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Unpacking Outsourcing Governance
Second Edition

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

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EXECUTIVE SUMMARY

Getting governance right in any contract is important, but getting it right in an outsourcing relationship is critically important because the service provider in essence becomes an extension of the company outsourcing. Great governance means shifting the mindset from simply managing the supplier to governing an extended part of your enterprise.

Unfortunately, many companies struggle with how to properly create and operate sound governance mechanisms in complex outsourcing relationships. Multiple studies have indicated poor governance results in what is often called "value erosion" or "savings leakage" and is a pressing problem for companies.

The University of Tennessee (UT) has studied how organizations contract for and manage outsourcing contracts since 2003. Our work has led to seven books including *Vested Outsourcing: Five Rules that Transform Outsourcing* and *Contracting in the New Economy*. In 2011 we launched the first edition of this white paper.[1] Now – 10 years later – we are launching the second edition. This second edition incorporates UT's research and insights from over 100 organizations that have been part of our field-based research with Vested Centers of Excellence around the world.

Our goal for this paper is to provide a practitioner-friendly overview of outsourcing governance. This white paper has three parts:

- Part 1 explores the fundamental concepts for developing an outsourcing governance structure
- Part 2 provides an overview of the key elements of a sound governance structure – regardless of the type of Sourcing Business Model used
- Part 3 goes into the design principles of creating a governance structure for highly strategic Vested outsourcing agreements

We conclude with a call to action, challenging outsourcing professionals to evaluate their outsourcing governance practices and – if needed – rethink their approaches to how they are working with their strategic outsourcing partners.

PART 1: Fundamental Concepts of Outsource Governance

To understand "good governance" it is first important to understand five key themes.

1. Governance is not free – but poor governance is costly
2. There is no clear definition of governance
3. The Elements of a sound governance program
4. Organizations should use "best fit" versus "best practices" governance designs
5. All complex contracts are incomplete; a contract should be a flexible framework

Each theme is discussed below.

Governance Is Not Free – But Poor Governance Is Costly

Governing an outsourcing relationship is not free; at a minimum, organizations must devote the right resources to achieve service excellence and general compliance. However, good governance is far more than compliance; it serves to create a healthy relationship that can quickly make decisions and resolve issues – and equally important – drives more proactive collaboration efforts to achieve continuous improvement and transformation initiatives. Research by Cullen, Seddon & Willcocks suggests that the cost of governing an outsourcing relationship ranges between 3% and 8% of a contract's value – with an average of 4.2%.[2] (see **Figure 1**)

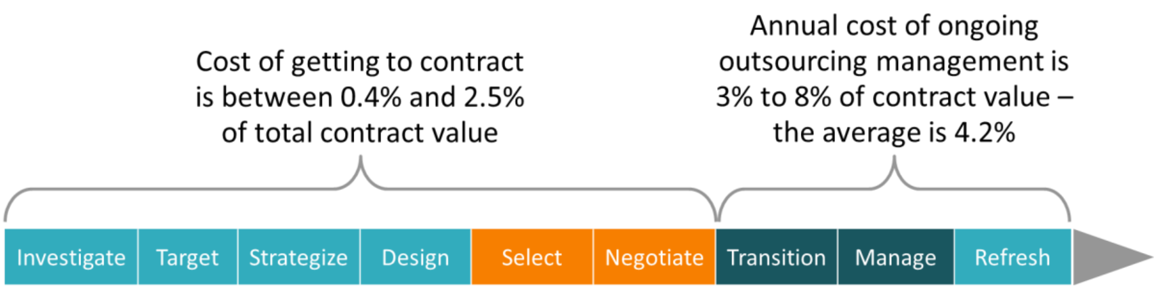

Figure 1

This means that if you have an annual $10 million spend with an outsourced service provider – you should spend at least $300,000 a year on ongoing governance and upwards of $800,000 a year for more complex outsourcing initiatives. We have seen very large and complex outsourcing deals spend upwards of 10% of the contract value on governance when there is a goal to drive significant transformation initiatives. However, the return on investment can be significant as the parties collaborate to create value generation opportunities.[3]

Some companies have an initial reaction of, "My gosh, we can't afford that kind of overhead!" We argue you should think about the cost and impact of *not* investing properly in governance and how it creates what is known as "value leakage" or "value erosion." Various studies show the impact of value leakage – ranging from 9.2% of a company's revenues (World Commerce and Contracting) to as much as 90% of a contract value (Corporate Executive Board). The following are some of the more reliable sources that have studied the impact of value erosion due to a lack of sound governance:

- The Corporate Executive Board 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.[4]
- World Commerce and Contracting reports typical organizations lose up to 9.2% of their revenue due to poor contract management.[5]
- The Outsourcing Center reports that poor governance plays a role in outsourcing failures as much as 62% of the time.[6]
- A global study of cost overruns and failures in construction projects found that poor communication and contract management made up two of the top ten reasons for failure.[7]
- The London consultancy Hudson & Yorke cites governance as "one of the main reasons why managed service or outsource agreements succeed or suffer."[8]
- A study by the construction industry consultancy Arcadis found the average dollar value of construction disputes in which it assisted parties was $67 million, with the average claim taking 19.5 months to resolve. Arcadis identified the failure to administer the contract properly and effectively as the most common cause of these disputes.[9]
- A Queensland Government Auditor General report cites poor contract management as a major contributor to cost overruns and timing delays on projects, noting the State lost approximately 12% in contract value (127 million Australian dollars on a base of A$1.5 billion) and had delays on average of four months.[10]

Poor governance also drives hidden transaction costs. For example:

1. **Redundancy** – when outsourcing deals are not properly structured and governed, the buying organization often creates a "shadow" organization
2. **Bureaucracy** – stems from having unnecessary rules and regulations in place, such as having too many people having to "sign off" on something
3. **Politics** – when a buying organization and the service provider are misaligned, team members can spend unnecessary time interpreting each other's motives and trying to read hidden agendas
4. **Disengagement** – when team members don't feel their ideas or issues are listened to properly, they often "clock out" and put minimal effort into the work
5. **Fraud**/**Brand Value Loss**– good compliance and fast-reacting governance can correct issues that might go undetected
6. **Divergent thinking** – when regions or units within an outsourcing deal solve issues, establish processes, or drive innovation in a vacuum, scalability is reduced, and impactful innovation may be lost

Fortunately, companies and industry organizations are beginning to understand the need to both design and institutionalize sound governance practices as a critical component of outsourcing relationships. But just what is "good governance"? Unfortunately, research suggests there is no clear definition of what good governance should be.

There is No Clear Definition of Governance

If governance is essential, why haven't organizations perfected the art, science and practice of great governance? Research by the European academics Florian Moslein and Karl Riesenhuber reveals one reason is a lack of clear understanding of just what good governance is. In fact, their research suggests there is not a clear definition of agreement governance!

Without a clear definition, it is easy to understand why organizations have such difficulty in creating and implementing sound governance. Oliver Williamson suggests governance structures should vary with the nature of the transaction/relationship. Moslein and Riesenhuber agree, noting that governance structures are typically customized to the scale and scope of the work. Contemporary research suggests there are two types of governance: contractual governance and relational governance[11] :

- Contractual governance refers to the measurement and enforcement of contractual clauses
- Relational governance covers "multiple dimensions" such as problem-solving, information sharing and negotiation efficiency"

The research concludes there has been very little focus on the relational aspects with the majority of the focus on the outputs of the relationship. More recently, an *Organizational Science* article expands on the idea that there should be both contractual and relational governance. The authors provide a simple 2x2 matrix providing insight into both.[12]

(See **Figure 2** to the right).

Means to enforce alliance governance mechanisms' ruling principles

Level of codification of alliance governance mechanisms' ruling principles	Contractual	Relational
Formal	**Formal contractual governance:** ***Conceptual definition:*** the set of codified enforceable promises that define the rights and obligations of the parties; for example: termination, auditing or lawsuit provisions.	**Formal relational governance:** ***Conceptual definition:*** the set of codified patterns of behavior to which parties are expected to conform; for example: exchange of personnel, decision-making rules or meeting procedures.
Informal	**Informal contractual governance:** ***Conceptual definition:*** the set of uncodified enforceable promises that define the rights and obligations of the parties; for example: confidentiality arrangements, task division or decision making.	**Informal relational governance:** ***Conceptual definition:*** the set of uncodified patterns of behavior to which parties are expected to conform; for example: trust and positive interpersonal relationships

Based on Keller et al (2021)

Figure 2

As an organization's trading partnership matures, business partners may evolve where and how they emphasize contractual versus relational governance.[13] Take for example BP and JLL. BP had outsourced its facilities management operations for several years using several service providers operating under an approved provider model. In 2020 they decided to make the shift to a Vested sourcing business with JLL becoming their global service provider for real estate and facilities management. As part of the shift to Vested, the parties created a formal relational contract that embedded the relational governance constructs into their outsourcing agreement.[14]

Elements of Sound Governance

As Keller and his co-authors suggest, good governance should include both contractual and relational governance mechanisms. UT's research affirms the premise that far too many organizations fail to properly include relational governance mechanisms in the outsourcing agreements. With this in mind, UT researchers set out to develop an outsourcing manual to help guide outsourcing professionals on what good outsourcing governance looks like. Their work led to the book *The Vested Outsourcing Manual* – published in 2011.[15] The book outlines four key governance Elements – or themes – and argues each of these Elements should be formally embedded into outsourcing agreements.

The Elements are:

1. ***Relationship Management*** – The Relationship Management Element outlines how an organization structures and supports its interactions with suppliers. UT researchers suggest nine design principles that – when applied – address both the formal and informal relational governance mechanisms as noted in **Figure 2**. Relationship Management includes things like having a tiered governance structure with specific roles, peer-to-peer communication protocols, continuity of resource rules and relationship health monitoring methods. As supplier relationships become more strategic, the governance mechanisms to manage the outsourcing relationship should become more formal and structured.
2. ***Transformation Management*** – The Transformation Management Element outlines how contracting parties should manage changes in their relationship. Good governance practice includes having formal processes for managing contractual changes. However, it also includes how the parties will collaborate on continuous improvement efforts or even work together on larger transformation initiatives or new product or process development. As supplier relationships become more strategic, organizations should increase their emphasis on how they collaborate to create value.
3. ***Exit Management*** – Exit Management mechanisms are essential for governing an outsourcing agreement because they ensure the parties have outlined how they will manage either a full or partial termination of the agreement. Exit Management practices can vary significantly, ranging from a simple termination for convenience to a comprehensive exit management strategy, which provides guidance on how the parties will unwind during an exit. As supplier relationships become more dependent, exiting the relationship becomes harder and more costly.
4. ***Compliance (Special Concerns and External Requirements)*** - The final Element addresses compliance and incorporates specific market, local, regional, national or even

company-specific compliance requirements. For instance, outsourcing agreements operating within the United States must comply with the United States Department of Labor's Occupational Safety and Health Administration (OSHA) standards or may have special concerns/requirements that are unique to the company such as data connectivity requirements to the buyer's internal systems.

