MANAGING THE RISKS OF OUTSOURCING:

A SURVEY OF CURRENT PRACTICES AND THEIR EFFECTIVENESS

protiviti®
Independent Risk Consulting

APICS®

Business Risk | Technology Risk | Internal Audit

Table of Contents

Page No.

INTRODUCTION

OBSERVATIONS FROM THE SURVEY RESULTS

OTHER CONCLUSIONS AND OBSERVATIONS

The Outsourcing Risk Management Survey, cosponsored by APICS and Protiviti, was placed on the APICS Web site on June 6, 2004 and closed on June 27. The purpose of the survey was twofold. First, to examine the risks involved in outsourcing and second, to evaluate the effectiveness of outsourcing risk management practices. The survey received 260 valid responses.

INTRODUCTION

Potential Negative Outcomes of Outsourcing

Outsourcing generally, and offshore outsourcing in particular, continues to be a key part of many companies' supply and cost management strategy. The strategy has proven to be effective but brings with it significant risks that must be recognized and managed. In outsourcing, a company is relying on someone else to run certain business functions. If not properly managed, companies may negatively affect their operations and customers. The product or service can be outsourced, but the risk cannot. Some of the potential negative outcomes can include

- On-time delivery performance and end customer satisfaction levels may decline because of delays at third parties. This risk can be severely aggravated as product/service is outsourced. Delays can be caused by many factors that are outside the control of the outsourcing company. Examples include port/customs delays, labor disputes, weather, and political unrest. More extreme examples include terrorism-related delays and interruptions and uncertainty resulting from the outbreak of contagious diseases such as SARS. As lead-time and variability increase, so does the need for higher stock levels and other costly buffers, while overall supply chain confidence deteriorates.
- Product or service quality may also suffer in outsourcing, affecting customer satisfaction. Companies must carefully select, qualify, contract with, and manage their outsourcing partners to ensure that quality does not deteriorate. This often requires adequate transition periods and/or parallel production as well as effective cross-training between companies. These aspects are often neglected because of cost saving efforts.
- The outsourcing transition phase may also fail if schedules and budgets are not achieved because of insufficient planning and/or resources. An outsourcing project must be run with the same discipline and planning as a well-run large-scale systems implementation. Outsourcing is a replacement of production or service functions, and these functions have a direct bearing on the company's ability to meet its commitments to customers and shareholders.
- Suppliers may not be financially viable, thereby exposing the company to supply interruption risk. Surprisingly, effectiveness of the "financial viability" criterion scored lower than others in the survey, indicating that a significant number of companies could be at risk of supply interruption or related problems because of their suppliers' lack of financial resources.

"Outsourcing started with companies outsourcing physical parts. Now the big shift has been to outsource intellectually based service activities like research, product development, logistics, human relations, accounting, legal work, marketing, logistics, market research. If you are not best-in-world in doing something and are doing it in-house, you are giving up competitive edge. You could outsource to the best in the world, up the value, and lower the cost."

James Brian Quinn, Ph.D.
The Outsourcing Institute

Over the past three to four years many studies on sourcing have been conducted by a variety of research and consulting firms. These studies indicate that most companies spend between 40 percent and 60 percent of revenues with third parties. By all accounts, the percentage of third-party expenditures is continuing to increase with the growing trend toward outsourcing, especially to Asia, and increasingly to Eastern Europe, Mexico, and South America. However, those who participated in this survey indicated that less than 19 percent believe their organizations spend more than 40 percent of revenues with third parties. There are several possible explanations for this significant disparity including the following:

> "There is shift going on in the management of outsourcing. You actually need a higher quality management in order to outsource successfully."
>
> James Brian Quinn, Ph.D.

- Some of those taking the survey included materials/inventory purchases only. The reality is that third-party spend includes traditional materials purchasing; a wide variety of purchased services; and many outsourced processes including manufacturing, information technology, payroll, and accounting, and so on.
- Those taking the survey may not have access to complete information on third-party spend and how it relates to company revenue.
- The companies represented in the survey spend less on third parties than most other companies. This explanation is unlikely given the number of companies and the mix of industries that participated in the survey.

Separating Outsource Risk Analysis from Risk Management

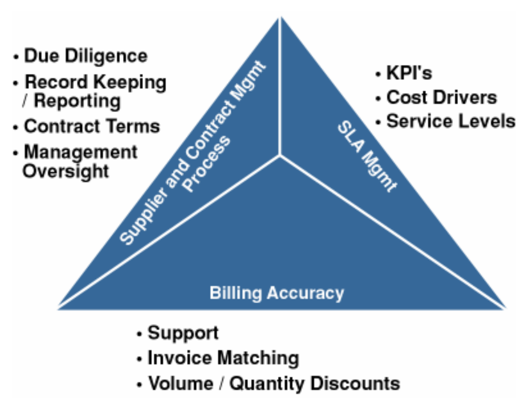
Outsourcing activity brings a significant set of risks. Most companies recognize this and respond by adopting a thorough risk analysis process. While risk analysis is a valuable tool, it must be accompanied by ongoing risk management to effectively mitigate outsourcing risks. The diagrams that follow illustrate this distinction.

