to the organisation providing strategic advice to line managers and align HR with the needs of the organisation. Refer to Ulrich, D. and Smallwood, N. (2005), *The HR Value Proposition*, Harvard Business School Press.
5. According to the logic of transaction cost economics there are a number of factors that influence vendor opportunism in outsourcing. The presence of specific investments in physical or human assets dedicated to a particular relationship will create switching costs for the buyer. Difficulties with measuring the contribution and performance of the supplier can also create problems in the relationship, as the sourcing organisation must expend additional resource on monitoring performance. Furthermore, differences in relation to the interpretation of performance can also create difficulties in the relationship. For example, where effective performance measures have not been developed for the outsourced process, it will be difficult to determine whether the supplier has executed the process better than when it was in-house. Uncertainty both in the business environment and in the requirements of the buyer may mean that it is not possible to write complete contracts and renegotiation and frequent amendments are required as circumstances change. Refer to Williamson, O.E. (1975), *Markets and Hierarchies*, Free Press.

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APPENDIX 1 GLOSSARY

Asset specificity – refers to the level of customisation associated with an outsourcing arrangement. High asset-specific investments are costs that have little or no value outside the outsourcing arrangement and create switching costs for the client.

Benchmarking – a continuous process of measuring and comparing performance in processes against organisations that are world leaders.

Business case – describes a business problem, and outlines a proposal on how it should be overcome.

Business process – a collection of activities that take a number of inputs and create an output.

Business process outsourcing – involves the vendor taking responsibility for executing a business process and delivering it to the client as a service.

Change management – involves the management of significant organisational change and business process redesign.

Codification – the extent to which tasks associated with a process can be described completely in a set of written instructions.

Critical success factors – represent those areas of an organisation or project that management needs to focus on to create high levels of performance.

Define-Measure-Analyse-Improve-Control (DMAIC) cycle – a process improvement approach used in Six Sigma, which involves a number of steps including: define, measure, analyse, improve and control.

Economies of scale – occurs when the unit costs creating and delivering a service decrease, as volume increases.

Explicit knowledge – knowledge that can be formalised, represented in words and numbers, and readily communicated.

Knowledge management – involves capturing, storing, updating, interpreting and using knowledge whenever necessary.

Opportunism – involves the vendor shirking on responsibilities agreed in the contract with the client. Factors that influence opportunism potential include high asset specificity, performance measurement difficulties, uncertainty, and changes in client requirements.

Outsourcing – the use of an external vendor to provide products or services previously provided by internal business functions.

Process idiosyncrasies – refers to processes that are performed in a specific or highly customised way by the client. Such processes create high asset specificity in outsourcing arrangements.

Process inter-dependencies – refers to the inter-connections between processes, business units and tasks. Complex interdependencies between processes can increase transaction costs.

Relational contracting – involves a contract where there are high levels of asset specificity. The focus in relational contracting is moving beyond a contractual mindset and developing a trust-based and mutually beneficial relationship.

Service level agreement – an agreement between the client and vendor that specifies the service levels required by the client.

Shared services – involves consolidating and standardising common tasks associated with a business function across different parts of the organisation into a single services centre.

Six Sigma – an improvement programme for eliminating waste and improving performance in business processes. Statistical and scientific methods are at the heart of Six Sigma, both in developing an optimum process specification, and reducing defects in the process to almost zero.

Stakeholders – individuals or groups of individuals who can influence the strategy of an organisation.

Standardisation – the extent to which the tasks in a process can be executed using a set of consistent and repeatable steps.

Tacit knowledge – knowledge that is based on subjective and experiential learning that is highly personal and difficult to formalise.

Transaction costs – the costs of selecting vendors, negotiating prices, writing contracts, and monitoring performance.

Workflow – the movement of information associated with the work procedures of an organisation.

Process mapping – involves creating a visual map of workflows within a process with the aim of improving process performance and delivering value for customers.

Unbundling – is another term used to refer to outsourcing a process to an independent vendor.

