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Unpacking Outsourcing Governance

How to Build a Sound Governance Structure to Drive Insight Versus Oversight

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EXECUTIVE SUMMARY

Governance structures matter. Effective contract governance is especially important for outsourced services, because the supplier or service provider becomes an extension of the company doing the outsourcing. A sound governance structure provides consistent management along with cohesive policies, processes, and decision rights that enable parties to work together effectively and collaboratively over the life of the agreement.

The University of Tennessee (UT)'s research shows that some of the best outsourcing relationships create a symbiotic relationship—in which the parties have a vested interest in each other's success. This research developed Vested Outsourcing's Five Key Rules, or tenets. Rule No. 5 underscores the necessity of creating a governance structure based on insight, not merely oversight.

Yet a distinct, standard definition of outsourcing agreement governance is hard to pin down. In fact, leading academics say a clear, standard definition does not exist. As a general rule effective outsource contract governance will maximize the potential for successful contract implementation.

The purpose of this white paper is to combine the best thinking from thought-leading organizations in outsourcing governance structures, including The Corporate Executive Board (CEB), the International Association for Contract and Commercial Management (IACCM), and from leading academics and economists. The authors also define what a governance structure is and outlines a governance framework approach that builds and incorporates past research and current practice.

Our approach starts with the proposition that a contract between a company and its service provider is first of all a legal and binding document, one that needs built-in protections. Unfortunately, many companies struggle with how to properly manage the contract relationship once it is signed. Often we hear only crickets when we ask a company to show us the governance structure it has with its service provider.

This is not a surprise; academic research in the area of contract governance is spotty. But consultancies are rising to the occasion. They are identifying this as a problem. More than that, they cite a growing body of research that links poor governance as a major reason for contract failure. On the good news side of the ledger, organizations are starting to understand the need to include contract governance structure as a critical component of outsourcing relationships. The bad news is that definitive leadership and practical direction is somewhat lacking.

We believe there is a need to define and think about contract governance in a new, more relevant way, with a focus on creating a governance structure that has a vested interest in managing what are often highly complex contractual arrangements in a more collaborative, aligned, flexible, and credible way.

Our goal is to provide a practitioner-friendly Governance Framework that builds on and incorporates UT's work in the area of vested outsourcing and the need for organizations to have a governance structure based on insight, not oversight.

This white paper also leverages research and data from CEB and IACCM. Our approach is to provide guidance that can help your organization craft a solid governance structure. This also will build the foundation for a solid working relationship among companies and their service providers through the life of their contract.

This paper has two parts that will help companies gain a better understanding of governance and guide practitioners to a clear and user-friendly governance structure.

Part one has three sections that explore fundamental concepts for developing an agreement governance structure. All parties involved in both the design and ongoing management of a vested outsourcing agreement should understand the basic nature and purpose of governance structures. This will help the parties involved understand why putting the effort into a governance structure is crucial.

We will first share the leading academic and applied research regarding governance structures and the key themes and principles needed to develop a sound governance structure. We'll also provide a working definition of a vested governance framework.

Part two addresses how to create a vested governance structure by presenting and defining the three key elements that must embody a successful governance structure.

The three elements are:

1. Relationship management structure;
2. Transformation management process;
3. An exit management plan.

PART ONE

FUNDAMENTAL CONCEPTS OF GOVERNANCE STRUCTURES

Before implementing the four elements of a vested agreement governance structure, we begin with some thoughts on the fundamental concepts of governance structure. We have teamed with CEB and IACCM to capture the latest thinking in governance structures.

The CEB found that in a typical outsourced deal the outsourcing company can erode up to 90% of anticipated value due to poor governance of the relationship.[1] This is often called "value erosion" or "savings leakage" and is a pressing problem for companies.

Other organizations agree that governance structures in outsourcing arrangements are typically nonexistent or broken. Studies share a common theme; governance structures definitely matter. Poor governance frequently is cited as the major reason for agreement failure. The following are some of the more reliable sources that have studied governance:

- The outsourcing center reports that poor governance plays a role in outsourcing failures as much as 62% of the time.[2] The center also identifies unclear expectations on objectives from the beginning and misalignment of parties' interests over time as the business environment changes as two major factors for outsourcing failures.
- The London consultancy Hudson & Yorke says governance "is one of the main reasons why managed service or outsource agreements succeed or suffer."[3]
- ARC Advisory Group found that changing the way people work and interact with each other in a performance-based or vested relationship—both internally and between companies—of necessity requires the proper metrics to create alignments that drive desired behaviors along with a high degree of trust, but "no true change will occur" without the support of the CEOs or other top-level executives.[4] In addition, there has to be a culture and relationship structure that embraces continuous improvement.

Companies and industry organizations are starting to understand the need to include agreement governance as a critical component of outsourcing relationships.

Governance Structure in Theory and Research

There are three constants that recur repeatedly in the study of contract governance and structure:

1. Contracts are incomplete or inadequate.
2. A contract should be a flexible framework.
3. There is no clear definition of governance.

Each is discussed below.

Contracts Are Incomplete or Inadequate

By their very nature agreements are works in progress, and most are still rooted in the classical approach to contract or agreement law; that is, they are designed primarily to address transactions and legal protections such as pricing and price changes, service levels, limitation of liability, indemnification, and liquidated damages.

The legal scholar Ian R. Macneil wrote, "Somewhere along the line of increasing duration and complexity [the agreement] escapes the traditional legal model."[5] Macneil's work pointed to a key reason why traditional legal theory is not adequate in today's business environment: "Classical law views cooperation as being 'of little interest' and external to the agreement." This argues for an agreement framework that encourages cooperation and dialogue. He taught that agreements can be "governed efficiently only if the parties adopt a consciously cooperative attitude."[6]

Macneil's work is recognized as instrumental in developing a wider view of the contract, which is called "relational contract theory." Macneil also said that business-to-business contracts are "instruments for social cooperation."[7] His idea was that contracts are rooted in relationships and activities that have a large context, rather than as discrete transactions prescribed in a contract.