Outsource Risk Analysis

Risk analysis is typically a point-in-time assessment. It is normally performed before supplier selection but is also a useful tool to periodically reassess a supplier's risk profile. As the diagram to the right illustrates, it is a process by which potential *suppliers* are compared to a set of *risk criteria* that the outsourcing company has established. As potential suppliers are filtered through the criteria, a *risk ranking* of the suppliers is developed. The best supplier may indeed be one that is rated as high risk. In this event, managers are aware that the supplier is high risk and can then write a more rigorous risk management process into the contract terms than would be required for a medium- or low-risk rated supplier. The desired supplier relationship will also be defined during the supply risk/impact analysis phase.

Outsource Risk Management

Risk management is an ongoing process that consists of three main elements: supplier and contract management, the service level agreement (SLA), and billing accuracy. Supplier and contract management keeps track of the statistics or historical performance of the outsourcing relationship over time. These statistics are continually leveraged to improve the performance of the relationship for both the outsourcer and the outsource provider. The SLA establishes what statistics will be kept and states the requirements of the parties. The SLA should be reviewed and updated periodically as determined by the contract terms. Billing accuracy is separated in this diagram because so many issues with outsourcing revolve around billing. The outsourcing party must continually review billing to ensure compliance with the contract terms.



Contract Risk Management

Companies generally benefit if they identify the outsourcing contracts that have the highest risk and importance to them. Once this is done, contracts can be segmented into categories such as high, medium, or low risk and can be managed accordingly. High-risk contracts will be on a more continuous review cycle because they provide a mission-critical product or service or have a high dollar or transaction volume. Medium-risk contracts might be actively monitored and reviewed on a frequent but not continuous (perhaps quarterly) basis. Low-risk contracts may not be as actively monitored. Rather there might be a set of metrics that are tracked and review might be triggered by deviations to contracted service levels.

Profile of Survey Respondents

Industry

The primary industry represented in this survey was manufacturing, distribution and technology (71 percent). Ten percent of the participants were from consumer products (CP) companies. The other industries represented included healthcare and life sciences, government, education and not-for-profit, financial services, energy, and media and communications.

Company Size

Companies of all sizes participated in the survey. The survey makes it obvious that companies of different sizes perceive different strengths and weaknesses in their ability to manage the risks associated with outsourcing. The chart below contains the breakdown of respondents.

Annual Revenues:	Survey Respondents
Less than $100M	40%
$100M to < $500M	27%
$500M to < $1B	9%
$1B to < $5B	11%
Over $5B	13%

Role and Title/Function

The survey benefited from having a good mix of professionals participate, as indicated by the following tables that profile roles in outsourcing and job title/function.

Role	Survey Respondents
Supply Chain/Procurement Leader	38%
Key Executive or Stakeholder	19%
Other Key Role in Outsourcing	23%
Insignificant Outsourcing Responsibilities	20%

The responses of those with insignificant outsourcing responsibilities were not analyzed in this report.

Job Title / Function	Survey Respondents
Senior Management	21%
Dept./Division Management	32%
Functional Management	19%
Other Supply Chain Professional	19%
Consultant	9%

OBSERVATIONS FROM THE SURVEY RESULTS

Each heading in this section reflects a section of the survey. The subheadings (underlined text) were risk considerations that survey respondents scored according to how effectively each one was managed in their respective companies.

Drivers of Outsourcing Review

The top three drivers that most often cause an outsourcing review are 1) the need to reduce cost or internal headcount, 2) internal capacity constrained by increasing market demand, and 3) internal manufacturing or service performance is insufficient or does not meet requirements.

Driver	Percentage
Need to reduce cost or internal headcount	29
Internal capacity constrained by increasing market demand *	22
Internal manufacturing or service performance is insufficient or does not meet requirements	20
Strategic sourcing process **	19
Regulatory, legal or environmental	6
Internal capacity is underutilized	4

* Senior management chose this as the most significant driver to cause an outsourcing review.

** Companies with revenues of $5 billion or greater chose the strategic sourcing process as the most significant driver to cause an outsourcing review.

Interestingly, senior management chose constrained capacity rather than the need to reduce costs as the primary driver of outsourcing reviews. The overall result may indicate that those below senior management may be assuming that outsourcing is being considered because costs are out of line. Perhaps management could lower the resistance to outsourcing by more deliberately communicating the rationale and objectives of each outsourcing program.

In the largest companies, the strategic sourcing process is what primarily drives an outsourcing review. This is a best practice for sourcing risk management and is one that could and should be adopted by all organizations.

Outsourcing: The Decision-Making Process

When determining what should be outsourced, the majority of respondents considered all four of the items listed below to be important or very important. The table lists these items by order of importance.

		Percentage Rated Important or Very Important
1	The company’s core competencies	82
2	Quality of product or service	77
3	Cost of internal vs. external supply	72
4	Need for specialized capability	64

Cost of Internal Versus External Supply
The cost of internal versus external supply is almost always a major consideration in making the decision to outsource. However, it is common to find that the total costs of the targeted outsourced functions are not well understood. Many companies struggle to identify the actual tasks performed by the functions being outsourced. These unknowns may affect the cost of the outsourcing or the level of satisfaction with the end product or service. Total costs including functional interdependencies must also be understood because they often drive costs indirectly related to the outsourced function. These total costs must also be included in the quantitative analysis.

