

LEGISLATING FOR SUCCESS

How to Create a Sourcing Contract and Operating Environment that will Ensure Sourcing Success

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This EquaTerra briefing paper looks at some of the pitfalls to avoid when negotiating a contract, and highlights three main areas companies need to provide for when legislating for success: creating contract flexibility, putting in place good governance structures and implementing proper change controls.

Although the sourcing market is maturing rapidly, many companies still remain naive as to the contractual elements that can make or break a sourcing relationship. Often the general environment during the contracting phase of a sourcing engagement is one of opposition and conflict. But there are no winners in aggressive negotiations as they lead to unworkable contracts and set a negative tone for future working relationships.

Companies must recognize the need to negotiate a good deal, but not too good. Contracts need to be 'fair and commercially reasonable' meaning the provider must be able to make money while the buy-side company must be able to save money. Although this seems logical, the lawyers who negotiate for the buy-side companies often forget this.

1. Creating a flexible contract

Companies should think logically about how they will run the deal in the future. Rights must be protected but the details must be workable. Flexibility needs to be built into the contract to ensure companies can readjust price points and re-examine methodologies. Being too detailed in the wrong places can cause breakdown in communication and make the contract unworkable. In one contract, for example, the lawyers set tough provisions for hourly wage rates, who could do which tasks and when these could be adjusted. The provisions were so complicated they were unworkable for the provider and, ultimately, resulted in it breaching its contract, which led to deterioration in the relationship. Building in flexibility means being able to look at the practical workings of the contract on a day-to-day basis. There are four key points a contract should address to make it flexible:

Allow for minor change: Contracts should be active and not set in stone. They should enable the parties to re-examine key points on a regular basis, for example, promoting and modifying service levels, or managing succession plans for key personnel. Inevitably a successful service will result in individual staff developing and moving on to new challenges. This is clearly a success that should be encouraged in order to attract quality new recruits. Often clauses concentrate upon key staff retention and locking staff in, rather than the development of succession plans, skills planning, and the maintenance of a robust service team through opportunity.

Focus on milestones: Companies should focus on milestones that ensure the appropriate level of management scrutiny, and that are supported in the contract by detailed acceptance criteria. Failure to provide such criteria prevents the parties from achieving agreed outcomes, which in turn puts pressure on the relationship. Assuming the acceptance criteria are in place, then milestone payments can be made contingent upon defined successful completion.

Opportunities also exist to place a successful twist on failure-oriented legislation. Although Service Level Agreements (SLAs) focus on failure, they can also be used to drive success. A variety of earn-back provisions on service credits may be employed, agreements can be drafted that allow performance thresholds to be raised or lowered, and facilities that allow the introduction of new service levels can be incorporated.

Benchmark for market/business change: As business cases change, or markets change, contracts need to be flexible enough to allow for changes to services, service levels and price points. Effective benchmarking should allow for changes to be made to the contract. For example, if a market moves dramatically by 10 or 15 percent against agreed benchmarks, then the contract should allow for both parties to come to the table to discuss changes in price points. The key is to remember both sides need to win and to have an open discussion about how this can be achieved.

Promote innovation: Success-based legislation constitutes more than just continuous process improvement or a gain-

share mechanism. Innovation provisions, where possible, should be mandated into a contract. The contract should embody clauses that cause the parties to actively manage, reevaluate, and reinvent. Specific contract clauses that support innovative behavior and continued activity may include: client advocacy and support of sales initiatives in return for strategy assessment of current service, technology developments, and new BPO initiatives inside and around the scope of the services. These types of clauses are already in use but they are vague; to correctly incentivise both parties, they need to be linked and regularly reassessed.

While creating a flexible contract is key to legislating for success, companies need to beware of creating too much flexibility or providers will run roughshod over their organizations and potentially impact the organization's business case for the transaction. There is a fine balance to be struck, which is where it is useful to talk to those companies who have done it before, or use advisors to give a good perspective on what is acceptable and the best practice in the marketplace.

2. Specify good governance structures

A good contract will make provisions for governance structures and the role and responsibilities that team has for ensuring a successful and innovative relationship is maintained. A layered governance structure will detail how the communications should be run between both parties and enable any issues or problems to be resolved early. For example, a governance structure should include a steering committee of top executives who meet twice a year, an operations governance team that meets monthly to review performance, and an account relationship governance team that meets weekly, as well as a transformation or innovation owner.

Not only does the governance team need to understand the contract and how it should be practically implemented, they must also communicate regularly with the other side to ensure both parties know how contract provisions are being met. It is often advisable to have individuals who were involved in the creation and structuring of the transaction to have an ongoing role in the governance organization so as to provide continuity and consistency with original tenets and underpinnings of the transaction.

3. Provide for change control

The failure of sourcing relationships and contracts is often placed at the feet of the provider. But the buy-side organization has a critical role to play in implementing the right change controls within its organization to help the new order succeed. The company must have realistic expectations about what can be achieved in years one and two, as well as a realistic end goal. By implementing proper change controls, expectations can be set and met.

Set clear expectations: Companies need to be clear on their retained responsibility and unrealistic expectations – are they enforcing the contract appropriately or not. Senior executives need to recognize that they are responsible for what gets done, not how it is done. They are now buying into a set of given services, at a particular price, which should be delivered to a specified level rather than delivering the services themselves. This may in turn require that the organization needs to acquire different retained skills. At the same time, the retained organization must be aware of unrealistic expectations and the appropriate time to discuss issues with suppliers.

Define lines of communication: The company's senior executives are responsible for communicating to its workforce how the new order will work and what should be expected from it. Often, outsourcing deals fail on the misunderstanding of what employees believe they should be receiving against what the deal is really about. Ensuring proper internal transformation and expectations throughout the organization is key to success. For example, employees need to know how outsourcing will change the way they do business or their job, what to expect in the new order and how they are locked in to certain elements or not. As part of this, organizations need to make sure they have a program office for internal change and that its activities are properly funded to enable real change.

The effect of legislating for success and putting in place a flexible contract, good governance structures and proper change controls will help organizations obtain the most return from their sourcing investment. One of the central axioms of sourcing is to access world-class capabilities of a provider to make certain that a desired future state is achieved and continues to evolve. With this in mind, the contract must legislate for the provider and the organization to focus on that evolution by allowing for continuous change and improvement.

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passionate about providing objective, conflict-free advice to our clients, which has fueled our exponential growth over the past three years. We help clients achieve significant cost savings and process improvement with outsourcing, internal transformation and shared services solutions. It is all we do.

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