Agreements: Ideally a Flexible Framework

Oliver E. Williamson, the 2009 Nobel laureate economist, also contributed to the themes of completeness and flexibility, writing that "all complex agreements will be incomplete—there will be gaps, errors, omissions, and the like."[8]

As far back as 1979, Williamson wrote that governance structure is "the framework within which the integrity of a transaction is decided."[9]

If a contract or agreement is incomplete due to the dynamic nature of business, what can the business community and legal community do? Williamson says an agreement should be a flexible framework and include a process for understanding the parties' relationship. Structuring agreements with flexibility prevents what he called "maladaptations," or aspects of an agreement that have become more harmful than helpful.

Williamson continues, "Because contracts are varied and complex, governance structures vary with the nature of the transaction." The scope of today's outsourcing relationships make it necessary to have governance structures that span not just checking for the integrity of a discrete activity or transaction, but rather how a company and its service providers work effectively together to achieve each other's desired outcomes.

What makes it hard for today's practitioners is the statement that governance structures "vary with the nature of the transaction." Put another way, it's difficult to pin down what should be in a good governance structure because by design it is supposed to have the flexibility to change with the nature of the work.

Without a flexible framework the agreement will ultimately lead to increased transaction costs. Williamson's seminal work on transaction cost economics looks at the entirety of the costs of doing business, including the contracting process, how organizations behave with regard to the contract, and how people behave during contract negotiations.[10]

Ideally, contracts are structured with flexibility so that potential maladaptations are eased or avoided through mechanisms that cope with unanticipated disturbances as they arise. In a 2002 paper, *The Theory of the Firm as Governance Structure: From Choice to Contract*, Williamson observed that while a contract is an exercise in organization or structure, economists "have been skeptical that organization matters and that it is susceptible to analysis."[11] He continued, "The surprise is that a concept as important as governance should have been so long neglected."

A flexible agreement can address the dynamic nature of business head on by crafting mechanisms that can cope with unanticipated disturbances as they arise.

No Clear Understanding of Governance

Research by the European academics Florian Moslein (Humboldt University of Berlin) and Karl Riesenhuber (Ruhr-University Bochum) suggests that companies should pay more attention to corporate and agreement governance to achieve a firm's goals.[12] This is especially true in an economy relying on service providers that play a vital role as an extension of a firm's capabilities.

Moslein and Risenhuber say a generally accepted definition of agreement governance is lacking. To make matters worse, Moslein and Riesenhuber note governance structures typically are customized to the scale and scope of the work. But how to define what a governance structure is when there is a moving target on what is governed? Unfortunately, they point out that contract governance "has thus far only been used rather sporadically."

Who can blame practitioners for not using something when there is not even a clear definition of what they are supposed to do!

Defining Governance

CEB, IACCM, UT believe it is time to put an official stake in the ground when it comes to defining governance and what should be included in a governance structure between a company and its most strategic suppliers. A good place to begin to define good governance starts with vested outsourcing's rule 5—which states that governance structures should provide insight, not merely oversight.[13]

Let us look at the definitions of the terms "governance" and "insight" to help gain clarity around a governance structure based on insight. Using the Macmillan Dictionary, governance is defined as the "process of governing a country or organization." Insight is defined as follows:

1. "A chance to understand something or learn more about it"
2. "The ability to notice and understand a lot about people or situations"

Thus, we can define governance insight as the process of governing an organization, enterprise, or agreement through learning and understanding. A good governance structure creates the chance to increase understanding of the business and to make changes that can help the company control its actions.

We submit this following working definition for vested governance:

A **vested governance framework** uses a relationship management structure and joint processes as a controlling mechanism to encourage the organizations to make ethical, proactive changes for the mutual benefit of all the parties.

PART TWO
VESTED GOVERNANCE FRAMEWORK

UT, CEB, and IACCM research shows that historically, some of the best outsourcing relationships create a symbiotic relationship—where the parties have a vested interest in each other's success. Good governance is a two-way process in which the parties agree on clearly defined and measurable outcomes, and then work together to ensure mutual success.

There are four elements needed to craft a vested governance structure that will provide insight, not just oversight. This framework can be used for all types of outsourcing arrangements—from the simplest to the most complex. By doing so, organizations can tailor the framework rather than guess what else to add.

The vested governance framework incorporates these elements:

1. **Relationship Management Structure**—The relationship management structure formulates and supports joint policies that emphasize the importance of building collaborative working relationships, attitudes, and behaviors. The structure is flexible and provides top to bottom insights about what is happening with the parties' desired outcomes and the relationship between the parties.
2. **Transformation Management Process**—Vested agreements are transformative because change in the vested environment is both desirable and expected. Transformation management supports the transition from old to new as well as improvement of end-to-end business processes. The focus is on mutual accountability for attaining desired outcomes and the creation of an ecosystem that rewards innovation and a culture of continuous improvement.
3. **Exit Management Plan**—The future is unknown; even the best plans fail or events will change the business environment. An exit management strategy provides procedures to handle these unknowns.

Figure 1 summarizes the four elements of a vested governance structure. We explore each element and explain the key differences between a vested governance structure with insight versus a governance structure built on an oversight mentality.

There is no magic bullet for creating a vested governance structure, no one-size-fits-all approach. The following sections discuss each of the elements of sound agreement governance.