Part 2 provides an overview of each Element and shows how each of the governance Elements should be designed based on the type of Sourcing Business Model used.

Organizations Should Use "Best Fit" versus "Best Practices" Governance Design

APQC regularly conducts benchmarking across Fortune 500 organizations. A 2018 study found organizations are applying governance through a much too narrow lens of simple SRM (Supplier Relationship Management) programs.[16] Among organizations with SRM approaches in place,

- 80 percent rely on SRM to reduce risk
- 72 percent rely on SRM to monitor contract compliance and service levels
- Only 38% are thinking more comprehensively about using governance mechanisms to drive innovation and transformation efforts

The APQC report points to a weakness of traditional SRM approaches in that they have typically focused on teaching buying organizations supplier relationship "best practices" rather than recognizing the reality that every business relationship is unique, powered by its own mix of people and processes, and driven by a very distinctive purpose. Rather, supplier relationships exist in a continuum, with purely transactional relationships at one end and investment-worthy equity partnerships at the other.[17]

Understanding the purpose of the business relationship along that continuum helps to determine the appropriate scope of work, performance management approach, pricing approach, and governance structure. As such, APQC argues that organizations need to evolve from *best practice* SRM programs to thinking in terms of *best-fit* governance mechanisms.

The book *Strategic Sourcing in the New Econom*y develops a framework for managing different types of contracts ranging from basic transactional contracts to a highly collaborative Vested business model with strategic suppliers.[18]

All Complex Contracts Are Incomplete -- Use a Flexible Framework

If contracting parties could specify their respective rights and duties for every possible future state of their relationships their contract might be called a "complete" contract. The contract would not have errors, omissions or ambiguities. While some argue it is impossible to write a complete contract, one point is clear; the more complex the contract, the harder it is to draft a complete contract. Perhaps this is why Nobel laureate Oliver Williamson astutely wrote, "All complex contracts will be incomplete, there will be gaps, errors, omissions and the like." Oliver Hart – another Nobel Laureate – points to the same fact.

Oliver Williamson and Oliver Hart have done seminal research on the concept of incomplete contracts. Incomplete contracts are particularly vexing where long-term relationships with high complexity are essential because it is impossible to predict all of the possible situations and market changes that will occur over the life of the relationship. As such, many aspects and events will simply not be addressed in the contract; and, where there is wording in the contract to deal with a particular situation, this wording will usually be open to different interpretations.

Simply put, it is myopic and inefficient to try to get to a complete contract in a highly complex environment. As far back as 1979, Williamson wrote that governance is “the framework within which the integrity of a transaction is decided.”[19] Instead of trying to write a complete contract, Williamson and Hart suggest putting in place governance mechanisms designed to help keep the parties in continual alignment post contract signing in addition to managing any shifts in the business environment.

Oliver Williamson suggests organizations should adopt a flexible framework and include governance processes that help the parties navigate their relationship. Structuring agreements with flexibility prevents what Williamson called “maladaptations.” Maladaptations are aspects of an agreement that have become more harmful than helpful and can cause friction and added transaction costs. To put it in layman’s terms, business is dynamic and changes in business needs can cause misalignment between a buyer and service provider if not dealt with in a productive manner. Creating a flexible contract framework with sound governance enables the business partners to address needed changes proactively and prevent friction, or ultimately dissatisfaction with the relationship.

Ideally, contracts are structured with flexibility so that potential maladaptations are eased or avoided through mechanisms that cope with unexpected disturbances as they arise. In a 2002 paper, 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.”[20] He continued, “The surprise is that a concept as important as governance should have been so long neglected.”

Simply put, creating a flexible contract framework coupled with sound governance mechanisms that can cope with unexpected disturbances as they arise can help organizations address the dynamic nature of business head-on.

PART 2: Aligning Governance to Business Needs

So just what makes good outsourcing governance? In Part 1 we shared key Elements of a good governance structure: relationship management, transformation management, exit management and compliance.

But what are the best practices? The answer is – as Williamson, Moslein and Riesenhuber point out (from Part 1) – *it depends.*

Oliver Williamson's work on how organizations should govern their supply chains earned him a Nobel Prize in 2009. Williamson advocated that organizations often incorrectly assume sourcing is a "make vs buy" decision. Many assume that the decision to insource (make) versus outsource (buy) results in one of two approaches:

(1) Use "the market" to identify qualified sources to perform the work (e.g., "buy")

(2) Retain or develop the capabilities in-house (e.g., "make") – what Williamson coined as a "hierarchy".

Williamson challenged the conventional make-vs-buy decision and advocated for what he called a "hybrid" governance approach for more complex and dependent relationships. In practice, hybrid governance can best be described as incorporating relational governance mechanisms which provide the operational constructs to help the parties shift from traditional buy-sell arms-length (market) approaches to more collaborative win-win operational constructs.

UT's research aligned seven common sourcing models to Williamson's continuum (**Figure 3**).

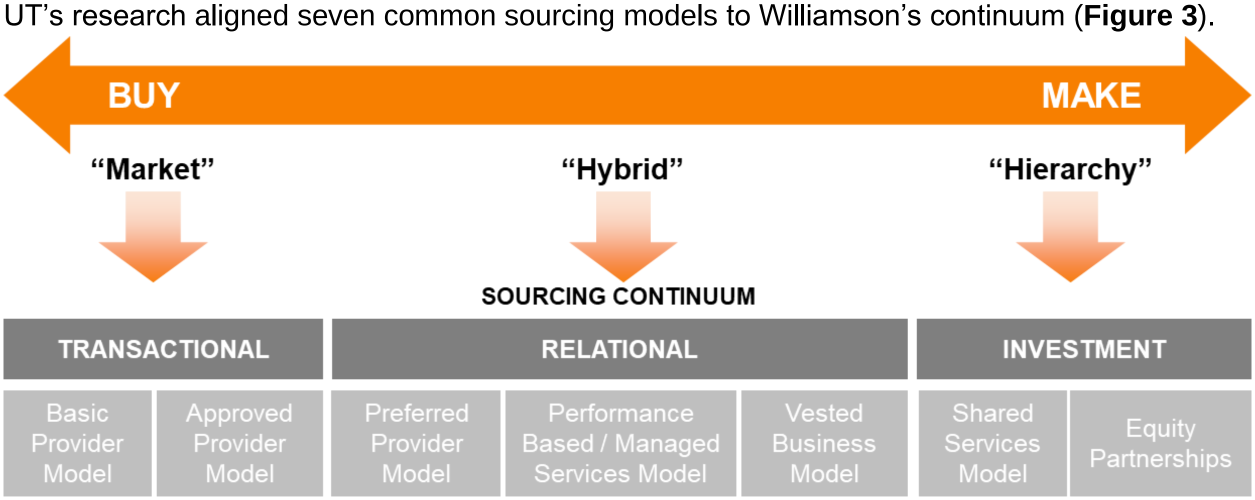

Figure 3

The UT researchers then mapped out guidelines for how organizations should approach governance practices for the various sourcing models.

The following section provides a high-level overview of the seven Sourcing Business Models and how an organization's governance approaches need to change based on the Sourcing Business Model used.

High-Level Overview of the Seven Sourcing Business Models

Supplier relationships exist on a continuum, with purely transactional relationships at one end and investment-worthy equity partnerships at the other. As organizations shift along the sourcing continuum, the purpose of the business relationships changes to be more strategic. In addition, the more strategic nature is almost always associated with a higher degree of dependency. With this in mind, UT researchers advocated that organizations need to align the appropriate scope of work, performance management approach, pricing approach and of course the governance structure to the various Sourcing Business Models. The below provides a high-level overview of each of the seven Sourcing Business Models and describes how they are different.

Basic Provider Model

The basic provider model uses a transaction-based economic model where there is typically a set price for individual products and services (e.g., price per unit, per hour, per mile, per call, per shipment). The basic provider model is best suited in situations where there are low-cost, standardized goods and services in a market with many suppliers. Buyers typically use frequent competitive bidding (often through pre-established catalogs or e-auction calendar events) and there is little or no impact to the business if suppliers are switched.

Approved Provider Model

An approved provider model also uses a transaction-based economic model. The main difference between an approved provider and a basic provider model is that in an approved provider model goods and services are purchased from suppliers that meet a pre-defined set of qualification characteristics, quality standards, previous proven performance or other selection criteria. Frequently organizations will have a limited number of pre-approved suppliers for various categories from which buyers or business units can choose. Multiple suppliers mean costs are competitive, and one firm can easily be replaced with another if the supplier fails to meet performance standards. A good example is how a Consumer Packaging Goods company uses several approved transportation providers on their approved provider list; the shipping department can call up any of the trucking companies on the list for a shipment.

Preferred Provider Model

A key difference between a preferred provider model and the other transaction-based models is that the buyer is moving to a more strategic, relational approach. Buying companies seek to do business with a preferred provider to streamline their buying process and build longer-term relationships with key suppliers. While the preferred provider model is still transactional, the way the parties work together goes beyond the simple purchase order – often with the goal for the supplier to provide a value proposition such as technology solutions, geographic coverage, or value-added services. A good example is Applebee’s restaurant. Applebee’s worked collaboratively with a preferred food services provider to develop customized value-added test kitchen service. Buying companies typically enter into multi-year contracts by using a master agreement that allows them to conduct repeat business efficiently.

Performance-Based/Managed Services Model

A performance-based model is typically a longer-term, formal supplier agreement. An appropriately structured performance-based agreement combines a relational contracting approach with an output-based economic model.[*] A key purpose of using a performance-based agreement is to shift the thinking away from transactional activities to predefined outputs or events. Organizations using a performance-based agreement work with a supplier who will commit to achieving predefined performance parameters or savings targets. Buyers often like using a performance-based agreement because it shifts management of the risk to achieve the predefined outputs to the suppliers. Organizations sometimes confuse the concept of "outputs" and "outcomes," but in performance-based agreements, the meaning of "outcome" is defined as the achievement of an event or deliverable typically finite in nature and is therefore easily understood. A good example of an output is a supplier's ability to achieve predefined service level agreements (SLAs).