Key executives most often rated the cost of internal versus external supply slightly lower than other respondents. The cost of internal versus external supply was rated very important by all but senior management. See table below. This is consistent with the results of the Drivers section above and demonstrates that senior management often views outsourcing as a means to achieve other strategic objectives such as market share expansion or to manage risks associated with constrained capacity.

	SC Leaders	Key Executives
Very important	48%	29%
Important	28%	42%
Average importance	15%	20%

Need for a specialized capability from a supplier
Companies are more often realizing that outsourcing decisions should be directly tied to corporate strategy and to an understanding of core competencies. Third-party suppliers can help increase the performance of the entire value chain if each of the participants in that chain understands and focuses on their respective core competencies. Core competencies might also include capabilities such as technical innovation or rapid response/flexibility.

The manufacturing industry most often rated the need for specialized capability from suppliers slightly lower than the other options. Functional management most often rated the need for specialized capability from suppliers as very important. Companies with revenues of $500M to $1B rated specialized supplier capabilities as more important than did other companies.

Project Planning and Project Management Risks

Project planning and management are critical disciplines to enable successful outsourcing initiatives. The planning and management referred to here go beyond PERT or Gantt charts and critical path analysis—although those are important disciplines and tools. But we also include the effective use of the people who possess the appropriate project management and risk management skills and experience and the ability to use the right tools and programs to get the work done. Members of outsourcing teams need to also bring with them specific knowledge regarding the outsourced product or function, business and stakeholder objectives, and the knowledge of the market and the skills to analyze the potential supply market and associated risks for the product or service to be outsourced. Team members must also be able to think critically about and assess what could go wrong and put sourcing and risk mitigation/contingency strategies and plans in place to handle those scenarios.

Approximately one-third of respondents said all project planning and management risks are managed with only average effectiveness. Additionally, almost 30 percent indicate project planning is done with less than average effectiveness. This indicates that there is a lot of room for improvement in project planning and management and project risk management as a whole.

Sourcing Strategy
Nearly 57 percent of companies manage this with average or less than average effectiveness. Additionally, consumer products companies rated themselves lower than did manufacturing, distribution, and technology (MDT) companies.
The perception of sourcing strategy effectiveness that senior management holds is lower than that held by departmental and functional management. Again, senior management appears to have a different perspective on the management of outsourcing risks and generally believes there is more room for improvement.

The lack of a rigorous strategic sourcing methodology and complete market and risk analyses to produce an effective outsourcing strategy, presents significant risks to an organization. These risks include inconsistent sourcing and selection criteria, lower quality, higher pricing, the loss of purchasing leverage, and so on. Savings and value improvements achieved through strategic sourcing flow directly to the company's bottom line. In comparison with top-line revenue growth, sourcing is normally a much more effective lever to improve overall company profitability and can generally be done much more easily than additional new product introductions, geographic expansion, acquisitions, and other sales or top-line growth strategies.

Outsourcing Methodology
Consultants, functional management, other supply chain/procurement professionals, and companies with revenues of $5 billion or greater most often said that their companies are effectively managing the outsourcing methodology.

Consumer products companies rated themselves lower than MDT companies, with more than 30 percent indicating they were below average. Senior management holds a lower opinion of outsourcing methodology effectiveness than departmental and functional management. More than 60 percent of senior management respondents described their companies' methodology as average or below average.

As with any important sourcing strategy, companies who do not follow a carefully developed and highly inclusive outsourcing methodology increase their sourcing risks dramatically. Without a detailed, disciplined methodology and procedures, companies will often suffer from inconsistently applied policies and strategies, higher risks and more serious risks, and processes that will be ad hoc rather than well defined and/or optimized. The results will tend to reflect lower efficiency, inconsistent supply results, and higher operating costs.

Outsourcing Team
Almost 64 percent of respondents rated the expertise and skill of the outsourcing team as average or less than average. Again, senior management tends to rate outsourcing team effectiveness lower than those at subordinate levels in the organization.

There are several characteristics to look for when assembling an outsourcing team. These include diversity of skills and opinion—the team must be cross-functional and members should have multidisciplined backgrounds. The team should be made up of people who will challenge themselves and others. The teams should contain the skills required to plan, analyze the supply market and risks, source and select suppliers, negotiate and to plan negotiations effectively, and design and execute comprehensive and effective contracts and supplier relationships and controls. They should be self-directed and should not easily accept the status quo. Supplier, product, and process-specific knowledge must be represented on the team. They must be able to work with people at all levels of an organization, internally and externally.

Assessment of Project Risk
Sixty-three percent of the time the assessment of project risk is carried out with average or less than average effectiveness. This would indicate there is a large opportunity for improvement, especially given all of the risks inherent in so many significant outsourcing decisions.

