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Unpacking Labor Procurement

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A White Paper Challenging Industry Practices for Buying Labor Services

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Executive Summary

The buying and selling of labor as an industry started more than 60 years ago with the founding of staff augmentation companies whose service was to "rent" employees and equipment to clients. Since then, the market has grown dramatically to include deliverables-based work and total function outsourcing. Today, it is commonplace for companies to use both traditional staff augmentation and deliverables-based approaches for buying labor. In many cases, either method will satisfy what is needed. ***Today's challenge is for buyers to determine the best way to structure the purchase to achieve the best value.***

To understand how to address this challenge, University of Tennessee faculty members conducted interviews with representatives from 20 companies that buy or sell deliverables-based labor. The primary purpose of the research was to identify best practices and pain points in labor services procurement by better *understanding the acquisition process,* and more specifically, by *understanding how companies develop the requirements* for buying deliverables-based work.

The research relayed two common themes surrounding the pain points in the category; 1) a lack of consistency and clarity regarding the definitions, tools and processes used; and, 2) an inability to define deliverables-based requirements clearly and build effective deliverables-based agreements.

The authors also explore an innovative new sourcing model—Vested Outsourcing—and assess the potential for companies to apply Vested Outsourcing principles to address the pain points in the procurement of deliverables-based labor.

Our Disclaimer

This white paper—while based on interviews from our research—is an opinion paper. It is the writers' attempt to summarize the complexities and challenges faced by many of today's corporations when buying deliverables-based labor, and to present some fresh ideas on how best to manage them. Our experience in the labor category leads us to suggest that applying Vested principles can be a game-changer in the industry.

We highly encourage you to read the book *Vested Outsourcing: Five Rules that Will Transform Outsourcing* to learn more.

Background

Development of the Labor-buying Industry

The temporary services market has grown exponentially since its inception nearly 65 years ago. Among the first, if not the first companies, were Kelly Services (1946) and Manpower (1948), providing small yet specialized support for growing industries by "renting" employees and equipment. The companies started out in industrial northern Midwestern cities—Detroit and Milwaukee, respectively—and by the mid-1950s, both companies were nationwide.

As the decades passed, "temporary agencies", as they were called, expanded their offerings, with many creating an emphasis on specialization. In addition, businesses needed their workforces skilled in newer forms of technology. Staying competitive meant having the foresight to acknowledge trends in technical knowhow, and invest in people training accordingly.

Companies like Manpower and Kelly Services responded to these market changes. Manpower, for example, edged ahead in the industry by making a commitment to its clients to not only place staff where they were most appropriate, but to also provide the necessary training. Another necessity was diversification. Kelly services, which started as predominantly female office servicers for typing, copying and operating office equipment, expanded with investments in light industrial, healthcare, legal and scientific research divisions.

In 1990, Harvard Business Review published C.K. Prahalad and Gary Hamel's article titled "The Core Competence of the Corporation", which heralded an era of analysis and selection of true competencies inside corporations.1 Business gurus such as Drucker, Peters and Waterman also challenged companies to "Do what you do best and outsource the rest!"2 This triggered a rise in outsourcing of non-core functions, which shifted the emphasis from "renting" employees to "outsourcing" services. The trend has continued, with the largest deals being full-fledged "outsourcing" efforts and smaller deals typically being structured as labor contracts.

As the shift occurred, "deliverables-based" project work emerged in the space between the temporary labor industry and the outsourcing industry. Deliverables-based work first came into vogue with some service providers striving to sell "deliverables" or projects rather than hourly billable rates which could be easily commoditized using a rate card approach. At the same time, buyers were attracted to the "all-included" aspects of project pricing. In addition, much of the skilled workforce became more comfortable with the "contractor" employment concept.

It is now commonplace for companies to use both traditional staff augmentation and deliverables-based approaches for acquiring labor. Today's challenge is for buyers to best determine how to structure the purchase to achieve the best value and optimal success.

Getting Grounded: Definitions

Nearly every company that participated in our study expressed frustration with a lack of consistency and clarity around the definitions associated with deliverables-based procurement efforts. This section will thus provide some basic grounding on the appropriate definitions.

The labor category typically has two main segments; staff augmentation and deliverables-based labor.

Staff Augmentation is usually characterized by a named contractor, a specific skill set, an hourly, daily or monthly bill rate, and a service that is paid for based on time elapsed. Staff augmentation is also often referred to as contingent labor or temporary labor. For staff augmentation, the outcome or end-product is the responsibility of the buyer, as is the supervision of the work. In many companies, management of this segment is done in conjunction with Human Resources departments for position approval, candidate selection and screening, on- and off-boarding, and building and system access.

Deliverables-based labor refers to labor or services that are purchased and paid for based on the receipt of a work product, successful project completion, or other tangible outcome as opposed to payment for usage of the seller's time. Deliverables are defined with specific objectives, requirements, standards, tolerance levels, incentives, acceptance criteria, calculations, milestones or delivery dates.

Although the definitions above are widely accepted and understood between buyers and sellers of labor and services, the terms used to describe deliverables-based labor varies significantly between and even within companies. The most common terms used are deliverables-based, consulting, SOW (Statement of Work), services, project work, and complex services. We use the word 'deliverables-based' because it appears to be the most descriptive of the actual activity involved.

> Definitions of SOW: "… pre-determined scope requirements, approved by the business, total vendor accountability, milestone or deliverables driven; customer has acceptance criteria. I am managing the vendor, providing him with requirements, milestones, deliverables and he responds. I manage the supplier."
>
> *--Procurement Manager*

In deliverables-based deals, there is an implied risk on the part of the seller because the product must be accepted by the buyer before invoice and payment activities may occur. For that reason, deliverables-based labor purchases must begin with a clear requirements definition, otherwise, suppliers will opt for a safer payment based on elapsed time.

About the Study

Participants and Study Purpose

The researchers conducted interviews with representatives from 20 companies who buy or sell deliverables-based labor. Participating companies spanned various industries: financial, retail, healthcare, oil & gas, electronics/ IT, manufacturing, and services. A full 66 percent of the firms interviewed have annual revenues in excess of $10B.

Industry	# of Participants	2010 Revenues ($ Billions)
Financial	2	10
Retail	2	10-15
Oil & Gas	2	18-30
Electronics/technology	4	4-30
Transportation/Logistics	1	10
Healthcare/insurance	3	20-50
Manufacturing	1	20
Services (large firms)	2	20-35
Services (smaller firms)	3	50-100 million

Figure 1: Study Participants by Industry and 2010 $ Revenues

The study objective was to identify best practices and pain points in labor services procurement. The interviews covered the following three main topics:

- *The labor category* – This part of the research identified the size, labels and definitions used for staff augmentation and deliverables-based segments.
- *The buying process* – For this part of the study, we codified the buying process into a seven step process flow. For each step in the process we identified the influencers, barriers, tools, and compliance/leakage. We distilled our findings into insights around best practices and pain points in each step.
- *SOW development and negotiation* – Our primary effort was to understand how companies develop the specific requirements for buying deliverables-based work. This included understanding what tools companies were using, how companies collaborated internally and with suppliers to negotiate on the fair value of the deliverables, and how companies managed and paid for the deliverables once work had begun.