Vested Model

The Vested sourcing business model is highly collaborative. The Vested model combines an outcome-based economic model with the Nobel award-winning concepts of behavioral economics and the principles of shared value: companies enter into highly collaborative arrangements designed to create value for the buyer and supplier above and beyond the conventional buy-sell economics of a transaction-based agreement. In essence, the buyer and supplier have an economic – or vested – interest in each other's success when working in a Vested model. A Vested model works best when an organization has transformational or innovation objectives it cannot achieve itself or by using conventional transactional sourcing models (basic provider, approved provider, preferred provider) or a performance-based agreement.

Shared Services Model

A shared services model is an internal organization that provides services across various departments or business units. It is often designed on a value-added arms-length outsourcing arrangement but can be structured as a performance-based or Vested model. Using this approach, processes are typically centralized into a "shared service" department or organization that charges members for the services used. Organizations use this model for a variety of functional services such as human resources, finance operations, and administrative services (such as claims processing in health care).

Equity Partnerships

If an organization does not have adequate internal capabilities to acquire mission-critical goods and services - and does not want to outsource or invest in a shared services organization - it may opt to develop an equity partnership. Equity partnerships create a legally binding entity and can take a number of different legal forms. For example, equity partnerships can include acquiring a supplier, creating a subsidiary or cooperative, or even establishing an equity-sharing joint venture.

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[*] *For more information about relational contracts see the book Contracting in the New Economy: Using Relational Contracts to Boost Trust and Collaboration in Strategic Business Relationships.*

How Governance Changes as You Shift Across the Sourcing Continuum

As organizations shift across the sourcing continuum supplier relationships become more strategic and dependent. However – properly structured – organizations can harness the potential of working with the supplier in a more strategic and collaborative approach. Rather than using the traditional SRM approach of applying best practices across the board, the Sourcing Business Model approach advocates organizations find a best-fit approach based on the Sourcing Business Model used. However, this requires organizations to rethink their perspective: procurement shifts from being transactional buyers to value architects, and business stakeholders shift from being operational managers to transformation leaders. Likewise, the supplier involvement changes, shifting from a "vendor" view to where the supplier becomes a true solution provider. (see **Figure 4**)

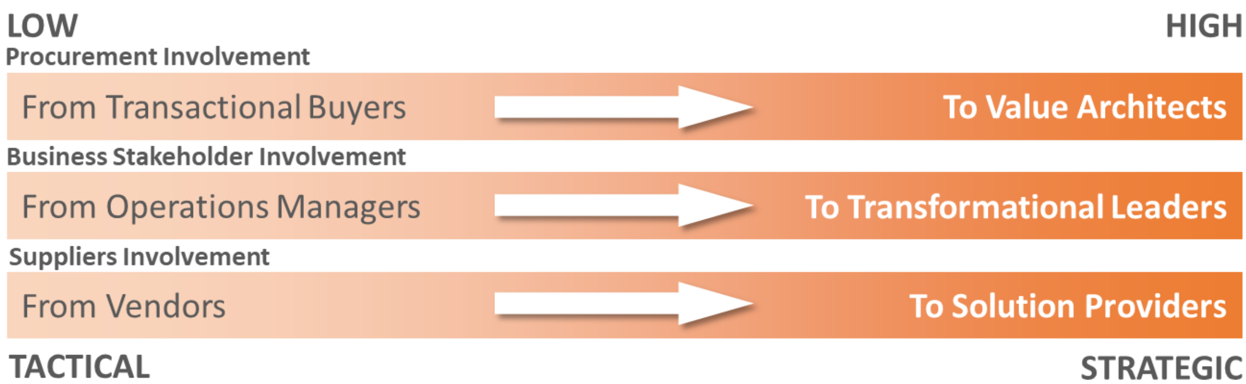
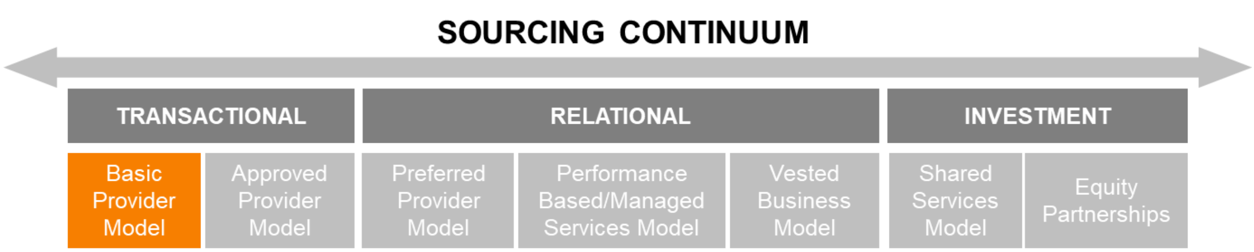


Figure 4

Governance for Basic Provider Model



The governance of a basic provider model is by far the simplest because the exchange between the buyer and supplier is typically just a simple Purchase Order (PO). In essence, there is no ongoing commitment to a relationship, and as such *Relationship Management* is typically limited to a simple three-way match process where the PO is compared against the supplier's invoice and the receiving report. A good three-way match compares quantities, price and terms appearing on the supplier's invoice to the information on the PO and the quantities actually received. The same process should be followed for service purchases—for example, a comparative matching of hours logged against hours invoiced.

GOVERNANCE	
Relationship Management	Delivery & Pricing Validation (Three Way PO Match)
Improve, Transform & Innovate	None / Market-Driven
Exit Management	One-Way / Limited Commitment to Buy
Compliance & Special Concerns	Compliance-Driven / Survey-Based

Because there is no commitment to doing business beyond the PO, there is no need for the *Transformation Management* governance Element.

Exit Management is also straightforward; if a supplier is classified correctly as a basic provider, switching suppliers should be relatively easy and low risk and it typically means not issuing the supplier any more POs.

Compliance Management of a basic provider is typically limited to validation of any special requirements during the bid process or oversight regarding delivery and pricing.

Governance for Approved Provider Model

SOURCING CONTINUUM

TRANSACTIONAL		RELATIONAL			INVESTMENT	
Basic Provider Model	Approved Provider Model	Preferred Provider Model	Performance Based/Managed Services Model	Vested Business Model	Shared Services Model	Equity Partnerships

An approved provider model also uses a simple transaction-based economic model. A key difference between a basic provider model and an approved provider model is the buying organization intends to do repeat business with the supplier – often having the supplier on an "approved vendor list".

This intent to do repeat business means that – to at least some extent – there needs to be some aspect of *Relationship Management*. It is common for buyers to put in place blanket POs for approved providers to make it easy to do repeat business. In some cases, buyers may even put in place a Master Agreement.

While typically buyers do not commit to a minimum volume level with approved providers, they may have tiered pricing that allows them to get rebates if volume thresholds are met. For this reason, relationship management efforts should include the tracking of volumes, pricing and rebate commitments. Because there is no commitment to continued business beyond the PO, *Transformation Management* is typically limited to market-driven improvements and does not include any deep form of collaboration to work on continuous improvement or larger-scale transformation initiatives.

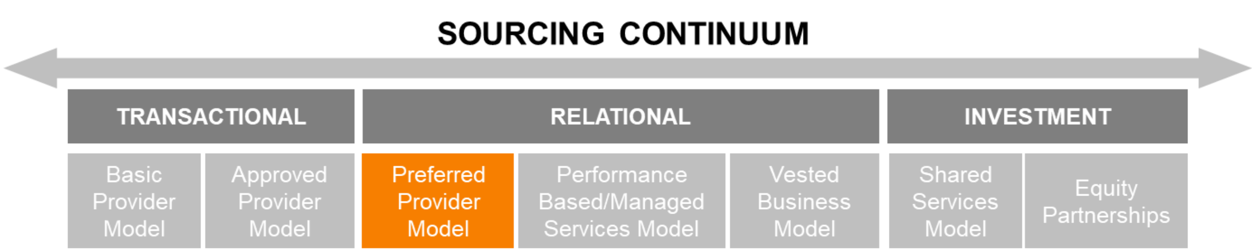
Exit Management is also straightforward; if a supplier is classified correctly as an approved provider, switching suppliers should be relatively easy and low risk and it typically means including a simple one-way for termination for convenience and termination for cause clause in the contract.

Compliance Management of an approved provider typically includes compliance-driven activities with oversight of delivery performance, pricing, and compliance against key risk exposure areas of special concern to the buyer or dictated by government regulations.

GOVERNANCE	
Relationship Management	Some Performance & Pricing Oversight
Improve, Transform & Innovate	Limited / Market-Driven
Exit Management	One-Way / Termination for Cause & Convenience
Compliance & Special Concerns	Typically Compliance-Driven / Survey-Based

The importance of compliance monitoring should not be overlooked even though an approved provider may have limited strategic value. A good example is Target's massive data breach that put the personal data of up to 70 million shoppers at risk.[21] Target had set up data interfaces for electronic billing, contract submission, and project management with many of its approved suppliers having access to the Target network. One of those suppliers was Fazio Mechanical Services, a refrigeration, heating, ventilating, and air-conditioning systems supplier. Two months after the breach, an investigation revealed that hackers had gained access to the retailer's systems using credentials stolen from Fazio Mechanical Services. The Target example highlights why more organizations are starting to hire third-party compliance management services to provide ongoing compliance monitoring of suppliers.

Governance for Preferred Provider Model



As organizations shift along the sourcing continuum to a preferred provider model, they begin to treat suppliers more strategically. This means thinking differently about each of the four Elements.

It is very common for organizations to shift from using a simple PO to having a formal master agreement with the supplier which outlines the terms and conditions for their relationship.

Because the supplier is more "strategic" there is a need to implement more formal *Relationship Management* practices. Here we often start to see companies implement SRM (supplier relationship management practices). For example, a buyer and supplier typically commit to quarterly business reviews and put in place formal protocols for managing business issues (e.g., poor scorecard results) or future requirements.

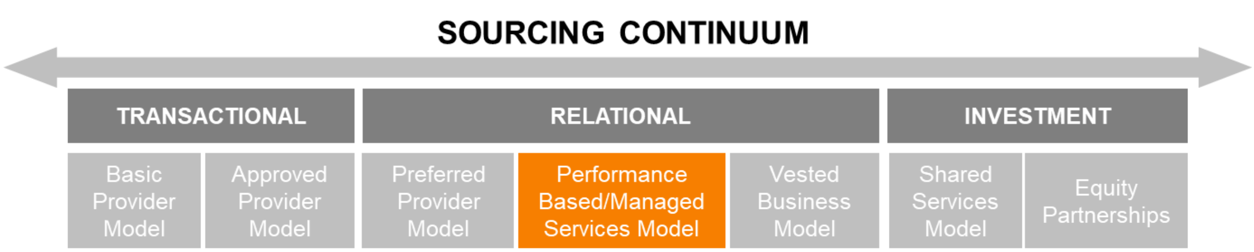
GOVERNANCE	
Relationship Management	Limited Supplier Relationship Management
Improve, Transform & Innovate	Beginning to Focus on Incremental Improvement
Exit Management	One-Way / Termination for Cause & Convenience
Compliance & Special Concerns	Typically Market-Based / Minimum Audit Requirements

Transformation Management also becomes more important. A key difference in a preferred provider model is that buyers may ask suppliers to add value by identifying continuous improvement efforts that improve service levels or reduce costs. Remember the Applebee's example of the test kitchen?