In this category, too, senior management rated effectiveness lower than the other respondents, with as many as 34 percent saying their companies' proactive management of outsourcing project risks was actually below average. Additionally, those holding other key outsourcing roles most often rated their companies' effectiveness at managing the assessment of project risk as below average.

Assessing and Managing Outsourcing Project Risks:
Outsourcing organizations need to use models such as the one presented here to help develop strategies and tactics for assessing and managing project risk. This is a generic project risk management model, but it applies equally to outsourcing and to systems integration/systems project risk management. The basic notion is that the project is continually being evaluated in relation to the goals and objectives that were set out initially. Items or barriers that could prevent the objectives from being achieved are identified. Then risk management strategies are put in place, followed by control mechanisms to ensure the risk management strategies are followed. The controls are actively monitored. Feedback from monitoring activities helps identify opportunities to improve performance and risk management capability. Proactive and effective project risk management can help to predict and then prevent major implementation problems.

Supplier Selection Risks

The survey showed that supplier selection risks managed most effectively are 1) the identification of best providers/suppliers, 2) the request for proposal/quotation (RFP/RFQ) process, and 3) the fair evaluation of proposals.

Respondents indicated that all the steps required to manage supplier selection are controlled better than other outsourcing risk management activities. The steps are summarized here with their respective scores.

- **Identifying best providers/sources** – Nearly 60 percent of respondents replied that they managed this with better than average effectiveness. Still, 13 percent do a less than average job.
- **Comprehensive RFP/RFQ** – Nearly 55 percent said they did a better than average job. However, there is always room for improvement, especially for the 17 percent that do a less than average job.
- **Proposals effectively evaluated** – 67 percent report they do a better than average job, and just over 10 percent say they do a less than average job.
- **Supplier financial viability** – While 53 percent reported that their organizations do a better than average job, that still leaves a large 47 percent with average or less than average effectiveness. That this element scored much lower than the others should send up a red flag. Financial viability is a major consideration when selecting suppliers and managing outsourced suppliers. It may be important that the supplier has the capital necessary for research and development. Additionally, it is important to understand other aspects of the supplier's business, such as who the supplier's major customers are, the supplier's susceptibility to the loss of a major account including the account of the company planning to do the outsourcing, and the supplier's ability to remain in business if such a loss occurs. In addition: What kind of financing is employed; how likely is it that note covenants will be triggered; and if they are, will the company be able to meet its obligations? These are some of the important questions that should be considered when assessing financial viability.
- **Technical evaluation** – More than 70 percent report doing a better than average job, while almost 10 percent report doing less than average.
- **Country risk assessment** – More than 57 percent are doing an average or less than average assessment of country risks. This could be a major problem because the rise in global sourcing is making it necessary to give more attention to country-specific risks. Management must be aware of these risks and either accept them or develop risk mitigation or contingency plans to handle them.

Outsource Contracting and Negotiation Risks

Outsource Contracting and Negotiation Plan
Fifty-eight percent of respondents said their company did not create and use an outsource contracting and negotiation plan. Creating such a plan is a best practice that organizations should follow to develop and negotiate sound, competitive, and enforceable deals.

Negotiation planning enables the outsourcing team to prepare for the contracting and negotiation process. Price and total cost are typically major factors in any negotiation plan, however, the planning process enables other key objectives to be identified, documented, and addressed proactively, including

- Defining and documenting a clear and precise understanding of expectations of the outsource supplier—the requirements of the outsourcing company
- Discussing and confirming the contract terms and conditions that the company needs to negotiate to govern performance
- Defining proactively what other actions need to be taken and what further information will be needed to ensure that the supplier will be able to fulfill all the requirements effectively
- Reconciling any key exceptions that may have been made by the potential supplier in response to the RFI/RFP/RFQ
- Documenting all information required to help ensure that the supplier understands and is prepared for the subsequent contract performance and management expectations and process

The negotiation plan should leverage documentation and information from the analysis phases and related activities in the outsourcing process that the team had gathered to this point in the negotiation and contracting process. These include

- A description of the product or service being outsourced and the business case
- The supply market analysis
- The procurement risk and business impact analysis
- The documented sourcing strategy
- A record of the RFI/RFP/RFQ process
- An analysis of proposals or bids received and the rationale for selecting suppliers with whom the company will negotiate
- The detailed analysis of the requirements and the total costs including price, time, quality, and so on that the contract must satisfy

With the negotiation plan defined and approved by the appropriate executives and/or stakeholders in advance, the outsourcing project team will be prepared and empowered to negotiate and agree on the contract within those preapproved parameters. Role-playing can be predefined for the negotiation process so that all members are clear as to what is negotiable and what is not and who will play which role in the negotiations.

Contracting and Negotiation
With the benefit of a comprehensive overall contract plan and a well-defined and agreed upon negotiation plan, companies can more easily and effectively manage the contracting and negotiation considerations. Survey participants were asked to rate how effectively their companies manage the following contracting and negotiation considerations.

- Product specification and performance standards
- Service level agreements
- Regulatory, privacy, information technology, and security requirements
- Intellectual property
- Transition requirements and provisions

The responses indicate that most companies believe they manage these considerations in a better than average way. However, “transition requirements and provisions” was the area of least confidence within the survey. More than half the respondents said this was managed with average effectiveness or lower than average effectiveness.

