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Cutting costs in the finance function

The first question to answer is whether you should outsource at all – and the second is how? **Peter Scott**, partner in ALS Consulting, sets out the key issues for the finance function to consider and offers guidance on best practice.

Introduction

The options open to businesses for sourcing finance processes, especially the transactional elements, have widened considerably over the past five years with the development of the outsourcing market. This is not to say that outsourcing certain parts of the finance process is particularly new, as many companies have outsourced payroll processing, for example, for many years. What is new is that a number of outsourcing service providers (suppliers) have developed a track record of delivering a range of transactional finance processes from low-cost locations, ie the 'nearshore' (generally Eastern Europe) and 'offshore' options (India, China and similar locations).

There are new examples being added to the finance process outsourcing (FPO) reference list every week, it seems. Well known names outsourcing all or part of finance in the past six months have included Goodyear, Procter & Gamble and MyTravel – these join an already impressive list that includes BP (one of the pioneers), General Motors and International Paper.

However, although finance outsourcing has a high profile and there is a high level of activity both at the investigatory and the implementation levels, it is still a relatively immature market. The potential outsourcing customer needs to be very clear about the challenges and issues his or her company will face in seeking the undoubted benefits; there is no 'one size fits all' approach. This paper seeks to act as a guide to the main points that need to be considered and what options are available.

What can be outsourced

It is useful to understand the main finance processes that have been outsourced to date, which are:

- *purchase to pay* – which the outsourcer will usually carry out from receipt of purchase invoices through matching, approval, dispute tracking, dealing with supplier queries and payment. This often includes expense claim processing;
- *accounting to reporting* – this usually includes chart of account maintenance, general ledger maintenance, key accounts reconciliation, period end closing, and report preparation (management, tax, VAT, statutory);
- *accounts receivable* – this often starts with cash application and includes routine dunning and customer account queries. More complex disputes and cases of non payment will be referred back to the business; and
- *cash and banking* – including bank reconciliations, and urgent, off process and routine payment processing.

There are several finance processes which can be outsourced

As a rule of thumb, if tasks can be documented to an 80/20 level or higher, if they are repetitive, and if they can be learned in no more than six weeks given a certain skill level, then

a supplier will be able to take on the process. The flip side, however, is that suppliers will only do what they are instructed to do by the customer and will not exercise judgement on their behalf. For example, if VAT regulations change and there are options available for compliance, the supplier must be told what route to take, although a good supplier would spot this and approach the customer for guidance.

Initial customer concerns often focus less on the practicalities of outsourcing and more on issues such as how to deal with important customers and suppliers and what happens if the business changes. In addition, confidentiality is a common concern – is the customer prepared to let a third party have access to sensitive commercial data?

Outsourcing raises issues of data confidentiality

Although the supplier will sign confidentiality and non-disclosure agreements, and can be sued if these are breached, there is no watertight way of dealing with this issue and ultimately it boils down to trust. However, most potential customers have a wide range of advisors and other third parties who are trusted with access to sensitive data – the outsourcing supplier should be no different.

With this understanding of what can, in general, be outsourced, it is worth considering the many options available. To simplify things we can think about this in two key dimensions:

- *what structure* – there are three main kinds of structure available:
  i) a contract with an outsourcing supplier, which is by far the most common arrangement of which there are now many examples;
  ii) joint venture (JV) with an outsourcing supplier, which is less popular now that the contracting route is readily available; and
  iii) an arrangement known as partnersourcing, where the customer has an in-house facility but employs a third party to run it and to provide the management; and
- *where* – there are three types of location available:
  i) onshore, ie in the UK;
  ii) nearshore – quite possibly but not necessarily in Eastern Europe; and
  iii) offshore, ie India or China.

'Bestshoring' or 'rightshoring' means the best solution for the customer

The terms 'bestshoring' or 'rightshoring' are also becoming more common in relation to outsourcing. They simply mean the best solution for a particular customer's requirements.

The main advantages and disadvantages of each option are set out in the tables opposite.

Selecting the right option

So, how should potential outsourcing customers select the right option? The first point to consider regarding location is language requirements. At present, if European languages other than English are required, offshore is not really an option although this may change in the future as the major outsourcing suppliers develop their capabilities and training. Having said that, some suppliers are promoting the 'front office/back office concept' in relation to foreign language offshoring, where the work which demands good spoken language skills would be done in Europe whereas any work which can be done by using reading skills could be done offshore.