Buyers also need to include *Exit Management* provisions in their master agreements. Typically, exit management includes a one-way termination for cause and termination for convenience. These clauses allow buyers not only to end a supplier relationship due to poor performance but also to change as business requires. Simply put, while buyers commit to building a closer relationship with suppliers, buyers may or may not actually commit to continued business. Most buyers think of exit clauses as a way to protect their own organizations, but it really is a two-way street where the supplier will also want to put in exit provisions. It is important to realize that suppliers may begin to ask for contractual safeguards to protect themselves such as compensating the supplier for asset-specific investments that cannot be easily reused for other clients in the event the supplier's contract is terminated early.

Last, as with an approved provider model, buyers put in place processes and protocols for *Compliance Management.* In a preferred provider relationship, compliance still focuses on audits against market-based requirements, but may also have audits against specific requirements based on the supplier's specific workscope.

Governance for Performance-Based Model



As a supplier relationship shifts along the sourcing continuum to a performance-based model, the need for enhanced governance becomes essential.

GOVERNANCE	
Relationship Management	Oversight Emphasis: Supplier Relationship Management
Improve, Transform & Innovate	Supplier Driven to Meet SLAs/Price Glide Path
Exit Management	Performance-Based Termination for Cause with Safeguards
Compliance & Special Concerns	Corporate Based Audit Requirements

A well-structured performance-based model applies formal *Relationship Management* processes and protocols. Relationship Management is most often typified by an oversight mentality supported by a formal SRM framework. Although the various SRM frameworks are unique, several themes apply to managing a supplier relationship in a performance-based model. These include:

- *The business owns the relationship.* Procurement plays a key role in facilitating the SRM process and establishing a cross-functional team so that the interests of all relevant stakeholders are served. However, the business owns the relationship and directly collaborates with the supplier so that business objectives are achieved.
- *Executive sponsorship and involvement.* The importance of partnerships is emphasized and the right priorities are set.
- *Dedicated governance structure.* Buyers and suppliers have key roles in how they work together. The structure is essential because supplier relationships are often not established in a structured way so that reporting lines, roles and responsibilities, and communication are clear. In larger outsourcing initiatives, the governance team is truly "dedicated" and is assigned with full-time resources. In smaller outsourcing deals, the governance resources may not be full-time resources – however, they will still have a dedicated role to provide the needed focus.

UT's research finds that one weakness of the traditional SRM process is that SRM is considered something that is not part of the contract. Our view is that once an organization shifts to performance-based models it should include a formal schedule or appendix in the contract that outlines how buyers and suppliers will proactively manage the relationship – including risk management.

Transformation Management also becomes a focal point. A performance-based model is designed so that the supplier takes risks to achieve performance and/or cost savings targets for the workscope under its control. This means that the buyer has already identified and contracted for the desired level of improvements and the burden of continuous improvement lies within the supplier. Within a performance-based agreement, the supplier has the flexibility and freedom necessary to drive essential changes in order to meet SLAs and cost reduction targets. Although the supplier is ultimately accountable and contractually obligated for improvements, the buying organization must ensure business stakeholders help the supplier drive process changes. In particular, the governance processes should include mechanisms for recording ideas and projects, tracking their progress, and ensuring both parties are aligned on improvement areas. Having the buying organization provide senior-level sponsors for the suppliers' project teams further assists in breaking down any barriers and helps deliver the performance both parties are looking for.

Exit Management: Organizations must also shift their approach to Exit Management when entering into a performance-based agreement because a performance-based agreement has a far greater degree of dependency. Codependency happens in two ways. First, performance-based models — by design—are longer-term in nature. There is no "right" answer to contract length, however, more complex workscopes requiring supplier investment are at least three years and sometimes span five or more years. Longer-term contracts are needed because they allow suppliers to recover their investments and improve margins after making those investments. The more supplier investment is needed, the longer the contract length. It is not uncommon for performance-based agreements to include options to extend the contract for up to five to seven years. We have even seen ten-year contracts and even one 25-year performance-based contract. In cases where the workscope may be simpler or fairly stable in nature, it is possible to have one-year contracts that include automatic renewal if suppliers meet certain standards.

Performance-based agreements also create a higher degree of codependency because they typically are higher in value and often have bundled workscope. A key reason for bundling workscope is that it provides flexibility for suppliers to make improvements. For example, by bundling dining and cleaning services into an "integrated" facilities management contract, suppliers can drive cost reduction through economies of scale in overhead and staffing management.

Combined, larger and longer-term contracts increase the risks for both buyers and suppliers by making exiting a performance-based relationship much more complex. With added risk comes added responsibility to put more time and energy into exit management planning.

Many organizations wonder how to deal with standard termination for convenience and termination for cause clauses. Buyers can start with the organization's standard clauses; however, suppliers will likely push back on standard clauses. This is not only expected, it is appropriate because suppliers are making investments in the organization's business solutions. The more asset-specific the investment, the more buyers need to look at these two termination clauses through different lenses.

A key differentiator is not the clauses themselves but the amount of time and protocols for how the buyer and supplier will unwind. For example, ask: "What is the appropriate amount of time to safely shift work to a new supplier?" A second key differentiator is that termination clauses consider the costs associated with early termination, especially terminating for convenience. If suppliers make asset-specific investments that have not been amortized, buyers need to make the suppliers whole if buyers terminate early for convenience.

Compliance Management also becomes more advanced. As with a preferred provider model, buyers put in place processes and protocols to audit compliance and external requirements unique to the suppliers' workscope. Because of increased codependency, buyers often have more advanced corporate audit requirements for these suppliers.

In some industries, performance-based models have more compliance and external requirements than preferred provider models due to the increased level of codependency. The focus includes topics such as how the firms will handle intellectual property (IP), data rights, or other government requirements. For example, when the non-profit Early Learning Coalition signed a performance-based contract with CMIT to manage its IT network, CMIT had preexisting IP. As part of the agreement, CMIT agreed to provide the Early Learning Coalition with a perpetual, worldwide, royalty-free nonexclusive license to use the CMIT IP for its internal business uses. This ensured that the Early Learning Coalition would not have service disruption if it switched suppliers at the end of the contract.

Governance for Vested Models

SOURCING CONTINUUM

TRANSACTIONAL		RELATIONAL			INVESTMENT	
Basic Provider Model	Approved Provider Model	Preferred Provider Model	Performance Based/Managed Services Model	Vested Business Model	Shared Services Model	Equity Partnerships

When an organization makes the shift to a Vested model they are committing to a highly collaborative strategic relationship with their supplier. Rule 5 of a Vested agreement is a "governance structure that provides insight, not merely oversight." A key difference between Vested and a performance-based governance structure is that the latter typically uses supplier relationship management (SRM) with an oversight mindset while a Vested model uses joint governance with an insight mindset that is heavily dependent on transparency. The below outlines how each of the governance Elements shifts when entering into a Vested model.

GOVERNANCE	
Relationship Management	Insight Emphasis: Strategic Relationship Management
Improve, Transform & Innovate	Joint & Proactive Transformation Management
Exit Management	Joint Exit Management Plan
Compliance & Special Concerns	Outcome-Based Joint Requirements

Relationship Management: A key theme in a Vested governance structure is managing the business with the supplier, not just managing the supplier. As such, a well-structured Vested relationship goes beyond the formal SRM processes and protocols. Rather, think of SRM as *strategic* relationship management.

A Vested relationship adopts nine relationship management design principles and formally incorporates these into the contract – typically in the form of a Schedule or Appendix to the Master Agreement. The relationship management design principles are:

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

6. Develop a methodology to measure the health of the relationship
7. Develop an issue/event resolution process
8. Develop a process to maintain continuity of resources
9. Establish a process to onboard key personnel

We explore each of these design principles, as well as Transformation Management and Exit Management, in Part 3 – Governance Design Principles for Vested Agreements.

Transformation Management. A key reason to enter into a Vested agreement is to proactively drive innovation/and or transformation in the spend category. For this reason, buyers and suppliers should develop a joint transformation management framework.

It is important to remember a Vested relationship is designed to share risk and reward. This means buyers and sellers mutually commit to staffing a transformation management lead for the relationship. For perspective, Microsoft's outsourcing agreement with Accenture for back-office finance administration services was designed with six full-time transformation managers—three from Microsoft and three from Accenture. The six were paired into three 'two-in-a-box' teams, with each joint team being accountable for transforming processes under their area of expertise. These two-in-a-box pairs work together closely to drive proactive change against Microsoft's desired transformation management goals.

A Vested relationship adopts five transformation management design principles and formally incorporates these into the contract, typically in the form of a Schedule or Appendix to the Master Agreement. The design principles include:

1. Transition Management – a common understanding of how workscope transition will be managed
2. Continuous Improvement – processes and protocols for driving smaller day-to-day continuous improvement efforts or solving business problems that arise
3. Invention/Innovation – processes and protocols for handling larger transformation ideas are much broader than continuous improvement efforts. Typically, invention and innovation require investment by one or both parties.
4. Structured Innovation Management Process – processes and mechanisms used to ensure all transformation initiatives (continuous improvement and larger invention/innovation ideas) are effectively and efficiently being managed to achieve the Desired Outcomes
5. Contractual Change Management – a formal process for updating and managing any changes to the actual commercial agreement or contract

A common theme for the design of each formal process is that they need to strike the right balance of flexibility and administration, as you want to empower the people working in the outsourcing deal, not inhibit desired results through a bureaucracy. This is also one reason why Separate Management Roles and their responsibilities should be included in the governance, and be connected to the processes – as further described in Part 3.

Exit Management: A Vested relationship, by design, creates supplier codependency. Many organizations believe co-dependency increases risk and is bad – especially if that means having just one supplier. However, UT's research shows a properly structured win-win agreement with a strategic supplier can actually reduce risk because suppliers commit to strategically investing to reduce risk.[22]

Codependency in a Vested agreement happens in three ways. First, Vested relationships are longer term in nature, typically a minimum of five years and often much longer. Many Vested agreements include an incentive where the supplier earns a contract extension at the end of each year. For example, at the end of year one, the supplier can earn the sixth year. At the end of year two, the supplier can earn the seventh year. This creates an evergreen contract with a rolling five-year contract duration that highly motivates suppliers to keep making investments to earn contract extensions.