One of the most critical phases in outsourcing, the transition process is the point when the dialog and direct responsibility are moving from the deal-makers to the operators. Thus, it is a time when issues may surface for the first time. Building transition requirements and provisions into the outsourcing plans and agreement can greatly ease this transition process and put the appropriate focus and expectation into this portion of the arrangement. Examples of transition requirements and provisions include building higher than normal levels of safety stock, temporary financing provisions, defining a transitional issue escalation process and criteria (this may include shorter time windows and higher levels of management than the normal escalation process), tooling moves and calibration, assigning capable resources, and developing contingency plans.

Transition and Startup Risks

In the transition stage, issues can surface for the first time that have not been anticipated or arranged for contractually and these may cause business disruption as well as unhealthy animosity between the parties.

Respondents said the top three effectively managed transition and startup risks are 1) product or service supply interruption, 2) plans for production factors, and 3) the mutual commitment by both teams.

Product or Service Supply Interruption

Seventy-six percent surveyed stated that this risk was managed with average or above average effectiveness. This is evidence of how highly outsourcing companies rate this risk. But, what of the remaining 24 percent who manage this risk with less than average effectiveness? They are taking on risks with potentially fatal consequences.

Interestingly, respondents holding other key outsourcing roles and functional management most often said that their companies are managing the risk of product or service supply interruption with below average effectiveness. Thirty-two percent said their companies were ineffective in managing supply interruption. If this bears out it is a serious condition.

CP companies again score themselves lower than do MDT companies. Thirty-two percent of CP companies say they are ineffective versus just 19 percent of MDT companies. This may be because the margin for error in CP companies is generally lower. CP companies tend to run the business with less inventory, and products tend to move faster than traditional discrete manufacturing products. Therefore, while performance might be similar, the typical CP company’s risks may be greater

Plans for Production Factors

Functional management most often said that their companies are managing plans for production factors with below average effectiveness. This may be because functional management has the most direct knowledge of transitional issues. Those in division and senior management positions may not be as aware of all the issues as they arise. Additionally, those in other key roles rate their companies’ effectiveness lower than do supply chain leaders and top executives, with 25 percent rating planning for production factors as ineffective.

Companies with revenues of less than $100 million and of $500 to $999.9 million most often said that their companies are managing plans for production factors with average effectiveness. Companies with revenues of $100M to $499.9M are less consistent than other companies. Fifty-four percent of these companies say they are either effective or very effective, but 19 percent say they are ineffective.

Mutual Commitment by Both Teams

Thirty-six percent of respondents said that their organizations effectively manage mutual commitment by both teams, whereas 32 percent said the organization was average at managing this risk. Those in other key outsourcing roles, functional management, and companies with revenues of $100 to $499.9 million most often said that their companies are managing the mutual commitment of teams with average effectiveness. Nineteen percent of those in other key roles said this risk was managed ineffectively.

Risks Specific to Management and Employee Resistance

Overall, risks specific to management and employee resistance were reported to be managed with average or better than average effectiveness more than 73 percent of the time. However, this implies that the risk is managed in a less-than-effective manner in more than 26 percent of the cases, which should be a big concern and which leaves a lot of opportunity for improvement for many organizations.

Employee resistance can be a major issue when outsourcing any type of operation. Losses in morale, productivity, and personnel are common. Sabotage is also possible. Relatively simple and effective strategies and tactics can be employed to dramatically reduce the impact of these risks, but they must be well *planned* in advance of any internal or external announcements regarding outsourcing.

Effective outsourcing communication as well as outsourcing change management plans should address specifically targeted audiences through the proper communication channels, with tailored messages, and timing. The planning should also address and most likely change compensation and incentive plans during the interim transitional period. In addition, the change management plan should assess and address roles, responsibilities, resource skills, training requirements, and so on. All these elements must be present to effectively minimize the inevitable resistance risks to outsourcing.

"The first thing you need to do is reassess the managers themselves. We used to promote managers for their capabilities within a function. They might be brilliant designers, lawyers, etc., but might not have the capabilities needed for managing outsourcing. This means being able to assemble information from outside sources. They need to have the ability to evaluate alternative cost structures and to understand the strategic risks of outsourcing to one partner versus another.... They need a totally different set of management skills, and the real essence of these skills is a learning capability and willingness."

James Brian Quinn, Ph.D.

Problem Escalation Process

Key executives most often said that their companies are managing the problem escalation process with average or below average effectiveness. Twenty-five percent of those in other key roles and 29 percent of key executives rated management of this risk as ineffective. This is another important part of the outsourcing relationship implementation process, and to help avoid frustration and failure, the associated relationship and performance risks should be managed proactively and effectively.

Outsource Contract and Supplier Performance Risks

Respondents said the top three effectively managed outsource contract and supplier performance risks are 1) supplier performance and compliance, 2) assignment of company and supplier roles, and 3) establishment of the performance feedback loop and controls.