If European languages are required, this work could be done either onshore or nearshore. Although nearshore will probably be cheaper, one of the differences from onshore is that, if the delivery centre is in Eastern Europe, foreign languages will in general be supplied through nationals of the delivery centre country, rather than by employing foreign nationals. Incidentally, this can sometimes come as a surprise to businesses outsourcing from Western Europe to Eastern Europe.

If only English is required, the work can be done in any of the three locations. Taking environmental factors such as political stability as givens, the main criteria are likely to be cost and culture given that highly educated English-speaking personnel are going to be available, unless of course there is a specific requirement such as experience of a particular enterprise resource planning (ERP) platform.

Regarding the structure of the deal, at present most companies go for an outsourcing contract with a supplier because it is the simplest option to enter into. In general, companies who believe that a JV is the best route are trying to get into the outsourcing business themselves, and need an experienced partner, or wish to share risk and reward more explicitly. However, it is a complex route demanding a considerable amount of management time and input, and experience shows that these arrangements are often unwound after two or three years.

Partnersourcing is applicable where the customer recognises that he does not have the

Table 1

The structural analysis

Structure	Main advantages	Main disadvantages
Contract with outsourcing supplier	● Moving finance outside the business is a catalyst for change ● Risk (eg achievement of process improvement targets) is transferred to the supplier ● Clearer division of responsibilities between supplier and customer than in most in-house shared service centre (SSC) implementations	● Possible perception that customer is not sharing equally in the benefits ● If the function goes outside the customer it may be difficult to bring back ● The contract may not be sustainable as interests are different ● Often very contractual and may be perceived as inflexible
Joint venture with outsourcing supplier	● Better potential to align supplier and customer interests ● Customer can retain ownership and governance control ● Staff potentially move 'within' customer group	● Joint venture contracting process can be lengthy and expensive ● Governance effort can be disproportionate – interests may not be as aligned as had been thought ● There may be a lack of clarity and discipline – the joint venture is neither inside nor outside the customer
Partnersourcing	● Customer retains ownership and responsibility ● Less deal structuring and contracting than the other options ● Supplier is incentivised or penalised based on results ie joint venture without the joint venture agreement	● Customer retains ownership and responsibility – no catalyst to change ● Relationship mainly fee based, less scope for incentivised deal structuring/financial engineering ● No long term commitment from supplier because of lower investment

Table 2

The location analysis

Location	Main advantages	Main disadvantages
Onshore	● Culturally identical – 'known quantity' ● Access to most foreign language skills by employing nationals ● Access to experienced staff	● May not be lowest cost
Nearshore	● Culturally similar ● Lower cost ● Access to highly educated staff	● Although there is access to a highly educated workforce, staff may not be as experienced as customer's ● Access to language skills through foreign nationals is often limited
Offshore	● Lowest cost ● Access to highly educated staff	● Greater costs of liaison and interaction due to more remote delivery centre ● Access to language skills is limited – ie little or no chance of moving a pan-European SSC to India ● May be cultural differences

expertise (or does not want to have the expertise) to run a service delivery centre himself/herself but on the other hand he/she wishes to retain control.

How to decide whether to outsource

Armed with this background about finance outsourcing it should now be possible to consider whether or not to outsource and, if so, what the benefits will be.

Yvonne Welch, business transformation outsourcing EMEA solutions lead at IBM, cites its recent study of 450 chief executive officers (CEOs) globally. "Although we found that four out of five CEOs now believe that revenue growth is the most important path to boosting financial performance, cost reduction remains a close runner up especially in Europe and Japan. In addition, we found that responsiveness to market demands needs to become a new key competence for most businesses. Of course, this has major implications for outsourcing, which should address these issues rather than being an end in itself, and should seek to generate value for the business in a number of different ways."

Customers must regard outsourcing as a solution to defined business issues, not an end in itself

It is important to recognise that outsourcing is a key strategic decision which requires careful consideration. In particular, potential customers must regard outsourcing as a solution to defined business issues, not an end in itself, and as a result they must be very clear on what their issues are, otherwise they are likely to make the wrong choices. The main questions to which outsourcing is a possible answer are as follows:

- how can we significantly and sustainably reduce the cost of finance processes?
- how can we enable greater focus on our core competencies and spend less time on non-value added activities?
- how can we improve our service levels significantly? and
- how can we continuously improve our processes and leverage the knowledge and experience of specialists?