APPENDIX 2 RESEARCH APPROACH

A case study approach was chosen to undertake the research. Use of the case study approach allows an increase in the quality and quantity of data obtained (Gummesson, 1991). The case study approach allows the researcher to analyse relationships and social processes that is not possible via a quantitative approach alone (Miles and Huberman, 1994). The initial phase of the research involved conducting a literature review in the areas of services outsourcing and business improvement. This literature review - *What do we know about services outsourcing?* - is published separately by ICAS and is available on the ICAS website at www.icas.org.uk/mcivor. A number of limitations were identified in the current literature including the lack of a structured framework for integrating business improvement techniques into the outsourcing process. In-depth case study research was then conducted with four organisations including a public sector organisation, a financial services organisation, a software company and a management consultancy organisation. The first stage of the data collection phase involved collecting data on the background and overall strategy of the company. Particular attention was given to the link between the strategy of each company and the drive towards outsourcing. The outsourcing processes chosen in each organisation were as follows:

- Public sector organisation – large scale human resource outsourced shared services arrangement.
- Financial services organisation – the evaluation of outsourcing of mortgage processing.
- Software company – the outsourcing of revenue processing for its Europe, Middle East and Asia territories.
- Management consultancy organisation – the outsourcing of facilities management services.

These case studies are presented in detail in Appendix 3. These case studies were chosen for a number of reasons. The case organisations had been applying business improvement techniques at various phases of the outsourcing processes studied including: benchmarking; Six Sigma; process mapping; process redesign; and knowledge management. Full access was granted to personnel, which facilitated the collection of data at the level of quantity and quality required. A number of sources were used for data collection in each company. The primary data collection source was via semi-structured interviews. An interview questionnaire based on the literature was designed and served as an interview guide.

Forty interviews were carried out with senior managers who were involved in formulating strategy, and with personnel from a range of functions at lower levels in the organisations, who were involved in implementing the outsourcing decision. Semi-structured interviews took place with each of the personnel involved, with the intention that personnel would freely express their views and experiences on the outsourcing process. Archival data in the form of internal memoranda, annual reports, strategy documents, vendor evaluations, trade and internal company magazine articles were also collated.

Case studies were developed from both the interviews undertaken with personnel involved in the outsourcing decisions and the archival data gathered. Using Eisenhardt's (1989) guidelines on case study analysis, within case analysis and cross-case analysis was carried out, to determine how business improvement techniques improved performance and reduced risk in outsourcing. As a result of this analysis a framework for employing business improvement techniques to improve performance and reduce risk in services outsourcing was developed as shown in Figure 1. This framework shows how business improvement techniques can be employed at various stages in the outsourcing process.

APPENDIX 3 BACKGROUND TO THE CASE STUDIES

The public sector organisation and the outsourced shared services arrangement

This case study focuses on the experiences of a UK public sector organisation that created an outsourced shared services arrangement. The shared services arrangement was part of a reform initiative to modernise and transform the HR function across 11 government departments. The arrangement involved: replacing outdated IT systems; modernising payroll and HR processes; and providing centralised administrative HR services from an outsourced shared services centre. Creating a shared services centre to handle routine queries and transactions allowed the HR function in the 11 departments to focus on more strategic and value-adding human resource activities. The HR services involved in the arrangement included: external recruitment; employee relations; HR data management; internal recruitment; payroll and absence management; and performance management and learning development.

The key drivers for the shared services arrangement were the need to replace a number of HR IT systems and the recognition that HR service delivery needed to be improved. During business case development the organisation explored a number of options, including a fully outsourced HR arrangement, but instead opted for partial outsourcing of the IT and maintenance elements. However, during a lengthy procurement process it was decided to increase the scope of the project to a fully outsourced HR arrangement. This included a shared services centre, with a contact centre processing HR transaction and casework, a managed payroll services and a managed IT services. The new arrangement would incorporate a transformed retained function comprising a corporate HR centre and a retained HR function in each department taking on a more strategic role.

