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Unpacking Sourcing Business Models

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21st Century Solutions for Sourcing Services

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Purpose and Background

This white paper is a collaborative effort between the University of Tennessee (UT), the Sourcing Interest Group (SIG), the Center for Outsourcing Research and Education (CORE), the International Association for Contracts and Commercial Management (IACCM) and industry and academic leaders that are passionate about improving how companies' approach procuring and working with outsourced service providers.

Today, outsourcing has grown into a formidable industry. The 110,000-member International Association for Outsourcing Professionals estimates the size of the outsourcing industry at more $6 trillion globally.[1] Outsourcing has risen across all major types of services and today many organizations -— such as the United States Air Force — spend more than 50 percent of its budget on services. This is not uncommon. Outsourcing is deep rooted in many industries such as logistics and transportation. Other industries such as IT and Human Resources have risen in the last decade.

The organizations and authors have teamed on this white paper to drive clarity around outsourcing business models and to help procurement, outsourcing professionals and commercial managers understand and use the appropriate sourcing business model to maximize their desired outcomes.

This white paper has four primary purposes:

1. *Establishes that outsourcing is a continuum.* In this section we highlight Dr. Oliver E. Williamson's Nobel Prize winning concepts and challenge organizations to consider a "hybrid" approach for outsourcing more complex outsourcing efforts.

2. *Provides an overview of the various sourcing business models, including traditional transaction-based models and newer outcome based sourcing models.* In addition to the overview, we explore the pros and cons of each model. We also explore how sourcing business models can be applied in a "Shared Services" environment.

3. *Provides guidance for determining the appropriate sourcing model* based on a set of common business attributes.

4. *Provides real examples* of each sourcing business model.

The paper is divided into sections that address each of the four focus areas.

Enjoy the read!

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[1] Information retrieved from the IAOP website at http://www.iaop.org

Introduction

Adam Smith, an eccentric Scottish academician at Glasgow University, observed the human propensity for self-interest and formulated the law of supply and demand in 1776 with the publication of *An Enquiry into the Nature and Causes of the Wealth of Nations.* His theory said that society benefits as a whole from a multiplicity of trading transactions because humans seek what is best for them, resulting in fairness and honesty among equals. As demand for repeat transactions emerged, trading preferences evolved and modern transaction-based business models were born. These transaction-based business models have been the cornerstone of conventional business relationships ever since and created some of the earliest forms of outsourcing.

For the most part, transaction-based approaches served business well through the 20th century. While the concept of outsourcing had been around for decades, the 1990's brought a new spotlight to outsourcing. Business gurus such as Tom Peters and Peter Drucker advised, "Do what you do best and outsource the rest!" and Harvard Business Review featured the leading thinking of Waterman and Peters on outsourcing non-"core" competencies.[2] Many companies jumped on the outsourcing bandwagon by outsourcing complex services normally referred to as "back office" functions such as Information Technology, Finance and Accounting, Facilities Management, Logistics and Transportation, Call Center support, and Human Resources support.

Today, virtually all businesses use the same transaction-based approach for procuring complex services (i.e., outsourcing) as they do to buy more simple commodities and supplies. Most complex outsourcing efforts fall into conventional agreements that typically focus on detailed per-transaction level pricing, paying either for a business task (cost per warehouse pallet stored, cost per minute of call, or cost per IT server) or on a per headcount basis.

Unfortunately, many business professionals wrongly assume that a transaction-based business model is the only sourcing business model. *For simple transactions with abundant supply and low complexity, a transaction-based business model is likely the most efficient model.* But the real weakness of a transaction-based approach emerges when any level of complexity, variability, mutual dependency or customized assets or processes are part of the transaction. A transactional approach cannot produce perfect market-based price equilibrium in variable or multidimensional business agreements. In many instances, other approaches may be more appropriate.

The purpose of this white paper is to drive clarity around outsourcing business models and help procurement, outsourcing professionals and commercial managers understand and use the appropriate sourcing business model to maximize their desired outcomes.

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[2] The quote is widely attributed to these men. It is unclear who said it first, but likely Peters did in In Search of Excellence (New York: Harper & Row, 1982). Drucker's quote retrieved from: www.qualitywriter.com/about-us/famous-quotes-deep-thought-humorfun-politics-sayings. Harold Waterman was also a proponent of outsourcing core functions, see David Souden, *Ingenuity and Engineering: The Waterman Story* (2002), retrieved from www.watermangroup.com/brochures/get_file?id=34.

Section I. Outsourcing is a Continuum

Companies that are looking to outsource generally go through a rigorous make vs. buy decision process before deciding to outsource. Many assume that the decision to insource versus outsource results in one of two approaches: either deciding to use "the market" to identify qualified sources to perform the work or retaining or developing the capabilities in-house.

Oliver E. Williamson challenged the traditional make-buy decision process with his work in the area of Transaction Costs Economics. Williamson received the Nobel Prize for his work in 2009. One of his key lessons was that companies should view outsourcing as a continuum rather than a simple market-based make versus buy decision.

Perhaps the best way to think of Williamson's work is to consider free-market forces on one side and what Williamson refers to as "corporate hierarchies" on the other.

Figure 1: A Continuum of Outsourcing Solutions

Developing a Corporate Hierarchy (Insource)

At one end of the continuum is what Williamson referred to as "Corporate Hierarchy." Companies that use a corporate hierarchy approach to secure goods and services invest to develop capabilities themselves (or insource).

A key factor in the decision to insource versus outsource typically revolves around whether the capability is a "core competency," meaning performing the work provides a competitive differentiation. Unfortunately, it is virtually impossible for a company to be good at all activities and these inefficiencies drive up the company's cost structures. It is this reason that visionaries such as Drucker, Waterman, and Peters encouraged companies to outsource activities that were not core competencies.

In some cases companies have concluded that they do not want to outsource non-core services.[3] As an alternative to outsourcing many of these companies have chosen to adopt what is commonly referred to

[3] There are a variety of reasons why companies may choose to not outsource non-core activities. Companies cite different reasons, but a primary reason is that service providers do not have the capabilities to provide unique or highly integrated services.

as a “shared services” structure, which is the establishment of an internal organization modeled on an arms-length outsourcing arrangement. Using this approach, processes are typically centralized into a “shared service” organization and departments are cross-charged for the services used.

Williamson’s work notes there are many hidden transaction costs associated with performing work that is non-core to the organization. One of the downfalls is that when work is insourced there is not any competition; this provides little incentive to drive inherent improvements in cost and quality. There is also high administrative control and a legal system that is “deferential to the management.” As a consequence, innovations that might come from the market or third parties are not shared or developed as rapidly as management typically likes — if at all.

Because these are additional bureaucratic costs, Williamson advises, “The internal organization is usually thought of as the organization of last resort.” In other words, if at all possible companies should not insource non-core services.

Using the Market (Outsource)

Companies that choose to outsource typically use what Williamson describes as “the market” for buying goods and services. The market uses the conventional free market economy for determining how companies will do business, including establishing a price. The market mode assumes that free market forces incentivize suppliers to compete on low cost and high service. This approach also features an absence of dependency; if buyers or suppliers are not happy, they can switch at any time with relative ease. Governance of the supply base is typically accomplished by switching suppliers or customers if a better opportunity comes along. As a result, the market approach can rely purely on classical contract law and requires little administrative control.[4]

The big advantage to using the market in the decision to outsource is that it enables a competitive process in determining whether a company is getting a good transaction price. The downside to the market mode is that it often assumes that the service acquired is somewhat standardized and therefore available from a variety of suppliers. Consequently service providers are often “competed” into outsourcing agreements that pose unnecessary risks. For example, Williamson points out that service providers might have “specialized investments” that can easily expose the business to significant loss if the contract fails and for which no safeguards have been provided. Often this investment is made to

[4] The legal scholar Ian R. Macneil was instrumental in developing a wider view of the contract, known as relational contract theory. He said that most contracts are ill-equipped to address the reality of business needs. In his 1968 work, *Contracts: Instruments for Social Cooperation*, Macneil wrote, “Somewhere along the line of increasing duration and complexity [the contract] escapes the traditional legal model.” He argued that contracts are rooted in the classical approach to contract law and thus crafted to address transactions and legal protections such as pricing and price changes, service levels, limitation of liability, indemnification and liquidated damages. He said business-to-business contracts should be “instruments for social cooperation.”

support innovation, which in turn provides a higher value offering or a more efficient business model. To protect themselves, service providers will raise their price to reflect the level of risk they have taken. To counteract this, and thus provide a more acceptable price to the customer, service providers will often negotiate heavily for contract safeguards in the absence of certainty. This “give and take” is a normal part of market-based negotiations.

The Catch-22

Deciding to insource or outsource is rarely a yes or no decision. Although each approach offers advantages, a real Catch-22 has emerged for companies that want to drive innovation and create a competitive advantage, yet still want to outsource a particular activity.[5]

In a transaction-based environment, procurement teams endeavor to limit relationship dependency in an effort to reduce the price of goods or services. Buyers strive to have uniformly available goods and services (e.g. commodities) that can be easily compared across various suppliers. A buyer’s goal is often focused around the company’s bottom line, which is typically reflected in terms of “price” paid.