A deal focusing on cost reduction could be very different to one focusing on service level improvement

If any of these questions are relevant to your business, then outsourcing can probably provide all or part of the solution. However, a deal where the main objective is cost reduction – the 'your mess for less' option – could be quite different to one where the focus is on service level improvement or continuous process improvement, and it could also affect the choice of supplier, because they don't all have the same track records in all aspects.

One other point which is often encountered with regard to process outsourcing is at what point it should be done – that is to say, should a customer standardise processes before outsourcing (why should the supplier get the benefits of sorting out our processes? We would have done that anyway), or should they outsource immediately to get the benefits of labour arbitrage? There are obviously a number of arguments on both sides. On balance, whilst the former argument seems more logical, in practice the day may never come when everything is harmonised.

Some companies might find it appealing to undertake a pilot project first in order to evaluate the outsourcing concept. If this is the case, typical project objectives for a pilot project could include the following:

- understand how to negotiate the most appropriate and mutually advantageous contractual terms;
- understand the actual tangible and intangible benefits;
- learn how to get the transition right first time, including operational, people and IT issues; and
- understand the main operational implications of using a remote supplier, including governance, change control, service level agreements and performance metrics.

Having decided in principle that outsourcing will provide at least a significant part of the solution to a business issue and that the customer will go ahead, the next step is to consider whether the necessary prerequisites are in place for a successful project. The two key requirements are:

- *full commitment of and leadership from senior management* – if internal shared services projects run into problems of acceptance by the finance and other affected stakeholders within the business, as they often do, at least the work stays within the company. For outsourcing this is obviously not the case and there will almost certainly be major resistance to overcome; and
- *willingness to commit the necessary resources* – this is often underestimated. It will be necessary to put together a team whose core members from finance, HR, IT, legal and possibly purchasing (this is a major procurement deal, after all) will be more or less full time for six months or more, supported by

as a minimum not only process specialists, but also tax, regulatory and other specialists (such as cost modelling) as and when required. This must all be supported by an appropriate programme management and risk management infrastructure.

External input from specialist outsourcing advisory firms is becoming increasingly common. This support can be extremely valuable because it will help ensure the customer gets the right deal, that nothing is overlooked and that an independent, experienced eye oversees the whole process.

Michael Clark, of Nestlé, who has led a number of outsourcing initiatives, has used specialist advisors on his deals and believes it adds considerable value. "We couldn't have achieved what we did in the timescales we set ourselves without this kind of support. It helped us to focus on what was really key, especially on the process and commercial aspects of the deals, and gave us assurance that nothing important had fallen down the cracks. The support provided meant we were in a position to predict, not react to, many of the difficulties along the way. The net result was that we were comfortable the contract terms were right for us in the circumstances and that quality experiences gained could be applied to future projects."

It is also important to recognise that the effect of outsourcing on the business will be significant and will impact in a number of different ways, for example:

- internal customers of finance will probably have to be much more rigorous in how they interact with the outsourcer than they were with the finance department as these requirements will be enshrined in the contract under the operating level agreement (OLA). For example, there may be a requirement to raise purchase orders for all commitments, or to provide data in a certain format by a certain deadline, or to be disciplined in the timeframes required for and quantity of ad hoc analyses. Formerly, with a bit of arm twisting and a co-operative finance department, this didn't matter so much. However, in the future indiscipline on the part of customers could prove expensive;
- third party suppliers may find themselves having to comply much more rigorously with data content and format requirements for invoices. For example, it may be a requirement that purchase order numbers are always quoted otherwise they won't get paid. Again, the in-house finance function may well have put up with these irritations but, unless agreed otherwise (and that is likely to have an implicit impact on cost) the outsourcer will seek to enforce the rules because it will make for a more efficient process;
- external customers may find that an outsourcer is the first line of cash collection as well as account maintenance; and
- there will need to be activities which the customer did not have before, such as contract management, as well as certain liaison activities with the supplier for IT or audit activities (and it is important for the customer to formally appoint someone with sufficiently senior responsibility to 'own' the contract and manage it).

Although these effects may at first sight appear negative, they do in fact encourage discipline and the outsourcing arrangement should provide transparency as to the impact, especially on costs, of deviations, so that decisions for example as to whether certain analyses are really needed can be taken.