Labor Buying Practices Today

During our interviews, the respondents discussed their labor categories, buying processes, tools, templates, and negotiations methods.

Figure 2 below highlights the best practices and pain points discussed by study participants

BEST PRACTICES	PAIN POINTS
Clear labor categories for staff augmentation	Murky definitions for deliverables-based labor
Consistent tool for staff augmentation from need to payment	Disparate tools, unclear end-to-end line of sight on deliverables-based, manual connections to payment functions
Clear buying process for staff augmentation	Unclear or inconsistent process for deliverables-based labor
Collaborative requirements building; aligning interests with providers	Challenges defining requirements, lack of disciplined approach
Cross functional buying team sources suppliers and negotiates SOW	SOW “delivered” to Procurement for final terms
Project methodology and precise standards followed	Challenges developing measurement criteria, managing change control, and scope creep
High compliance, open management reporting	Significant bypass at sourcing and negotiations steps, light consequences for maverick spend

Figure 2: Best Practices and Pain Points Summarized by Study Respondents

Almost all of the companies interviewed expressed frustration in buying deliverables-based labor. Two common themes were 1) a lack of consistency and clarity regarding the definitions, tools and processes used; and 2) an inability to clearly define deliverables-based requirements and build effective deliverables-based agreements. Each is discussed below.

Lack of Consistency of Definitions, Tools and Processes

Definitions: Consistency and clarity often begin with definitions. As mentioned, labels and definitions for deliverables-based labor varied between and within the companies represented by the study respondents. The most common label used was “Statement of Work” (SOW) to refer to project or deliverables-based work. Several companies pointed out that even though they used the term ‘SOW’ it really referred more to the document between the buyer and supplier and not the purchasing process. There was also a lack of conviction that fellow employees in their company would recognize the same labels and definitions.

Obviously clear definitions help align buyers and sellers, as well as colleagues in the same company. Industry associations have pointed this out as well. We recommend that companies not only gain clarity into the difference between staff augmentation and deliverables-based work, but also create definitions for outsourcing and offshoring as these terms also seemed to cause confusion. The absence of clear definitions in the labor category wears down efficiency, causes rework, and reduces the amount of expenditure control that companies could have if they were to drive a common, clear definition in their workplace.

Processes and Tools: Many procurement organizations have invested millions of dollars to standardize and streamline the labor category. This includes rationalizing the number of suppliers they work with and implementing Vendor Management System (VMS) tools to track the major characteristics of staff augmentation, such as skill sets, bill rates, locations, and the number of hours bought. For the most part, today's tools work wonderfully in helping companies get their arms around the staff augmentation segment of their labor category and as a result, most companies report having a much firmer grasp on that area than they do on deliverables-based work.

The problem is that not all procured labor goes through a formalized process or VMS tool. "Maverick" spending by business units, coupled with an inability to monitor the early steps of the deliverables-based buying process, was widely reported by the respondents. In fact, all of the companies interviewed felt they were experiencing what is commonly referred to as "Savings Opportunity Leakage" in the deliverables-based segment of the spend. The most frequently cited cause was a lack of clarity around rules and processes when it came to buying deliverables-based work. Participants also reported maverick spending because there was loose process monitoring, making it easy for the end-users to bypass a formal procurement process.

How big is this problem? One study participant revealed only $31 million of their $150 million spend went through the company's formal processes and tools. Figure 3 below provides the breakdown of where and how this is happening. The waterfall chart on the right illustrates the effects of a $250,000 spend threshold rule (the dollar amount under which a project is not obligated to follow the sourcing process) which effectively removed $45 million from being bid competitively. A low Non-IT sourcing participation percentage (30 percent) removes another $74 million.

Procurement Participation		
Step	IT	Non-IT
Sourcing	60%	30%
SOW	10	20
PO	20	45
Invoicing	5	5

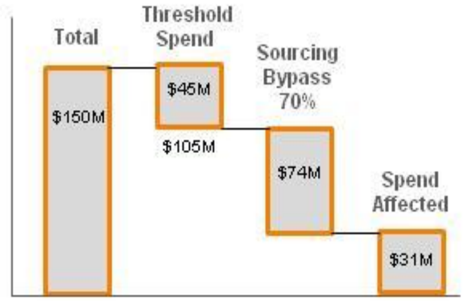

Figure 3: Procurement participation and spend affected at a Healthcare/Insurance firm

Inability to Define Requirements and Build a Deliverables-based Agreement

Defining Requirements: Several frustrated firms on the buy side reported that as they hunkered down and competitively bid suppliers and rates for common labor types, service providers have also hunkered down and adopted a “while the meter is running” approach. For some, this has become a vicious cycle. With thinner margins service providers can no longer absorb the cost of poor requirements definition. And for large, complex, or specialized projects, service providers are no longer willing to invest time with the buyers only to see their scoping effort and best ideas run through an RFx machine. As such, the safest approach for many service providers has been to opt for time-based contracts.

It is the authors’ opinion that standardization efforts and VMS tools are an excellent option for getting clarity on the worker, but are lacking in getting clarity about the work itself. Specifically, companies should strive to address a primary recurring theme with deliverables-based labor projects; that requirements were not clearly defined.

Building Deliverables-based Agreements: We also believe that better capabilities on requirements definition could actually move work *back* to the deliverables-based category. Deliverables-based procurement requires a crisp definition of ***what*** is being bought and what is expected as a result—not the details of the how the work is done or who is doing it. Clients who can fulfill a need with a deliverables-based purchase can reduce their risk and liability and take more control of their budget by purchasing an agreed-upon deliverable versus time and materials.

The Buying Process

Virtually all companies interviewed had seven primary steps in their buying process for buying labor. Each of the steps are outlined in Figure 4 and described in more detail below.