As complexity and dependency increase, buyers tend to migrate to an approved provider or a preferred provider sourcing relationship. For the most complex high-risk/high-cost contracts companies will tend to focus on continuity of supply due to extreme mutual dependency. In these cases, an investment-based approach to insourcing is often used. Investment-based approaches can take the form of internal capability development or co-investment such as a joint venture. Under a joint venture a company will often create an equity partnership or other legally binding business arrangement with a firm that gives the company access to the desired capabilities. Another common investment-based option is to centralize the service into a “shared services” group aimed at driving efficiencies. Shared services are discussed on more detail later.

The Catch-22 comes into play because companies that are using transactional, approved or even preferred supplier arrangements are finding that their service providers are meeting contractual obligations and service levels — but they are not driving innovations and efficiencies at the pace they would like to see. Suppliers argue that investing in their customer’s business is risky because buyers will simply take their ideas and competitively bid the work. Companies want solutions to close the gaps, but they do not want to make investments in people, processes and technology where they do not have a core competency. The result is that the industry is at a crossroads, with both buyer and service providers wanting innovation — but neither wanting to make the investment due to the conventional transaction-based commercial structure of how the companies work together.

[5] Catch-22 generally is regarded as a no-win situation that uses self-contradictory circular logic. For instance, you may need a pass to enter a particular building, but in order to get a pass you have to visit an office in the same building.

The Rise of a Hybrid Approach

Because of this Catch 22, Williamson advocated for a third “hybrid approach” as the preferred method for dealing with complex services where there is a high level of dependency and the market cannot be used to switch suppliers freely and where an insource solution may not be a good fit.

Companies that use a hybrid approach can apply various approaches with suppliers to create strategic and longer-term relationships that can offset the weaknesses found in a pure market-based or pure insource based approach. We refer to this hybrid approach as Vested indicating that both parties are invested in identifying the best collective solution.

Section 2 of this white paper outlines six types of sourcing business models, including the hybrid approach most often referred to as Vested Outsourcing. These six sourcing business models should be considered as tools in the procurement and outsourcing professional’s toolkit. Each of the sourcing business models is discussed in detail on the following pages.

Section II. Types of Outsourcing Business Models

Research by the International Association for Contract and Commercial Management shows that most companies operate under conventional transaction-based models that are constrained by a formal, legally oriented, risk-averse, and liability-based culture.[6] There is growing awareness that transactional-based approaches approach do not always give each party the intended results. University of Tennessee research and the authors’ industry-specific experiences applying alternative outcome-based approaches for complex contracts demonstrate that alternative sourcing business models are a viable alternative to the conventional transactional methods. Outcome-based approaches are gathering momentum as senior leaders see positive results from carefully crafted collaborative agreements.

This section of the white paper outlines six sourcing business models that fall into three categories. Each model differs from a risk/reward perspective and should be evaluated in the context of what is being procured. The characteristics and attributes for each of these approaches are reviewed in detail below.

[6] “Contract Negotiations Continue to Undermine Value,” International Association of Contracting and Commercial Management Ninth Annual Top Ten Terms Report, April 2010.

Figure 2: Sourcing Models

Sourcing Business Models	Sourcing Business Model Categories		
	Transaction Based	Outcome Based	Investment Based
Simple Transaction Provider	X		
Approved Provider	X		
Preferred Provider	X		
Performance-Based Relationship		X	
Vested Relationship		X	X
Shared Services (internal)			X
Equitable Partner (external)			X

Transaction-Based Models

Most companies use transaction-based business models for their commercial agreements when they make a “buy” decision. Conventional approaches to transaction-based models keep service providers at arm’s length. Three types of transaction-based sourcing relationships have evolved over time as businesses wrestle with how to create service provider relationships that are better suited for more complex business requirements. The three types are simple transaction providers, approved providers, and preferred providers.

The economics for each of these types of supplier relationships is very similar in that the supplier gets paid by the transaction. There is typically a pre-defined rate for each transaction, or unit of service. For example, a third party logistics service provider would get paid monthly for the number of pallets stored, the number of units picked, and the number of orders shipped. A call center service provider would get paid a price per call or a price per minute.

Transaction-based business models are best suited when a supplier is supplying a standardized service with stable specifications which is easily measured through a commonly understood set of metrics. Payment can be triggered based on successful transactions completed.

The three types of transaction-based providers can be described as follows:

Simple Transaction Provider

A Simple Transaction Provider is a supplier who is one of many available in the marketplace, typically providing a low cost, repetitive service. The services provided by this type of provider are often competitively bid frequently with no interruption of service or impact to the business. Simple transactions are often triggered by a Purchase Order which signals that the buying company agrees to buy a set quantity of goods or tasks (or hours) outlined in the purchase order. The primary supplier relationship is solely based on a review of performance against standard metrics (did the supplier work that many hours or provide the good or service in the quantities purchased).

Approved Provider

An Approved Provider is a supplier who has been identified to offer a unique differentiation from other transactional suppliers and provides a cost or efficiency advantage for the client company. The differentiation could come in the form of geographical location advantage, a cost or quality advantage, or a small disadvantaged business and is ultimately "approved" to assist with meeting the client company MWBE goals. An Approved Provider is identified as a pre-qualified option in the pool of transactional suppliers and has fulfilled preconditions for specified service. Procurement professionals typically turn to Approved Suppliers as regularly solicited sources of supply when bidding is conducted. An Approved Supplier may or may not operate under a Master Services Agreement — an overarching contract with the buying company. Approved Suppliers may or may not also have volume thresholds to be in an “approved” status. In addition, Approved Suppliers may or may not participate in supplier management reviews.

Preferred Provider

A Preferred Provider is a supplier that has been qualified, may have a unique differentiator, and has had demonstrated performance with the buying company. Typical conditions are met such as

- Previous experiences
- Supplier performance rating (if the client company has a rating system)
- Previous contracts compliance performance
- Evidence of an external certification (e.g. such as ISO certification)

Buying companies often seek to do business with a Preferred Provider in an effort to streamline their buying process and build relationships with key suppliers. Buying companies often enter into a longer-term contract using a Master Services Agreement that allows for the companies to do repeat business efficiently. It is common for Preferred Providers to work under a blanket PO with pre-defined rates for work. For example, a labor-staffing firm may have a “rate card” that has the hourly rate established for various types of staffing needs. The buying company can easily request staffing support from the

Preferred Provider using the pre-determined blanket PO and rate card. Another example might be a facilities management firm having a pre-agreed rate of a certain price per square foot to manage a company's buildings. Often companies will work with a Preferred Provider under a supplier relationship management plan where both companies agree on improvement or other opportunities.

It is important to point out that a Preferred Provider is still engaged in a transactional business model, but the nature and efficiencies for how the companies work together goes beyond a simple purchase order.

The table on the following page outlines typical characteristics of each of the transaction-based business model approaches frequently used today.

Figure 3: Attributes of Transaction Based Business Models

Sourcing Relationship	Focus	Interaction	Cooperation Level	Required Trust Level	Characterized by
Simple Transaction Provider	Cost and Efficiency	Standard Terms, Fixed Price	Low-Automated where possible	Minimal – single transaction	Abundant and easy to resource, no need for a relationship
Approved Provider	Economies of Scale, Ease of transactions	Blanket , Negotiated Terms, Pricing Agreements	Medium – based on pricing or specifications	Medium – common terms and price agreement	Managed by category locally and across business sector , purchases bundled for economies of scale
Preferred Provider	Capability, Capacity, and Technology transactions	Contract, SOW, Pricing Agreement, Possible Gain Sharing SLAs	High – Set out in long term service contract	High – defined by contract, high spend zone	Integral supply across business units, delivering added value and capability, not so abundant, a pain to re-source

Outcome-Based Business Models

An outcome-based business model pays a service provider for the realization of a defined set of business outcomes, business results, or achievement of agreed-on key performance indicators. Outcome-based approaches are used most widely in the aerospace and defense industries. Often they are referred to as performance-based logistics because they couple maintenance and support to the procurement of the product. Rolls-Royce PLC was the first known organization to explore outcome based approaches in the 1960s. However, outcome-based business models did not gain traction until around the year 2000, and the use still is limited. A good example of an outcome-based business model is when an airline pays its outsourced ground crew for achieving a 20-minute turnaround time after the plane has been parked at the gate. In the simplest form, the service provider does not get paid if they do not deliver results. An outcome-based business model typically shifts some or all risk for achieving the outcome to the service provider.

Outcome-based business models have gained in popularity in the last few years as more companies outside of the aerospace industry have adopted the concepts and have expanded the thinking to pure outsourced service deals. A well-structured outcome-based agreement compensates a service provider's higher risk with a higher reward. However, many companies wrongfully structure deals around "all risk, no reward;" in such cases, a supplier or service provider that does not meet the desired results is penalized.

There are two types of outcome-based business models; a performance-based agreement and a Vested Outsourcing agreement.

