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Management Update: Use Risk Analysis as a Guide to Better Sourcing Decisions

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ANALYSIS

Outsourcing can move some risks out of your company, but bring in others, like mismanagement of relationships. A risk analysis framework can help you manage these perils across all four stages of the sourcing cycle.

Business Risk Is Harmful

Business risk can harm profits, revenue, cash flow, assets, and financial or economic positions. Companies, ranging from the totally risk-averse to those that are willing to take risks, have various ways of dealing with business risk, while different business processes may demand different risk levels. Risk prevention, detection and mitigation require considerable management and investment. And the level of business risk that a company accepts in a process is a business decision, not a technical one.

A traditional approach to controlling and reducing any risk is to move it out of the business — but this may be costly. Service providers will make strategic and careful, high-level business decisions about how much to charge before taking over risks on behalf of clients. Outsourcing or buying services are seen as important in controlling and reducing risk, but they tend to be approached too optimistically. The reality is that sourcing services will reduce some types of risk, but create or increase others.

The New Risks

The new risks are mostly associated with:

1. **The service contract.** As the legal vehicle for binding the agreement, the service contract should, in principle, satisfy the expectations of both parties. But problems can occur for instance with terms and conditions, service-level agreements, statements of work or service schedules. For clients, these problems may be deficiencies in the services and their effects on business objectives. For providers, these may be inappropriate revenue and margins.

2. **A specific provider.** Risks may include financial troubles, a decline in competitiveness, lack of innovation or a growing cost structure.

3. **A specific service offering.** Some service offerings may be immature; others may have deficient delivery capabilities, suffer technology lock-in, or be less competitive or innovative.

4. **The overall service market.** The market may suffer through the impact of offshore sourcing or because of an adverse business climate, intense competition, immature players or provider consolidation.

5. **The ability to manage the service and the relationship to get what is needed.** This internal risk is very often underevaluated, as it's the main cause of dissatisfaction with outsourcing and services acquisition.

6. **The ability to change the service and the relationship.** External services need to be continuously adapted to the client's organization, business strategy and changing needs.

Often, enterprises will focus mostly on points 1 and 2, and, perhaps, on point 3. But all those complex issues are aimed at selecting a good provider and securing a strong contract. Very often, service relationships are unsatisfactory for both parties as a consequence of other unmanaged risk areas (see points 4 to 6).

Unfortunately, identifying, assessing and managing sourcing risks cannot be condensed into any one “point,” like a contractual clause or a single best practice. Best practices can assure that the contract covers every reasonable aspect of the relationship — from intellectual property protection to force majeure — but the contract itself cannot take account of market risk (point 4), the client’s relationship management skills (point 5) or, as yet, unknown requirements (point 6). Also, best practices, when choosing a service provider, cannot guarantee that the client’s original requirements were well defined, or that the client organization will appropriately change and adopt the new processes and solutions as a result of the services provided.

A Holistic Approach

Sourcing risk management requires a holistic approach and should be applied in a structured and coherent way to all four phases of the sourcing life cycle: Strategy, selection, negotiation and management.

Sourcing risk management is a key part of overall sourcing governance practices. It requires setting up a system of mechanisms to manage risks. These will be complementary across phases in the sense that a preventive mechanism in a particular phase will avoid occurrences of risk in a later phase. For example, a good process of due diligence reduces the risk of poor performance by the service provider.

But these preventative mechanisms may not catch all risks and may need to be complemented first by a detection mechanism then by a mitigation mechanism. For example, a service level with a penalty clause does not prevent the service from falling below the agreed level. It needs a service measurement to detect it and a specific action to restore the desired service level.

Risk Throughout the Life of the Sourcing Deal

In this research Gartner focuses on the governance of risk throughout the life of the sourcing deal, and the opportunity to use risk management as a guide in indicating the overall effectiveness of sourcing management. To do this, businesses should:

- Adopt a risk framework, which is usually aligned at corporate level. Different businesses have different frameworks to manage and control risk at the business level.
- Apply the risk framework as part of the sourcing strategy development (and any subsequent sourcing decision) to identify major sources of risk, and their overall probability and impact.
- Define how each identified risk can be further assessed, according to probability and impact, at each step of the sourcing deal. Businesses can also define how each risk is managed, according to best practices related to that risk at each stage, from a holistic perspective.