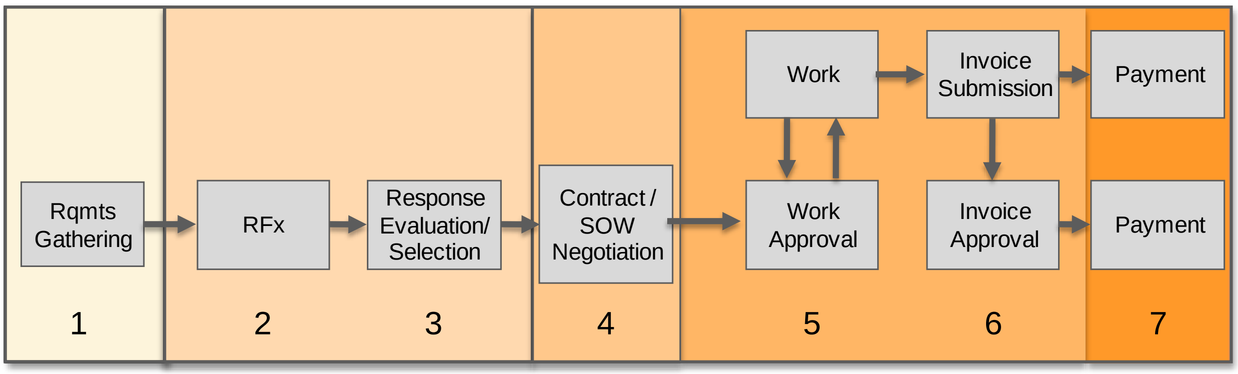

Figure 4: The Current Labor Buying Process

Step 1: Requirements Gathering

The first step of buying any form of labor is to gather requirements. Simply put, what is the user trying to accomplish? Gathering requirements and accurately articulating them along with their expected outcomes was cited by everyone interviewed as the single most important thing to "get right" with deliverables-based work. In general, the beginning phases of this activity appear to take place more on the end-user level than collaboratively with the procurement team, with the latter team being brought in toward the end of the cycle in either the supplier evaluation or SOW phases. Explanations for lack of early collaborative efforts centered on lack of time, resource restrictions, or gaps in expertise. Companies also reported taking steps to align interests with suppliers before they engage, both on the procurement and technical project levels.

Steps 2 and 3: RFx Activities

All companies also had a process for managing RFx activities. For deliverables-based work, more often than not, the RFx process occurred outside of a company's procurement function. In most of the companies responding, there was a correlation between the power of the business unit inside the company and those who picked their own suppliers and enlisted procurement's help later in the cycle.

Several factors contributed to this:

- Budget and procurement tools that could signal that a business unit was about to embark on a project were not in use,
- Lack of enforced policies that required business units to engage procurement early; and,
- Expenditure threshold levels requiring procurement's involvement were set at a high level due to workload constraints.

Steps 4-7: SOW Negotiation thru Payment

Steps 4-7 involve finalizing the work scope with a formalized contract or SOW and continue through project completion and payment. The procurement organizations surveyed had varying amounts of involvement in the SOW development and negotiations process however, they all described disciplined collaboration with the Legal organization on contracts and even Statements of Work when required. In all cases, the contract/SOW step was done manually and separately from both the sourcing and payment steps. Several respondents described manual steps in which the terms of the executed SOW were then linked to the corporate accounts payable process for use as trigger mechanisms for payments.

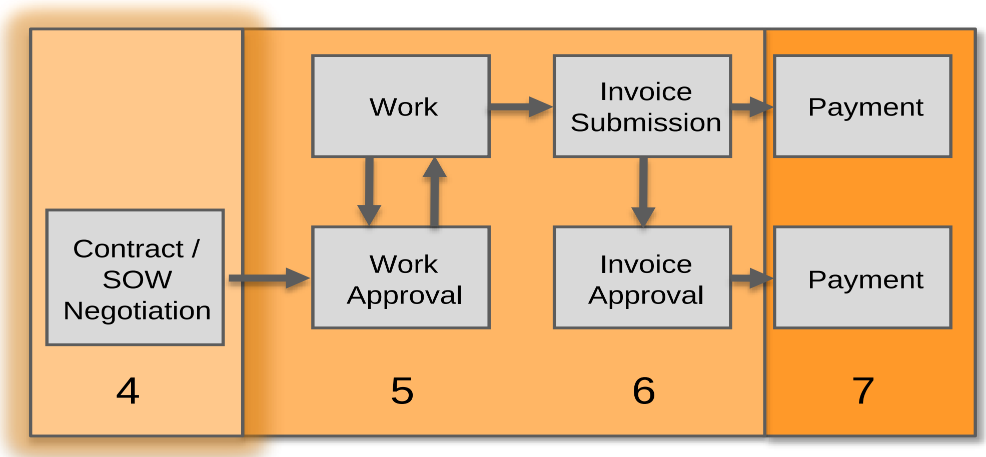

Figure 5: Diagram of Contract to Payment Flow

Regarding the SOW negotiations themselves, respondents used risk and reward structures in only a small subset of their deals. The majority of deals were still negotiated as payments for the suppliers' time to deliver an agreed upon product in a specified timeframe. Clients and providers mentioned the challenges of defining clear requirements, measurement criteria, and of managing change control among the major reasons for structuring time-based deals.

The Technical Perspective

Conversations with those involved in buying labor for technical or IT projects yielded considerable insights. The IT and engineering professionals interviewed for this study said the procurement aspects of the process were minor in relation to the actual requirements definition and project management. Their emphasis was heavily on picking the right technical partner and getting the project correctly scoped, detailed, and executed in alignment with their corporate standards and project life cycle methods. The focus was on timelines, testing, proofs of concept, and implementations. Again, a variety of tools were used for these tasks. The best practice noted in this phase was the *voluntary* collaboration between procurement organizations and the project teams throughout the project term, with dedicated resources as needed from both sides; however, this was rare as the majority of the respondents described a scenario in which the purchasing aspects and the technical aspects of the project parted ways almost immediately after execution of the SOW.

> "The [SOW] originates as a word document but everything gets recorded, precisely, according to methodology in the project documentation repository in extremely robust folders …Sourcing becomes the procurement process of getting the vendor… it's like 5 percent of the rest of the project which follows extremely rigid standards".
>
> *-- IT Engineer*

> "We're not involved in managing these projects. Once that PO has been cut, we don't really have much involvement."
>
> *-- Procurement Manager*

In most cases, once the project began, project management tools became the dominant drivers of work flow, and project managers doubled as business managers to ensure that deliverables, approvals, invoicing, and payments ran smoothly. At that point, procurement's only view is payment date and amount.

Specific Observations: The 7 Step Buying Process

The research team discovered several weaknesses with the existing buying process. While the 7 steps are the correct steps, companies varied in their ability to follow the process consistently, gain the most benefits from each step, and negotiate the best deals. The general issues described below explain the reasons for Pain Point theme #1: a lack of consistency and clarity regarding the definitions, tools and processes used.

Inconsistent Toolsets for Requirements – SOW (Steps 1-4)

Companies today are using a mix of tools and templates to carry out the steps of procurement activity. Most companies interviewed used PC-based templates (e.g. Microsoft Word, Excel) and simple email exchanges to document requirements and deliverables and manage RFxs. We view this as a real weakness and believe it is necessary for companies to explore ways to standardize their approach. From examination, it appears that the primary procurement systems available today do not adequately address business needs in steps 1-4.

The absence of a consistent, cohesive toolset for requirements through SOW activities (see Figure 6 below) presents several problems, the first of which is consistency. Clearly, the opportunity for consistent dialog between suppliers and client is challenged, as is the opportunity to have consistent teams in the dialog. Manual emailing of information and response opens the possibility for missed communications that can unlevel the playing field for suppliers and diminish the client's ability to have all corporate parties play their appropriate role in the negotiation.