Performance-Based Agreements

The relationship with suppliers under a Performance-based agreement is different than with transactional providers. Typically performance-based agreements begin to shift the thinking away from activities to outcomes; however they often still pay a supplier using transaction based pricing triggers. These contracts are often also called "pay for performance" because they often have an incentive or a penalty tied to specific service level agreements (SLAs) outlined in the contract.

For example, a company outsourcing call center services will likely still pay a cost per transaction (most often a cost per call or minute). However, they create incentives or penalties if the service provider does not hit a metrics such answering 80% of the calls within 20 seconds.[7]

Performance-based agreements typically require a higher level of interface between a service provider and a buying company in order to review performance against objectives and determine the reward or penalty options that are typically embedded in the contract. These reviews are periodically scheduled and generally include representatives from the service provider and the client company contracting resources.

Occasionally the buying company's service user(s) participate in the reviews. However, in these relationships there is a great tendency for the client company to solely make the reward determination. If this is not done properly and fairly, it can cause the buyer-supplier relationship to become more adversarial in nature. It can also lead to what the University of Tennessee researchers term the "Watermelon Scorecard" because it results in a service provider spending all of their time on meeting SLAs and my not lead to overall business needs such as improved flexibility or the ability to focus on process changes that may be valuable — but could risk service levels.

The length of Performance-based relationship is also typically longer in a performance-based agreement. It is not uncommon to see agreements spanning three to five years; however, the contract language may

[7] It is the authors' opinion that incentives work better than penalties and create a more positive working relationship with service providers.

allow for termination at the client company's determination (termination for convenience) within 30, 60 or 90 days.

Vested Outsourcing

Vested Outsourcing is a highly collaborative outsourcing business model where both the client and service provider have an economic vested interest in each other success. A good example is Microsoft and Accenture who entered into a 7 year agreement where Accenture was challenged to transform Microsoft's back office procure to pay processes. The agreement is structured so that the more successful Accenture is at achieving Microsoft's goals, the more successful Accenture itself becomes. The Microsoft-Accenture case study is profiled in Section IV.

The term Vested Outsourcing was originally coined by University of Tennessee (UT) researchers to describe highly successful outcome-based outsourcing agreements the researchers studied as part of a large research project funded by the United Stated Air Force. UT research revealed that the Vested Outsourcing agreements combined an outcome-based model with the Nobel award-winning concepts of behavioral economics[8] and the principles of shared value.[9] Using these concepts, companies enter into highly collaborative arrangements designed to create value for all parties involved above and beyond conventional buy-sell economics of a transaction-based agreement.

The Vested Outsourcing business model is best used when a company has transformational or innovation objectives that it cannot achieve itself or by using conventional transaction-based approached or performance-based approaches. These transformational or innovation objectives are referred to as Desired Outcomes; it is these Desired Outcomes that form the basis of the agreement. A Desired Outcome is a *measurable business objective* that focuses on what will be accomplished as a result of the work performed. A Desired Outcome is not a task-oriented service-level agreement (SLA) that often is mentioned in a conventional statement of work or performance-based agreements; rather it is a mutually agreed upon, objective, and measurable deliverable for which the service provider will be rewarded — even if some of the accountability is shared with the company that is outsourcing. A Desired Outcome is generally categorized as an improvement to cost, schedule, market share, revenue, customer service levels, or performance.

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[8] Behavioral economics is the study of the quantified impact of individual behavior or of the decision-makers within an organization. The study of behavioral economics is evolving more broadly into the concept of relational economics, which proposes that economic value can be expanded through positive relationships with mutual advantage (win-win) thinking rather than adversarial relationships (win-lose or lose-lose).

[9] Shared value thinking involves entities working together to bring innovations that benefit the parties—with a conscious effort that the parties gain (or share) in the rewards. Two advocates are Harvard Business School's Michael Porter and Mark Kramer who profiled their "big idea" in the January–February 2011 *Harvard Business Review Magazine*. The article states that shared value creation will drive the next wave of innovation and productivity growth in the global economy. Porter is renowned for his Five Forces model of competitive advantage. Due to his prominence, it is likely that his take on shared value, although focused on society, likely will cause practitioners to embrace shared value approaches.

Another good example of a Vested Outsourcing agreement is Jaguar and Unipart. Unipart was inherently incentivized under their 10 year agreement to make heavy investments that would increase dealer support and ultimately improve customer loyalty for service parts management effectiveness and efficiency. Under the agreement, Unipart helped Jaguar move from number 9 in JD Powers customer loyalty to number 1.[10] Together the companies were able to reduce the number of cars waiting on warranty parts by 98%, while reducing inventory by 35%.

The following table outlines the typical characteristics of both a performance-based and Vested Outsourcing approaches.

Figure 4: Attributes of Outcome Based Business Models

Sourcing Relationship	Focus	Interaction	Cooperation Level	Required Trust Level	Characterized by
Outcome-Based/ Performance-Based Relationship	Outcomes or Performance	SRM Governance, Performance Incentives, Fees at Risk	Integrated	Integrated	Longer term relationship
Vested Outsourcing Relationship	Mutual Gain, Shared Outcomes	Vested Agreement, Vested Governance Framework, Performance Incentives, Margin Matching	Integrated – cooperative, Win-Win	Integrated – behave as single entity	Interdependent outcomes, aligned, mutual gain, managed performance, long term relationship

Investment-Based Model (Insource)

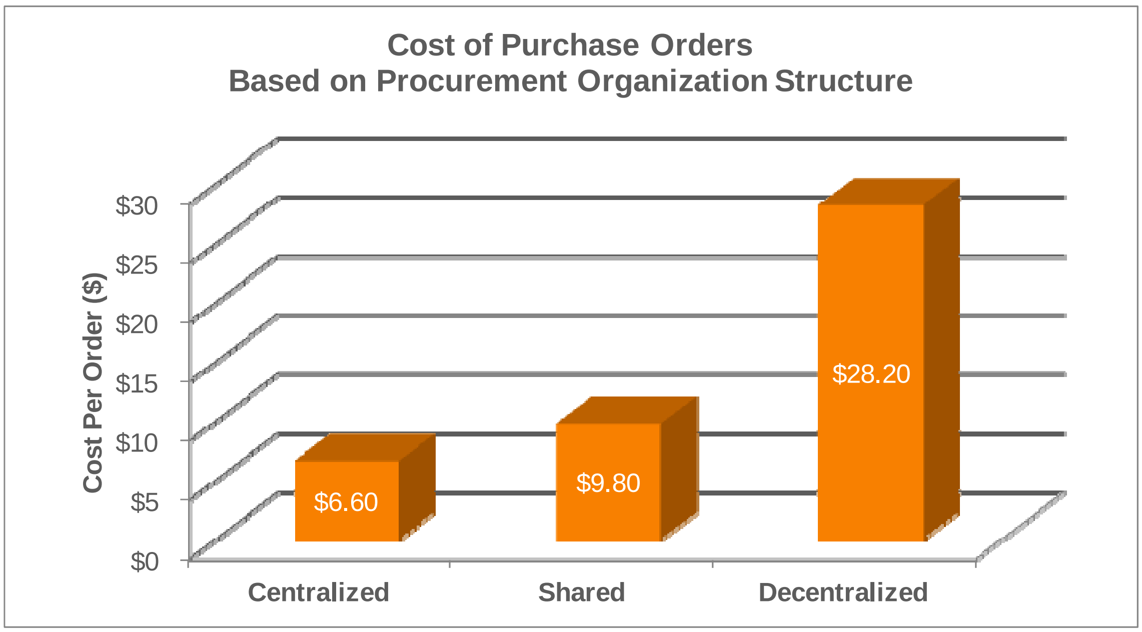
Shared Services

Companies that struggle to meet complex business requirements using conventional transaction-based or outcome-based approaches typically invest to develop capabilities themselves (or insource). In such cases, many companies have chosen to adopt what is commonly referred to as a “shared services” structure which is the establishment of an internal organization modeled on an arms-length outsourcing arrangement. Using this approach, processes are typically centralized into a “shared service” organization and departments are cross charged for the services used.

[10] J.D. Power press release, retrieved December 2010 from: www.jdpower.com/autos/articles/2010-Sales-Satisfaction-Index-Study.

A key driver when developing a shared services organization or a joint venture structure is to centralize and standardize operations that improve operational efficiencies. The results can be significant. APQC (American Productivity and Quality Center) research shows a direct correlation between low procurement cost and a centralized or shared services procurement function. Specifically, companies with centralized and shared services procurement functions have procurement costs almost one-third of those that have decentralized functions.[11] Figure 5 shows the procurement cost performance of centralized, shared, and decentralized procurement structures.

Figure 5: Procurement Cost Performance



While these savings are significant, is there a better way to manage shared services? Specifically, can shared services organizations achieve further improvements by better understanding the various sourcing business models? The authors believe the answer is yes.

The authors' experiences indicate shared services organizations typically act like an outsourced service provider, performing services and then "charging" their internal customers on a per-transaction or headcount basis. This approach very much mirrors a conventional "preferred supplier" relationship. The authors believe that shared services organizations could and should consider adopting a Vested Outsourcing business model for working with their internal customers.