The outsourcing arrangement should provide transparency as to the impact of deviations

It is also worth noting that it is naïve to think that once processes have been outsourced the customer can forget them; that is one way for the arrangement to go sour. Whilst the customer need not constantly look over the outsourcer's shoulder, the relationship should be one of mutual trust and support. When things go wrong, the customer should be ready and willing to help rather than merely criticising. In this way, the supplier learns and the customer will get the best deal in the long term.

One could argue that, rigorously applied, most of the points above could apply to in-house shared services centres – although this level of discipline is rarely present. Nonetheless, there is one key difference, which is that with an in-house centre difficulties can be muddled through by throwing resources at them but with outsourcing this cannot happen regularly without the supplier looking to the customer for financial compensation in some way.

With an in-house centre, difficulties can be muddled through by throwing resources at them

An overview of suppliers and how to select one

This is a rapidly changing area and inevitably by the time this paper is published the details will be out of date. As a result, this section is intended to provide an impression of the market rather than a definitive guide and it

absolutely does not seek to imply any qualitative judgements, which can only be made by businesses seeking to outsource based on their own assessment of suppliers. In addition, it must be stressed that this data refers to FPO only – it does not include, for example, industry vertical processing in the financial or airline industries which is an entirely separate topic.

FPO suppliers can be grouped into several categories

FPO suppliers can be grouped into several categories. The first category covers the global IT/consultancy players, such as Accenture, ACS, CapGemini and IBM. HP are also rapidly establishing themselves in this group.

The second category tends to focus on specific regions, for example UK and/or India, and includes Logica, Vertex and Xansa. These companies are predominantly UK based.

The third category covers the ever increasing number of offshore based suppliers, predominantly Indian, and includes ICICI OneSource, Infosys Progeon, Transworks, Wipro Spectramind and WNS.

Each of these companies (and others not listed above) will be able to provide good references and impressive delivery centres which match the particular needs of customers.

Trust and chemistry are important, as the contract may run for seven years or more

In addition, each supplier has its own character and way of working, which potential customers need to form their own opinions about. It is not appropriate to go into this here, except to say that trust and chemistry are probably even more important than usual as the contract may run for seven years or more.

Turning to specific selection criteria, typical examples would be as follows:

- *business case* – how do the different business cases proposed by the suppliers compare to each other? It is of course important for the customer to be clear on the analysis techniques to be applied, such as net present value, payback, internal rate of return, recurring savings as a percentage of existing costs and so on;
- *approach to the work, including transition plan and the solution for service delivery* – how comfortable do you feel with the transition approach? Do you think that the supplier is putting forward an achievable timetable that fits your requirements and any constraints? Do you believe the delivery solution will work, including hand-offs and any requirements which may be imposed on you?;
- *IT connectivity* – the supplier's remote delivery location will have to link to your systems and network. How feasible an approach has the supplier suggested? Does it take into account any security requirements you may have? Will the connection be fast enough? Are you happy with any requirements the supplier has placed on your IT team?;
- *the proposed supplier teams for transition and delivery* – do the people have relevant prior experience of finance outsourcing, as opposed to in-house shared services? Are they practitioners from the delivery centre, who may not be as well presented but will have to live with the consequences of the transition, or are they consultants who may be more polished overall but will be moving on to the next project? Each approach has its advantages and disadvantages but it is important to know which one you are getting;
- *relevant cross border (if that is required), multi client experience* – does the supplier have demonstrable experience of the type you are seeking? What do you regard as enough experience to satisfy yourself that you are not a guinea pig?;
- *references* – given that no supplier will knowingly give you the name of a poor referee, it is pointless just asking 'were you happy?' Ask open questions to learn what you need to know, for example whether the supplier used the same approach he is proposing for you and how it worked;
- *flexibility of approach to specific requests concerning contractual terms* – the customer should be very clear from the outset on specific terms he/she is looking for in the contract, rather than waiting to see what the supplier proposes. This will save a lot of time for everyone because important issues will be addressed upfront rather than lying dormant until the end. Typical terms (such as what happens on termination, liability caps and so on) are set out below; and
- *other specific issues related to the customer's circumstances* – such as the supplier's ability to deal with specific initiatives, for example systems implementations, or to improve process performance.

Clearly, the selection process works both ways and, whilst the customer evaluates the supplier, the supplier will qualify the customer taking into account size of deal, perceived likelihood of the deal actually going ahead (ie is the customer serious and is the necessary sponsorship in place), number and nature of competitors (has someone got an inside track?) and so on. Some suppliers have

minimum deal sizes and will soon let you know where you stand. Others will be prepared to consider a deal if it is complementary to other deals they have and has low selling costs. If suppliers decide to bid they put a lot of time and effort into it and will want to be sure at each step of the process that they have a good chance of winning.