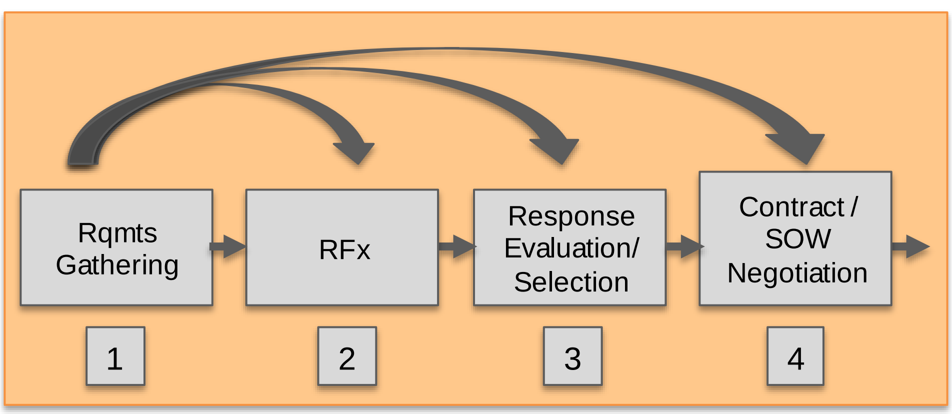

Figure 6: Tying requirements to the RFx process and SOW

Requirements Gathering and RFx Activities: Despite its status as the 'single most important thing to get right' the requirements-gathering phase was often cited as a major pain point among those interviewed. Companies expressed weaknesses in the following areas:

- inconsistent and inadequate toolset for the process

- lack of discipline to do formal requirements gathering before diving in to start the work
- inability to balance workload, gain commitment from complete team, and move quickly
- gaps in expertise
- involvement of the solutions suppliers in drafting the requirements

Sourcing Bypass or "Maverick" Spending: When firms talked about "bypass," they talked in terms of bypassing the sourcing function (bringing procurement into the process at SOW time), or bypassing procurement entirely (entering the process at the PO step or worse, at invoice payment). Companies have different spend threshold rules and differing lines of sight regarding bypass, but between the two, several estimated that in some areas of their companies, between 30-60 percent of deliverables-based spend bypassed the sourcing function. Suppliers' views corroborated that percentage with one large consulting company noting that they "never" deal with procurement at all.

Because of the amount of sourcing bypass in the RFx phase, several companies sought to improve this picture by establishing Master Services Agreements (MSAs) with set pricing and terms in place with the firms their project managers were most likely to work with. But even that did not solve the problem completely, according to procurement managers. Most procurement professionals believed the only way to ensure the best value was to use an objective competitive bid process.

SOW Negotiations: When discussing the negotiations and SOW processes, many respondents reported structuring deliverables-based deals that actually compensated suppliers purely for the time they used in creating the deliverable. Take for example, a deal in which the supplier estimated completion of a project in two phases; phase one to be delivered in 30 days and phase two in 90 days. The SOW might be structured with the first phase equaling the dollar equivalent of 30 days * the supplier's daily rate (or hourly rate * 160) to be paid after acceptance of the first deliverable, and the dollar equivalent of 60 days * the supplier rate paid after acceptance of the second. The problem here is one of missed opportunity on the part of the buyer to get the best value from the situation. In this arrangement, the supplier has no incentive whatsoever to complete the project in less than the pre-established time frame.

> "Our tool does not help us very much in the RFx process and that's where we create the competitive environment."
>
> *-- Procurement Manager*

Although it may seem the "safe" approach, absence of risk and reward in deliverables-based deals diminishes returns on both sides. On the client side, it does not encourage efficiency, accountability to do their part to support the provider, or effective governance. For the provider, it does not provide incentives for innovation or investments that would expand their business with that client and others.

Varied Approaches for Procure to Pay (Steps 4-7)

Interviews revealed that Purchase Orders use varied. Some firms opted to upload the deliverables and payment amounts into a procure-to-pay tool, some opted to cut a PO for the full amount of the Statement of Work and then rely on downstream teams to "receive" only portions of the dollar value of the PO at a time, and some opted to note the project cost center as a reference on the supplier invoices, with no PO cut at all. Several companies described a multi-step process for payment that appeared to include manual matches and hand-written approvals followed by uploads into the payment system.

All 20 of the companies in the study managed some, if not all, of their deliverables-based work manually. This was especially true in the IT and Professional Services/Consulting category for larger projects. Companies that manually manage the linkage between what they source and negotiate with what they ultimately pay risk losing a coordinated view and control of the process. One of the interviewees described the reconciliation process between managing the project from a technical work plan point of view and from a business point of view (work, invoicing, and payment approvals) as a "herculean" effort. Others described the process as "woefully lacking" with the corporate payment records not containing sufficient information to aid in building corporate memory records for later use. For example, information from actual project experience such as timely completion, quality, and supplier capabilities remains on the project level and cannot feed directly into supplier management and future sourcing activities. This can potentially hurt both the company and service provider since the company cannot easily trace project experiences to an aggregate level.

> "Our invoice matching and settlement is a real problem."
>
> *-- V.P. Procurement*

Overall Policy Compliance: All but one firm interviewed pointed to the CFO as the final policy and compliance authority for managing deliverables-based work. In the one case, the Chief Procurement Officer reported directly to the CEO. While practically everyone noted their company had limited consequences for non-compliance of procurement policies, several companies shared their success in bringing maverick spending to manageable levels by wide distribution reporting within the senior leadership ranks.

> "What do we do with people who break the rules? We don't fire them, we make them Vice Presidents!!"
>
> *-- VP, Sourcing*

Clients with high compliance rates all named CFO involvement and support as the determining factor and a best practice. Other best practices cited were review of budget approvals on the front end of the process, appropriate reporting processes at the end of a project, compliance reporting, and periodic audits.

Real World Frustrations

As we saw from the specific observations for each step in the procurement process, there are frustration points throughout the process. To help bring these frustrations to life, we'll share five real world anecdotes from our interviews.

Anecdote 1: Company A outsourced IT application development under deliverables-based approaches. It often found service providers would hit the service levels of the deliverables – but were not meeting the business needs. The company referred to this as "Green Scores, Red Faces" because on the surface the supplier performed well, but overall business objectives were not met. A closer analysis showed that requirements were not clearly defined and the procurement process bought "activities" versus deliverables that met the business needs.

Anecdote 2: Company B was frustrated with one of the "strategic" suppliers who provided engineers for maintenance of their manufacturing operation. While the engineers showed up consistently to perform the work, the company felt that the engineers were not progressive in terms of preventive maintenance, value engineering or other types of innovative ideas that would bring value to their company.

Anecdote 3: Company C noted the pains of payment capabilities. Their system worked as follows: the supplier worked and then sent in a paper invoice. The manager manually matched the invoice to the appropriate piece of work, approved it in writing and sent it to Accounts Payable offshore. Accounts Payable then input the invoice into the ERP system, and it got paid.