A Vested Outsourcing business model seeks to align the interests of the company with the interest of the service provider by following five "rules" for structuring the buyer-supplier relationship. The authors believe these rules — if followed by shared services organizations — will better align the interests of internal shares services organizations with their internal customers.

[11] Benchmarking statistics courtesy of APQC. To learn more about APQC visit www.apqc.org

While many shared services organizations are set up to naturally follow some of the Vested Outsourcing rules, it is the authors' opinion that most shared services do not follow all five of the Vested rules. Doing so would create a tighter alignment and further drive effectiveness for the provider. Specifically, the authors believe that shared services organizations and joint ventures could benefit by applying the lessons of Vested Outsourcing. The following table provides the authors viewpoint with regards to maturity of shared services in applying Vested principles.

Figure 6: Application of Vested Principals in Shared Services Business Models

Vested Rule	Level of Shared Services Adoption
Outcome-Based vs. Transaction-Based	Low
Focus on the What, not the How	Medium
Clearly Defined and Measurable Desired Outcomes	Medium
Pricing Model with Incentives that Optimize for Cost/Service Tradeoffs	Low
Insight vs. Oversight Governance	Medium

Equity Partner

Some companies decide they do not have the internal capabilities, yet they do not want to outsource for a variety of reasons. In these cases, companies may opt to develop a joint venture or other legal form in an effort to acquire mission-critical goods and services. These equity partnerships can take different legal forms, from buying a service provider, to becoming a subsidiary, to equity-sharing joint ventures. These partnerships often require the strategic interweaving of infrastructure and heavy co-investment. Equity partnerships, by default, bring costs "in house" and create a fixed cost burden. As a result, equity partnerships often conflict with the desires of many organizations to create more variable and flexible cost structures on their balance sheets.

The table below outlines the typical characteristics of both shared services and joint venture-type investment-based approaches.

Figure 6: Attributes of Investment Based Business Models

Sourcing Relationship	Focus	Interaction	Cooperation Level	Required Trust Level	Characterized by
Shared Services	Leveraging Cost and Investments	Cross Company Services May include multi-company service	Integrated – cooperative, Win-Win	Integrated – dictated by equity sharing	Formal charter, intercompany governance structure, interdependent outcomes, aligned goals and objectives, managed performance, Win- Win relationship
Equity Partner	Equity Sharing	Joint Venture Asset Based Governance Framework	Integrated – cooperative, interrelated structure	Integrated – dictated by equity sharing	Legally bound, formal strategic partnerships, mergers and acquisitions, asset sharing/ holding

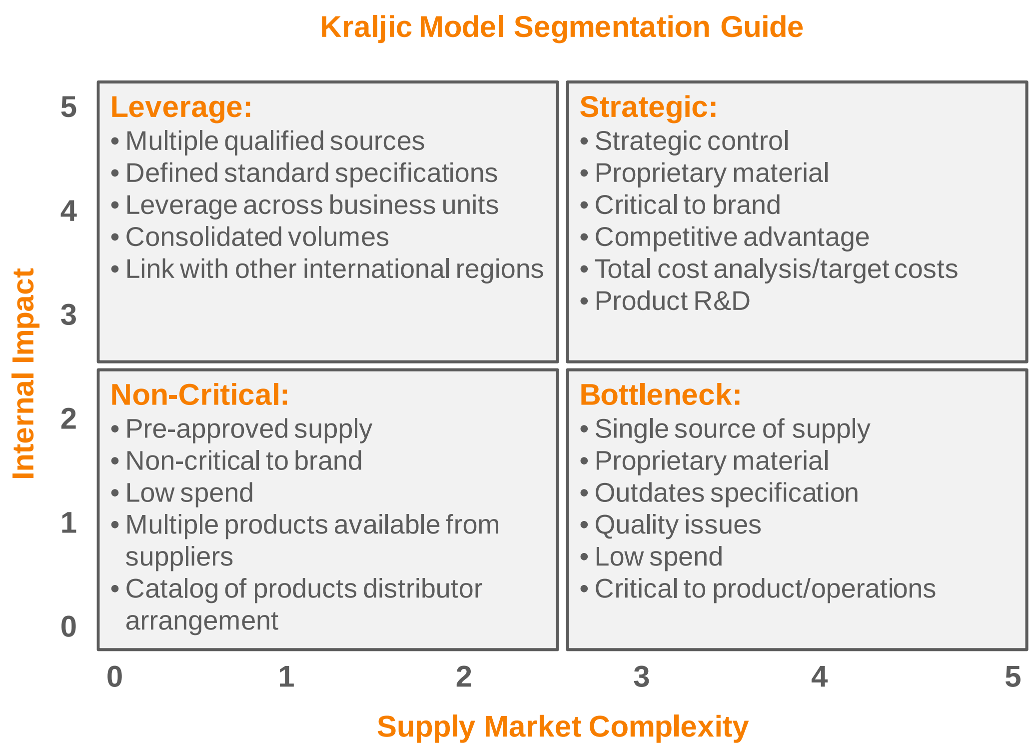
Section III. Determining Which Sourcing Business Model is Best For Your Situation

The Conventional Approach — The Kraljic Model

The authors believe understanding the evolution of strategic sourcing is important to helping companies determine the right sourcing business model. It is our belief that many companies have not evolved their approaches to keep pace with the changing business environment, especially as it relates to how they buy and manage strategic outsourcing deals.

The foundations for today's strategic sourcing approaches were birthed in 1983 with Peter Kraljic's Portfolio Purchasing Model. The Kraljic Model focuses on helping companies segment their total supply spend into four groupings: Non-critical, Leverage, Strategic and Bottleneck.[12] Using the Kraljic model to segment supply spend enabled companies to prioritize their time and allocate resources based on two core attributes — internal impact and supply market complexity. This is mapped in Figure 4 below.

Figure 7: Kraljic Model Segmentation Guide



[12] Peter Kraljic first described his Kraljic model or matrix in "Purchasing Must Become Supply Management," *Harvard Business Review* (September-October 1983). The model can be used to analyze the purchasing portfolio of a company with regard to two factors: profit impact and supply risk.

Kraljic described a broad definition and management objective for each group.

- **Non-critical items.** Defined as common in the marketplace with low unit cost and low complexity. The management objective is to identify ways to eliminate management by using a procurement card or a pre-priced catalog from which anyone can buy.
- **Bottleneck items.** Defined as unique or sole source items with low cost and high complexity. The management objective is to identify ways to mitigate supply interruptions or lifecycle transitions.
- **Strategic.** Defined as the most complex to manage and are typically defined as critical to the brand or business objectives. The management approach includes requests for supplier collaboration or "agreed to" value-add activities to protect the company's competitive position. In some instances, the collaborative process is quite entailed but is largely driven by enticing the supplier's participation through the promise of a longer term contract or additional volume growth.
- **Leverage.** Defined as items that are lower in complexity, yet typically are higher in costs or potential impact to the buying company. The management approach includes standardizing and consolidating items in this quadrant to increase a company's buying leverage in the marketplace.

Kraljic — rightfully so — advocated that companies focus their attention and resources on the Strategic and high cost Leverage category groups.

The Kraljic approach recommends that companies use three approaches to manage overall spend. The model provides several actions or methods for procurement professionals that focus on increasing purchasing power through leverage (or mitigating risk from lack of purchasing power). This "leverage" mentality primarily leads procurement professionals primarily to transactional sourcing models. The three approaches are as follows:

1. Exploit — Make the most of your high buying power to secure good prices and long-term contracts from a number of suppliers, so that you can reduce the supply risk involved in these important items. You may also be able to make "spot purchases" of individual batches of the item, if a particular supplier offers you a good deal.
2. Diversify — Reduce the supply risks by seeking alternative suppliers or sources of supply.
3. Balance — Take a middle path between the exploitation approach and the diversification.

The leverage based philosophies for the Kraljic model quickly became foundation for many companies' strategic sourcing efforts. Companies began to centralize their procurement groups and create "commodity managers" to apply Kraljic's suggested approaches. Procurement organizations rationalized their supply base and turned to use new tools and technology for competitive bids and in some cases adopted reverse auctions to identify the lowest market place price. These efforts helped companies to greatly reduce their spend.

While arguably effective, the Kraljic model does have weaknesses.

The first is that Kraljic's model does not address later thinking that emerged around the desire to outsource non-core activities. The model primarily focuses on leveraging the direct spend items versus complex indirect spend such as outsourced services. As companies increasingly challenged their internal core competencies, a surge in outsourcing occurred. While the Kraljic segmentation matrix does work for segmenting services spend, in many situations movement of work to an outside supplier is completed by procurement without a comprehensive understanding of internal versus external capabilities and interface requirements. Often the work activities are considered business support (assumed to be non-critical or standard) rather than direct product support (identified typically as unique or strategic) without understanding business impact. As a result they are incorrectly classified as Non-Critical or Leveraged. Procurement teams without the involvement and knowledge of other internal functional resources have often assumed that they can leverage a service but later suffer with supplier performance issues and strained relationships because process considerations and interactive relationships have been insufficiently defined.