Shaping an outsourcing deal

Although there is no real mystery to shaping an outsourcing deal for finance – basically the objective from the customer's perspective is to ensure that he/she knows what he is going to get and what he/she is going to pay for it – the detail needs to be clear on what happens if things change (which is almost inevitable over a seven year deal) and what happens if they go wrong ie the defined service is not delivered.

In the excitement of doing a deal, these are not always issues that a customer feels motivated to focus on, and indeed he/she may feel like a wet blanket for doing so. Nonetheless, it is key that proper mechanisms are in place for dealing with these issues to minimise 'agreements to agree'. Outsourcing deals last for a long time, things will go wrong and the people who negotiate them are not the people who will run them.

Some key issues to focus on in shaping a typical deal are as follows:

- *who will do what, as far as processes are concerned* – a clear responsibility matrix is important. In general, a supplier will do anything as long as the ground rules are clear. However, a supplier will not and cannot be expected to exercise judgement on a customer's behalf unless this is explicitly part of the deal. For example, if VAT regulations change, the supplier may point this out to you (or maybe not) but will need further guidance as to how you wish to comply – they will not make the decision for you;
- *what will the service level from the supplier be* – it is important to set key performance indicators (KPIs) which reflect activities over which the supplier has control, rather than setting global KPIs where the customer also has a major influence. For example, as far as the service level agreement (SLA) is concerned there may be little value in having a KPI for percentage of invoices paid on due date, if this depends to a large extent on the customer approving invoices within a certain timescale and over which the supplier may have little or no control. It may be better to set a KPI which starts with the receipt of a properly authorised invoice by the supplier and measuring his/her ability to pay it within a defined timescale. It is also important to define and to prioritise what is really important, rather than trying to measure everything that happens;
- *what will the customer have to do* – clearly, the customer will have defined responsibilities to enable the supplier to fulfil his/her obligations. These are specified under the OLA. For example, the customer will have to deliver defined data on time, notify changes to accounting policies and authorise invoices on time. The OLA will be an important part of the contract;
- *who will do the reporting* – having set comprehensive SLAs, OLAs and KPIs, it is important to define who will report against them and how. In general the supplier will take this responsibility and many have tools, often web-based, for doing this and for reporting the results on a defined basis;
- *what happens if the customer wants to terminate the agreement* – outsourcing contracts last for several years and over that timescale many things can happen to the customer or his/her business and, although it seems rather perverse to devote effort to termination during negotiations it is important to do so. Where there has been material breach of the contract terms by the supplier, for example where the service level is significantly and persistently too low, then the customer can generally terminate the contract without compensation. However, where the customer simply decides that he/she wishes to end the deal because it does not suit him/her anymore ('for convenience') the supplier's position will generally be that he/she would want compensation for loss of future profits for the unexpired portion of the contract and recovery of investment to date, the logic being that the deal is for the timeframe specified, not for a shorter period, and significant effort will probably have been invested to win and set it up;
- *what happens if anything changes during the period of the contract* – there is nothing more certain than significant changes during the lifetime of the contract and that one or other of the parties will believe the change to be grounds for a change in price. For example, transaction volumes will increase or decrease, businesses will be bought or sold and new ERP systems will be implemented. As a result, there needs to be a clear process for agreeing changes, ideally with worked

KPIs should reflect activities over which the supplier has control

During negotiations it is important to devote effort to the terms of termination

examples so there are no misunderstandings. As support to this process it is important to agree a schedule of rates for any work that needs to be done, differentiating between consultant and delivery centre resources;

- *what happens if the service falls below the KPIs set* – the most common mechanism for dealing with this situation is known as a service credit regime. This reflects the view that, if you don't get the service you paid for, you are entitled to a discount. In practice the discount will often be limited to a certain percentage of the total fees payable each month and will probably also have an annual cap. In addition, there may be an opportunity for 'earnback', where the supplier is refunded the service credit if his/her performance against the KPI in question is on target over a subsequent defined timeframe. The mechanism for determining the exact nature of the service credit regime will vary from contract to contract but customers should expect that suppliers will seek to limit the scope for incurring service credits;

A service credit regime is the most common way of dealing with shortfalls in supplier performance