Anecdote 4: One engineering project manager described the business aspect of his job in terms of "chasing everyone down" at invoice time, getting approval signoffs, and making sure everyone knew what business tasks belonging to them needed to be performed and when because "you know there are no task lists for this kind of stuff."

Anecdote 5: An account manager at a service provider was constantly frustrated that their highly talented Subject Matter Experts were being compared to "project managers". The account manager resolved to only staff the "C" team candidates for the client, reserving her "A" team resources for clients who "got it".

Playing by the Rules – The Principles of Vested Outsourcing

We turn now to the concept of Vested Outsourcing, with the intention of introducing it as a potential alternative for purchasing and managing deliverables-based labor and services. While the term "outsourcing" may not seem appropriate for buying deliverables-based labor, the authors' experiences suggest many deliverables-based labor purchases are, in the simplest form, outsourcing in that the buyer procures the result of the service.

Vested Outsourcing is a methodology that enables buyer and seller to structure an agreement and relationship that focuses on achieving Desired Outcomes rather than specific transactions. In this methodology, a Statement of Objectives is framed rather than the traditional Statement of Work. At the heart of the agreement are economics that incentivize the parties to work together to gain mutual benefits, be they financial, process innovation, or client/market related. The goal is to create an agreement geared to solving the problem – not just buying labor as a task. The result is a carefully crafted agreement where the service provider has a ***vested interest*** in achieving the company's Desired Outcomes versus simply getting paid to perform the work.

The Vested methodology stems from research conducted by the University of Tennessee and sponsored by the United States Air Force. As part of the original research, the research team studied multiple outsourced arrangements to develop common ailments shared by the unsuccessful deals and common elements shared by the successful ones. This led to the development of the five basic rules firms should follow when creating Vested win/win business relationships. The rules are outlined in the book *Vested Outsourcing: Five Rules that will Transform Outsourcing* and briefly described below.

- **Rule 1:** *Focus on outcomes, not transactions.* Many typical outsource arrangements focus on cost per transaction, or cost per unit of measure. In a Vested approach, the focus shifts to buying outcomes versus transactions.

- **Rule 2:** *Focus on the "What," Not the "How"* The concept behind this rule is to have each party focus on what it does best. Most companies that outsource tend to direct the outsourcer on how the work is to be done. Under this rule, the buyer relies on the seller's expertise to develop solutions that achieve the Desired Outcomes.

- ***Rule 3:*** *Agree on clearly-defined and measurable outcomes.* Develop a limited number of high-level metrics that will measure performance in a thoughtful and collaborative environment Explicit definitions and calculations need to accompany the metrics.

- **Rule 4:** *Optimize Pricing Model Incentives for Cost/Service Trade-offs.* The pricing model should balance risk and reward for both parties. Providers should be rewarded for making the work better, not just performing it. Examples of this would be same service for lower cost, higher service for the same cost, or higher service *and* lower cost.

- **Rule 5:** *Governance structure provides Insight, not merely oversight.* A properly designed governance structure creates and institutionalizes processes that manage the business, not simply the supplier.

A carefully crafted outsourcing agreement following Vested Outsourcing's Five Rules results in a win-win arrangement, with both parties having a ***vested interest*** in each other's success.

The Vested Outsourcing Business Model

Conventional thinking has typically focused on negotiating most agreements at a detailed per-transaction level, by paying either for tasks or on a per headcount basis. For simple transactions with abundant supply and low complexity, a transaction-based business model is likely to continue to be the most efficient model. However, alternative sourcing business models such as Vested Outsourcing are likely a better fit for more complex deliverables-based deals. This report and the authors' experience in the labor-buying market point to a disconnect between the cost of the labor provided, the way it is being purchased, and the business results being accomplished.

FLAWS WITH OUTSOURCING TODAY	VESTED OUTSOURCING SOLUTION
Outsource providers get paid to perform an activity, not solve the company's problem.	Contracts for results, not activities. Companies are not paid unless results are achieved.
Companies may say "collaboration" – but behave and contract for their own self-interest (What's in it for Me - WIIFME).	The contract itself is structured to deliver mutually beneficial financial gains; outsource providers make more money when they achieve the client's Desired Outcomes.
Companies outsource to service provider "experts", and then dictate work processes in areas in which the company has conceded deficiencies in knowledge and expertise.	Leverages the outsource provider's expertise by allowing service providers to determine the best possible way to solve the company's problem.
Companies focus on "lowest price" versus "best value", which creates hidden costs (e.g. Nobel Prize winning work on Transaction Cost Economics)	Transparency and a big picture perspective expose hidden costs; contract is structured to avoid hidden costs.

Figure 7: The Flaws of Today's Outsourcing and Vested Solutions

Could adopting a Vested Outsourcing approach reduce the frustration levels for some segments of outsourced or deliverables-based labor purchases? We think so! The next section provides an overview for how companies can apply Vested approaches to deliverables-based labor purchases.

Applying Vested Methodology to Deliverables-based Labor Purchases

This section discusses the Five Rules of Vested Outsourcing and how to apply them to procuring deliverables-based services. Application of the Five Rules can greatly improve Pain Point theme #2: inability to clearly define deliverables-based requirements and build effective deliverables-based agreements.

Rule Number 1: Focus on outcomes, not transactions

The Vested Outsourcing methodology begins with consideration of what is actually purchased and the relationships with various service providers with whom a company transacts business. To aid in the discussion, we will revisit the 7 step process where we have inserted a new step at the beginning, *Business Model Mapping*.

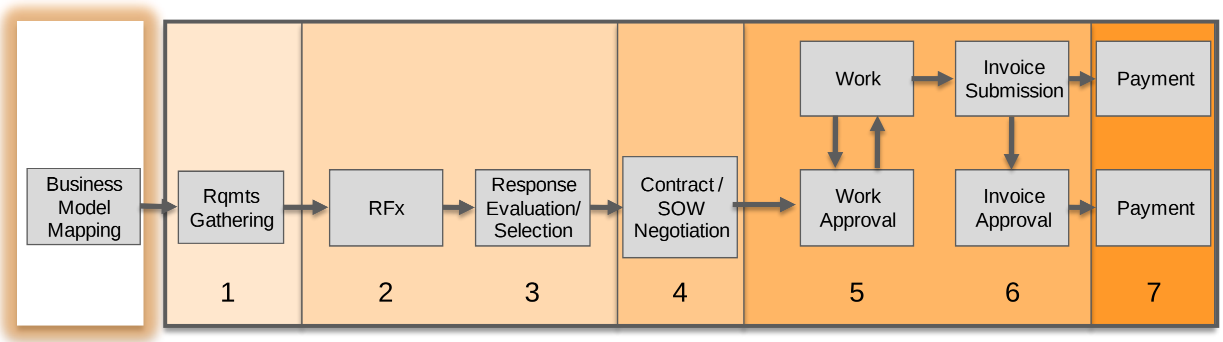

Figure 8: The Labor Buying Process with Business Model Mapping

A key first step of buying any service is to understand both the attributes and which sourcing business model is the most appropriate. A good way to examine this is through the lens of the Business Model Map, described in detail in The Vested Outsourcing Manual. One can use the business model map to examine each attribute of a potential deliverables based procurement and determine the best sourcing business model for each desired outcome. For example, outsourced IT programming, drug and background screening, janitorial services, auditing services, or a call center services may align in different "zones."