Figure 1: Three Elements of a Vested Governance Structure

Element	Vested (Insight) Mentality	Oversight Mentality
Relationship Management	▪ Relationship management focus ▪ Reverse bow tie structure, layers ▪ Joint policies that emphasize the importance of building collaborative working relationships, attitudes, and behaviors	▪ Service provider management focus ▪ Bow tie structure ▪ Agreements viewed as risk avoidance mechanisms that monitor transactions/functions
Transformation Management	▪ Agreement components viewed as a flexible framework ▪ Regular contact/review systems for service, performance, IP, and IT management updates; joint review boards for potential agreement changes and service issues ▪ Focus on performance and transformation ▪ Emphasis on end-to-end business metrics as well as service provider SLAs; mutually accountable for top-level desired outcomes; focus on root-cause analysis ▪ An ecosystem that encourages and rewards innovation, ideas directed to the right people	▪ Agreement components viewed as fixed ▪ Infrequent communication or only when emergencies arise ▪ Little or no provisions for regular reviews beyond monthly revenue/cost accounting reports ▪ Focus on service provider metrics and scorecards ▪ Narrow SLA focus on the service provider SLA targets; focus on reporting ▪ No clear systems or attitudes that set joint processes for innovation as a continuing culture beyond "feel-good" PR
Exit Management, People/Changes Management	▪ Addresses how to handle future unknowns ▪ Based on fairness ▪ Seeks to keep parties whole in the event of a separation when separation is not a result of poor performance	▪ Focus on terms and conditions that are risk averse ▪ Entity with the most power typically uses that power to negotiate in their favor without regard to fairness

1. Relationship Management Structure

Effective relationship management establishes the mechanisms for how the relationship and business will be managed and includes how the parties will address changes in the key components of the agreement itself.

Organizational Alignment

Organizational alignment is the process by which the parties arrange the people and systems to manage the outsourcing agreement. There are six techniques that you can use when aligning organizations:

1. Create a tiered management structure.
2. Establish separate service delivery, transformation, and commercial management roles.
3. Establish peer-to-peer communications protocols.
4. Develop a communications cadence.
5. Develop a process to maintain continuity.
6. Establish a performance management program

In general, any companies that outsource think they have a best practice because they have deployed Service Relationship Management (SRM) techniques. SRM is the practice of creating mechanisms to increase the efficiency and effectiveness in how a company works with their service providers to lower business costs. Some SRM efforts are designed to build deeper relationships that foster improved collaboration efforts and innovation. A benefit of SRM is that it creates a common frame of reference for companies and their service providers, creating unified business practices and terminology for working together.

We advocate many SRM concepts and highlight some of the best practice approaches in this paper. We encourage practitioners to leverage many of the best practice SRM elements. However, for true organizational alignment, we suggest deployment of SRM practices with a unique spin—the vested approach of getting to win-win thinking (or "what's in it for we"—WIIFWe), especially in developing processes to jointly manage the business to achieve desired outcomes.

The biggest difference between **managing a service provider** and strategically **managing a relationship** starts with a philosophy of how the parties work together. While SRM is most definitely not a "whose-throat-to-choke" exercise, our experience shows that typically companies applying SRM tend to utilize a "what's-in-it-for-me" (WIIFMe) mind-set to manage their service providers.

The wider view of the vested approach is that the processes should encourage a shared accountability for achieving desired outcomes. Companies should manage their vested relationships with the same level of intensity as customer and employee relationships. Aren't your strategic service providers really an extension of your own firm?

A vested governance structure deeply embeds WIIFWe thinking into each of the SRM best practices. Figure 2 shows how vested outsourcing shifts thinking from conventional service provider management approaches of WIIFMe to the WIIFWe thinking that is critical for a vested relationship.[14]

Figure 2: Transitioning from WIIFMe Service Provider Management to WIIFWe Relationship Management

WIIFMe Thinking		WIIFWe Thinking
Get the service provider to meet our needs.	Becomes	Find a way to meet both our needs.
"It's in the agreement. Now it's the service provider's problem."	Becomes	Work together to achieve the performance and compensation goals.
Blame and punish the service provider.	Becomes	Communicate the issues; jointly find solutions.
Unpleasant surprises	Becomes	Integrated planning and communications

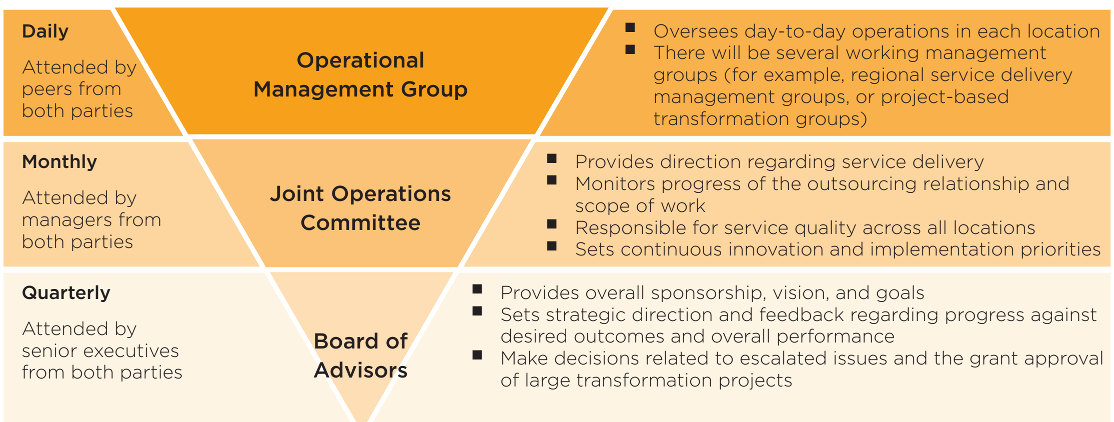
1. Tiered Management Structure

Once an initial agreement is signed, the focus changes to day-to-day operations and getting the work done. Too often, the parties put the "strategy" on the shelf in a vinyl binder and don't refer back to it until a new executive comes in and wants to create his or her own plan. This is often referred as "strategic drift." For this reason, governance structure should start by establishing an organizational structure that ensures vertical alignment between the executives and the employees in the organizations that are charted to get the work done. We recommend creating a tiered structure with peer-to-peer alignment. This helps ensure that not only are day-to-day priorities executed efficiently but also that neither party loses sight of strategic goals.