- *what happens if the service falls significantly below defined KPIs* – the service credit regime is intended to deal with infrequent, minor shortfalls in performance. If the service level in a particular area falls so far short that the customer believes it is in effect no longer being provided, he/she may want the ability to suspend payment until the fault is rectified. The precise circumstances in which this happens will need to be carefully defined but again it can be a useful device for concentrating attention on key areas;
- *what happens if there is significant and persistent failure against defined KPIs* – if this occurs, and assuming the customer does not want to terminate the contract for a material breach, it is useful to have what is known as a step in right, where he/she can suspend payment and send in his/her own staff or consultants to maintain and/or rectify the problems. Who bears the cost of this will be a matter for negotiation;
- *what happens if the supplier causes loss to the customer* – this could happen where, for example, the supplier pays an invoice for the wrong amount and for whatever reason this cannot be reclaimed from the vendor. Providing the supplier is clearly at fault the customer may wish him/her to reimburse the amount lost, up to the limit of liability agreed for the contract (see below);

What happens if the supplier causes loss to the customer?

- *what happens if the contract is terminated* – in general the customer will have to pay so called trailing costs, which are those costs that the supplier cannot immediately stop paying, such as space costs or other commitments. In addition, the supplier will probably include staff redundancy costs in this calculation although there will probably be a duty on the supplier to mitigate all trailing costs;
- *what happens with regard to transfer of undertaking of protection of employment (TUPE) rights* – responsibility for the cost of TUPE rights will have to be explicitly defined in the contract. For example, if the commercial basis of the deal is transfer of work to a low cost location, and existing employees make a claim that TUPE should apply, the supplier will generally require the customer to meet the cost of any awards. Clearly, it would not make commercial sense to allow existing employees to transfer to the low cost location at their previous salaries. Likewise, when the contract terminates, the supplier will generally take responsibility for TUPE. This area can be complex and it is generally one where specialist legal input is required;
- *what happens if the parties cannot agree* – this could happen for a number of reasons, for example inability to agree the impact of changes, whether service credits are payable or whether OLAs have been met. As a result, it is important to have a clear escalation process, which sets out who has the final say, including independent arbitration if appropriate;
- *what rights does the supplier have to provide other services* – many suppliers are able to provide other services to customers, such as consultancy. The customer will have to decide whether he/she wants to give the supplier any rights to do this, including exclusivity, which may have a bearing on the price offered for the outsourcing deal. On the other hand, customers can of course grant the supplier no other rights beyond exclusivity in providing the outsourcing services; and
- *what is the overall liability cap for the supplier* – there are a number of ways listed above where the supplier can incur liability for losses and damages in connection with supplying the service. He/she will, however, always seek to limit this in some way, for example to an annual monetary limit related to the level of the service charge. No supplier will accept a situation which exposes him/her to an unlimited liability.

As regards the financial aspects of a deal, the main costs are the transition charge and the service charge.

The transition charge is to enable the supplier to transfer the processes from the customer's location to his/her own delivery centre. In general transition charges comprise knowledge capture (ie understanding and documenting how the customer's processes work), knowledge transfer (training the supplier's staff and workshadowing) and set up/infrastructure costs (recruitment, fitting out premises and setting up IT connectivity). These costs can be significant and depend to a certain extent on the state of the customer's processes and documentation; for the customer, it can be time very well spent to document processes thoroughly, even down to workstation manuals, as the supplier will have to do this anyway. It is also worth trying to negotiate a fixed or capped charge for transition.

The service charge is for the ongoing delivery of the service. There are a number of possibilities for these costs, the most common of which are as follows:

- *fixed price* – this means that the price for the service is fixed given certain assumptions on volume and scope. However, if any of the assumptions change by specified amounts (eg volumes change by plus or minus 10%) then the price will change through change control;
- *open book* – this means that the customer agrees the cost base and an acceptable margin with the supplier for a given level of business. As this level changes up or down, or processes change, the supplier will discuss with the customer how he/she can react as regards redeploying staff or reducing other costs;
- *transaction based* – for example, the customer would pay per invoice or remittance processed. This would be easier for, say, accounts payable and accounts receivable than it would be for management reporting. Despite this way of pricing appearing to be simple and logical, in practice there are fewer business process outsourcing (BPO) deals priced on this basis at present than other approaches; and
- *one of the above with a gainshare mechanism built in to reflect future investments by either or both parties* – these arrangements are more complex and may have a so called 'cap and collar' arrangement to limit the downside and upside for the parties.