Figure 9 profiles the Business Model Map.

Mapping Attributes	Transaction Based			Outcome Based	Hybrid	Investment Based
	Simple Transaction Provider	Approved Provider	Preferred Provider	Outcome/ Performance Relationship	Vested Outsourcing Relationship	Equitable Partner
	Zone 1	Zone 2	Zone 3	Zone 4	Zone 5	Zone 6
Vital to core business purpose	Minimal	Low	Medium	Medium to High	High	Critical
Enhances brand image	None	Low	Medium	High	High	Critical
Impact on customer experience	None	Low	Medium	High	High	Critical
Maintains customer experience	None	Low	Medium	High	High	Critical
Opportunities for efficiency gains	None	Low	Medium	High	Very High	Critical
Contributes to Innovation	None	Low	Medium	High	Very High	Critical
Consistently safe and reliable	Not capable	Semi-skilled	Skilled	Professional	Professional	Expert
Impact on operational safety	Minimal	Low	Medium	High	High	Critical
Organic growth capability	None	Low	Medium	High	Very High	Constant
Access to critical systems and processes	None	Low	Medium	High	High	Critical
Availability of required technology	Universal	Limited	Restricted	Scarce	Scarce	Unique
Impact of supplier loss or failure	None	Low	Medium	High	High	Critical
Cost to switch supplier	None	Low	Medium	High	High	Very High
Dependence on assets/capabilities	None	Low	Medium	High	High	Critical
Lean supply cost	Low	Medium	High	High to Invest	Invest	Capital
Cost of Staff	Minimal	Low	Medium	High	High	Very High
Availability of qualified personnel	High	High	Medium	Low	Low	Low
Skill level of predominant personnel	Unskilled	Semi-skilled	Skilled	Professional	Professional	Expert

Figure 9: The Business Model Mapping Tool

The Business Model map is applicable to suppliers as well. The rationale in this case is that work in scope is a good candidate for using the Vested approach, but the supplier is not. Another possibility is that the transactional supplier is a good candidate for a Vested partner, but the parties' existing relationship model, contractual agreement or culture do not give the parties the ability to reflect that potential.

Many companies have started to foster highly collaborative relationships in buying categories and with suppliers that are more strategic in nature. Several companies in the University of Tennessee research specifically mentioned encouraging buyers and procurement teams to engage suppliers proactively early on with more strategic work. More strategic relationships are excellent candidates for Vested arrangements, especially if they are currently compensated on an hourly basis. It makes sense that a company may alter or streamline procurement steps for highly strategic suppliers in zones 4 (performance-based) or 5 (Vested Outsourcing) of the mapping model (see Figure 10 below).

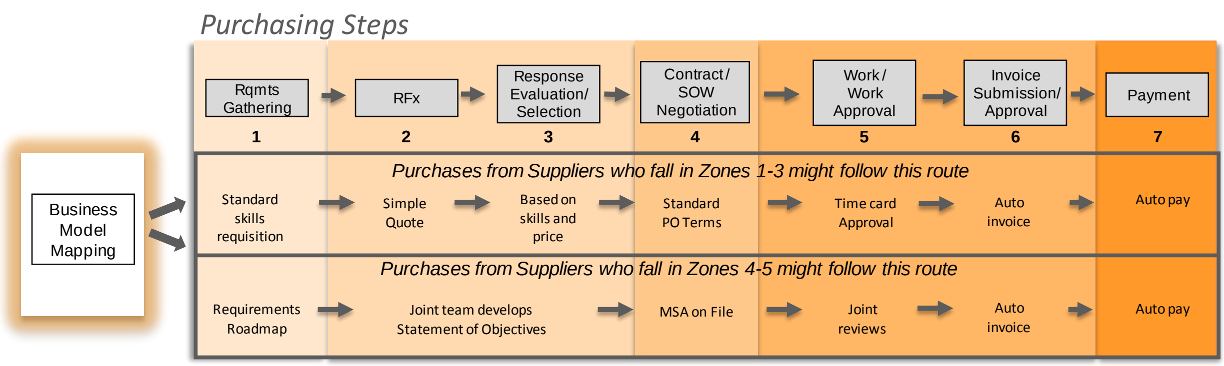

Figure 10: Business Model Mapping Drives the Actual Procurement Process Used

More detailed information on Business Model Mapping is also presented in *Unpacking Outsourcing Business Models*, another white paper by the University of Tennessee scheduled for release in October 2011 in conjunction with the Sourcing Interest Group, The International Association for Contract and Commercial Management, and the Center for Outsourcing Research and Education.

Rule Number 2: Focus on the WHAT, not the HOW

Everyone participating in the research study cited accurate requirements-gathering as the single most important driver of successful outcomes when buying deliverables-based work. The Vested Outsourcing methodology requires cross-functional participation, addresses stakeholder positions, establishes appropriate performance metrics and drives the much needed collaboration between procurement organizations and the project teams, holding **the team (including the supplier)** jointly accountable for successful delivery of the requirements.

The University of Tennessee researchers developed a "Requirements Roadmap" template to help buyer and seller teams work collaboratively to clearly define their requirements. The

Requirements Roadmap, once completed, becomes the foundation for what the companies will work towards. A key component of the Requirements Roadmap is developing the Statement of Objectives which ultimately establishes the foundation for deliverables-based services procurement.

Figure 11 illustrates the Requirements Roadmap template. For each Desired Outcome, Objectives are established and the standards by which they will be measured are clearly defined.