The second weakness is that the Kraljic model does not address Williamson's findings that the "market" is not always the best fit for procuring goods and services. The Kraljic approach emphasizes simplifying and standardizing categories to drive all sourcing into a transactional, competitively bid model. The problem is that many outsourced requirements have high impact, are very complex and often require customized solutions and deeper degrees of collaboration for solving business problems. Transactional sourcing models don't easily apply. Using the market inappropriately is like trying to put a square peg in a round hole; it results in suboptimal or less desirable outcomes for these requirements. It is the authors' opinion that the Kraljic model does not account for the fact that a need exists for a hybrid approach, which Williamson points out.

The third weakness is that the Kraljic model suggests companies use leverage as a core sourcing tactic and offers several techniques to drive category purchases into a leverageable market-based approach. Kraljic's "leverage" and "exploit" thinking has grown to be popular over the last three decades. However, Williamson's pioneering work in Transaction Cost Economics revealed that using a "muscular" approach as a key tactic does not create mutual advantage and can greatly increase a company's transaction costs and decrease trust levels in supplier relationships. Williamson observed "Organizations that uses the muscular approach for buying goods and services not only use their suppliers — they often use up their suppliers and discard them. The muscular approach to buying goods and services is myopic and inefficient." Williamson won a Nobel Prize in 2009 for his insights. It is particularly important to heed Williamson's wisdom during volatile market times when "winners" and "losers" can flip-flop positions rapidly and leverage can switch quickly.

Taking a leveraged approach with all suppliers simply doesn't work. Kraljic himself noted this weakness in a 2008 interview with CPO Agenda. Kraljic was asked if he had chance to rewrite the article in 2008 with the benefit of 25 years' hindsight, if there would be anything he would add. He responded: "I would not change it other than to add trust into the equation — the importance of trust in long-term relationships with suppliers. You need to create win-win."[13]

Since the introduction of the Kraljic model in 1983, strategic guidance and decision support tools have evolved as well. Contemporary companies have responded to economic changes, a global marketplace

[13] "Reflections of a Pioneer," CPO Agenda (Autumn 2008). Retrieved at http://www.cpoagenda.com/previous-articles/autumn-2008/features/reflections-of-a-pioneer/

and more sophisticated business management objectives by recognizing the impact of supply requirements and the value of supplier relationships in the business model. In addition, a surge in outsourcing has caused companies to rethink their approaches to supply management. The following Figure 5 graphic depicts key milestone influences in the maturity of supply management.

Supply Management Maturity Timeline

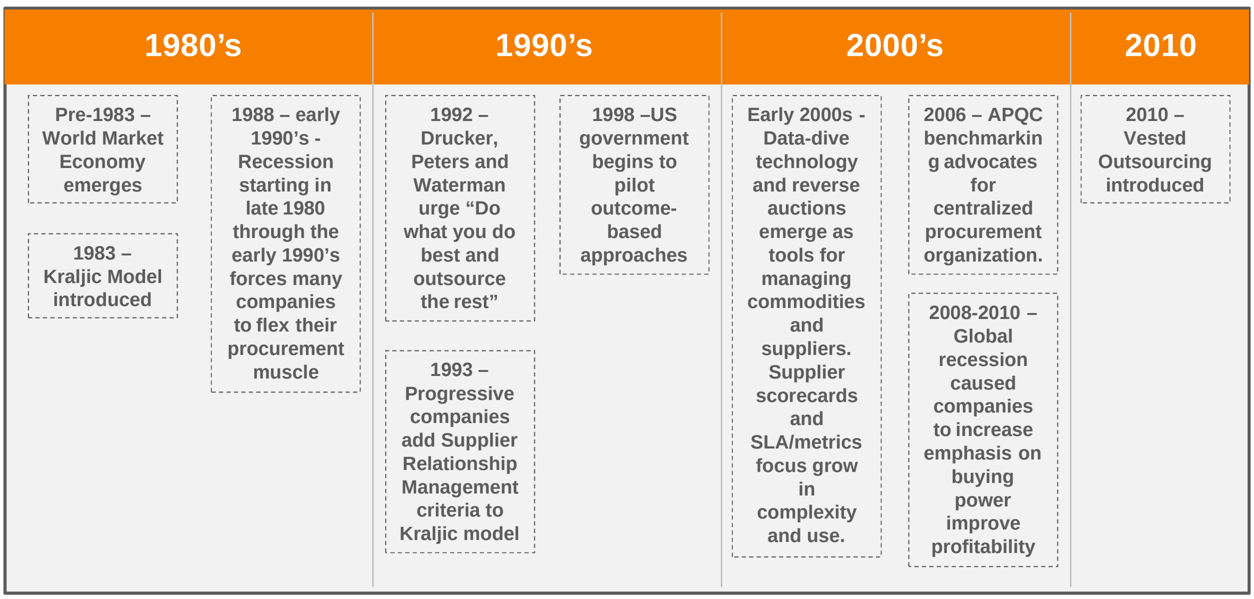


Figure 8: Supply Management Maturity Timeline

Over time many procurement organizations have sought ways to address the weaknesses in the Kraljic model. Some companies and thought leaders have modified the original model, believing that the original Kraljic attributes are insufficient and do not adequately address the business needs. In the early '90's some companies began adding Supplier Relationship as an attribute for consideration in the Strategic Quadrant to support the need for responsive supply in its global marketplace.[14]

The authors believe the rise of outsourcing — and in particular failures in large outsourcing deals — have created a perfect storm in the strategic sourcing and outsourcing professions. While progressive companies have evolved their use of the Kraljic Model, the authors believe today's procurement, outsourcing and commercial professionals need a more modern approach for determining which sourcing business model to use for which types of outsourcing deals. The next section outlines a simple Business Mapping Model that can help companies select the right sourcing model for what they are buying.

[14] Michelle E. Bernson, "The Value of a Common Approach to Lean," MIT (2004) retrieved at http://dspace.mit.edu/bitstream/handle/1721.1/34753/56607252.pdf?sequence=1

Sourcing Business Model Mapping — An Alternative Decision Framework

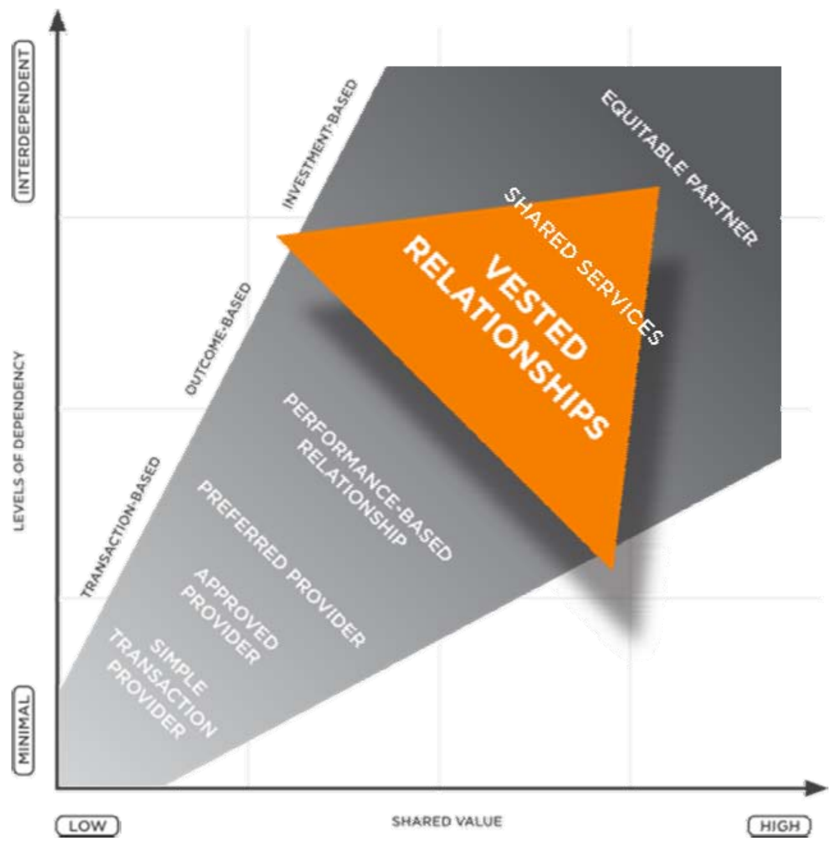
As mentioned previously, the conventional approach for developing a sourcing strategy is to use a segmentation tool such as the Kraljic model or supplier capability matrix to identify “strategic” focus areas. While this is a good approach for prioritizing spend categories or suppliers, it falls short of ensuring the organization is using the right sourcing model for the right job and does not include consideration for whether the work should be insourced or outsourced.

Our experience is that many companies treat their procurement organizations as functional silos and many procurement professionals perform detailed supply segmentation and develop strategies without the vital input from their business counterparts. On the flip side, procurement professional complain that all too often business groups throw their requests over the wall and do not spend enough time truly understanding the business needs and requirements. We strongly advise that procurement professionals and business leaders come together and review the overall competencies of the organization as a key strategy for matching the right sourcing approach to the right business needs. This can be done through a more holistic “Sourcing Business Model Mapping” decision framework that allows a company to align their business attributes and the most appropriate sourcing business model.