Second, Vested relationships are designed to give a supplier the freedom and flexibility to make changes to the workscope—the "how." Suppliers make conscious investments in process improvements and technologies that help them achieve mutually defined Desired Outcomes.

Last, buying organizations often choose to bundle workscope in a Vested Agreement. For example, BP made the strategic decision to bundle a variety of facilities and real estate management services under one contract with JLL.

Combined, these decisions increase the stakes for buyers and suppliers. With added risk comes added responsibility to spend more time and energy in exit management planning as firms develop a physical agreement or contract that supports the Vested relationship. First and foremost, buyers and service providers must be fair and balanced in terms of how they plan to exit the relationship. The intent of a Vested relationship is that neither party should be harmed if an exit is necessary.

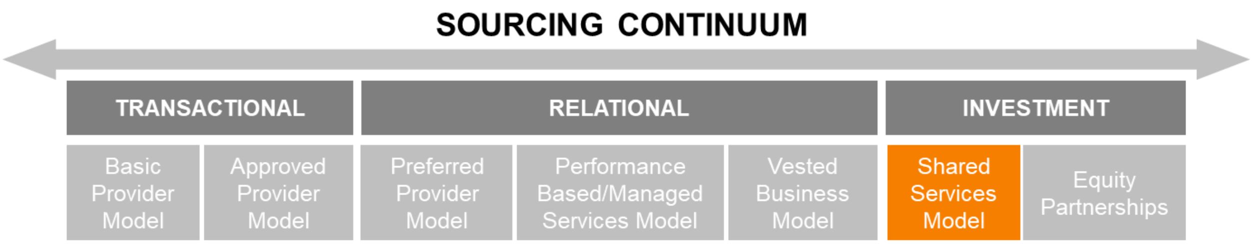
As buyers and suppliers work through exit management, they should seek to understand and appreciate each other's perspective. Rather than negotiate standard termination clauses that are common in typical buy-sell agreements, they should instead seek to reach a fair and balanced approach for how the parties will unwind if necessary.

Compliance Management*:* Organizations often use a Vested model because they are operating in an environment with significant risk. In such environments, compliance is a key driver of success. As with the other relational sourcing models, buyers should put in place processes and protocols to ensure that special concerns and compliance requirements are met. A key difference in Vested arrangements is that, in many cases, suppliers have a significant role in ensuring that standards are met. For example, Accenture is accountable for ensuring that Microsoft complies with all Sarbanes-Oxley regulations. It is Accenture's responsibility to know when regulations change and stay in compliance without interruption, not Microsoft's.

Vested models are also used to create highly motivating environments for suppliers to invest in developing competitive advantages for buyers. For example, McDonald's and its fish suppliers collaborated with the Marine Steward Council to lead the industry in developing new regulations for sustainable fishing. McDonald's became the first company in the world to achieve 100% Marine Stewardship Council certified fish sustainability status. Likewise, beef suppliers collaborate to create quality standards that are 10 times higher than the US Food and Drug Administration regulated standards for food safety.

Finally, most Vested agreements also need to have a fair and balanced way to manage intellectual property – especially when suppliers invest in client-specific process and product improvements. As such, buyers and suppliers need to think through the ramifications of intellectual property. Many find creative ways to jointly manage and reward innovation through licensing agreements.

Governance of a Shared Services Model



Governance is critical to Shared Services Organizations (SSOs). Unfortunately, it is often overlooked because the supplier is "internal" and often stakeholders don't see the need to spend the time and resources needed for proper governance of their SSO. We advocate sound governance across each of the Elements is equally important to an internal supplier relationship.

A key part of governing an SSO is setting up formal *Relationship Management* mechanisms with each business unit to ensure that the SSO clearly understands and responds to the dynamic needs of internal customers. As you structure your shared services model, ask yourself these questions:

- How will the SSO work with the various internal clients?
- What are the processes and protocols around decision rights for investments?
- How will conflicts of interest be managed?

GOVERNANCE	
Relationship Management	Shared Control and Management
Improve, Transform & Innovate	Core Innovation Capabilities
Exit Management	Divestiture
Compliance & Special Concerns	Investment-Based Joint Requirements

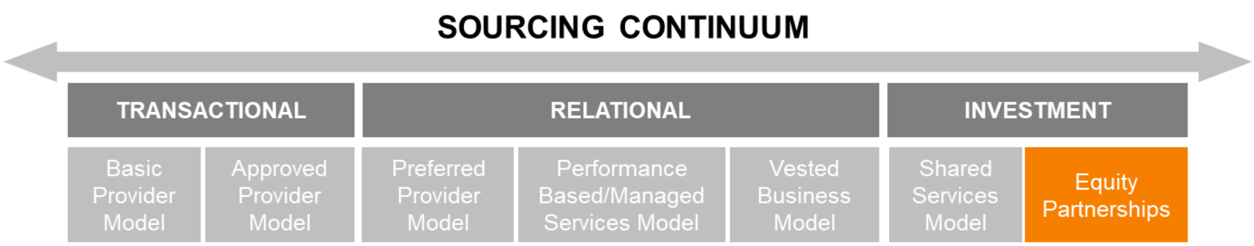
We contend the only reason to set up an SSO is if the organization will invest in the capabilities to drive performance and cost at a rate better than using the market/working with a supplier.

However, organizations often overlook the *Transformation Management* aspects of governance when setting up an SSO. Thus, their SSOs often become an inefficient cost center over time which frustrates their internal business unit customers. This is a miss. For this reason, SSOs must outline how they will work with business units to drive continuous improvement and transformation efforts.

It is also important to understand that a well-structured shared services model must proactively determine its *Exit Management* strategy. This includes identifying the factors enabling the organizations to recognize when the SSO is no longer a viable option. For example, will the SSO be spun off or disbanded if the organization is not achieving a minimum performance threshold or benchmark cost targets? There is no need to continue developing an internal capability if the market provides a competitive cost and service advantage.

SSOs should also have formal *Compliance Management* mechanisms at least equal to what they would do with a supplier.

Governance of an Equity Partnership



Some organizations decide they do not have internal capabilities and a shared services model is not an appropriate solution to fulfill their requirements. In these cases, organizations may opt to develop an equity partnership such as a joint venture (JV) or another legal form in an effort to acquire mission-critical goods and services. Legally, equity partnerships bind potential business partners through formal structures.

Typically, these partnerships are asset-based with a formal and comprehensive governance framework. They come in many forms, such as acquiring a supplier, creating a JV, establishing a subsidiary, and joining a cooperative (co-op).

Setting up an equity partnership can be a costly and complicated process. In addition, many countries have unique laws that must be understood and complied with. For this reason, we cannot offer general guidelines for structuring equity partnerships. Rather, we suggest you check with a local consultant and attorney in the countries where you will do business.

Comparison of Governance "Rules" Across Each Sourcing Business Model

As illustrated in the examples above, designing a good governance structure "depends". In the book *Strategic Sourcing in the New Economy,* we share a simple chart that compares the rules of thumb for each of the Sourcing Business Models.

Figure 5 (following page) provides a simple table with the rules of thumb summarized into one page.

TRANSACTIONAL (MARKET) — RELATIONAL (HYBRID) — INVESTMENT (HIERARCHY)

GOVERNANCE	BASIC PROVIDER	APPROVED PROVIDER	PREFERRED PROVIDER	PERFORMANCE-BASED / MANAGED SERVICES	VESTED	INVESTMENT (EQUITY PARTNER / SHARED SERVICES)
Relationship Management	Delivery & Pricing Validation (Three Way PO Match)	Some Performance & Pricing Oversight	Limited Supplier Relationship Management	Oversight Emphasis: Supplier Relationship Management	Insight Emphasis: Strategic Relationship Management	Shared Control and Management
Inspire, Transform & Innovate	None / Market Driven	Limited / Market Driven	Beginning to Focus on Incremental Improvement	Supplier-Driven to Meet SLAs / Price Glide Path	Joint & Proactive Transformation Management	Core Innovation Capabilities
Exit Management	One Way / Limited Commitment to Buy	One-Way / Termination for Cause & Convenience	One-Way / Termination for Cause & Convenience	Perf-Based Termination for Cause w/Safeguards	Joint Exit Management Plan	Divestiture
Compliance & Special Concerns	Compliance Driven / Survey-Based	Typically Compliance-Driven / Survey-Based	Typically Market-Based / Minimum Audit Requirements	Corporate-Based Audit Requirements	Outcome-Based Joint Requirements	Investment-Based Joint Requirements

Figure 5

PART 3: Governance Design Principles for Vested Agreements

The purpose of Part 3 is to provide a deeper dive into the design principles for three of the four Elements of a Vested governance structure: Relationship Management, Transformation Management, and Exit Management. We are intentionally not addressing the fourth Element – Compliance Management because of the significant variability in unique compliance and internal special concerns. Simply put, it would be impossible to provide any type of rule of thumb when literally thousands of external requirements exist around the world and every company has unique special compliance approaches.

Figure 6 below is a high-level summary of the design principles for each of the Elements.

Element 7 – Relationship Management	*Element 8 – Transformation Management*
1. Tiered Management Structure	*1. Transition Management*
2. Separate Management Roles	*2. Continuous Improvement*
3. Peer-to-Peer Communications	*3. Invention*
4. Communications Cadence	*4. Structured Innovation Management Process*
5. Relationship Management	*5. Contractual Change Management*
6. Relationship Health Monitoring	***Element 9 – Exit Management***
7. Issue Resolution Management	*1. Termination Notice Process*
8. Continuity of Resources	*2. High Level Exit Transition Plan*
9. Onboarding Key Personnel	*3. Exit Team, Governance and Reporting*
	4. Transfer of Resources

Figure 6

Before designing a Vested governance structure, two overarching concepts are important.

The first is there is no magic bullet. Simply put, there is no one-size-fits-all approach. In Part 3 we share proven design principles for creating a governance structure for a Vested agreement. These design principles have been field-tested in practice by Vested Centers of Excellence who have collectively helped over 100 organizations make the shift to a Vested outsourcing business model.

Our recommendation? Follow the design principles with your partner, and you will have a better chance of success. Omit one of the design principles and almost certainly you will eventually see the weakness stem from not incorporating the concepts. For example, organizations that fail to create a structured innovation management process will almost always fail to realize their Desired Outcomes because they are not properly identifying, prioritizing and implementing continuous improvement and transformation management initiatives.