The exact mechanism used will depend on the circumstances; in general, fixed price is simplest to run and is best where the processes and volumes are expected to be fairly stable. Open book sounds straightforward but implies a degree of partnership and transparency that many suppliers may not be comfortable with – it is best used where significant changes are expected over time.

A common concern that customers have is that suppliers will gain the benefit of process improvements that would have been made anyway, and many companies entering into an outsourcing deal will have a list of these. Common examples include increasing the use of purchase orders, implementing procurement cards or introducing new ERP systems. One way to deal with this is through change control as and when the circumstances arise.

However, if the customer is able to be sufficiently specific about the improvements and their impact he/she may be able to negotiate them into the service charge. The benefit of this is that the onus would be on the supplier to increase the charge if the improvement does not take place, as opposed to decreasing the charge if it does take place which is the effect of the change control route.

If, on the other hand, the supplier implements process improvements, eg the implementation of automated data capture tools for incoming invoices, then he/she may argue that he/she should receive most if not all of the benefit for this.

The third possibility is joint development of an improvement initiative, where sharing of the gain can be negotiated. However, in general this will be negotiated as and when it arises, rather than at the contract stage.

It is impossible to generalise as to what individual companies should seek to negotiate, as this depends entirely on the circumstances. However, the one common thing that customers should aim to achieve in contract negotiations is transparency and clarity. The precise costs and benefits of deals will vary from one contract to another, but the common thread is that you should know exactly what you are letting yourself in for. In the pressure of negotiations there may be a temptation to rely on trust alone but, whilst trust is obviously a very important ingredient of the overall deal, it is no substitute for clarity.

It is much better to sort things out before contract signature, whilst the customer has negotiating power, than afterwards, when this

> The service charge mechanism used will depend on the circumstances

> Customers should aim to achieve transparency and clarity in contract negotiations

may be more limited. The main points to watch out for in negotiating a contract are set out in the box below.

How to implement

How to implement an outsourcing deal

The common phases of implementation of an outsourcing deal are:

- *formulate a sourcing strategy* – the first step is to determine what your sourcing strategy is for defined finance processes. This will include evaluation of options such as in-house shared services, process automation and outsourcing;
- *gain market awareness* – having decided to outsource, the next step is to understand the market, the key players, the possible locations and the pros and cons of each. This step could involve informal meetings with suppliers, visits to delivery centres and possibly even a formal request for information (RFI), in order to develop a short list of possible suppliers;
- *determine the scope and issue a request for proposal (RFP)* – once a supplier short list has been developed, and outsourcing is still seen as the right approach, the next step is to issue an RFP. There are different schools of thought on RFPs; should they be very specific, requiring a very comprehensive response, or should they focus on a smaller number of key questions, enabling the suppliers to demonstrate flexibility and innovation? There is no right or wrong answer to this and it often comes down to the customer's corporate style. However, the main objective should be to enable comparability between suppliers' bids; it is no good having them use different assumptions for key parameters (eg treatment of transition costs, pricing bases or contract length). Generally, unless there are good reasons for not doing so, it is best for customers to be transparent regarding the performance and costs of their existing processes; otherwise, suppliers have too much guesswork regarding the customer's business case and will probably get it wrong;
- *evaluate responses* – this should be done against specific criteria, including business case, quality of delivery centre and the other factors listed earlier but also including softer factors such as the cultural fit and compliance with the bid process;
- *select supplier with whom to negotiate exclusively* – when you feel you have identified the right supplier you need to enter into a period of exclusive negotiation with them, with a view to signing a contract. The other suppliers should be told this and one should be selected as a fall back if negotiations with the preferred partner should fall through. The customer should also expect to issue a memorandum of understanding, to include covering the supplier's costs incurred for transition before the contract is signed;
- *negotiate the contract* – this will involve legal, commercial, process/IT, HR and risk management input and will last anything from six weeks to six months or longer. It should cover all the points listed earlier and more, and will be fairly intensive. The amount of effort that needs to go into contract negotiation is normally underestimated and the sticking points are often not what you would expect them to be; and
- *undertake the transition process* – once the contract is signed the real work of transition will start in earnest – recruitment, delivery centre preparation, IT, workshadowing, communications with the existing staff – there are a huge number of tasks to co-ordinate and the supplier will take responsibility