A tiered management structure uses a layered approach, with each tier having specific responsibilities for managing the different aspects of the business. This tiered approach creates vertical alignment between the upper management, mid-management, and day-to-day workforce. Each layer is responsible for examining the relationship and business success through its "lens." Each layer also makes sure the relationship is not only focused on the tactical elements but also the strategic and transformational components. Regardless of how often or well people communicate, not all issues are solvable at the lowest levels in the relationship. Some matters will need escalation.

We recommend creating a three-tiered organizational framework. Figure 3 illustrates a three-tiered structure.

Figure 3: Tiered Governance Structure



This three-tier "layered" governance structure can work well for almost any type of vested relationship. A layered approach ensures that each different level in the organization is providing guidance across three key areas: functional working levels, operational level and executive level, in a timely and consistent manner.

2. Establish Separate Service Delivery, Transformation, and Commercial Management Roles

A vested agreement by design is meant to drive transformation. Thus, a governance structure should promote and drive transformational efforts. We also recommend alignment of the governance organization to support three primary governance roles: service delivery management, transformation management, and agreement compliance. For larger outsourcing deals, create three functional groups or roles for each of these areas. For smaller deals, dedicate at least one person to transformation management and agreement compliance. Each governance role is outlined below:

Service Delivery and Management—This function is responsible for the efficient and effective delivery of service, responsive customer service, and ensuring that service delivery complies with regulatory and internal policy requirements. The size of this group will vary according to the size of the deal, but is preferably limited in number.

Transformation Management—This function has responsibility for driving ideas, innovations, and process changes across both parties. The size of this group will also vary according to the deal size. All deals—regardless of size—should have at least two transformation management resources staffed full time on the agreement, one from the company and one from the service provider. For larger deals we recommend a "process champion" where there is a dedicated person for large processes.

Commercial and Relationship Management—This function is responsible for managing the commercial and contractual aspects of the outsourcing relationship and the overall relationship across the various stakeholders in the two organizations.

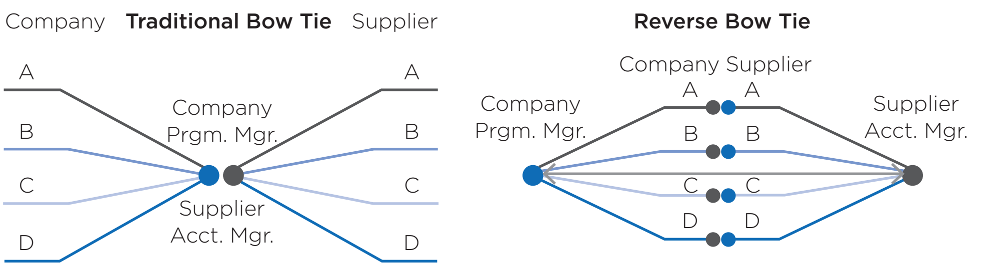
These functional governance roles should be embedded into each layer of the governance organization. The larger the deal, the more people in each of the roles. For those already worrying about overhead costs, please note that governance is not free; it means devoting the right resources to not only achieve service excellence but also to help drive the desired transformation.

3. Peer-to-Peer Communication Alignment

After determining the tiered structure and establishing the various functional roles within the structure, we recommend the parties focus on horizontal integration. One way to do this is to "map" the various individuals into the structure using a peer-to-peer alignment approach commonly known as "reverse bow tie." Many companies insist on using traditional hierarchical structures where everything flows through the outsourcing company's program manager and the service provider's account manager. This approach is depicted on the left in Figure 4 as a "traditional bow tie" model.

We recommend a change to direct functional communication through the appropriate contacts in the respective organizations, as shown in the diagram on the right in Figure 4. Using this "reverse bow tie" approach, managers of individual components are responsible for keeping the company's program manager and the service provider's account manager fully informed.

Figure 4: Creating Horizontal Alignment



This communication model improves the flow of information and helps to empower company and service provider teams. Remember, it is essential that managers hear about problems from their teams first. Failure to do so will doom this model.

Another key point is that peer-to-peer mapping is done for each governance-level structure. Many companies often only establish peer-to-peer communications protocols at operational levels, focusing on performance management and resolving day-to-day tactical issues. While the majority of the communications will occur at a lower operational level, the real benefit of using the reverse bow tie approach is that it streamlines communications across all layers. At the lower levels, the conversations tend to be about day-to-day tasks, while the higher-levels channel discussions around providing executive direction.

4. Develop a Communications Cadence

Establishing a regular cadence is an important aspect of the governance structure. The communication cadence is the "rhythm of the business" because it helps the parties establish a formal mechanism for managing the business. The example in Figure 4 alludes to a communication cadence by suggesting that the executive layer meet twice yearly, the operating committee meeting quarterly, and the sourcing/functional teams meet monthly.

The frequency should be shortened during the first year of the outsourcing relationship. Frequency should only change once the parties establish a solid footing and the business is working smoothly. We recommend that executive layer meet quarterly, the operating committee meet monthly, and the sourcing/functional teams meet weekly and even daily if needed.

As with any team, regularly scheduled conference calls, team meetings, and face-to-face formal reviews are the grease for the wheels. Governance involves free-flowing communication between operational groups, their managers and the executives of the companies. The most successful teams have formal mechanisms (and informal protocols) for talking daily, weekly, monthly, quarterly, and annually.

5. Develop a Process to Maintain Continuity

One of the most common pushbacks from organizations wanting to adopt vested outsourcing is, "I love the concept, but what if we sign up for risks under the agreement and the players change and throw out the rules? We have had trusting relationships and when a player changes, the pendulum swings and any progress we have made is lost."