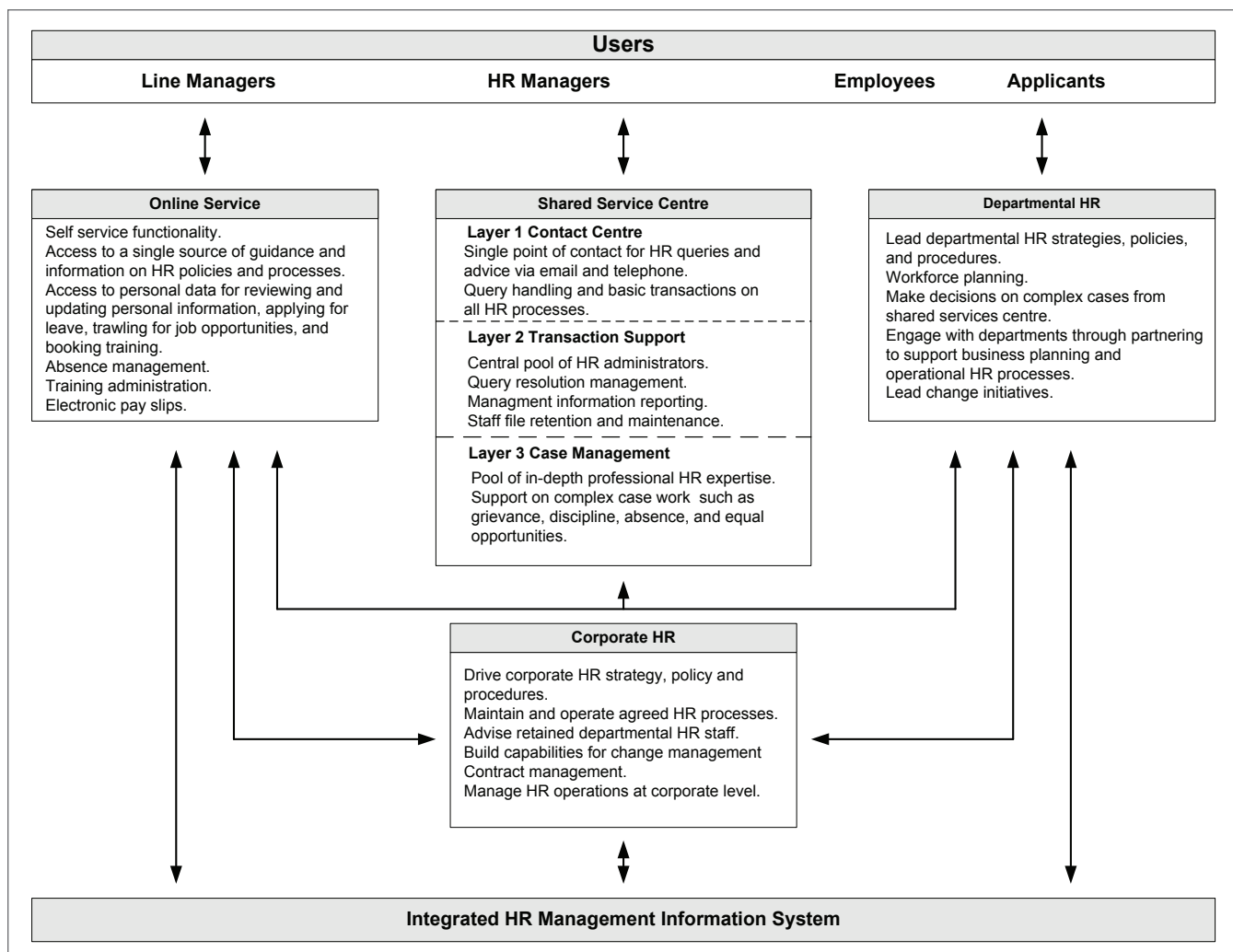
There were a number of challenges with this arrangement. It was a highly complex, large scale shared services arrangement involving 11 departments with 28,000 staff. There was a high degree of novelty, as few shared services arrangements of this scale had ever been attempted in the UK public sector. Implementing the arrangement would require significant organisational change. Line managers, who traditionally passed all HR-related issues to departmental HR, were expected to take more control and ownership of HR issues. There were many disparate systems and widely varying interpretations of corporate policies across the 11 departments, which made the task of enforcing a consistent and standardised approach challenging. Contracting was extremely challenging as there were significant shortcomings in existing processes and systems, and there was a lack of knowledge internally on contemporary IT-enabled HR systems and service level determination.

After detailed contract negotiations, a consortium of four vendors was selected including:

- A prime contractor who was responsible for the implementation, and overall management of the IT services, which involved implementing the Oracle software application to deliver the HR services;
- A shared services operator who was responsible for managing and operating the shared services centre through a front-office employee HR contact centre, and a back-office operation providing transaction services, casework and professional support to managers and employees;
- A specialist HR consultancy who was responsible for providing support on deploying best practice, business process redesign during implementation, and driving transformation in the retained HR function; and
- Oracle who was responsible for providing specialist Oracle consulting services, and working with the development staff of the prime contractor.