The main points in negotiating a contract

- Do not try to negotiate a deal which will be impossible for the supplier to sustain. Ultimately, suppliers are in business to make a profit too and the customer must accept this. Suppliers will also not accept open ended risk. A deal founded on ill will is unsustainable.
- Do not be seduced by the supplier into accepting that the contract needn't be too specific and that everything can be sorted out amicably after signature, as and when it arises. This is known as 'agreement to agree' and in fact is really no agreement at all. At the very least, do try to understand how changes will work.
- Do not forget that suppliers are very sophisticated negotiators who have a duty to get the best deal for their company. The customer also needs to have a negotiating strategy and to make sure that all members of the team stick to it.
- Do be aware that, if you use the supplier's contract as a basis for negotiation, it will inevitably be loaded in the supplier's favour and you will have to spend time understanding it thoroughly. It is much better to use your own contract, if you are in the happy position of having one.
- Do be clear on what your position is on all of the key commercial terms that are important to you, including those listed above. If you don't know what you want, the chances are that you won't be happy with what you get.
- Do make full notes of what the supplier promises during the sales pitch and make sure that what is important to you is in the contract. Otherwise, there is no guarantee that what you bought is what you get, and contracts usually contain provisions to the effect that it represents the whole understanding between the parties, which means that anything in the sales presentation is superseded.

for this. The usual timescale is at least three months to the first transition.

Apart from the contractual issues, the main issues to focus on are the typical issues in any major process change programme, ie:

- a clear communication strategy and plan for all staff, not only those affected, and careful consideration of the important people issues, including packages, retention bonuses and so on. You will want existing staff to be co-operative and to participate fully in the workshadowing process (ie train the people who will be taking their job over). Also, there will inevitably be TUPE issues to consider;
- careful design of processes to identify who will be doing what, and where the key hand over points are between the customer and the supplier; and
- design and thorough testing of the IT and connectivity issues to ensure that the supplier has full access in his/her remote location to the systems he/she needs and is not hampered for example by slow response times. It is also important to discuss the deal with all of the software suppliers and to negotiate the transfer of licences where appropriate.

The entire programme must, therefore, be properly resourced and customers often underestimate what is required because the impression can be formed, erroneously, that the supplier will do everything.

How do outsourcing deals work in practice?

A typical outsourcing deal would have the following features, once it is up and running:

- regular reporting by the supplier against a range of predefined criteria which are consistent with the SLA/OLA mechanisms and quite possibly the service credit regime. The reporting may well be web-enabled;
- a multi-level governance structure, to deal with everything from day-to-day issues to pricing change requests to strategic issues such as major scope changes; and
- a contract management infrastructure at the customer's head office which ensures the arrangement runs smoothly from a process and a contractual perspective. In particular, it is important to ensure that all complaints and problems are dealt with openly and transparently, rather than being left to fester.

Can outsourcing work for small to medium-sized enterprises (SMEs)?

By far the majority of FPO deals have been for major companies, most involving 50 people as a minimum. It is interesting to consider whether outsourcing can be a viable proposition for the SME sector (where lack of appropriate internal skills may be a reason to consider outsourcing). There are two main barriers:

The majority of FPO deals have been for major companies

- *cost* – as noted above, outsourcing deals have fixed setup costs, such as IT and fitting out. If the deal size is small, the customer's business case will be less easy to justify; and
- *finding a supplier* – the major suppliers listed above are unlikely to be interested in deals for a handful of staff and in general are looking for deals involving at least 100 heads. However, recent research carried out by ALS Consulting has indicated that with new entrants, increased competition and sunk investment in centres there appears to be an appetite amongst some suppliers to do much smaller deals of 20-50 heads, which opens up access to savings based on labour rate arbitrage to SMEs which they couldn't get themselves. In addition, a number of so called 'Tier 2' suppliers have declared an interest in the SME market and are marketing heavily within it.

What makes a successful deal?

In summary, it is worth reconsidering the seven key points which will give an outsourcing deal the best chance of success:

- take the lead, know what you want and manage the process to your agenda;
- negotiate a deal sustainable by both parties;
- agree as much as possible upfront – keep 'agreements to agree' to a minimum;
- understand the pricing dynamics for changes and try to get worked examples;
- plan for the best but make sure you are covered for the worst – think especially about what happens if the service isn't delivered to your satisfaction and what happens if you want to terminate early;
- resource the project to cover all the key skills required; and
- remember you are dealing with professional negotiators who want to get the best deal. **F&M**

Plan for the best but make sure that you are covered for the worst

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