The second is there is a significant mindset shift that must occur as organizations make the shift to a highly collaborative win-win Vested strategic partnership. Rule 5 of creating a Vested agreement is a "Governance Structure using Insight vs Oversight". As such, designing a governance structure should make the shift from a "What's-in-it-for-Me" mindset to a "What's-in-it-for-We" mindset. **Figure 7** below shows how the mindset shifts.

WIIFMe Thinking		WIIFWe Thinking
Get the service provider to meet our needs	Becomes	Find a way to meet both of 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

Figure 7

Relationship Management Element

Effective relationship management establishes the mechanisms for how outsourcing partners will manage the overall business and the relationship. One of the biggest traps of designing a sound governance structure is that many companies that outsource think they have a best practice because they have deployed Supplier Relationship Management (SRM) techniques. While some SRM efforts are designed to build deeper relationships that foster improved collaboration efforts and innovation, UT's field-based research suggests traditional SRM approaches fall short. We encourage practitioners to leverage many of the best practice SRM elements; however, for true organizational alignment, we suggest the 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.

Organizations seeking to develop sound governance for a Vested strategic outsourcing deal should incorporate the following nine design principles of the Relationship Management Element.

1. Create a tiered management structure
2. Establish separate service delivery, transformation, and commercial management roles
3. Establish peer-to-peer responsibility and communications protocols
4. Develop a communications cadence
5. Establish a relationship management process
6. Develop a methodology to measure the health of the relationship
7. Develop an issue/event resolution process
8. Develop a process to maintain continuity of resources
9. Establish a process to onboard key personnel

Each is discussed briefly.[†]

[†] *For a comprehensive understanding of each design principle, we encourage you to enroll in the University of Tennessee's **Creating a Vested Agreement** online course or work with a Vested Center of Excellence.*

1. Tiered Management Structure

Once an initial agreement is signed, the focus changes to day-to-day operations and getting the work done.

We recommend a tiered management structure that provides guidance across three key areas: functional working levels, operational management levels, and the executive level. Using a tiered approach creates vertical alignment between the upper management, mid-management, and day-to-day workforce, with each layer being responsible for examining the relationship and business success through its “lens.” A layered approach is also effective for helping organizations make decisions at the proper level.

Most outsourcing relationships use a three-tiered organizational framework; however, it is possible to have more tiers. Organizations typically do not have more than four tiers and a good tiered management structure never has less than two tiers. **Figure 8** illustrates a typical three-tiered structure.

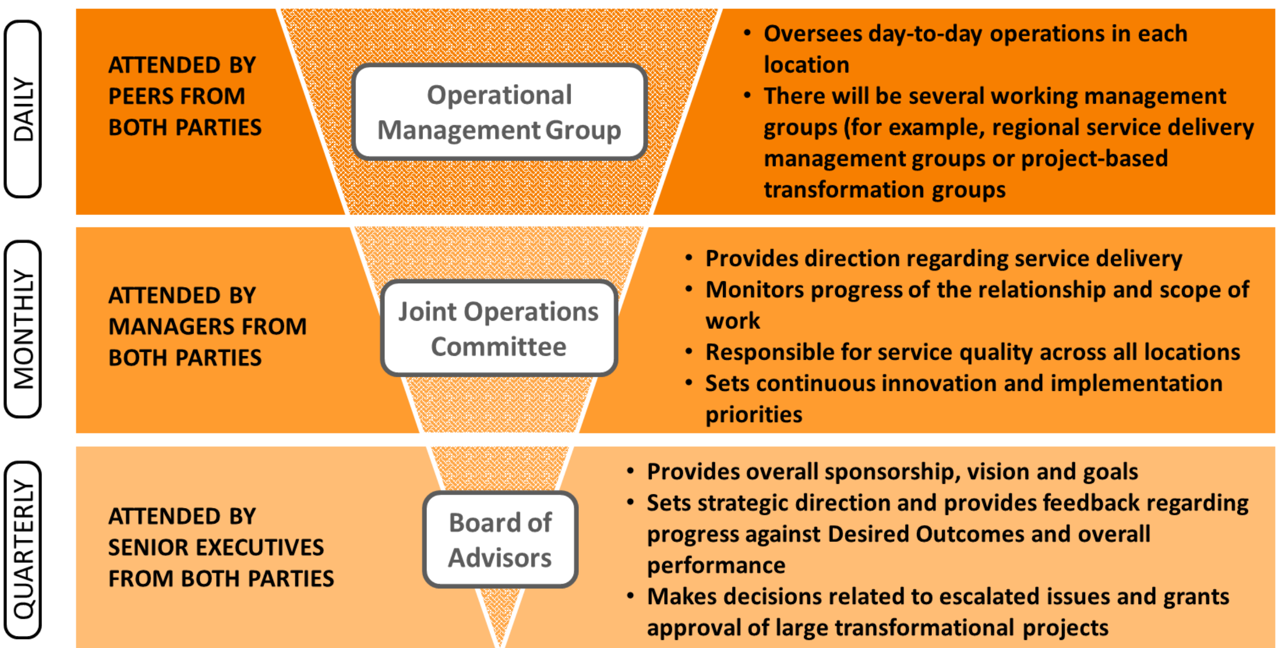


Figure 8: Tiered Governance Structure

2. Separate Management Roles

UT researchers have linked having four key roles to successful outsourcing agreements. These roles are service delivery management, transformation management, relationship management and commercial management. The individuals assigned to these roles are referred to as “Key Personnel” and are typically full-time and dedicated resources. UT research indicates the most successful deals have at least one full-time person per company in each of the key roles. For those 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.

Larger outsourcing deals such as the Microsoft-Accenture “One-Finance” deal have multiple people dedicated to the service delivery and transformation management roles and have a total of 16 Key Personnel a part of their outsourcing partnership.

It is possible to have fewer than one full-time person per key role for smaller outsourcing relationships. We find smaller outsourcing deals sometimes combine the commercial management and relationship management roles. Because Vested agreements are designed to drive transformation, we do not recommend combining the role of Transformation Manager.

The below shares a brief overview of each role.

Service Delivery 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 and complexity of the deal, but should include the key governance operations roles and not the actual workers/supervisors of the work. For example, while Microsoft and Accenture had hundreds of people around the world supporting their outsourcing effort, the Service Delivery Key Personnel only included six full-time team members to Service Delivery Management (three from Microsoft and three from Accenture), with “two-in-a-box” partners managing a specific region.

Transformation Management – This function has the 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. For example, Microsoft and Accenture dedicated six full-time team members to transformation management (three from Microsoft and three from Accenture) with “two-in-a-box” partners being process champions driving improvements in their area of expertise.

Commercial Management – This function is responsible for managing the commercial and contractual aspects of the outsourcing relationship. Key roles include managing the pricing model and any contract change efforts. Commercial Managers often also facilitate overall governance efforts such as coordinating quarterly business reviews and monthly operations reviews, and managing operational dashboards and reporting. UT research finds the most successful outsourcing deals have at least one full-time Commercial Manager, but may have a small team based on the size and complexity of the deal. However, typically only the lead is considered a Key Personnel.

Relationship Management – This function is the most senior role in the relationship – promoting the intent and objectives of the parties over the term of the agreement. The Relationship Manager’s primary role is to manage the overall relationship, providing leadership, advice, and guidance during the term of the agreement. Typically, an agreement has only one Relationship Manager for each company with both roles being dedicated full-time resources. For the Service Provider, this individual typically falls under the account management function. On the Buyer side, the Relationship Manager can reside in any number of functions, including a business unit, operational functional unit, or a centrally located supplier management function.

3. Peer-to-Peer Communications

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 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 (e.g., a ‘vendor manager') and the service provider’s account manager. This approach is depicted on the left in **Figure 9** as a “traditional bow tie” model.

A Vested agreement uses direct functional communication known as a “reverse bow tie” or “two-in-a-box” approach (depicted on the right in **Figure 9**).

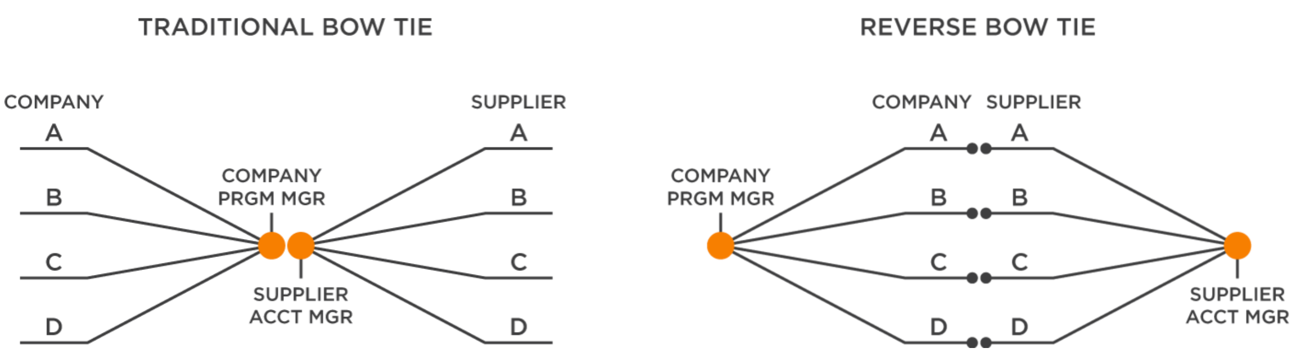


Figure 9: Creating Horizontal Alignment

A reverse bow tie approach improves the flow of information and helps to empower company and service provider teams to work together to streamline communications across all layers. Peer-to-peer “two-in-a-box” mapping should be done for all governance tiers. Many companies often only establish peer-to-peer communications protocols for Key Personnel. However, we argue the real power comes from creating two-in-a-box pairings at the lower levels and empowering operational levels to focus on performance management and resolving day-to-day tactical issues. When properly executed, two-in-a-box pairing fosters the appropriate conversations at the right level and enables faster decision-making and less bureaucracy as people have direct access to their peer. Furthermore, it helps to solidify a decentralized working relationship making the outsourcing deal less prone to suffer from a single person leaving the deal governance to pursue a new role in their career.

4. Communications Cadence

Establishing a regular cadence is an important aspect of the governance structure. The communication cadence creates a “rhythm of the business” because it helps the parties establish a formal mechanism for managing the business. As with any team, regularly scheduled conference calls, team meetings, and face-to-face formal reviews are the grease for the wheels. The most successful teams have formal mechanisms (and informal protocols) for talking daily, weekly, monthly, quarterly, and annually.

The example in **Figure 8** (shown previously) suggests a communication cadence by suggesting the most senior tier Board of Advisors level meets quarterly, the joint operating committee meets monthly, and the operational teams meet daily.

A good rule of thumb is that the governance cadence should be shortened during the first year of the outsourcing relationship with the frequency changing once the parties establish a solid footing and the business is working smoothly.