This is a real fear. For this reason the governance framework should contain a process for ensuring continuity of personnel. Below are some of the best practices we have seen for maintaining employee continuity:

- Mutually identify a limited number of personnel that are designated as "key personnel" for both parties.
- Establish a provision that prevents either party from removing, replacing, or reassigning key personnel during an established timeframe. Two to three years is a reasonable duration that enables promotions effectively.
- Develop a process for communicating key personnel changes. For example, establishing communications protocols when key personnel become unavailable (sickness, jury duty, resignation, etc.).
- Establish a provision for replacement of key personnel.
- Use a formal escalation process for personnel mismatch concerns. For example, in some cases one of the parties (typically the company outsourcing) might have employees that denigrate or verbally abuse the service provider's personnel. This is intolerable and the agreement should have provisions that address escalating improper behavior between the parties or between employees.

An agreement is managed by people. We advocate strongly for a people management component of the governance framework.

6. Establish a Performance Management Program

Vested outsourcing isn't just about implementing innovations. There is also the need to govern the day-to-day business and the relationship. A performance management program that does the following:

- Measure end-to-end performance against KPIs and desired outcomes, not just service-level agreements (SLAs).
- Provide a mechanism to measure the overall health of the relationship and effectiveness of transformation efforts.
- Enable the parties to "score" performance to capture perception gaps.
- Include a neutral third party to help facilitate decisions on final performance scores and other aspects of governance.
- Include a proactive problem-solving and dispute-resolution process.

Each attribute is discussed below.

Measure End-to-End Performance—For many companies, the most efficient way to oversee normal operations is through a well-designed scorecard. Scorecards play a key role in tracking performance against agreed-on metrics. A common mistake when developing a scorecard is using a "service provider scorecard" that focuses on the detailed service-level agreements rather than the end-to-end desired outcomes and business needs. It is critical to have an overall "business" scorecard because it is highly likely that the parties will need to work together to achieve the business goals. An integrated, business-focused scorecard can help the parties emphasize performance against the desired outcomes and business needs, not just performance against the service provider's tasks.

Mechanisms to Measure the Overall Relationship—Performance management should also include understanding the overall health of the relationships. For example, let's take a look at how Whirlpool applies this concept with its strategic 3PL service providers. Kevin O'Meara, Director of Supply Chain Operations at Whirlpool Corporation, has embedded five key principles to ensure the overall health of the relationship. Figure 5 illustrates the Whirlpool approach (note the service provider is referred to as a "company" in the illustration).

While Figure 5 specifically refers to how Whirlpool works with a 3PL, the model is relevant to any vested outsourcing relationship. What is attractive about this model is its emphasis on transparency of communication, collaborative problem solving, trust, and finally service provider profit opportunity.

Figure 5: Whirlpool Approach to Understand Overall Relationship Health

Company Communication
- Open and honest communications
- Adequate and timely information transfer

Company Help (Responsiveness)
- Joint efforts to achieve cost/quality objectives
- Collective responsibility; joint problem solving

Company Problem Solving (Proactiveness)
- Elimination of barriers; ease of doing business
- Alignment of key processes (product development, S&OP, etc.)

3PL Profit Opportunity
- Opportunity to make advantaged returns
- Rewards for strong performance joint process improvement

Working Relationship
- Mutual trust/alignment of objectives
- Senior management ownership

Joint Scoring of Performance to Measure Perception Gaps—A well-designed scorecard will allow the parties to rate each other's performance and their own. This joint approach for scoring performance will highlight gaps in perceived performance and prompt better conversations about why this gap exists and potential resolutions. Figure 6 below is a scorecard that uses a joint measurement approach.

Figure 6: Performance Scorecard

Service Provider Scorecard									
KPI		Possible Score 100	Scores						
			Client					Self Score	Comments/ Examples
			Individual Score				Client Score		
Category Weighting 25%		KPI Weight							
1	KPI Example 1								
2	KPI Example 2								
3	KPI Example 3								
4	KPI Example 4								

Include Neutral Third-Party Facilitation—While the need for a joint measurement approach is obvious, problems can escalate to the point where a third-party mediator is needed. There is a trend to use neutral third-party facilitators in overall agreement governance and in particular for the performance management aspects. We support this concept and have seen it work well; however, we recommend the inclusion of the neutral third party as part of the overall governance team from the inception of the program.

Include a Proactive Problem-Solving Process—When we talk about proactive problem solving, we mean establishing a process for channeling problems in a constructive and meaningful way. Embedding a formal problem-solving process into the agreement creates a sense of accountability to solve problems in a timely manner using an agreed-on escalation and decision process. This proactive approach prevents parties from ignoring problems until they need an intervention, such as arbitration or litigation. Some issues can be, and ought to be, handled at the day-to-day level of implementation. As business happens, problems may arise that require internal escalation. Decide how to identify those issues, who should address those problems and what type of third-party intervention the parties may choose if the problem cannot be resolved.

2. Transformation Management

There is an obvious overlap in getting from the initial agreement to transitioning the work scope to maintaining the business in an ongoing and dynamic environment. Making these transitions requires a sound process for making changes to the actual agreement.

As we have done previously, we'll start by getting grounded with regard to what is "transformation management." The Macmillan Dictionary defines "transformation" as a change into someone or something different, or the process by which the change happens. "Management" is the control and operation of a business or organization.

When the words are combined we can infer that transformation management is defined as the operation of helping an organization to become different—both with regard to people (someone) and processes (something).

To be successful, a vested agreement should include transformation management processes to help an organization stay aligned in a dynamic business environment. This is crucial given that the one thing that is certain is that change is the only constant. It is also why scholars such as Ian Macneil and Oliver Williamson (as previously noted) talk about cooperative behavior under a business agreement that is a flexible framework. We all know that change also puts pressures on even the steadiest of relationships. A vested agreement needs to create mechanisms for dealing with the changes to ensure the organizations stay aligned and continue to work effectively together toward the parties' desired outcomes.