The structure of the new HR arrangement, developed from contract negotiations with the successful consortium, and had a number of elements is shown in Figure A1. The client signed a public private partnership (PPP) agreement¹. The contract was for up to 15 years, with an option for the client to terminate at any time after the 10th year. The arrangement was projected to be cash neutral as the cash savings achieved from implementing the new services and systems would be allocated to contribute towards future contractor service charges. Previously, there had been 900 staff involved in the provision of HR service, giving a full-time equivalent (FTE) ratio of 1:32². Under the new arrangement 350 staff were retained internally in the HR function, giving a FTE ratio of 1:80. Around 500 staff were redeployed internally to other posts, or internal staff transferred into the shared services centre, and there were no compulsory redundancies.

Figure A1 Structure of the outsourced shared services arrangement



Financial services organisation and mortgage processing

This case study emerged from outsourcing research undertaken with a financial services organisation with operations in the UK, Europe and the USA. The principal objectives of the organisation were to deliver a distinctive value proposition to its customers and to be in the top quartile of its European peer group in terms of earnings per share. The financial services organisation offered a range of financial services including deposit taking, current account facilities, residual and commercial mortgages, and other tailored products and services. Senior management at the financial services organisation were keen to evaluate the potential of outsourcing certain areas of the business as a means of improving performance and reducing cost. One area that the financial services organisation had considered outsourcing was the area of mortgages, as this had been a major issue of concern for the bank over a number of years. It had been experiencing considerable growth in this area whilst internal systems could not cope with the increasing volume of transactions.

A number of senior managers undertook an in-depth investigation into the feasibility of outsourcing this area in order to address this issue. This involved an investigation of both their existing systems and the capabilities of external vendors. The investigation revealed that the bank had under invested in suitable technology and was managing the increased workload through increasing staff numbers along with the introduction of excessive overtime. The investigation also revealed that management in the mortgages department were spending a considerable amount of their time sanctioning mortgages, which prevented them from effectively managing the department.

In relation to the analysis of external vendors, senior management identified and carried out some initial analysis of a number of potential vendors. These vendors had a lower cost base and could provide higher levels of service than the bank could attain internally. Initially, senior management considered outsourcing mortgage processing to one of these vendors. However, analysis of the bank's internal processes in mortgages had revealed that there were complex interdependencies in the form of unwieldy reporting structures and process duplications that would prevent the bank from transferring the relevant processes to this vendor. Senior management decided instead to embark on a business improvement exercise and radically redesign the existing mortgage processing structure internally, which involved separating mortgages into two distinct processes – sales/sanctioning and

processing. This strategy also involved allocating additional resource to ensure the processing aspect was improved. This involved re-defining current work roles and drawing up key performance indicators to include productivity rates, quality of work, turnaround times and levels of cross sales achieved.

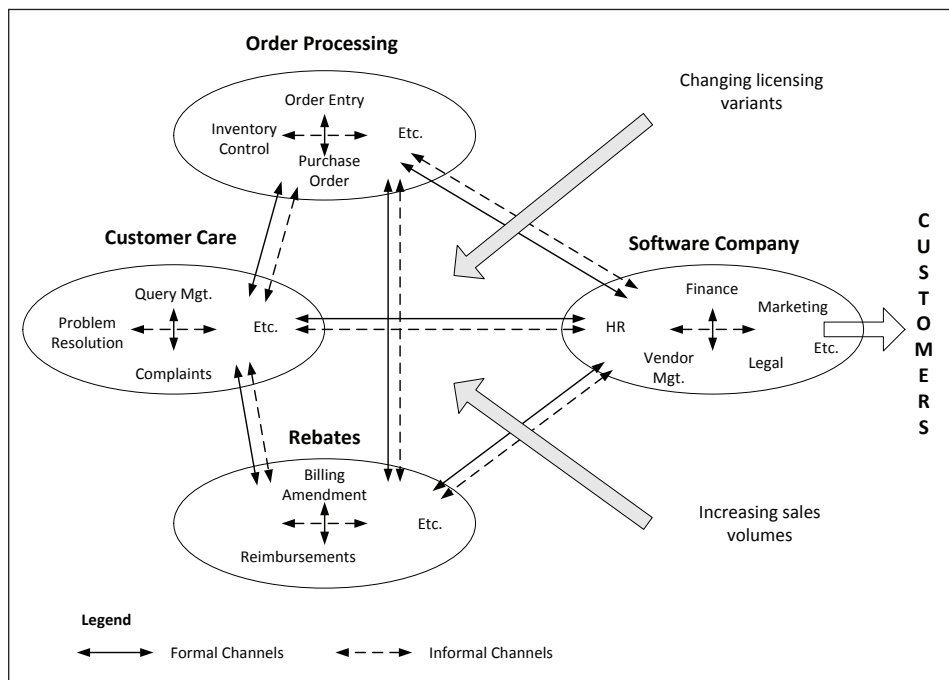
The software company and revenue processing