Risk evaluation tools should evolve so that they continuously check and balance the sound advancement of sourcing initiatives against business-defined acceptable risk levels, and support every go/no-go checkpoint. These would work in conjunction with other relevant elements that evolve from phase to phase in the sourcing cycle like objectives and priorities, statements of work, provider understanding and service-level agreements.

As examples, look at a couple of traditional sources of risk that show how the guidelines work. One is general and known as “natural hazard,” while the other is very specific to sourcing initiatives and is termed “unprofitable deal for the provider.” The guidelines make clear the interdependency within the proposed system of complementary mechanisms.

Natural Hazard

Typically external and unpredictable, this is usually a low-probability, high-impact risk. It is not sourcing related, although it must be accounted for, particularly in outsourcing deals.

Phase 1 — Strategy

Disaster recovery (DR) and business continuity (BC) must be a part of every sourcing decision. The priority of that objective will differ, depending on variables like service type, gap analysis (current state vs. desired state) and criticality to the business.

Phase 2 — Selection

DR and BC objectives must be part of the request for proposal and selection criteria. This item should be included in discussions with other clients as part of an active reference check. Providers' security standards, DR and BC processes, and boundaries of responsibility should also be discussed.

Phase 3 — Negotiation

The DR and BC sections must be included in statements of work and service-level agreements, and in relevant terms and conditions like force majeure, penalties, termination clauses, liabilities and audits. Project activities must be defined and contracted as part of the transition phase and to fill any gaps.

Phase 4 — Management

DR and BC plans must be updated regularly as a shared responsibility and process between client and provider. General testing of DR and BC should be run periodically on a global basis. Other, specific, security and continuity tests should be planned locally. Direct or third-party audits should be regularly applied to DR, BC and security issues.

Unprofitable Deal for the Provider

This is a typical, external and predictable source of risk. Its impact is proportional to the severity of the economic pain for the provider. And it helps underline potential ambiguities in identifying risks.

Phase 1 — Strategy

Sourcing initiatives, which are aimed at reducing costs, must start with a baseline evaluation. The client must retain the ownership of the business case, which will demonstrate convincingly if real savings can be expected and achieved. Asking providers "can you save me money on this budget?" is a sure sign of impending failure.

Phase 2 — Selection

The selection process must balance needs, requirements and quality with price. Price can be the main parameter only when comparing similar products or commodities. This is rarely the case in IT services.

Phase 3 — Negotiation

Terms and conditions, service-level agreements, statements of work, responsibility matrices and technical collateral are all required (and must be synchronized) to define the scope and quality of the service. All these elements should be factored into the business case of the provider and then into the contract pricing structure.

Phase 4 — Management

Requests for change from users or business units can directly affect provider revenue, cost and, therefore, profitability. However, innocent requests for changes can also have a sizable impact on the scale or scope of a project, and on project management processes. Best practices in this phase cannot automatically cope with risk management deficiencies made in previous phases, sometimes years before. Relationship management, change management and specific problem management procedures — and a flexible contract — must be in place to mitigate those risks.

Managing Risks

To manage risks, you cannot focus on each risk-control mechanism individually. Effective risk management requires that you use all of them to guide you through the four phases of the sourcing cycle, for they are all interconnected. The more you demonstrate the effectiveness of your guiding framework to risk management, the more your service provider will be willing to take over risks on your behalf — and the premium for doing so will be smaller.

After having established a quite satisfactory outsourcing relationship, a client said, “Now I understand what you were saying at the beginning: In outsourcing, the different aspects and details are all related, and important for the outcome.” This perhaps shows the importance of having a guiding framework to managing sourcing risks.

Bottom Line

- From the earliest phase of a sourcing strategy or decision, a risk framework must be used to track and manage major risks, and to select the best sourcing options.
- It should also underline where in the sourcing cycle a specific risk can be prevented, detected, mitigated and managed, and how this can be done.
- A thorough business case and risk framework will support the go/no-go decisions throughout the four phases of the sourcing cycle, and provide the best guide to managing your sourcing deals.

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For related Inside Gartner articles, see:

- “Management Update: Manage Risks When Selecting an ESP,” (G00122480)
- “Management Update: Avoid Deal Failure by Managing Sourcing Risks,” (G00122479)

This research is part of a set of related research pieces. See "Inside Gartner Top View" for an overview.

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