These are all critical control areas for successful outsourcing. A range of effective and efficient performance and compliance monitors and controls must be in place. The outsourcing team should also have well-defined procedures, reporting matrices, and meeting schedules/calendars, and document in detail and consistently execute the roles and responsibilities for all parties.

To manage outsourcing performance risks, management controls and forums should be set up and executed to address issues such as

- The analysis and resolution of performance issues
- Internal and external customer issues
- Personnel issues
- Joint proactive crisis prevention and contingency planning
- Third-party provider issues (as applicable)
- Forecasting and demand planning (S&OP) issues

- Recommendations for changes
- Planning of new initiatives
- Review of major changes to either party's processes or technology
- Billings and payments

Supplier Performance and Compliance

Of those surveyed, 43 percent reported that this area is managed with average or lower than average effectiveness. Those holding other key outsourcing roles and companies with revenues of $1 billion to $4.9 billion most often said that their companies are managing supplier performance and compliance with average effectiveness. Of those in other key roles, 21 percent said they were ineffective at managing supplier performance and compliance.

These results may come as a surprise to many. However, performance and compliance issues are evident in a wide range of industries for organizations that are outsourcing both services and/or materials. Considerable effort and attention can go into the planning, sourcing, selection, and contracting phases, only for the entire effort to fail to meet expectations because of a lack of investment in and commitment to supplier management and contract administration. Absent very effective processes for managing supplier and contract performance and compliance, the company leaves itself open to a host of risks, all of which should have been identified in the analysis and planning phases of the outsourcing program.

Company and Supplier Roles

Eighty-five percent said that assigning company and supplier roles is done effectively. Those holding other key outsourcing roles, functional management, and other supply chain/procurement professionals most often said that their companies are managing the assignment of company and supplier roles with average or above average effectiveness. Key executives rated the effectiveness of the management of this risk higher than supply chain leaders and those in other key roles. If this is a strategically important relationship, then the company and supplier roles should include executive-level assignments to lead that relationship at the customer and at the supplier.

In addition, important and successful strategic outsourcing arrangements generally enjoy the benefit of executive-led oversight councils. These councils are typically established with executives from both parties taking the lead supported by relationship managers and account managers on both sides of the agreement. These roles as well as the roles and responsibilities contract administration, supplier management, and other key stakeholders and contributors must be clearly and effectively defined and documented

Oversight councils are created and maintained to address strategic mid- to long-term plans, initiatives, and risks as well as to help with some of the more immediate performance issues, resource needs, barriers, decisions, modifications, and arbitration.

Performance Feedback Loop

Almost 43 percent manage the performance feedback loop and controls with average or less than average effectiveness. Supply chain leaders and companies with revenues of less than $100 million most often said that their companies are effectively managing the performance feedback loop.

CP companies rated themselves lower than MDT companies, with 44 percent saying they were just average. Given the nature of consumer products (fast moving, short life cycle, promotions-driven) it may actually make sense that they have less-developed feedback loops with their suppliers. Suppliers in this industry often receive effective and efficient feedback through point-of-sale data, the rebates process, and promotions programs.

Those in other key roles rated their companies lower in this area than did supply chain leaders and key executives. Twenty-three percent rated their companies as ineffective.

Establishment of Formal Executive-Level Roles

Just 32 percent say they establish formal executive-level roles with better than average effectiveness. More than half of the respondents scored their companies' effectiveness of this best practice as average or ineffective, with about 26 percent saying it was managed with below average effectiveness.

Audits of Supplier Processes, Documents, and Data

More than 25 percent conduct audits of supplier processes in a less than effective manner and about 55 percent in an average or lower than average manner.

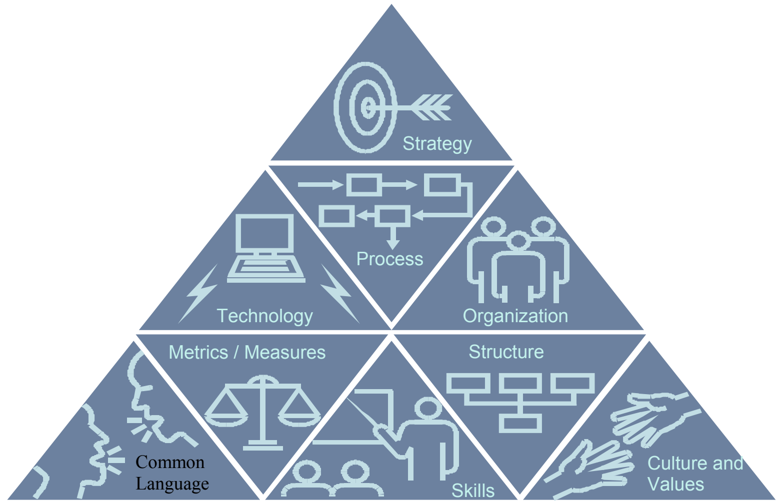
Supply chain leaders, key executives, senior management, department/division management, companies with revenues of $100 to $499.9 million, and companies with revenues of $5 billion or greater most often said that their company's are effectively managing audits of suppliers. Functional management most often said that their companies are very effectively managing audits of suppliers.