5. Relationship Management

A good outsourcing relationship includes a Relationship Management Program that helps the parties integrate key aspects of their partnership into governance to ensure alignment of interests over time. For example,

- A bi-lateral view of performance - measuring end-to-end performance against Key Performance Indicators and Desired Outcomes
- Integrating the budgeting process into governance to ensure the economics of the relationship stay within the party's guardrails
- Integrating strategic planning efforts into the relationship (e.g., annual review/adjustment of Desired Outcomes and Key Performance Indicators)

6. Relationship Health Monitoring

A key part of *Relationship Management* is to define how the parties will monitor the health of your relationship. Successful Vested agreements almost always have a formal annual relationship health check – with the most progressive organizations doing a quarterly relationship health check conducted by an independent organization – often the parties' Standing Neutral.

Many organizations confuse a relationship health check with performance management. A relationship health check differs from monitoring performance because it focuses on monitoring the overall health of the relationship – in addition to performance. There is no "one-size-fits-all" relationship health check program, but typically a relationship health check program includes the following components:

- Monitoring how all parties are living into the intentions
- Monitoring how well the governance bodies are supporting the business
- Monitoring Trust and Compatibility levels (e.g., using a 360-degree Compatibility and Trust assessment)
- Monitoring the effectiveness of communication
- Monitoring satisfaction with the achievement of Desired Outcomes
- Monitoring the degree of WIN-WIN within the deal, i.e. if the parties experience the fulfillment of Desired Outcomes leading to mutually beneficial results & economics

7. Issue Resolution Management

Typically, outsourcing relationships handle issue resolution using two approaches.

First – and most obvious – is a formal "dispute" clause in the contract. This clause typically states how the parties should notify each other if a dispute arises and calls out if the parties must use mediation, arbitration or litigation (or a combination) for settling disputes. While this is good, it fails to establish a process for managing issues while they are small and preventing them from becoming formal disputes.

Second – many outsourcing relationships – especially business process, IT and facilities management outsourcing deals, view issue resolution through the lens of end-user complaints. For example, the service provider typically has a formal process for tracking end-user complaints – which often includes using a software management solution. While this is good, it is limited in focus and does not include a sound process for managing issues - or events – effectively that fall outside of end-customer complaints.

The best organizations embed a formal and bilateral issue/event resolution management process into their governance framework that focuses on resolving *all types of issues or events while they are small* – well before there is a formal dispute. A well-designed issue/event resolution process is proactive in nature and has three equally important components:

- Identifies the situation (classification of the issue/event)
- Determines the severity and degree of urgency
- Provides guidance/process for how the parties should resolve the situation

Resolving issues/events while they are small can prevent the need for more formal intervention such as arbitration or litigation. To enhance this process, we recommend the inclusion of a Standing Neutral for facilitation if an issue is not solved early in the issue resolution process.

Figure 10 shares an example from a facilities management outsourcing agreement.

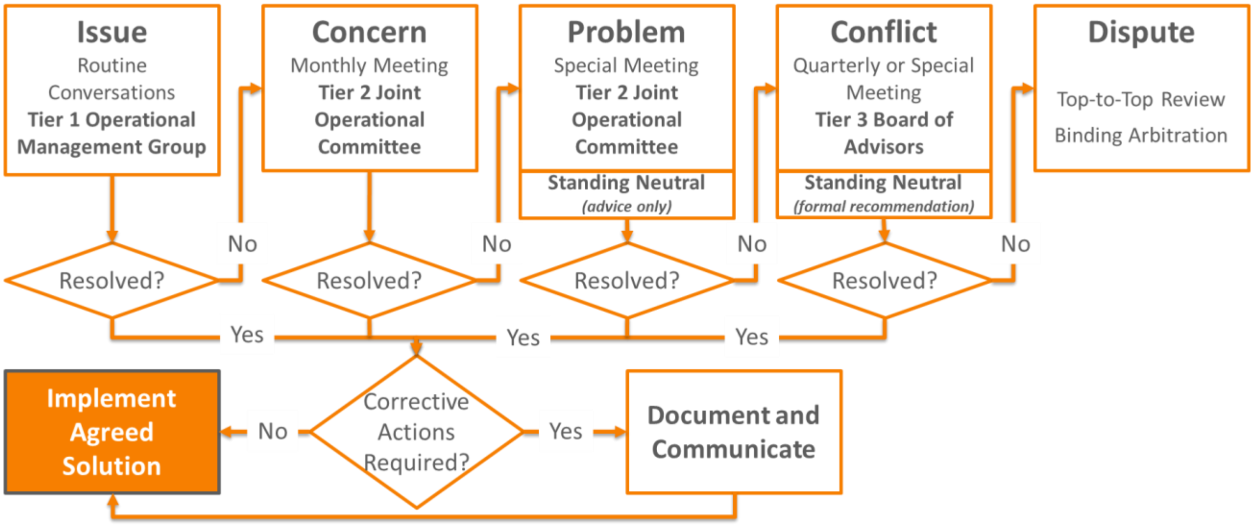


Figure 10

Research has shown that in most cases the Standing Neutral is not required to make a recommendation; however, when they do, the recommendation is accepted in 95% of cases. Continuous access to the Standing Neutral, not just when a problem arises, builds trust and confidence.[‡]

8. Continuity of Resources

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 and something UT researchers have coined as 'The New Sheriff in Town' Syndrome. We advocate that a well-structured governance framework should contain a process for ensuring continuity of resources, especially for Key Personnel. Below are some of the best practices we have seen for maintaining key personnel continuity:

- Mutually identify a limited number of personnel 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 the replacement of key personnel.

[‡] For more information about Standing Neutrals, see Unpacking Standing Neutrals white paper – an open-source white paper published by the University of Tennessee which is available at www.vestedway.com

- Use a formal escalation process for personnel mismatch concerns. For example, in one case the buying company had an employee that denigrated 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.

9. Onboarding

Onboarding is defined as the act or process of orienting and training a new employee.[23] Onboarding is essential for Key Personnel essential to the success of the outsourcing relationship, but should also extend to all team members and potentially other business stakeholders or customers that interface with the supplier

Because each outsourcing relationship has unique aspects, there is no "one size fits all" onboarding program. However, there are several best practice tips that you can leverage.

- Use different approaches for different target audiences which tailors the message to the audience. For example, in a Business Process Outsourcing (BPO) agreement the parties tailored onboarding material based on the type of team members. Executives, Key Personnel and Site Leaders all had customized onboarding paths. While some of the onboarding material was the same, other onboarding training and materials were unique
- Help new team members understand the outsourcing partners' overall Statement of Intent (Shared Vision, Guiding Principles, and Intended Behaviors) – the key aspects of the agreement they will be responsible for
- Emphasize both the Vested mindset and the hard skills needed
  - Learning how to manage by insight – managing the business with the Service Provider, not just managing the Service Provider
  - New processes such as Pricing Model maintenance
- Use sound communication and change management techniques to make relevant concepts sticky/easy to learn

A key point to designing a good onboarding program is to remember the program is not a simple once-and-done initiative. Onboarding should not only be done during the initial rollout of the agreement, but should also be done throughout the life of the agreement as new employees come on board.

Transformation Management Element

To succeed, a Vested agreement should include *Transformation Management* processes to help an organization stay aligned in a dynamic business environment – allowing the parties and their outsourcing agreement to evolve in a controlled manner. The Macmillan Dictionary defininitions are:

1) "Transformation" is a change into someone or something different, or the process by which the change happens.
2) "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 regarding people (someone) and processes (something).

The *Transformation Management* Element of an agreement should contain different types of transformation:

1. Initial Transition Management – documenting a common understanding of how the initial transition of workscope is managed and how a wider "What's-in-it-for-We" mindset is to be achieved in the wider organizations. This will ensure the relationship gets off to a good start by establishing a clear understanding of the transition.
2. Innovation Management, including
   - Continuous Improvement – documenting the expectations for managing day-to-day continuous improvement efforts or business problems that arise.
   - Invention/Innovation – guidelines and a process for managing larger-scale transformation initiatives.
   - Structured Innovation Management Process – establishes the philosophies and the protocols and processes outlining how the parties will manage transformation initiatives.
3. Contract Change Management – process for updating and managing any changes to the actual agreement.

A brief overview of each follows:

1. Initial Transition Management

In some cases, an outsourcing agreement may represent a first-generation outsourcing initiative where a company-operated function is transitioned to a new service provider. In other cases, the transition could be from an old service provider to a new service provider or it may simply entail a scope change and a new way of doing things between the same parties. If there are considerable workscope shifts between the parties, your Vested agreement should include a formal agreement on how the parties will manage the initial transition.

Service providers are typically very knowledgeable regarding transitions and many of the larger companies have formal "transition" or "ramp-up" teams solely focused on a successful ramp-up. It is also fairly common to have a full-time project manager assigned to guide the parties through the transition period, but it is also important to make sure that your transition team includes a significant number of resources who were in the initial sourcing/solutioning/contracting phase. This is known as a "stay-behind team". Having a stay-behind team will ensure continuity of resources and prevent common complaints about a misalignment between what was "bought vs sold" as the solutioning team pulls out after the sales/contracting phase. The most successful outsourcing agreements have between 50-80% of the team members stay behind, with a minimum of 1/3 of the core team who participated in the solutioning/contracting stay behind as part of ongoing governance. We also recommend your agreement include a clear understanding of the roles, responsibilities, and major time frames for transitioning the work.

In addition to outlining transition resources, your agreement should also document the organization's transition plan. In most cases, the contract simply refers to the high-level transition plan (vs incorporating a detailed plan). Your transition plan should include the following:

- Change management efforts, including how to roll out initial Onboarding as described above in Relationship Management #9
- Assumptions
- Target transition schedule, including
    - Key activities, milestones, and decision points
    - Key dependencies
    - Performance criteria to be measured and achieved at each stage of the roll-out
    - Go-live criteria
- Quality control and delivery management procedures
- What each party company must provide or other special requirements (such as not transitioning during peak months)
- Risk assessment
- Testing methodology and criteria
- Transition Project Management protocols, such as progress reviews and issue resolution (ideally using the same process outlined in the *Relationship Management* Element

As you begin your transition, we recommend operationalizing *Relationship Management* mechanisms as one of the first key milestones of the transition. Getting the governance structure operationalized enables the parties to have the governance basics in place to handle any issues that come up during the transition. For example, the transition team will test the issue resolution process and cadence outlined as part of the *Relational Management* Element.