Figure 9 graphically maps the six sourcing business models outlined in Section II.[15] The axes used to classify the business models are that of dependency and shared value. The more dependency, the more the commodity based market approaches should not be used. The second axis is that of shared value. The more potential reward to an organization, the more a company should strive to use risk/reward incentives that are inherent in outcome-based or investment-based approaches.

[15] Source: Vitasek, Crawford, Nyden and Kawamoto, The Vested Outsourcing Manual. Palgrave Mamillan. 2011.

Figure 9: Sourcing Business Model Mapping Framework



The Sourcing Business Model Mapping framework (Figure 10 — following page) provides an excellent tool to help determine where to plot each sourcing category. The example provided represents a completed map for call center services for a major credit card issuer. Prior to conducting the Sourcing Business Model Mapping review, the credit card issuer was spending in excess of $100 million with multiple call center suppliers, which they competitively bid on every 2 years. Using the mapping exercise, the company realized it was calling its supplier “strategic” but were using a heavy handed market based approach that was focused too much on price per minute rather than achieving the company’s Desired Outcomes — to drive card holder loyalty. The company decided to reduce the number of call center suppliers to two, migrating their primary supplier to a Vested Outsourcing business model and keeping their second supplier as a transaction based preferred supplier

Figure 10 Example of Completed Sourcing Business Model Map for Call Center Services

Call Center Services (Major Credit Card Issuer)	Transaction Based			Outcome Based	Hybrid	Investment Based
Mapping Attributes	Simple Transaction Provider Zone 1	Approved Provider Zone 2	Preferred Provider Zone 3	Outcome/ Performance Relationship Zone 4	Vested Outsourcing Relationship Zone 5	Equitable Partner Zone 6
Vital to core business purpose	Minimal	Low	Medium	Medium to High	High	Critical
Enhances brand image	None	Low	Medium	High	High	Critical
Impact on customer experience	None	Low	Medium	High	High	Critical
Maintains customer experience	None	Low	Medium	High	*Very* High	Critical
Opportunities for efficiency gains	None	Low	Medium	High	Very High	Critical
Contributes to Innovation	None	Low *(today)*	Medium	High	Very High	Critical
Consistently safe and reliable *service*	Not capable	Semi-skilled	Skilled	Professional	Professional	Expert
Impact on operational ~~safety~~ *security*	Minimal	Low	Medium	High	*Very* High	Critical
Organic growth capability *(channel flexibility)*	None	Low	Medium	High	Very High	Constant
Access to critical systems and processes	None	Low	Medium	High	High	Critical
Availability of required technology	Universal	Limited	Restricted	Scarce	Scarce	Unique
Impact of supplier loss or failure	None	Low	Medium	High	*Very* High	Critical
Cost to switch supplier	None	Low	Medium	High	High	Very High
Dependence on assets/capabilities	None	Low	Medium	High	High	Critical
~~Lean supply cost~~	~~Low~~	~~Medium~~	~~High~~	~~High to Invest~~	~~Invest~~	~~Capital~~
Cost of Staff	Minimal	Low	Medium	High	High	Very High
Availability of qualified personnel	High	High	Medium	Low	Low	Low
Skill level of predominant personnel	Unskilled	Semi-skilled *Core Workers*	Skilled	Professional *Management*	Professional *Management*	Expert

The parties involved modified the business model map to support the business (items in italics and strike through).

Source: The Sourcing Business Model Mapping framework is a collaborative framework of the authors of The Vested Outsourcing Manual. The original concept was developed by Jacqui Crawford, co-author of The Vested Outsourcing Manual.

To complete the Sourcing Business Model Map, a company should go through each business attribute and select the appropriate description. The goal is to map the importance of your company's own specific competencies against the Desired Outcomes for each competency area. For example, you will likely map IT services differently than accounting services and differently than distribution and logistics. The table lists some of the most commonly cited Desired Outcomes in corporate business plans and it may be necessary for you to modify this generic list. Remember that outcomes are benefit-based and therefore last longer and do not change as often as tasks, which may be deployed to deliver outcomes. Once completed, the Sourcing Business Model Map will typically align with one or two of the sourcing models. For example, the sample Sourcing Business Model Map above suggests a performance-based or a Vested Outsourcing sourcing business model.

Other Influences

Organizational Design and Culture

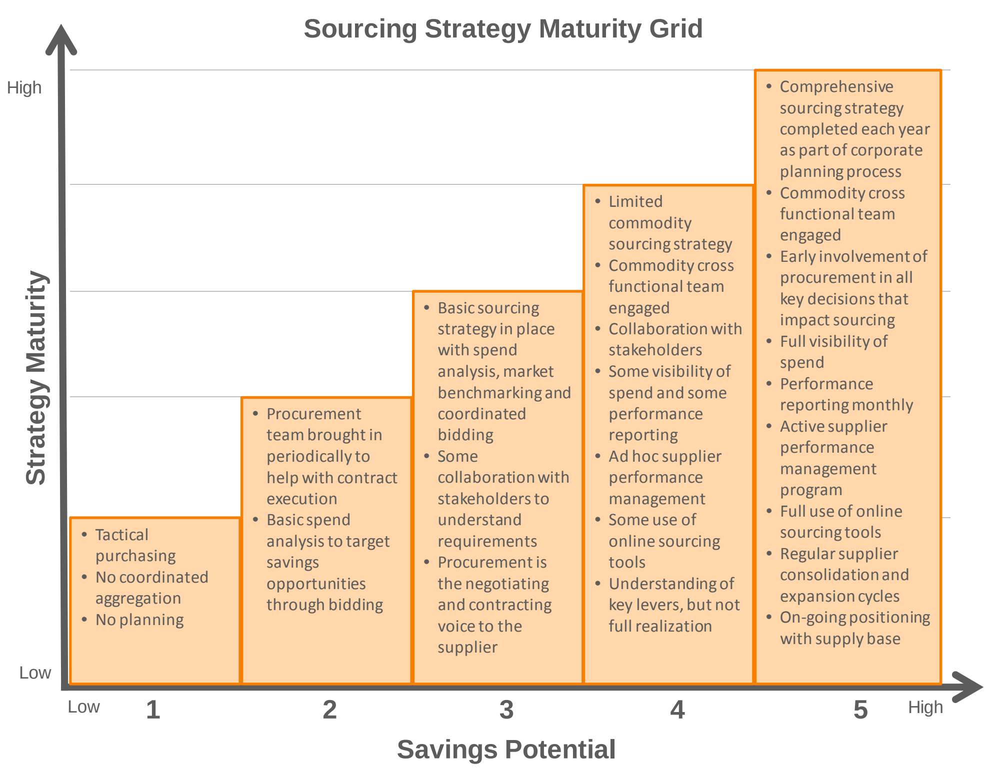
Organizational design and company culture can greatly influence the sourcing model selection — especially when it comes to deciding if an outcome-based approach is appropriate. Just because the business environment might be conducive to a certain sourcing business model, the organizations may not be cultural compatible or ready. For example, an organization that has a culture of micromanagement will likely struggle deploying Vested Outsourcing because they will find it hard to move away from telling the supplier “how” to do the work.

Ultimately, organizations have personalities or behaviors that mirror current leadership. Understanding the organizational design and the cultural atmosphere will assist any company in identifying potential roadblocks when selecting the sourcing model that will provide ultimate value.

Procurement Maturity-Review of Experience

A company’s experience and maturity in strategic sourcing can also influence a company’s choice for the ideal sourcing business model. There are five stages of maturity. The maturity level increases across the five stages companies develop their expertise, knowledge and supplier integration collaboration capabilities.

Figure 11: Sourcing Strategy Maturity Grid



Source: The Forefront Group

Companies with a low level of maturity tend to be tactically focused on executing day to day purchase orders. Companies with a high degree of maturity think about sourcing from a more holistic approach, proactively managing the companies spend and suppliers. Maturity matters when it comes to selecting a sourcing model. Simply put, if a company has a very low level of strategic sourcing maturity they likely will not posses the skills sets needed to manage more complex outcome based agreements. This skills mismatch can strain an organization and the supplier relationship. For example, let's say that a company's IT department has been working with an IT server provider on many one off projects and also has a separate infrastructure deal. Under the current agreements, the company has a Master Service Agreement and treats each project as a separate PO. The CIO is happy with the supplier's performance and wants to move to a Vested Outsourcing agreement. However, he feels the procurement department "simply does not get it". His procurement representative does not understand the concept of Desired Outcomes and does not feel the value in establishing a more formal governance structure. In fact, the procurement person on the team thinks governance is "free" and he is not willing to migrate from multiple POs to a broader Vested agreement. In this scenario, the organization should not pursue a Vested Outsourcing approach since the organization is not internally aligned.

