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MANAGING THE RISKS OF OUTSOURCING AGREEMENTS

Ralph L. Kliem

Outsourcing relieves an organization from the burden of carrying out complex activities. It also relieves an organization over its control of those activities. An organization can minimize this loss of control by managing certain risks associated with outsourcing before it enters into an outsourcing agreement.

OUTSOURCING IS NOT NEW. For decades its popularity languished in a variety of forms. In the 1990s, however, it became very popular, although enthusiasm for it has stabilized. Outsourcing is, of course, contracting with another company to deliver services that would be normally offered in-house.

Outsourcing offers several advantages, such as enabling existing staff to concentrate on core competencies, focusing on achieving key strategic objectives, lowering or stabilizing overhead costs, obtaining cost competitiveness over the competition, providing flexibility in responding to market conditions, and reducing investments in high technology.

There are several disadvantages, as well, to outsourcing agreements. Those include becoming dependent on an outside supplier for services, failing to realize the purported cost savings from outsourcing, locking into a negative relationship, losing control over critical functions, and lowering the morale of permanent employees.

Executive management is increasingly recognizing that sometimes the disadvantages of outsourcing outweigh the advantages even after an agreement has been signed. Many companies are canceling outsourcing agreements, renegotiating agreements, or hiring their own staff to provide in-house services once again.

There are all sorts of reasons for having second thoughts, including arrogance or uncooperative behavior of the vendor, competitive advantage in the market no longer exists, costs of the services are too high, quality of the services is inadequate, and types of services are unnecessary.

Unfortunately, many companies could have avoided problems such as these with their outsourcing agreements if they took one effective action: perform a meaningful risk assessment.

RISK MANAGEMENT 101

Before discussing the specific types of risks with outsourcing agreements, a rudimentary knowledge of risk in general is necessary.

Risk is the occurrence of an event that has some consequences. A *vulnerability* or *exposure* is a weakness that enables a risk to have an impact. *Controls* are measures that mitigate the impact of an event or stop it from having an effect. The *probability* of a risk is its likelihood of occurrence (e.g., 60 percent chance of happening). The *impact* of a risk is its degree of influence (e.g., minor, major) on the execution of a process, project, or system.

The basic idea is to have controls in place that minimize the negative consequences of a "bad" outsourcing agreement, known as risk management.

Risk management consists of three closely related actions:

- risk identification
- risk analysis
- risk control

Risk identification is identifying risks that confront a system or project. *Risk analysis* is analyzing data collected about risks, including the impact and probability of occurrence. *Risk control* is identifying and verifying the existence of measures to lessen or prevent the impact of a risk.

Risk management for outsourcing agreements offers several advantages. It helps identify potential problems with agreements. It enables one to develop appropriate responses to those problems. Finally, it helps to better identify which mission-critical functions to retain and which functions to outsource.

Despite the advantages of risk management, there several reasons why it isn't done. One, it is viewed as an administrative burden. Two, the understanding and skills for conducting risk

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management are not readily available. Finally, the information required to do risk management is not available.

There are several keys to effective risk management. Risk management is best performed as early as possible, preferably before signing an agreement. It requires identifying and clarifying assumptions and addressing key issues early. It requires having the right people involved with the outsourcing agreement, such as subject matter experts knowledgeable about key issues.

One final caveat: Risk management is not a one-time occurrence. It must be done continually. The reason is that risk management involves taking a snapshot in time and using it to anticipate what might happen in the future. The conditions of an environment, however, may be extremely dynamic and may challenge the validity of assumptions incorporated when managing risk. Hence, it is wise to continuously revalidate risk management before, during, and after negotiating an outsourcing agreement.

RISK IDENTIFICATION

There are many potential risks confronting outsourcing agreements. These risks can fall into one of three categories: legal, operational, and financial.

Legal risks involve litigious issues prior to and after negotiating an agreement, such as

- including unclear clauses in the agreement
- locking into an unrealistic long-term contract
- not having the right to renegotiate the contract
- omitting the issue of subcontractor management

Operational risks involve ongoing management of an agreement, such as

- becoming too dependent on a vendor for mission-critical services
- being unable to determine the quality of the services being delivered
- not having accurate or meaningful reporting requirements
- selecting a vendor that has a short life expectancy
- being unable to assess the level of services provided by a vendor
- having a vendor fail to provide an adequate level of services

Financial risks involve the costs of negotiating, maintaining, and concluding agreements, such as

- not receiving sufficient sums for penalties and damages
- paying large sums to terminate agreements
- paying noncompetitive fees for services

These categories of risks are not mutually exclusive; they overlap. However, the categories help to identify the risks, determine their relative importance to one another, and recognize the adequacy of any controls that do exist.