Transformation management processes should allow the agreement to evolve in a controlled manner. It should support—not hinder—continuous improvement and innovation. When a change impacts key elements of the agreement, such as the price or related service costs, service delivery or the obligations of either party, follow a documented process that includes an assessment of the impact of the proposed change.

The transformation management element of an agreement should contain four components, each targeted for different types of transformation:

1. It should document a common understanding on how the initial transition of work scope is managed. This will ensure the relationship gets off to a good start by establishing a clear understanding of the transition.

2. It should include philosophies for driving overall transformation initiatives—what is called a continuous innovation management process. This part of the agreement is designed to establish the protocols and processes outlining how the company will manage ideas that the parties need to agree on and invest in to help them achieve their desired outcomes.
3. The agreement should contain a process for managing day-to-day continuous improvement efforts or business problems that arise.
4. It should include a process for updating and managing any changes to the actual agreement. This is also referred to as contractual document management.

Only by establishing clear protocols and process for each will the organization achieve maximum effectiveness as it drives transformation.

Initial Transition Management

For some teams, the overall agreement may represent a transition from a company-operated function to a new service provider or from an old service provider to a new service provider. For others, it may simply entail a scope change and a new way of doing things between the same parties. If there is considerable workscope shifts between the parties, the vested agreement should include a formal agreement for how the parties will manage the initial transition.

Regardless of what is included in the transition agreement, there are three aspects of the transition process:

1. Maintain team continuity from the initial sourcing process, through transition to day-to-day operations.
2. Include an effective communication and training campaign around the transition.
3. Include a high-level target plan.

1. Maintain team continuity from the initial sourcing process, through transition to day-to-day operations

Service providers are typically very knowledgeable regarding transitions and many of the larger companies have formal "transition" or "ramp-up" teams that are solely focused on a successful rampup. In fact, one item to put into the transition agreement is the actual roles or job descriptions of the people that were on the transition team. For example, it is fairly common to have a full-time project manager assigned to the project, someone who likely will transition off the project after the transition is complete.

Until now the team has likely been an integrated multifunctional solutions team comprised of various participants from the parties. As the team designs the transition, there is a natural need to expand the team to include more members from the parties that are responsible for the actual transition and day-to-day business. To be successful, the team must retain at least a core of the integrated solutions team on the project. It is important that the agreement include a clear understanding of the roles, responsibilities, and major time frames for transitioning the work.

2. Include an effective communication and training campaign around the transition

As the transition plan is developed, a formalized resource plan is also needed. The transition should include a deliverable to create a formal "blueprint" of the work once it is transitioned to ensure key workscope elements are transferred and the resources are properly established.

The transition management plan should clearly spell out workscope transfers, staff transfers, and the roles of third parties that are possibly involved in the transition or setting up interfaces. It should also include a training plan such as any processes for "work shadowing," "knowledge capture," and "knowledge transfer." This training plan would also include training material and process documentation, especially if there are any local statutory requirements or processes. If the service provider did not create a performance work statement (PWS), it's appropriate for the service provider to complete a PWS once the work is transitioned.

3. Include a high-level target plan

The last part of the transition management plan is to document the actual high-level plan itself. The finite details likely will change, but the agreement itself should outline the high-level agreed-to-transition plan. This should include documenting the following:

- Assumptions;
- Target transition schedule, including:
    - Key activities, milestones, and decision points;
    - Key dependencies;
    - Performance criteria to be measured and achieved at each stage of roll-out;
    - Go-live criteria;
- Quality control and delivery management procedures;
- What each party company has to provide or other special requirements (such as not transitioning during peak months);
- Testing methodology and criteria; and
- Transition Project Management protocols, such as:
    - Progress reviews;
    - Issues Resolution.

The team should also outline potential risks to performing the transition. A risk assessment exercise at the inception of the relationship enables the parties to look at potential relationship landmines before they take place and jointly design methods to overcome these issues as they arise.

Finally, as the transition begins, implement the organizational aspects first—putting in place the resources for each of key positions you outlined in your relationship management structure. Keep in mind that this is a partnership, a new phase in outsourcing. It is a team working together and learning from each other. Start positive and stay positive.

Continuous Innovation Management

A vested relationship and agreement is designed for change. For this reason, the vested agreement should include formal processes for managing ideas, opportunities, and innovations that can help the parties achieve their desired outcomes.

A vested agreement is designed to reward service providers for innovative ideas and investments that deliver results against the Desired Outcomes. It is important to understand that innovation is the key driver of economic growth for businesses. In fact, Robert Solow was awarded a Nobel Prize for his work linking innovations in business products and process as the key reason for business growth. His work found that 87% of all economic growth for businesses comes from these innovations.[15] Establishing a joint continuous innovation management process needs is thus a fundamental part of a vested agreement. The agreement should spell out exactly how the parties will communicate and make investment decisions with regard to potential innovations that can help the parties achieve the desired outcomes.

Significant revenue streams can come through continual improvements of a product or service. Innovations entail risk but doing nothing is even riskier. As the economist Joseph Schumpeter said, companies that resist change are "standing on ground that is crumbling beneath their feet."[16]

One misconception is that innovation only applies to R&D in terms of developing new products and services. The American Productivity and Quality Center (APQC) is debunking this myth. The Center's studies have shown that innovation applies in virtually all parts of a company and its underlying processes. One area where innovation is mostly untapped is in business operations. A vested agreement should focus on making the business more effective through process innovations. In short, innovations help make the pie bigger for the parties when they are focused on delivering results against the desired outcomes.

While business leaders agree that innovation can yield great benefits, almost all will also agree that investing in innovation involves costs and risks that could have a negative effect if the efforts do not result in successful end products or services. For this reason, it is crucial that an agreement include a continuous innovation management process so that the parties can review potential ideas and jointly agree that the idea is worth pursuing.