Strategic sourcing maturity does not just pertain to a company's procurement group. More strategic deals demand the procurement and business groups play a more integrated role. We have seen procurement groups proactively wanted to shift to more strategic sourcing business models for outsourcing deals and become frustrated by mid-level management personnel in the business groups who demonstrate what University of Tennessee researchers refer to as the Junkyard Dog syndrome.[16] A classic example of the junkyard dog syndrome occurred when a Telco Company outsourced their facilities management under a performance-based agreement. The majority of the Telco Company's employees transferred to the service provider and "management" remained. The problem? The performance-based agreement had 20% of the service provider's fees at risk based on the service provider's ability to meet detailed SLAs. The real estate group (the business owners) didn't clearly define the metrics. This led to deep frustration because the group would score the service provider "red" and invoke a penalty on metrics that the companies never agreed to. The service provider consistently found themselves never earning the fee at risk portion due to fuzziness over requirements and metrics.

It is important to understand a supplier's ability to operate under a more strategic sourcing business. Performance-based and Vested Outsourcing agreements rely on the service provider to be more innovative and share in risks/rewards. Some suppliers are simply too risk averse. More importantly, suppliers may not have the capabilities or cultural fit for the more innovative thinking that more strategic sourcing business models demand.

In some cases, companies looking to outsource using more advanced sourcing business model also question whether their service providers can truly bring innovation or process improvements. We have found that buying companies that have low level of strategic sourcing maturity often suppress their suppliers through rigid contract vehicles. For example, one company complained their suppliers did not bring innovation — yet they did competitive bids every six months to "test the market". Our experience is

[16] See Kate Vitasek, Mike Ledyard, and Karl Manrodt, *Vested Outsourcing: Five Rules That Will Transform Outsourcing* (New York: Palgrave Macmillan, 2010).

that often a high level of maturity is never reached, not because the supplier doesn't have the ability, but because the company culture prohibits advancing to more strategic relationships.

When it comes to maturity and the ability to apply more advanced sourcing business models, we advocate that both the company and the service provider self reflect on their existing relationship. Are the companies saying they want to be more strategic, yet working under a sourcing business model that is driving transactional behaviors? Are both parties capable of adopting a more advanced sourcing model for their outsourcing efforts? We encourage you to stop and reflect to see if you have a mismatch in your sourcing strategy and your sourcing business model. Simply put, saying you want a more strategic partnership with your suppliers and then treating them like a simple commodity is likely causing frustrations in both parties.

Section IV: Case Studies

The purpose of this section is to provide actual case studies that show how companies are applying each of the six sourcing business models.

Case Study — Simple Transaction Based

A hospitality company with several properties purchased a variety of low cost basic food items such as salt, mustard and other condiments, snack items and pasta. Each property did their own purchasing and no specific requirements were applied to these basic food items because all items were standard in the marketplace and a number of suppliers provided the products. However when the Company investigated the number of items that were being procured as basic food items the estimated number exceed 16,000 of items and multi-millions of dollars of annual spend.

The company believed there was a better way to manage these items. The Company sought to put in place a process that would obtain more detailed information across all properties on these items, without adding resources to manage them and to obtain the lowest market price. The Company implemented a standard e-auction tool which was used by all properties.

This improved the efficiency of the property procurement process and did not interfere with the quick turnaround needed. Item requirements were entered into the on-line e-auction tool, the suppliers in the marketplace placed their bids and the lowest pricing supplier won the order. No negotiations were conducted, a purchase order was generated using standard terms and conditions and distribution program and the properties exerted limited effort to manage a multi-million dollar spend which allowed their purchasing resources to focus on higher cost items.

Case Study — Approved Supplier

FinanceCo is a financial services firm that is heavily invested in Information Technology (IT) as part of its product offerings, requiring frequent refreshes in hardware. To support its core business the company has significant spend in the computer servers category. The category is critical to the organization, but there are many suppliers available in the market. Therefore the company’s sourcing strategy was to select multiple approved suppliers in order to simultaneously take advantage of best-in-class solutions and mitigate risk. The Procurement and IT business functions within the organization worked closely together as part of the strategic sourcing initiative. This step in the sourcing process resulted in a market analysis, a needs assessment, and forecasts in annual spend. The two teams worked together to create requirements, build a specification and identify a diversified supply structure.

After an initial qualification of solution providers and prior to the competitive bid (conducted as a Request for Proposal), the firm's engineers worked with the solution product engineers to benchmark the firm's current offerings and requirements, complete an intense evaluation for qualification and proof-of-concept through lab analysis. This step in the process resulted in a ranked list of solution offerings, a shorter list of qualified suppliers, recommendations for improvement in the firm's product offerings, and specific requirements for the competitive bid. Along with those requirements, the firm issued an RFP with their annual spend forecast.

Following lengthy negotiations with solution providers, the firm selected two suppliers to support the category spend; one supplier supports mission critical computer servers vital to the firm's own product offerings and a second supplier fills the need for non-critical business applications. Now sourcing happens from a master contract with approved providers operating from proven requirements. Providers are governed through a model that is flexible enough to support future product releases and ongoing procurement. The product/supplier decision was a balance of a Total Cost of Ownership (TCO), which included base product cost and operating cost over the three year life of the contract and bottom line savings.

Case Study — Preferred Supplier

BankCo is a financial services company that established a successful relationship with Standard Register to consolidate warehousing and inventory management of the bank's forms and marketing materials. The strength of this successful relationship was founded on a flawless execution during transfer of seventeen tractor-trailers of materials into Standard Register's warehouse over a 10-day period, plus the supplier's commitment to reduce the client's baseline costs by 10%.Cost reductions were rapidly achieved through effective sourcing, reduced packaging, process savings, reduced shipping costs, increased inventory turns, on-demand print for selective forms, and storage cost reduction.

Standard Register soon approached their client to beta-test their new technology and process solution to manage commercial print bid and print production management. They collaborated with their client to implement integrated processes for competitive bids and print production management, in-sourcing a full time manager into the client organization. Savings were in excess of 25% from previous experience, and the client experienced significant reduction in the previously manual work effort in print production management. For Standard Register, the client became a reputable reference and an enthusiastic spokesperson to their industry analysts.

Case Study — Performance-Based United States Navy

The Navy's was recognized by the Secretary of Defense for their "Performance-Based Logistics" contract with Raytheon for their H-60 FLIR program. The Navy set out to improve the performance of the H-60 FLIR system which enables the Navy's H-60 helicopter to detect, track, classify, identify and attack targets like fast moving patrol boats or mine laying craft. When first developed, the FLIR was expected to have at least 500 hours of operation before failure but in reality was averaging less than 100 hours. At one point in the Atlantic Fleet alone accounted for more than one-third of the 21 deployed H-60 helicopters that had FLIR system failures.This system, made up of three components: a turret unit (TU) electronic unit (EU) and a hand control unit (HCU) was experiencing only 41% TU availability, 17% EU availability and 80% HCU availability.

The Navy and Rytheon implemented a ten-year, fixed price agreement that was priced per flight hour and valued at $123 million. This fixed price by flight hour contract gave Raytheon incentive to improve reliability and help reduce the necessity for removal of these units from the aircraft. Originally cost savings were projected to be around $31 million but have now been estimated to exceed $42 million.

Raytheon also implemented an online Maintenance Management Information System that allowed for real time data collection by NADEP Jacksonville; an online manual has eliminated the need to have printed copies made and distributed.

In the first three years of the contract the H-60 FLIR components have experienced a 100% availability rate and achieved a 40% growth in system reliability improvement as well as a 65% improvement in repair response time.[17]

Case Study — Vested Outsourcing - Microsoft

The catalyst for changing at Microsoft was simple. Microsoft had grown as an entrepreneurial enterprise, and along the way had cobbled together finance processes on a country-by-country basis. These patchwork processes were floundering under their own weight, threatening future efficiencies. In 2006, Microsoft began a complete reengineering of its major global finance processes and operations. Microsoft thought long and hard and determined that the best path forward for a major transformation would involve outsourcing. Microsoft felt the best approach was a "lift and shift" where the service provider would as quickly as possible determine a clear and accurate baseline that it would be expected to improve with Microsoft. The service provider would then be highly compensated for achieving transformational results.

To accomplish the objective, Microsoft applied a Vested Outsourcing approach by contracting for transformation instead of contracting for the day-to-day work under a transaction-based or managed services agreement. In short, Microsoft created a relationship where Accenture, the outsource provider, would have a vested interest in achieving Microsoft's Desired Outcomes. They would shift the economics of the model whereby Microsoft would buy Desired Outcomes, not individual transactions or service levels

[17] Department of the Navy, Commander, Naval Supply Systems Command, Nominations for the Secretary of Defense Performance-Based Logistics Award, June 5, 2005

for a set book of business. Accenture would be paid based on its ability to achieve these mutually agreed upon outcomes. For Microsoft some of the biggest outcomes were around achieving a single, global finance solution with effective, consistent processes across the world.