The risks vary, too, depending on the phase in the life cycle of an outsourcing agreement. There are essentially seven phases to an outsourcing agreement:

1. Determine the business case for or against outsourcing.
2. Search for vendors.
3. Select a vendor.
4. Conduct negotiations.
5. Consummate an agreement.
6. Manage the agreement.
7. Determine the business case to decide whether to renew, renegotiate, or terminate a contract. Exhibit 1 shows a sample of some of the risks that could exist for each phase.

EXHIBIT 1 A Sample of Risks in Each Phase

Phase	Risk
1. Determine the business case for or against outsourcing	Using incorrect data
2. Search for vendors	Using a limited selection list
3. Select a vendor	Entering biases into the selection
4. Conduct negotiations	Not having the right people participate in the negotiations
5. Consummate an agreement	“Caving in” to an unfair agreement
6. Manage the agreement	Providing minimal expertise to oversee the agreement
7. Determing the business case to renew, re-negotiate, or terminate the contract	Ceasing a relationship in a manner that could incur high legal costs

RISK ANALYSIS

After identifying the risks, the next action is to determine their relative importance to one another and their respective probability of occurrence. The ranking of importance depends largely on the goals and objectives that the agreement must achieve.

There are three basic approaches for analyzing risks: quantitative, qualitative, and a combination of both.

Quantitative risk analysis uses mathematical calculations to determine each risk's relative importance to the others and the probabilities of occurrence. The Monte Carlo Simulation technique is an example.

Qualitative risk analysis relies less on mathematical calculations and more on judgment to determine each risk's relative importance to the others and the probability of occurrence. Heuristics, or rules of thumb, is an example.

A combination of the two approaches uses both quantitative and qualitative considerations to determine a risk's relative importance to the others and its probability of occurrence. The precedence diagramming method, which uses an ordinal approach to determine priorities according to some criterion, is an example.

Whether using quantitative, qualitative, or a combination of tech-

EXHIBIT 2 Analysis Result

Risk	Probability of Occurrence	Impact
Unable to assess the level of services provided by a vendor	High	Major
Locking into an unrealistic long-term contract	Low	Major
Select a vendor that has a short life expectancy	Medium	High
Paying large sums to terminate agreements	High	Minor

EXHIBIT 3 Analysis Result

Preventive Controls	Detective Controls	Corrective Controls
Provide ongoing oversight during the execution of the agreement	Establish minimum levels of performance in an agreement	Renegotiate because of changing market conditions
Have the right to approve or disapprove of subcontractors	Maintain ongoing communications with the vendor	Indentify conditions for discontinuing a contract

niques, the results of the analysis should look like Exhibit 2.

RISK CONTROL

There are three categories of controls: preventive, detective, and corrective. *Preventive controls* mitigate a threat from exploiting the vulnerabilities of a project. *Detective controls* disclose the occurrence of an event and preclude similar exploitation in the future. *Corrective controls* require addressing the impact of a threat and then establishing controls to preclude any future impacts.

With analysis complete, the next action is to identify controls that should exist to prevent, detect, or correct the impact of risks. This step requires looking at several factors in the business environment that an outsourcing agreement will be applied, such as agreement options (e.g., co-sourcing, out-tasking), core competencies, information technology assets, market conditions, and mission-critical systems.

There are many preventive, detective, and corrective controls to apply during all phases of outsourcing agreements (see Exhibit 3).

After identifying the controls that should exist, one must then verify their existence for prevention, detection, or correction. Determining the controls that exist requires extensive time and effort. This information is often acquired through interviews, literature reviews, and by having a thorough knowledge of a subject. The result is identification of controls that exist and those that need improvement.

Having a good idea of the type and nature of the risks confronting an outsourcing agreement, the next step is to strengthen or add controls. That means deciding whether to accept, avoid, adopt, or transfer risk. *Accepting* a risk means letting it occur and taking no action. An example is to lock into a long-term agreement regardless of conditions. *Avoiding* a risk means taking action so as to not confront a risk. An example is to selectively outsource noncritical services. *Adapting* means living with a risk and dealing with it by "working around it." An example is a willingness to assume services when the vendor fails to perform. *Transfering* means shifting a risk to someone or something else, such as subcontracting.

TOOLS

The "burden" of risk management can lighten with the availability of the right software tool. Several tools now operate on the microcomputer and support risk identification, analysis, and reporting, or a combination of both. Choosing the right tool is important and, therefore, should have a number of features. At a minimum, it should be user-friendly, interact with other application packages, and generate meaningful reports. Some of the more popular packages include Opera™, RANK-IT®, and Monte Carlo for Primavera™.

AVOIDING A DISMAL FATE

Risk management plays an important role in living with a workable, realistic outsourcing agreement. Unfortunately, risk assessment takes a backseat before, during, and after negotiating an agreement. As a result, many companies are now renegotiating and canceling agreements. Some examples include large and small firms canceling long-term, costly agreements with highly reputable vendors. The key is to use risk assessment as both a negotiation tool and a means for entering into an agreement that provides positive results. ▲