Of companies with revenues of $500M to $999M, 24 percent said they were ineffective in their audits of suppliers. This might indicate that as companies approach revenues of a billion dollars, they do recognize the need for supplier audits but have not yet invested sufficiently to build the capability effectively.

OTHER CONCLUSIONS AND OBSERVATIONS

Common Challenges

Outsourcing presents some common challenges regardless of what is being outsourced. If these challenges are met, outsourcing can be a highly effective strategy. Challenges include



Understanding the Hidden Risks
Outsourcing may have widespread impact on other business processes, your reputation, or your customers, and so on

Meeting Operational Performance Targets
Quantifying the success of the outsourced operation not only by evaluating service level agreements (SLAs) but also by tying the operation to your customer service and other related goals

Achieving End-User Satisfaction
SLAs that meet the contractual requirements may not meet the needs of the other key business process stakeholders

Achieving the Promised Cost Savings
Understanding, quantifying, and communicating the true value improvements generated through the outsourcing duration

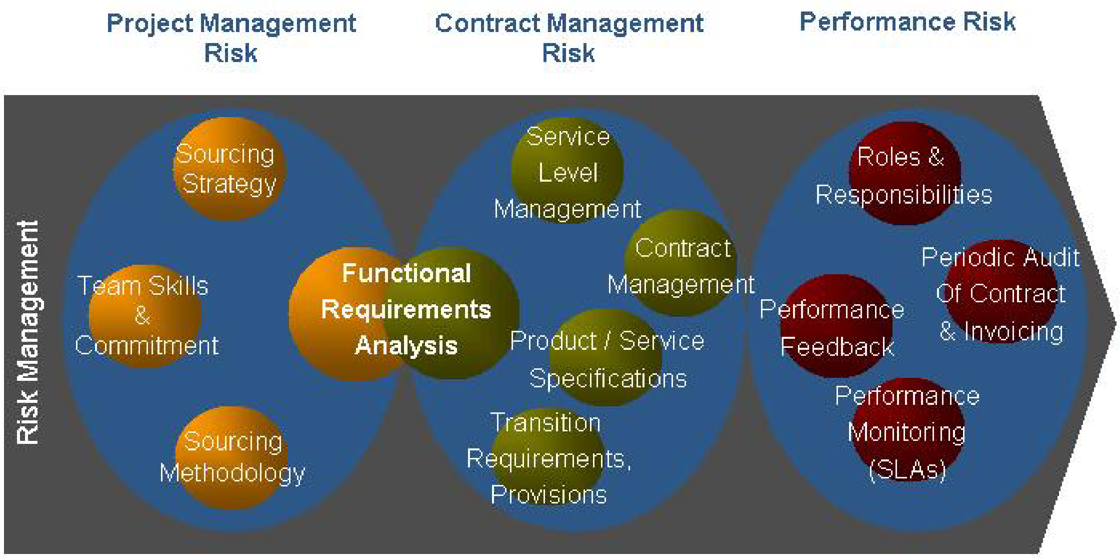
Reasons for Failure

Many reasons exist for the failure of outsourcing arrangements. Each reason can be unique to a particular company and situation. The following list will help identify some potential failure points that may arise during an outsourcing process.

- **Outsourcing a function that is broken** – The natural tendency may be to get rid of things that are not working well. This tendency must be avoided when considering which functions to outsource. Why? Because business requirements cannot be adequately communicated with a broken process, and managing a process effectively requires an understanding of how it is supposed to work. The process must be fixed before it can be outsourced.
- **Lack of understanding the total cost structure, value improvements, or savings and/or avoidance** – If cost is a factor in the decision to outsource, all parties must understand the financial goals of the outsourced function. Not only should the goals be stated, but how they will be monitored should also be clear. Because some assumptions that were valid when the arrangement was executed may eventually prove to be invalid, the agreement must define and report on what is expected to be delivered for both parties. Total costs of the function must be defined.
- **Misunderstanding the service levels -** Although they are often documented, it is common for SLAs to be misunderstood. This is why it is a good idea to run parallel operations for a period of time or to build an interim checkpoint into the agreement. The checkpoint can be used to make sure SLAs are, achievable and understood and to make adjustments if needed.
- **Strategic sourcing process not effectively employed** – As obvious a necessity as it seems, many times an effective strategic sourcing and supplier selection process and methodology is not leveraged.
- **Contract management is ineffective** – Likewise, an effective contract management process is not always employed. Risk of failure increases dramatically if the outsourcing arrangement is not well designed, negotiated, managed, controlled, and executed.
- **Upfront risk assessment is not performed** – Again, if the risks of the outsourcing program are not clearly understood before action is taken, it is easy to make a bad outsourcing decision, even when the best supplier is chosen.

Outsource Risk Management Framework

Building on the need to satisfy management's expectations, Protiviti has developed a series of tools and methodologies such as the outsource risk management framework that is illustrated below. The framework depicts the types of risk management activities that should be considered throughout the outsourcing life cycle.