In February 2007, Microsoft signed an outsourcing agreement with Accenture, with an original contract term of seven years at a value of $185 million. In just two years, Microsoft was realizing its transformational goals, including:

- Reducing the number of systems used to manage its finance operations from 140 to less than 40.
- Prior to launching OneFinance, financial controllers, for example, spent more than 75% of their resources supporting transactions, compliance activities and local reporting — some 530,000 hours annually worldwide. After just the first two years of OneFinance, this dropped to 23%.
- Service levels miss rate of only 0.43%. This is remarkable given the complexity and scale of the Microsoft procure-to-pay process. While hitting SLAs in important — the real benefit to Microsoft comes in looking at the bigger picture. For example, Accenture delivered a 20% increase in first time pass on accounts payables.
- Satisfaction levels amongst Finance Operations' customers (Finance and Procurement community) substantially increased. While the overall satisfaction increased, the proportion of customers either "Dissatisfied" or "Strongly Dissatisfied" moved from 33.3% to 3.4%
- Increasing coverage of SOX compliance from just 15 "large" countries in the pre-outsourcing era to all irrespective of size or complexity following outsourcing with zero un-remediated S-Ox 404/302 & audit control deficiencies.
- Microsoft has already neared a 20% reduction in the cost of the contract and the expected reductions are estimated to exceed 35% by the end of the contract.

A Vested sourcing business model has led Microsoft and Accenture to award winning status in the world of outsourcing. In 2008, the Outsourcing Center awarded the OneFinance contract the "Most Strategic Outsourcing Contract for 2007".[18] In March 2010, the Shared Services Outsourcing Network awarded the Microsoft-Accenture outsourcing relationship as the "Best Mature Outsourced Service Delivery Operation." In February 2011, the team won its third award from the International Association for Outsourcing Professionals.

[18] "Growing the Business to Drive Value," *OutsourcingCenter*, August 1, 2008. Retrieved at http://www.outsourcing-journal.com/aug2008-moststrategic.html

Case Study — Shared Services — Bell Canada/PSI

In 1995 Bell Canada's distribution operations were operating at service levels at 10% to 15% below industry average and at a cost base of $100 million. Bell Canada (the largest telecom services company in Canada) decided to spin off the assets and the staff of the distribution business into a standalone, wholly-owned subsidiary known as Progistix Solutions Inc. (PSI). The idea was that by creating a separate shared services entity with their own P&L, PSI would be driven to operate more efficiently. PSI was chartered to provide a full range of order management and inventory management business processes for all of Bell's operating businesses and a new CEO was brought in to turnaround the business.

At its inception PSI had an estimated revenue stream (benchmarked by Deloitte) of $55 million against its cost base of $100 million. Progistix had a mandate to achieve a financial breakeven state and to meet industry average service levels. The new CEO chose to judiciously blend new talent with experienced incumbent managers. This combination ensured that the valuable learnings embedded in the corporate history would not be lost and that best practices from outside could be introduced by new managers with direct experience in the new practices.

With the team in place, PSI put in place the basics of a business:

- Transactional services contracts were negotiated and executed between PSI and its client groups
- A financial management system was built to support the business
- Distinct HR policies and systems were built to manage the employee base of over 1000 of which over 75% were unionized
- A client management organization was assembled to better understand and meet client needs

With its own P&L, the shared services group carefully reviewed where it needed to invest in business processes and technology to meet its charter of becoming a profitable business unit and raising service levels to its Bell counterparts. PSI invested in three key areas:

- Replaced the aged technology infrastructure and outdated applications
- Renegotiated the four collective agreements to align wage rates and work rules with the logistics services market
- Commenced the long process of culture change from an entitlement based telecom services company to a market focused logistics services competitor

Clearly the cultural change would be the most difficult. By moving non-core functions to an organization dedicated to enhance quality in their respective field (shared services or outsourcing), these employees gain respect and self-confidence enabling them to perform at much higher levels.

In addition to the attention to the key priorities above, the management team was driven through profit-sharing incentives to dramatically reduce costs in all parts of the organization. As a result of their efforts, PSI reduced its costs by $45 million yielding a breakeven position in 1998. In addition systematic improvements raised service levels to industry standards, with over 95% of the orders processed during the day were picked, packed, shipped, and delivered to customers by the end of the next day.

During the next two years, PSI was able to generate industry standard profits and grew the revenues by 15%. By the end 2000, PSI's shareholders at Bell Canada made a decision that they no longer needed to own PSI to benefit from its services. Bell Canada sold Progistix for $40 million to Canada Post Corporation in June 2001 and continues to provide services to Bell Canada – as well as many other customers.

Case Study — Joint Venture — Samsung and Sony

The consumer electronics giants Samsung Electronics and Sony established a 50-50 joint venture in 2004 for the production of liquid crystal displays for flat panel televisions. The companies formed a new company near Seoul, South Korea, S-LCD Corp., with an initial capital budget of nearly $2 billion.

The two tech giants — and fierce industry rivals — structured the venture so that stocks in S-LCD were held by South Korea's Samsung at 50 percent plus one share of stock and 50 percent minus one by Japan's Sony. "The two companies will invest evenly, but Samsung has the ultimate initiative," said a Sony spokeswoman.[19]

The upstart Samsung had begun construction of an LCD production facility in 2003 at a large projected capital expenditure over the next decade for what was then a relatively new technology and market, while Sony had no production base for large LCD panels. A joint collaboration was thus advantageous for both companies.

The deal It was also controversial. Sony had pulled out of a Japanese-state-backed LCD-panel development group to close the deal with Samsung.

In 2006 Bloomberg Business Week described the venture as a win-win: "They have pulled off one of the most interesting and fruitful collaborations in global high-tech by jointly producing liquid-crystal display (LCD) panels. And it's an alliance that is reshaping the industry."[20]

[19] Yoshiko Hara, "Samsung, Sony complete LCD joint venture deal," EE Times-Asia, March 11, 2004.
[20] "Samsung and Sony's Win-Win LCD Venture," *Bloomberg Business Week*, Nov. 28, 2006.

The venture was instrumental in Sony's introduction of the hugely successful Bravia LCD-TV lineup. It also put Samsung's own LCD-TV business on the map, with the company emerging as a trend-setter in the LCD-panel industry, aided by Sony technology that helped ensure high-quality, sharp TV pictures.

"The Sony-Samsung alliance is certainly a win-win," said Lee Sang Wan, president of Samsung's LCD unit.[21]

The alliance had industry-wide impact in the TV market for large screen sets. It also changed the pecking order among LCD-TV makers.

In 2008 the companies strengthened the venture by committing another $2 billion to build a new facility to produce so-called eighth-generation panels.

In the intervening years, despite global economic and financial turmoil, currency fluctuations, heavy competition and new entrants in the LCD and electronics market, and more recently the earthquake and tsunami in Japan, the S-LCD venture has survived.

The earthquake and faltering global demand in the LCD market did force S-LCD to reduce capital by $555 million in April 2011. There were even rumors that the joint venture might be dropped due to losses in Sony's TV business, but Sony quashed that idea in August.

"Televisions are a core business for Sony and it would be unthinkable for us to shrink that business," said Kazuo Hirai, Sony's executive deputy president. When asked about the Samsung partnership, Hirai asserted: "We are absolutely not thinking of abolishing the joint venture, and it's not something that would be easy to do."[22]

The venture is unusual and remarkable in terms of its scope and duration. Two fierce competitors put their rivalry aside to achieve the win-win in an emerging market.

[21] Ibid.
[22] "Sony rules out exiting TV business or LCD panel venture," *Reuters*, August 4, 2011.

Summary

Today, virtually all businesses use the same transaction-based approach for procuring complex services (i.e., outsourcing) as they do to buy more simple commodities and supplies. Unfortunately, many business professionals wrongly assume that a transaction-based sourcing business model is the only sourcing business model. *For simple transactions with abundant supply and low complexity, a transaction-based sourcing business model is likely the most efficient model*. But the real weakness of a transaction-based approach emerges when any level of complexity, variability, mutual dependency or customized assets or processes are part of the transaction. Simply put, a transactional approach cannot produce perfect market-based price equilibrium in variable or multidimensional business agreements and instead increases transaction costs.

As companies strive to transform their operations through outsourcing or seek innovation from their suppliers, they will most certainly need to better understand their business environment and the various sourcing business models that are available. It is important that today's businesses leaders understand that the fundamental differences of each type of sourcing business model and consciously strive to pick the right model for the right environment, ultimately picking the right approach to use for the right job.

As you embark on your journey to outsource more effectively, the authors urge you to consider the fact that outsourcing is more than a make-buy decision — it is a continuum. As a sourcing, contracting or outsourcing professional it is your job to understand your business environment and use the right sourcing business model that will best accomplish your objectives. We also challenge companies that have created Shared Services groups to explore the concept of Vested Outsourcing as a way to help better align and bring market based thinking to a captive insourced environment.

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Kate is an internationally recognized innovator in the practice of supply chain management and outsourcing. She is the author of over 200 articles and 3 books, including *Vested Outsourcing: Five Rules that will Transform Outsourcing*. She is a faculty member at the University of Tennessee's Center for Executive Education and has been recognized by World Trade Magazine on their Fab 50+1 list of people and concepts influencing global commerce. She's been cited by the Journal of Commerce as a "Woman on the Move in Trade and Transportation" for her leadership and was honored as a "Woman of International Influence" by Global Executive Women. Vitasek has served on the Board of Directors for the Council of Supply Chain Management Professionals and has been called a "Rainmaker" for her tireless effort in educating the supply chain profession. She can be reached at kvitasek@utk.edu

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