Continuous innovation management relies not only on the parties' ability to collaborate and generate ideas, but also on their ability to implement ideas that can deliver value. The problem isn't a dearth of ideas; it is in their execution. Develop an effective means for identifying good continuous innovations by scoring the projects for value.

Using a scoring approach helps the parties understand the nature of their collaboration projects. Companies should differentiate between long-term collaborative projects and shorter-term quick wins. Both are equally important but require a different level of effort as the ideas go through the continuous innovation management process.

The parties should develop a formalized process and guidelines for managing and picking ideas and innovations to implement. Also create a portfolio of ideas. Many ideas may be generated and business cases even built only to find that the joint operating committee or the board of advisors veto the idea.

The following are good approaches to use in creating an innovation management process:

- Keep ideas in an "innovation pipeline." Just because it was rejected once does not mean that it is not feasible to bring forward again.
- Measure how many ideas are generated relative to how many get implemented. The best companies will implement a large number of ideas—as much as 90%.
- Develop a Pareto chart of reason codes as to why ideas do not get implemented.
- Clearly document desired hurdle rates for the project and create a formalized process teams can use to help them capture their ideas and quantify their ideas.
- Develop a decision framework and process for selecting ideas to implement.

Continuous Improvement Program

The third component of transformation management is putting in place a continuous improvement program for managing day-to-day operations. Continuous improvement programs are different from continuous innovation management, which tends to focus on larger-scale transformation initiatives that often need investments or resources.

Transformation initiatives are often cross-organizational in nature and are tied to the desired outcomes. These initiatives come in all shapes and sizes. Six Sigma and Lean programs are

Note: A Pareto chart is a graph showing the most frequently occurring problems or sources of problems in descending order.

two of the most popular approaches. Regardless of the continuous improvement approach that is adopted, it should have the following attributes.

Joint—Not Separate Approach

There are many instances where one or both of the parties have their own continuous improvement program. This is great for improving efficiencies separately within each company. However, the parties should decide on a single continuous-improvement approach for managing a single joint continuous-improvement effort across the workscope.

Transparent Fact-Based Decisions

Building trust starts with a transparent relationship based on facts and the ability to "see" critical components of the business in a timely manner. Develop a root-cause analysis process to determine service failures. The process should highlight—rather than hide—the data and how the process is not yielding the performance against the desired outcomes.

End-to-End Focus on Accountability

No matter who performs the root-cause analysis for failures, it is clearly understood that the root cause of the failure may reside with either party. Most continuous improvement processes are one-sided and focus on the service provider. The parties should look at the end-to-end process and measure failures at the highest level and then drill down into the root-cause analysis.

Customer Satisfaction Survey

The parties should just measure their internal performance. They also should look externally. This may include end users (such as the case with call center outsourcing) or internal customers (such as the case with back office outsourcing). Getting direct feedback from "customers" helps keep the parties aligned on how the users define success.

Formal Benchmarking Reports

When possible, the parties should adopt a formal benchmarking process. The purpose of benchmarking exercises is to monitor progress toward goals, identify successes and problems, scorecard performance, track customer satisfaction, identify new opportunity areas for improvement, and quantify business value delivered.

Change Control Procedures

The vested agreement should contain change control procedures that the parties use to request, assess, process, and approve or reject modifications to the agreement. They should develop a written change request process that either party can use to initiate a formal change to the agreement. A change request is required for modifications that affect the price or related costs of the services, impact the delivery of the service, or impact the obligations of either party under the agreement. Typical events that trigger change requests include but are not limited to:

- Changes in applicable law that have a material impact on the services,
- Changes in relevant policies and procedures by either company,
- Introduction of new or updated technology tools,
- Changes in volumes not included in the agreed on pricing,
- Changes in work scope not included in the agreed on pricing that will require additional staffing or costs,
- Changes to service-level targets,
- Changes in key personnel,
- Requests for additional work for one-time projects that will require additional staffing,
- Material increase in any reporting requirements, and
- Changes in assumptions outlined in the pricing model.

Adopting a change management process is most crucial during the transition phase. In the early phases of the relationship as workscope transitions, key stakeholders in the old and new models may be unreceptive to the change, may not understand why the change is necessary, or may be new to the entire process.

In almost all cases, the team responsible for implementing vested outsourcing principles will likely find it has varying degrees of supporters and detractors. A good change management process is used throughout the life of your relationship. It is not just used for the initial transition, but to manage any jointly agreed transformation initiatives

We have found there is a natural tendency for the focus on documenting changes to wane after the initial transition phase is completed. Prevent this by establishing a commercial management role within the governance framework (as discussed earlier under Relationship Management). The commercial manager should document trigger events that drive an update of the agreement.

3. Exit Management Plan

Because nothing lasts forever, a valid question to ask is: What happens when the agreement ends?

If the agreement is properly structured and is achieving the desired outcomes while continually improving performance, renewal of the agreement or contract is likely. Most companies would like to envision a long-term productive relationship that spans decades—such as the famed Coca-Cola and McDonalds relationship that is in its 55th year.[17] During our involvement and study of vested outsourcing relationships, we have yet to see parties separate after they make the paradigm shift to become vested with each other.

Unfortunately, relationships can fail at times no matter how promising the start, how well-written statements of intentions and objectives are, or how well structured the governance framework. Business and market conditions can change suddenly, people move on, projections fail to pan out, and companies change hands. An important facet of the governance framework therefore is a credible exit management plan.

One of the potential dangers of outsourcing is that a company becomes so entwined with and dependent on the service provider that the potential benefits of changing to a new service provider cannot match the pain of extraction. This occurs most often when service provider management becomes service provider abdication. By maintaining proper insight, and a balanced relationship between company and service provider, two good things happen:

- The likelihood of the partnership degrading becomes less and less, and
- The ability to dissolve the partnership as required by new circumstances remains in play.