Before and during the actual outsourcing effort, project management activities center on the sourcing strategy, which should be tied to the overall company strategy. The team must be cross-functional and composed of personnel with the proper technical (product/service), process, and analytical skills. The sourcing strategy should drive the supplier selection and relationship. Finally, to minimize the risk of project failure, the team should employ proven outsourcing and risk management methodology.

To mitigate contract management risk, it is best to develop a contract plan and a negotiation plan to proactively plan and document all aspects of the agreement including service level agreements, escalation procedures, product specifications, transitional requirements, roles and responsibilities, and exceptions.

The foundation to managing and controlling performance risk is built during contract planning, negotiation, and post-award management of the contract and supplier phases. Here, the primary tool is the development and negotiation of a comprehensive contract that includes an effective performance feedback mechanism that should be supplemented by performance monitoring and periodic contract and invoice audits as well as other measurements and controls. Clarity of roles and responsibilities in this stage will be critical to the management of the contract and will also support the achievement of supplier and contract management process efficiency and control objectives.

In conclusion, materials and services outsourcing provides management with highly important strategic and competitive alternatives in today's challenging business environment. But outsourcing is often a high risk and/or high impact proposition for organizations. The more successful organizations have developed comprehensive approaches to project planning and decision making; have employed rigorous tools, frameworks, and methodologies; have demanded excellent cross-functional and cross-company teamwork; and have implemented highly effective risk management, performance management, compliance and control techniques, and disciplines.

ABOUT PROTIVITI INC.

Protiviti is a leading provider of independent internal audit and business and technology risk consulting services. We help clients identify, measure, and manage operational and technology-related risks they face within their industries and throughout their systems and processes. Protiviti also offers a full spectrum of internal audit services, technologies, and skills for business risk management and the continual transformation of internal audit functions. Protiviti, a wholly owned subsidiary of Robert Half International Inc. (NYSE: RHI), has more than 30 locations in North America, Europe, and Asia.

About Protiviti's Supply Chain Risk Consulting Service Line

At Protiviti, we draw on our deep procurement process knowledge and experience, and our risk and business consulting and internal auditing expertise. We use the most current and proven procurement/supply risk management techniques and tools. We constantly seek to improve our knowledge and to develop and enhance our supply risk management tools and methodologies in conjunction with our clients. We provide independent supply chain and procurement risk consulting services on a project-by-project basis. We also provide such service to our clients through the internal audit channel. We serve clients across the full range of industries. We leverage our in-depth and up-to-date knowledge management database and cross-industry experience to help management at our clients to develop achievable and results-focused action plans for their organizations. These plans address all procurement capabilities in parallel, recognizing the interdependencies among capabilities. What results is an agreed-upon, integrated, and actionable set of short-term, intermediate and long-term plans that help drive crossfunctional and executive-level buy-in and commitment as well as superior business results.

About the Authors

Philip O'Keeffe, CPIM, is co-leader of Protiviti's supply chain risk consulting service line. O'Keeffe spent 20 years in supply chain, procurement, and operations management leadership positions in a number of industries in Europe and the United States before joining the consulting industry in 1998. He is passionate about helping clients improve supply chain management performance and risk management capabilities. O'Keeffe specializes in procurement/sourcing, resource planning, scheduling, and control as well as strategic planning. Philip has authored a number of other white papers which have been published by APICS, including *Understanding Supply Chain Risk Areas, Solutions, and Plans* and *Reduce Supply Chain Risk and Improve through High-Impact Supply Chain and Procurement Capability Assessments*.

Scott Vanlandingham, CPIM, is a Managing Director at Protiviti, where he co-leads the Supply Chain Risk Management practice. In this role, he assists companies in identifying, measuring and managing the risks inherent in their supply chains. Prevoiusly, Scott was a partner with Arthur Andersen and held executive consulting positions at Ernst and Young (now CapGemini). Scott began his career as a Manufacturing Engineer in the Aerospace and Defense industry for eight years. In Scott's 18 years of professional experience he has been fortunate to work on supply chain issues in multiple industries including discrete and process manufacturing, consumer products, high tech, oil and gas, steel, medical devices, and food service. His experience includes process improvement, reengineering, and complex systems integration. He has been responsible for several ERP implementations including SAP, QAD, JDE and Oracle. Scott is a certified SAP Consultant in Materials Management and Production Planning.

For more information about Protiviti's supply chain risk services, please contact Philip O'Keeffe or Scott Vanlandingham at (888) 556-7420.

ABOUT APICS

APICS is the recognized global leader and premier provider of inventory and supply chain management education and information for individuals and organizations. For more than 45 years, APICS has been setting the standard in professional certifications, education programs, and publications for manufacturing and service industry professionals across the entire supply chain.

APICS' Enterprise Knowledge Solutions are results-oriented educational, training, and membership programs designed especially for your company. APICS believes that education and training should not be a "one-shot" approach. Realizing that maintaining supply chain and inventory management excellence requires continuous commitment to training and knowledge, APICS will provide your team with customized or competency-based education as well as useful industry tools and resources.

For more information on how you can empower your employees through APICS' Enterprise Knowledge Solutions, send an e-mail to solutions@apicshq.org or call (703) 354-8996 ext. 2387. You can also learn more about the APICS community at www.apics.org