This case focuses on the European operation of a global software company that marketed software products to a range of customers including large corporations, small companies, government organisations, academic institutions and individuals in Europe. A key role of this operation involved processing revenue from its European customers. The company outsourced a number of elements of revenue processing including order processing, customer care and rebates to three vendors. Due to the importance of the processes, the company decided that the three vendors should be located on the same site, as this would allow for greater control.

There were a number of challenges associated with managing revenue processing. Revenue processing involved a lot of manual work, such as data entry and document scanning, which often led to errors in areas such as invoice accuracy, invalid contract agreements and incomplete documents. The software company had complex licensing agreements and pricing and rebate rules, which created complexity and often slowed down the total cycle time for processing revenue. Rather than opting for standard product options, customers such as large corporations often required a different suite of the company’s software products for each of its European sites, which led to different licensing agreements and pricing rules being applied. The software company frequently changed aspects of licensing agreements, which had knock on effects for processing.

After operating successfully for a number of years, the outsourcing arrangement encountered significant difficulties for a number of reasons. The outsourcing arrangement with the three vendors had grown on an incremental basis. Although the services provided by each vendor were closely related, there were poor communication interfaces between each vendor. There were informal communication channels between the software company and the vendors, which meant that customer queries were not being formally recorded and dealt with. For example, when a customer logged a contract query with the software company, it set off a series of informal telephone conversations between people in the software company and vendors, which often led to the query not being dealt with quickly enough. The inter-dependencies between the processes in each of vendors were not fully understood which meant no one vendor was taking responsibility for problems that arose. This created a blame culture amongst the vendors and the software company. This was all taking place in the context of increasing demand for the software company’s products and changing licensing agreements as shown in Figure A2.

Figure A2 Poorly understood and informal interdependencies



Retention was a problem for a number of reasons, including the lack of career development opportunities in the vendors and the transient nature of foreign language employees being recruited. All of these difficulties created a situation where managers in the software company were spending a considerable amount of time addressing any problems that arose with each of the vendors.

This problem was further exacerbated as there were separate vendors involved. Although, the vendors were located on the same site, managers in the software company were afraid to let go of the process and were operationally managing the vendors.

As a result of these difficulties, the software company terminated the contract with the three vendors and consolidated the three processes (order processing, customer care, and rebates) to one vendor. They chose a global vendor that already had close links with the company at corporate level. The vendor had sufficient capacity and skills to deal with the increasing requirements of the software company and could offer a number of standard processes that it provided to other clients. Prior to outsourcing this process, the software company embarked upon an internal business improvement initiative which involved a number of initiatives. It recruited additional expertise in the area of Six Sigma process analysis and workflow mapping, which allowed it to remove inefficiencies and idiosyncratic requirements from many of the processes involved prior to handing responsibility for the processes over to the vendor. The company also invested additional resource in codifying tasks and deriving performance levels associated with as many of the processes as possible. Undertaking this up front analysis allowed it to communicate its requirements more clearly to the vendor and created fewer problems in the early phase of the relationship.

This approach continued once the software company entered into the outsourcing relationship with the vendor. Although the software company could not completely eliminate the specific and changing nature of the requirements associated with many of the processes, it adopted a more formal approach with the vendor to documenting and updating processes, which involved using Intranets to store process maps and repositories of important knowledge. Documenting and reducing the idiosyncratic requirements from many of the processes limited the effects of employee turnover and also made it less difficult to move the processes to another vendor in the event of difficulties with the vendor.