Outsourcing agreements often address what happens at the end of the agreement purely from a liability point of view, through termination clauses either for convenience or for cause. These clauses may address the notice period or financial obligations under the agreement but do little to set forth how to unwind the business relationship. In fact, these clauses may provide incentives for the service provider to just dump and run, stripping resources from the program long before the transition is complete.

An exit management plan will facilitate a smooth, effective transition of services delivery, minimum disruption of ongoing delivery, and efficient completion of all agreement obligations.

The plan is invoked with the issuance of a formal termination notice under the agreement, specifying:

- The portion of services included in the scope of termination,
- The estimated exit transition period and vendor delivery centers affected, and
- The period of time following a termination notice that the parties will have to agree on the specific scope of transition services provided by the vendor.

A company we studied is an excellent example of planning ahead. The company was crafting a 12-year agreement that included a nine-page exit management plan, “just in case.” The plan was very specific about the roles, duties, and expectations of both the company and the service provider should the parties decide to terminate. We find working through an exit management plan at the beginning of a relationship is far easier than when quite possibly the parties are in a heated debate and separation is imminent. The plan may not need as much detail as the example, but it should describe how the essential elements of the agreement are managed when the agreement ends (in part or in full). A summary of the components of an effective exit management plan follows.

Termination Notice

The exit management plan enters force when a formal termination notice is delivered by either party or when services are transitioned once the agreement or work scope expires. The scope of the termination notice must be specific about the services included (including processes and geographies) and also should include an estimated exit transition period, service provider delivery centers affected by the transition, the location of replacement delivery centers, and vendor transition assistance charges. Establish exit management teams within one week of the termination notice issuance, and the detailed exit plan should be developed and submitted in less than a month.

Exit Transition Period

Just as there is a transition period when an outsourcing agreement is first implemented, there is a transition period in the event of agreement termination. The transition period usually will encompass the period of time from the date of the termination notice until the date on which any transition services are completed.

Exit Transition Plan

The objective of developing an exit transition plan is a smooth, effective, and uninterrupted transition of service delivery with minimum disruption and efficient completion of an agreement obligation. This can only happen if there is a plan to make it happen and if it is managed. The exit process is managed through an exit management governance process that is specifically set up within the overall governance structure of the agreement. The transition is run by an exit manager who supervises the exit management team made up of representatives from the company and the service provider. The exit management team oversees the entire transition process. If the work being transitioned is spread over a large geographic area, there may be a need to include team members from each location.

The exit transition team is responsible for the following activities:

- Program management,
- Due diligence,
- Services transition and continuity (including knowledge transfer, documentation and enabling systems transfer),
- Facilities transfer,
- Human resources transfer,
- Fully answering all reasonable questions about the services or transfer, and
- Coordination with the respective company and service provider organization members to sustain continued service delivery as per SOO requirements in the agreement.

The exit transition plan will vary by the workscope and complexity of the agreement but all exit transition plans will include:

- The timelines for the various activities required to exit the business,
- A list of the personnel responsible for planning, managing, and implementing the services transfer,
- A list of the information required for continued performance of services in an orderly manner that minimizes disruption in the operations during the transition period,
- Preparations for a transfer of knowledge regarding the transferred services,
- Support for the transfer of resources used in the delivery of services,
- Communication plans for external customers and all impacted stakeholders,
- Identification of all security and disaster recovery tasks,
- Inventories of all licenses, permits and other agreements that require notification, assignment, or transfer of rights,
- Personnel and resource transition/transfer procedures, and
- Lists of confidential information, equipment, materials and IP so that it can be returned or destroyed.

Governance and Reporting

The exit management process should be managed within the overall governance structure developed as part of the agreement as will the resolution of issues that arise from the exit transition. The exit transition plan should specify reporting requirements. Reports to the governance committee are issued frequently. If the exit transition period is short (under 60 days), daily or weekly reporting is advisable. Reports to the governance committee will:

- Provide status on progress against the exit transition plan,
- Identify key issues impacting the delivery against the plan,
- Identify potential risks to the plan, and
- Detail key actions that need to be taken by the various stakeholders to facilitate a smooth transition.

The exit management plan will provide a sort of reverse snapshot of the entire governance framework, proving that it is vital to get the structure right at both ends of the relationship.

CONCLUSION

The term governance is daunting and confusing. However, by narrowing the lens and creating a governance structure to manage a contract, it is easier to apply a practical approach and tools to help manage the agreement. A sound governance structure is needed for all agreements and contracts—but it is essential for large outsourcing contracts where the service provider becomes an extension to the firm to perform key tasks.

We have seen that while governance is difficult to define, especially in outsourcing contracts, a major reason that agreements sputter or fail is the lack of a proper governance framework. Governance encompasses a joint process and flexible framework that over time defines and structures an enterprise/contract that in theory and practice works for the mutual benefit of all the parties by ensuring that they act ethically, employ best practices, and adhere to formal laws.

A vested governance framework puts the definition into practice. This framework is built on four interlocking and overlapping structural, flexible, and collaborative elements: Relationship Management, Transformation Management, Exit Management and Special Concerns, and External Regulations. The framework and the three elements provide the road map of the transformational power to help companies implement vested outsourcing's fifth rule: A collaborative governance structure based on insight rather than oversight. We hope you will find this white paper, framework, and practical guidance useful in helping you apply governance structures to your outsourced relationship.

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For more information about vested outsourcing: Visit the University of Tennessee's Web site dedicated to vested outsourcing at www.vestedoutsourcing.com where you can download white papers, watch videos, read articles, and subscribe to our vested outsourcing blog. We also invite you to attend one of our vested outsourcing open enrollment courses by registering for an upcoming class at http://vo.utk.edu.

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