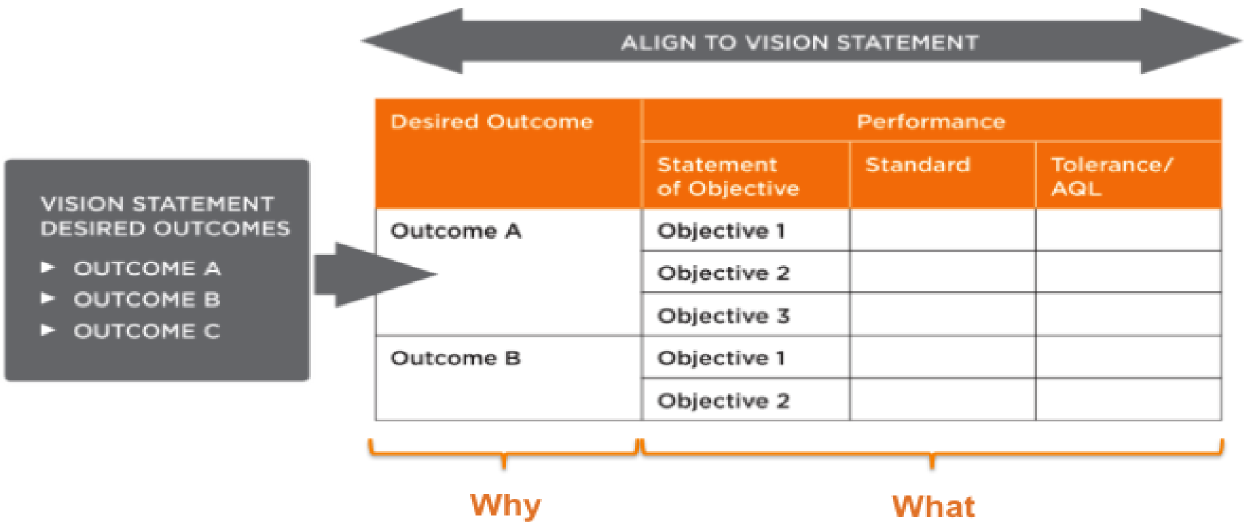

Figure 11: The Requirements Roadmap Template

Once the Desired Outcomes are established, Vested agreements contain mutually agreed upon metrics that define success between the two parties. The goal is to have a limited set of high-level metrics that that are clearly stated. To do this, a performance statement for each objective that includes a standard and a tolerance should be detailed.

Once these items are determined, the steps to issue a coherent RFx to prospective suppliers or to create a Statement of Work with a supplier become much easier. In fact, as part of the research efforts, the Defense Acquisition University automated the Requirements Roadmap process to help make requirements gathering much easier and intuitive.

The following page provides an example of a completed Requirements Roadmap.

Desired Outcome	Performance				Incentive	Inspection			
	Objective	HOW	Standard	Tolerance / AQL		Who	Data Source	Calculation	How Often Collected
Seamless and Timely outcome-based execution of Professional Services for Program Management, Financial, and Procurement	Program Management: develop Risk Mitigation plan and provide support documents to assure requirements delivery	Risk Mitigation Plan delivered	Complete and accurate	None	None	Program Mgr.	Documents Delivered	Errors Identified per deliverable document	Monthly
		Accurate Milestone Decisions Plans to meet master schedule	Deliverables are complete and accurate	None	None	Program Mgr.	Documents Delivered	Errors Identified per deliverable document	Monthly
			Delivery to Master Schedule dates	2 days variance to schedule	None	Program Mgr.	Master Schedule	Days early/late	Monthly
		Management Program Change Requests	Requests processed in 15 days	5 days variance	Standard process cycle reduction of 5 days = X% bonus	Program Mgr.	Change Request Database	Receipt of Request to Completion	Monthly
	Financial: prepare, develop and assist in completing financial reports	Financial Statements Preparation	Delivery of accurate statements	No errors	None	Finance Mgr.	Finance Portal	Errors per statement	Monthly
			On time delivery	By Due Date	None	Finance Mgr.	Finance Portal	On time Delivery	Monthly
	Procurement: reduce corporate risk and exposure through timely contract management and market research	Contract Closeout	Closeout w/in 30 days	10 days variance	None	Sourcing Mgr.	Contract Database	On time Delivery	Monthly
			Savings Identification Report	Monthly Report with plan	X% Savings Realized	Sourcing Mgr.	Procurement System	$ recovery over contract cost	Monthly
		Delivery of Market Research Reports	Quarterly report complete with current external forces impact identification	Achieve objective by end of first year	Standard Support KPIs achieved. Targets achieved: X% bonus	Sourcing Mgr.	Reports Delivered vs. Baseline Benchmark	On time Delivery	Quarterly
Decrease Total Cost of Support	Increase Deliverable Solutions within existing budget during contract lifecycle	Deliver increased number of solutions with no increase to budget	Increase delivered solutions: Yr. 1=10%, Yr. 2=20%, Yr. 3=30%, Yr. 4=40%	Increases no less than 5% improvement per year	Exceed annual objectives=X% bonus	Finance Mgr.	Baseline Process Cycle Calculation	Average cycle per deliverable divided by number of deliverables	Quarterly
	Develop Deliverable Standards	Reduction of unique reports	No less than 3 per year	None	None	Business Mgrs.	Baseline Reports	Baseline/Current	Annually
	Provide innovation to improve professional services delivery against business requirements	Provide process improvement and technology solutions to reduce deliverables cycletime	Solutions provided to drive 5% cycle time reduction per year	5% per 18 mos.	Targets achieved: X% bonus	Program Mgr.	Baseline Process Cycle Calculation	Number delivered and adopted per year	Annually

Figure 12: Example of a completed Requirements Roadmap

Rule Number 3: Agree on clearly defined and measurable desired outcomes

Integral to the Requirements Roadmap is establishing exactly how success is measured. We call this the Quality Assurance Plan. This includes identifying the source of data, metric calculations, frequency and responsibilities for capturing key metrics data and reports. In Vested agreements, governance activities rely heavily on performance reporting. Reporting and regular review meetings occur at all levels and functions.

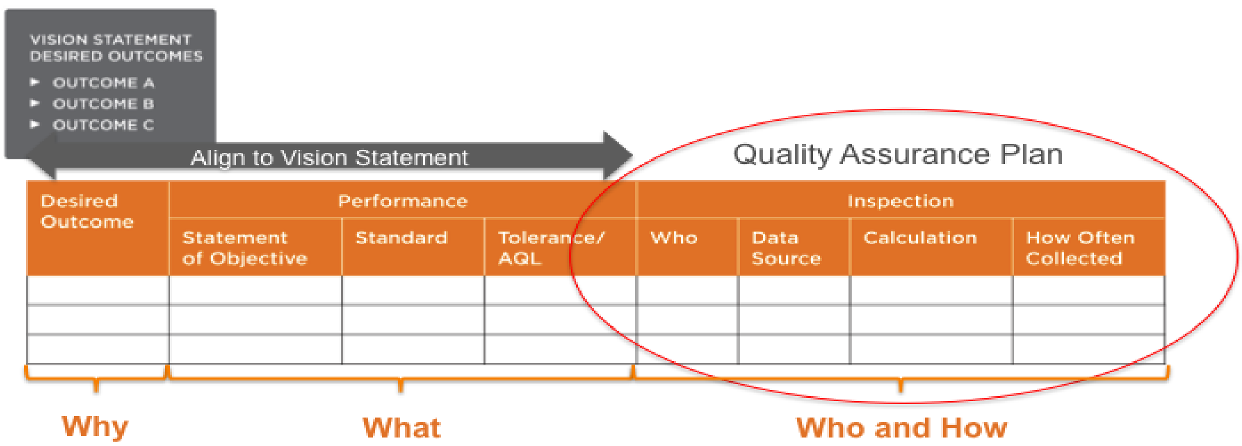

Figure 13: The Quality Assurance Plan

Rule Number 4: Optimize pricing model incentives for cost/service trade-offs

The Vested Outsourcing approach shifts the economics of how companies pay their suppliers to an outcome based approach, moving from paying for a transaction to paying for results. In the purest sense, a company would not pay the service provider unless the deliverable was completed and achieved the expected results. A common downfall with the conventional rate card-based approach to pricing based on rate * time is that it encourages what University of Tennessee researchers coined as the “Activity Trap”.