It is important to note that in some cases organizations are simply evolving their outsourcing relationship and do not really go through a traditional transition to ramp up the supplier. Often organizations overlook the fact there will still be a need to transition new aspects of the agreement. For example, consider Dell and FedEx. The companies had worked together for eight years in a transactional Preferred Provider model. When the parties shifted to a Vested agreement, they did not have to physically transition any of the work, but they did have to transition much of the way they were working to follow the Vested Five Rules, such as shifting from a transactional pricing approach to implementing a transparent pricing model with incentives.

2. Innovation Management

A Vested agreement is designed to reward service providers for investing in innovative and transformative initiatives 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 economic growth comes from these innovations.[24]

A Vested agreement includes three components for managing innovation; continuous improvement, innovation/invention, and a structured innovation management process.

Innovation can be viewed as a continuum – with continuous improvement on one end and invention on the others. We differentiate between Continuous Improvement and Invention as illustrated in **Figure 11**:

Figure 11

Continuous Improvement

The first component of innovation management is a continuous improvement program. Continuous improvement programs come in all shapes and sizes, with Six Sigma and Lean programs being two of the most popular approaches. Regardless of the continuous improvement approach 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 programs. 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 promptly. Develop a root-cause analysis process to highlight – rather than hide – how processes may not be 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.

End User/Customer Satisfaction Focused - A good continuous improvement program seeks to make improvements that benefit end users/customers. Customers may be defined as end users (such as the case with call center outsourcing) or internal customers (such as the case with back-office outsourcing where the customer is an employee wanting to get an invoiced approved). Getting direct feedback from “customers” helps keep the parties aligned on how the users define success.

Benchmarking - In many cases, organizations 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 the business value delivered. While we support benchmarking, we caution that benchmarking efforts should not include the traditional approach to compare a service provider’s costs on an ‘apples-to-apples” basis because an outcome-based economic model is very different from conventional transactional deals where it is easy to compare price per transaction.

Invention

Totally new inventions are rare, but you will likely have many larger ideas that need investment and are much broader than continuous improvement efforts. Most people think of these are transformation initiatives.

As mentioned previously, a Vested agreement is designed to reward service providers for innovative ideas and investments that deliver results against the Desired Outcomes. It is essential that the agreement factor in how the organization will share any value created with the service provider to reward them for their role in implementing transformation initiatives. This should include a clear link to the pricing model in the agreement.

Fostering a culture of innovation is essential for success. Below are several proven best practices for creating a successful transformation program.

- Never say “no”, but rather “how can we?”
- Use “skunkworks” teams to tackle specific challenges
- Use pilots to test new concepts
- Leverage “startups”
- Make it fun/Involve people

Structured Innovation Management Process

Continuous innovation management relies not only on the parties’ ability to collaborate and generate ideas, but also on their ability to implement ideas that deliver value. The problem isn’t a dearth of ideas; it is in their execution.

Following are some proven tips for creating a structured innovation management process.

- Keep ideas in an “innovation pipeline” to track the progress of how ideas move from idea through approval to pilot to full-scale implementation.
- Develop a decision framework, criteria and process for selecting ideas to implement. Clearly document desired hurdle rates for any transformation initiatives and create a formalized process teams can use to help them capture their ideas and quantify their ideas.
- Integrate your innovation management process into your tiered governance structure/cadence to ensure timely review and approval of ideas.

- Measure how many ideas are generated relative to how many get implemented. The best companies implement a large number of ideas – as much as 90%. Develop a Pareto chart[25] of reason codes as to why ideas do not get implemented.
- Create an “idea warehouse” to capture/store any ideas that are not approved; just because an idea was rejected once does not mean that it is not feasible to bring it forward again.

4. Contractual Change Management

A Vested agreement should contain a formal contract change management process that allows either party to initiate a formal change to the agreement. Typical events that trigger change requests include but are not limited to:

- Changes in applicable law with 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 workscope 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 increases in any reporting requirements
- Changes in assumptions outlined in the pricing model

Adopting a contract change management process is most crucial during the transition phase. 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 any updates to the agreement.

Exit Management Element

Unfortunately, relationships can fail – or simply just fizzle out – no matter how promising the start. No matter how well-written the agreement, business and market conditions can change suddenly, people move on, projections fail to pan out, and companies change hands. No matter what reason the relationship ends, all outsourcing agreements should include a well-thought-out exit management plan.

Outsourcing agreements often address what happens at the end of the agreement purely from termination for convenience or termination for cause clauses. However, these clauses do little to set forth how to unwind the business relationship in the event of an exit. In fact, they 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 service delivery back in house or to another service provider. 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. A good exit management plan includes the four components highlighted below.

1. 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 workscope expires. The termination notice must be specific about the services included (including processes and geographies) and 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.

2. 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.

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

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 the continued performance of services in an orderly manner that minimizes disruption in the operations during the transition period
- Preparations for transferring knowledge regarding the transferred services
- Support for transferring resources used in the delivery of services
- Communication plans for external customers and all affected 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
- Lists of confidential information, equipment, materials and IP so it can be returned or destroyed

3. Exit Team

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
- Coordination with the respective company and service provider organization members to sustain continued service delivery as per SOO requirements in the agreement

4. 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 affecting the delivery against the plan
- Identify potential risks to the plan
- Detail key actions that need to be taken by the various stakeholders to facilitate a smooth transition

CONCLUSION

Getting governance right in any contract is important, but getting it right in an outsourcing relationship is critically important because the service provider in essence becomes an extension of the company outsourcing.

The good news is that companies and industry organizations are starting to understand the need to design and institutionalize sound governance practices as a critical component of outsourcing relationships. And organizations such as the University of Tennessee (UT) are spending significant effort doing research into just what is "good governance." For the last 10 years, UT faculty have worked with Vested Centers of Excellence around the world who have provided field-based research and support to help UT pilot various governance mechanisms.

This paper set out to unpack outsourcing governance and share the learnings from over a decade of research on outsourcing governance. We hope you found this white paper, framework, and practical guidance useful in helping you apply governance structures to your outsourced relationship. While the paper started with five key themes stemming from governance in theory – we hope the real value is in how to put these theories into practice. In Part 2, we summarized the key Elements of a sound governance structure. We hope you find the one-page "cheat sheet" **(Figure 5)** an easy-to-use rule of thumb for structuring a governance program – regardless of the type of Sourcing Business Model used.

For those working in complex or high-stakes outsourcing relationships that demand collaboration and innovation, we hope Part 3 helps to further unpack what good governance means for a highly strategic Vested outsourcing agreement by helping you see a high-level explanation of the various design principles used in crafting a Vested agreement.

Still want to continue to learn more? For an even deeper dive, we highly recommend you consider taking the University of Tennessee's *Creating a Vested Agreement* online course which provides a deep dive into each of the governance design principles, shares examples from successful outsourcing agreements, and includes a comprehensive toolkit for helping you work through the design principles.

As we close, we would like to challenge you – as outsourcing professionals – to evaluate your outsourcing governance practices and – if needed – rethink your approach to how you are working with your strategic outsourcing partners.

Last, keep in mind that governance is not free. Recall from Part 1 that the average cost of outsourcing governance is 4.2% of the contract value with the benchmark for complex deals needing to be resourced at up to 8%-10% of the contract value. While governance may not be free. the University of Tennessee researchers have chosen to make this white paper freely available as part of the Creative Commons. Feel free to share this paper with your colleagues, clients and suppliers

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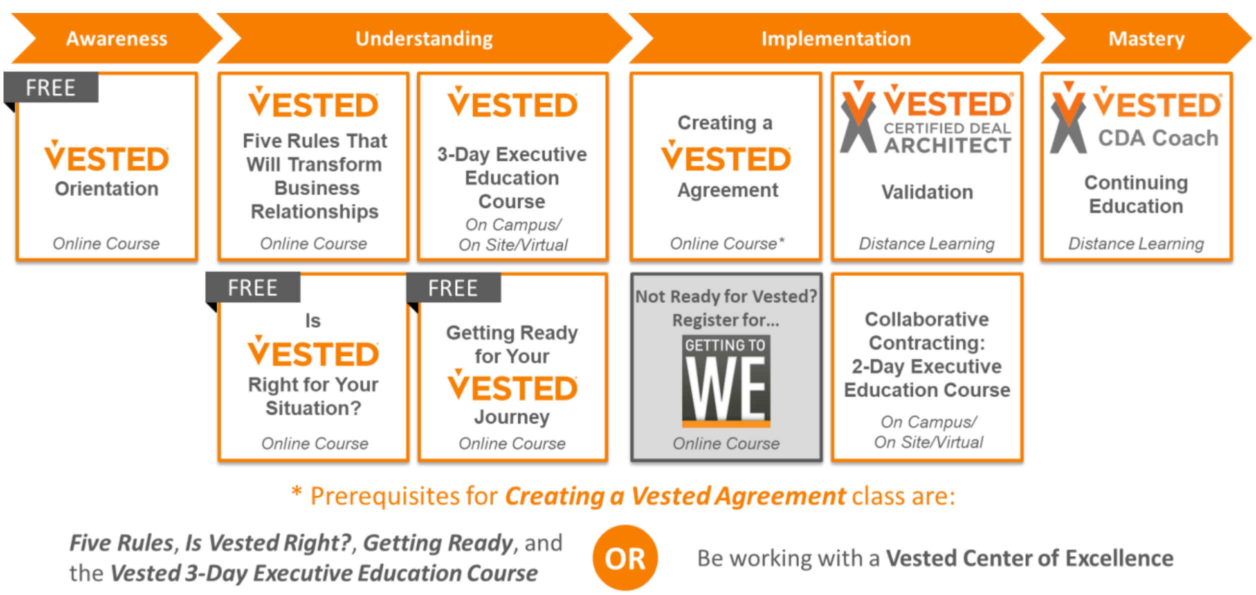
FOR MORE INFORMATION

The University of Tennessee is highly regarded for its Graduate and Executive Education programs. Ranked #1 in the world in supply chain management research, researchers have authored seven books on the Vested business model and its application in strategic sourcing.

WHY | WHAT | HOW | WHEN | NEGOTIATE THE RELATIONSHIP | TELLS THE REAL STORIES

We encourage you to read the books on Vested, which can be found at most online book retailers (e.g., Amazon, Barnes and Noble) or at [www.vestedway.com/books.](http://www.vestedway.com/books)

For those wanting to dig deeper, UT offers a blend of onsite and online courses including a capstone course where individuals get to put the Vested theory into practice. Course content is designed to align to where you are in your journey ranging from Awareness to Mastery. For additional information, visit the University of Tennessee's website dedicated to the Vested business model at http://www.vestedway.com/ where you can learn more about our Executive Education courses in the Certified Deal Architect program. You can also visit our research library and download case studies, white papers and resources. For more information, contact kvitasek@utk.edu.



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