



**EXCITED ABOUT ALL THOSE SAVINGS FROM OUTSOURCING?  
DON'T FORGET THE RISKS...**

By Glen Wedel, KPMG

**IMAGINE THIS:** you've just presented the business case on your company's first venture into outsourcing. The numbers look great. Everyone's excited. Then the CEO looks you in the eye and says, "This looks like a great opportunity. But what are the risks?"

There are many valid and important business drivers leading organizations to consider outsourcing. Potential cost savings, increased flexibility, capital cost avoidance and turning fixed costs into variable costs are achievable benefits. But with outsourcing comes new and important risks that must be managed and mitigated, but are often overlooked or underestimated. If off-shoring is involved, not only does the potential financial benefit increase, but the risk also increases.

You could respond to your CEO by breaking down the risks into the following six key categories.

### Strategic Risk

Strategic risks refer to how well an organization has aligned its outsourcing activities with its overall business strategy and then put the resources and structure in place to execute. This includes garnering sufficient internal executive support and involvement, and ensuring that the service provider understands and is aligned with the service recipient's business strategy.

For example, if your organization's strategy is to be the low-cost producer, but the vendor's strengths and strategy for profitability is driven by providing value-added services or encouraging system changes and enhancements, there is a misalignment that will almost undoubtedly lead to frustration.

Additional strategic risks with off-shoring include lack of understanding of the local market, inadequate scale to drive targeted benefits, political stability in some countries and potential public relations issues.

### Operational Risk

Operational risk refers to the risk of the vendor to actually deliver the outsourced service to the expected standard, whether that be in terms of quality, quantity or timeliness. It also refers to the ability of the vendor to respond or recover from unforeseen events. Within this category of risk there are some elements that jump out in terms of criticality.

All too often in the rush to meet some artificial deadline to get a deal signed, companies view service levels and performance measures as "details" that can be worked out later. This could not be further from the truth. Service levels and performance measures are the heart of what makes outsourcing relationships work or fail. Vendors will focus in on how they will meet the service levels. If the service levels are poorly defined, or cannot be measured appropriately, you run the risk of regular friction in managing the relationship with your outsourcer. Your organization could also find itself facing potentially costly amendments to the outsourcing deal to change the service levels to meet your needs.

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When off-shoring is involved, additional operational risks are often present such as high turn-over rates for staff and infrastructure instability. These risks are harder to mitigate and make selection of the right vendor even more important than for a domestic outsourcing.

### Financial Risk

Let's face it, the vast majority of organizations outsource for some short-term or long-term financial benefit. It doesn't matter if those savings are in real dollars or cost avoidance, financial benefit is in there somewhere. But there are risks associated with the actual cost of vendor provided services failing to meet business case projections.

Financial risk exists throughout many elements of the deal, starting with transition. It is not uncommon for surprises to appear during the transition, which can drive cost up for the vendor and service recipient. Knowing this, vendors will attempt to structure the transition terms to push unexpected costs back to your organization. Additionally, organizations often underestimate the volume of resources required to support their transition responsibilities. Transition is a lot of work for both parties. Be ready and build in some contingency.

During the life of the deal, financial risks exist around the change-oriented elements of the deal, such as service recipient initiated process and system change requests. Traditionally, the volume of change is limited by supply side constraints within, for example, your IT organization. But in an outsourced environment, theoretically, the supply side constraint is removed and, without good demand management, change-oriented costs can skyrocket, dramatically eroding your estimated savings.

Another financial risk involves the future unfolding in a scenario not predicted when the pricing mechanism in the deal was designed as part of the initial contract. This risk can be mitigated to some extent using comprehensive sensitivity analysis during design, to create pricing models that capture a broader range of scenarios. Additionally, you can build in specific checkpoints during the contract's life to allow for resetting of pricing based on shifts in the business environment. This often includes benchmarking.

If off-shoring is involved, there are additional financial

risks around taxation and currency fluctuation that require additional expertise to manage and mitigate. Engaging the right tax and treasury professionals is a critical mitigation strategy.

### Regulatory Risk

Regulatory risk is caused by violation of laws, rules, regulations, prescribed practices and ethical standards. One of the more recent examples of this relates to Sarbanes Oxley compliance and the impact of outsourcing. Many auditors are flagging outsourced controls as an area of concern and companies are finding it challenging to figure out how to monitor and validate the required controls that are, in fact, in place at their vendors. Your internal controls experts should be engaged to make sure the appropriate contract language is in place to ensure compliance.

Internationally there are additional complexities in dealing with local legislation and regulations, including taxation and labour laws that must be considered. This requires you to know the off-shoring country to ensure you are in compliance.

### Technology Risk

Technology is critical to the delivery of the outsourced service and often for communication between the service recipient and the vendor. During transition, when responsibility for these systems is being migrated, technology risk is significant and requires careful planning and execution to mitigate.

Additional technology risks arise when end-user requirements are not well defined or are poorly communicated to the vendor. This refers to both current needs and the flexibility to meet future needs.

When off-shoring is added, technology risk increases. More effort is required in assessing the true technology capabilities of the vendor and the overall infrastructure of the city or region the vendor is located in. This further complicates disaster recovery planning and security requirements. If software development is involved, then there can also be risks associated with theft of intellectual capital. This further highlights the needs for extensive due diligence in vendor selection.

### Reputational Risk

Reputational risk refers to the potential impact to the organization's reputation resulting from the vendor's actions. This can occur in varying ways and with various stakeholders. High profile examples occur when vendors or their employees violate privacy or security requirements, with significant press given to off-shoring violations.

However, this can also refer to the organization's reputation with customers should the vendor fail to perform. "It's our outsourced vendor's fault" will not be an acceptable answer to your customers. Your CEO is going to want to know you have done the appropriate due diligence on the vendor's ability to deliver and that you have the right per-

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formance management program in place to monitor performance.

If you have thought about these risks, you might also be able to give your CEO guidance on how you plan to mitigate them. One of the critical success factors for successful outsourcing requires a comprehensive risk-management program. This program needs to cover the entire outsourcing lifecycle. The program requires input from experts from various disciplines, including operations, information technology, finance, tax, treasury, legal, internal audit and others. The risk-management program requires both a sponsor and an "owner" who actively manages the risk program throughout each stage of outsourcing.

The earlier the risk-management process begins, the greater the opportunity for the organization to mitigate risk or transfer risk to the vendor during the contract negotiation stage of the lifecycle. While not all risks can be addressed with smart contract terms, it can help organizations mitigate many key risks. Organizations considering outsourcing should also consider engaging the vendor in discussion around risks and concerns early in the process. In some cases, the vendor will have dealt with some of the risks previously and will be able to recommend courses of action. In other cases, they can work with the service recipient to develop joint strategies to identify, monitor and manage risk.

The main lesson learned: organizations that acknowledge and proactively address the risk of outsourcing are much more likely to have a successful deal than those that do not. So instead of being blinded by all those dollar signs related to savings, use them as motivation to put the right risk management program in place. Your CEO will appreciate your diligence. Otherwise you might find all that black ink turning red, and you know your CEO won't appreciate that.

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