The Activity Trap can occur when a provider is compensated based on the number of transactions or on time elapsed rather than outcome. An example comes from a company that was transferring sales support activities from one outsourced provider to another. The company found that the data required to run certain reports was no longer current, and the new data was stored in a new format in a different location. The current provider was not made aware of this fact, so the reports that it had produced for the past five months were wrong. In a damage control drill, the service provider learned good news as well as bad news: The sales manager who had requested the reporting had been transferred, and the new sales manager did not use the (now-inaccurate) report. But since it was still a required activity, the company was being charged for each report – whether needed or not. Upon further investigation, the company discovered that more than 300 unused reports were generated each month at $75 a report—a whopping $22,500 per month.

The authors suggest companies consider a more Vested approach for more strategic deliverables-based labor work where the service provider gets paid very minimal margins and markups on the people doing the work and a large incentive when the buyer and supplier agree "success" is achieved. This approach accomplishes several objectives and balances risk and reward between the two companies.

- It covers "the basics" for the supplier so that it is not operating in the red just to do business.
- It allows the buyer to shift some of the risk for the outcome to the supplier.
- It incentivizes the supplier to deliver performance.
- It rewards the supplier for its investments—which can be used again and again with other clients.
- It strives to "unbundle" labor for large projects to ensure the right people are staffing the right roles versus focusing on an overall "blended" rate.
- It allows the buyer more visibility to total cost and a heightened opportunity to reduce it.

Rule Number 5: Establish a governance structure based on insight, not oversight

It is important to manage the agreements in an optimal manner by recognizing a few key concepts. The first point is that change is a constant factor in any business relationship and the goal is to have a flexible enough arrangement that can accommodate the realities and pace of business. The second point is to have joint relationship management on both sides of the deal. This helps multiple levels in each party to get a view of the outcomes and the joint progress toward them. Focus should always center on jointly managing the business, not just the supplier or the resource in the seat. The third point is that Vested relationships are expected and designed to be transformative. Outsourced work is expected to improve – not simply be performed. The transformative function drives the idea and process innovation for both parties.

Governance structures for deliverables-based projects should accommodate the gaps caused by the toolset disconnects within each party and between the parties. For example, activities that incorporate all expenditures (stop spend leakage) between the parties help both sides do activities that tie requirements to outcomes and deliverables, and investments that improve the work. Additionally, governance structures and tools can scale up or down to meet size or complexity needs of all projects.

Summary

As companies continue to learn more about how to better manage deliverables-based labor, there are several important lessons to make the journey easier. First, companies should separate true staff augmentation from true deliverables-based activity. Next, companies should examine the current process for buying deliverables-based labor and organize it as closely as possible to conform to the seven step process outlined. This should help mitigate the confusion and savings leakage that clouds this labor category and costs money. Companies that have existing strong labor buying (VMS) tools will have a definite advantage in this area. Companies looking to buy a VMS for staff augmentation are strongly encouraged to look at tools that do both well.

The third important lesson is to take existing deliverables-based deals and start looking for areas of improvement in current SOWs and contracts. Companies can use the Business Model Map template to determine if the deal or supplier should migrate to a more strategic sourcing business model such as Vested Outsourcing. We encourage you to take the Vested Challenge and ask the following questions:

- Are you willing to focus on outcomes and not transactions?
- Are you willing to allow the service provider to come up (or least help define) the best solution?
- Are you willing to incentivize the service provider to make a decent profit if it delivers quantifiable value?
- Are you willing to develop a governance structure that provides insight into the relationship, instead of oversight?
- Can you identify risks and do you feel comfortable jointly managing them with your supplier?
- Are you willing to focus on value and total costs versus simply “price”?

If you answered yes to the questions, Vested Outsourcing is a good for fit for your work.

The authors believe that Vested Outsourcing concepts applied to deliverables-based work can bring exceptional results. The concept of buyer and seller coming together and working on under a ‘What’s in it for We’ (WIIFWe) approach can have powerful outcomes for both parties. The most important driver for success is the ability to shift the economics from paying for a transaction to paying for results.

About the Authors

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Kate is an internationally recognized innovator in the practice of supply chain management and outsourcing. She is the lead faculty member on the University of Tennessee's pioneering Vested Outsourcing concept and was named as one of World Trade Magazines 50 most influential people impacting global commerce. She is the author of over 200 articles and 3 books, including Vested Outsourcing: Five Rules that will Transform Outsourcing. She has been recognized as a "Woman on the Move in Trade and Transportation" by the Journal of Commerce for her leadership in the profession and was honored as a "Woman of International Influence" by Global Executive Women. She has served on the Board of Directors for the Council of Supply Chain Management Professionals and has been called a "Rainmaker" for her tireless effort in educating the supply chain profession. She can be reached at kvitasek@utk.edu

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Michèle Coquis has 23 years' experience in the Information Services industry for a Fortune 200 company, 11 of which were managing the procurement of time-based labor and deliverables-based services. As category director, her responsibilities included strategy development, sourcing, category management, supplier management, and operation of one of the largest technical and clerical labor buys in the industry. Prior to that, Michèle performed roles in data center migration, new business startup, client support, and operations management in the US and South America, supporting clients in industrial manufacturing, government, military, chemicals, financial, health care, communications, and retail industries. Michèle can be reached at mcoquis@theforefrontgroup.com

For more information about Vested Outsourcing:

Visit the University of Tennessee's website dedicated to Vested Outsourcing at http://www.vestedoutsourcing.com where you can download white papers, watch videos, read articles and subscribe to our Vested Outsourcing blog.

We also encourage you to read the book *Vested Outsourcing: Five Rules that will Transform Outsourcing* and to attend register for the University of Tennessee's classes on Vested Outsourcing classes at http://vo.utk.edu

3 Day Vested Outsourcing Open Enrollment Class

Getting to A Vested Agreement Self-Paced, Online Course

2 Day Collaborative Contracting

Certified Deal Architect Program

For questions about this white paper, contact Bonnie Keith at bkeith3@utk.edu

Endnotes

[1] C.K. Prahalad and Gary Hamel, "The Core Competence of the Corporation," *Harvard Business Review* 68.3 (1990): 79-91.

[2] The quote is widely attributed to these men. It is unclear who said it first, but likely Peters did in *In Search of Excellence* (New York: Harper & Row, 1982). Drucker's quote retrieved from: www. qualitywriter.com/about-us/famous-quotes-deep-thought-humorfun-politics-sayings. Harold Waterman was also a proponent of outsourcing core functions, see David Souden, *Ingenuity and Engineering: The Waterman Story* (2002), retrieved from www.**waterman**group.com/brochures/get_file?id=34.