The management consultancy organisation and facilities services

This case study focuses on a global management consultancy and the outsourcing of facilities services for one of its European territories. Facilities services management includes the delivery of non-core services and real-estate activities, and was a significant operating expense for the consultancy organisation. The bundle of services includes: cleaning, security, mail, audio visual services, office supplies, building maintenance, reception services, workspace management, and information technology support. All these services were outsourced to external vendors. The outsourced arrangements varied from large bundled services, such as building maintenance to single service elements, such as ordering fresh flowers.

In this case the management consultancy operated an internal helpdesk to run the facilities services for its employees. When an employee had a request for a facilities service, such as booking audiovisual equipment or logging an equipment fault, it contacted the helpdesk by email or telephone. The helpdesk was then responsible for directing these service requests to the relevant vendors and dealing with any queries from internal employees or vendors thereafter. However, a number of problems had arisen with this outsourcing arrangement. In particular, there were significant performance differences against the service level agreement (SLA) between those recorded at the helpdesk and those reported by vendors. Moreover, in some instances helpdesk staff were not allocating the services request to the correct vendor. The requirements of employees in relation to facilities services had been changing, and yet this arrangement failed to keep pace with this. For example, although many employees were affiliated with certain offices the actual time spent working at these offices was relatively low, as a result of employees working from home or working on client sites for long periods of time. Employees had to book work space and accommodation in advance of visiting offices with the facilities services function. The management consultancy had made little effort to forecast its requirements, which created difficulties for some vendors in meeting their requirements on time. Consequently, a team from both the management consultancy organisation and key vendors, led by an external consultant, was established to address these difficulties. Using a Six Sigma approach this team applied the Define-Measure-Analyse-Improve-Control cycle to improve the outsourcing arrangement. As a result of this approach significant improvements in performance were achieved.

ENDNOTES

1. A public private partnership (PPP) is an agreement between government and the private sector for the provision of public services or infrastructure. The goal of PPP for government is to access the management skills of the private sector, and reduce the capital expenditure involved in large projects.
2. FTE ratio denotes the number of HR staff to employees in the organisation.

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Dr Ronan Mclvor is a Professor of Operations Management at the University of Ulster. He has carried out extensive research in the area of outsourcing and supply chain management. He is currently carrying out research in the area of outsourcing with a number of service and manufacturing organisations. His work has been published in a number of leading international journals including the *European Management Journal*, *Journal of General Management*, *Journal of Operations Management*, and *OMEGA*. He has authored a number of books including *The Outsourcing Process: Strategies for Evaluation and Management* and *Global Services Outsourcing*, which have been published by Cambridge University Press. He is on the editorial board of a number of international journals including the *European Management Journal* and *Strategic Outsourcing: An International Journal*. He has been a visiting professor at the University of Missouri, USA, and has also taught on executive development programmes in Europe and the USA.

ABOUT SATER

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SATER's objective is to promote research into, and education of, accountancy, finance and management together with all subjects in any way related. In fulfilling its charitable objectives, it also seeks to provide public benefit by making grants for research projects which result in reliable evidence for use in the development of policy – by professional bodies, standard setters, regulators or governments.

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Further details about SATER and the ICAS research programme can be found from the SATER and ICAS websites: scottishaccountancytrust.org.uk/research.html and icas.org.uk/research.

David Spence
Chairman of SATER
March 2013

Services outsourcing has become a common feature in the global economy. However, whilst outsourcing offers the potential to reduce costs and improve performance it is not without risk. This research project develops a practical framework in which business improvement techniques can be employed to improve performance and reduce risk in various stages of services outsourcing.

The project involved an initial review of existing literature on services outsourcing and this has been published separately on the ICAS website under the title "What do we know about services outsourcing?". This identified a lack of a structured framework for integrating business improvement techniques into the outsourcing process. In-depth case study research was then conducted with four very different organisations that had been applying business improvement techniques at various phases of the outsourcing process.

As a result of this analysis a practical framework is developed and presented in this report, together with illustrations from the case study organisations. Both the benefits and challenges of applying business improvement techniques are also discussed and potential strategies for overcoming those challenges are suggested. The report concludes with a number of considerations for those involved in or currently considering services outsourcing.

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