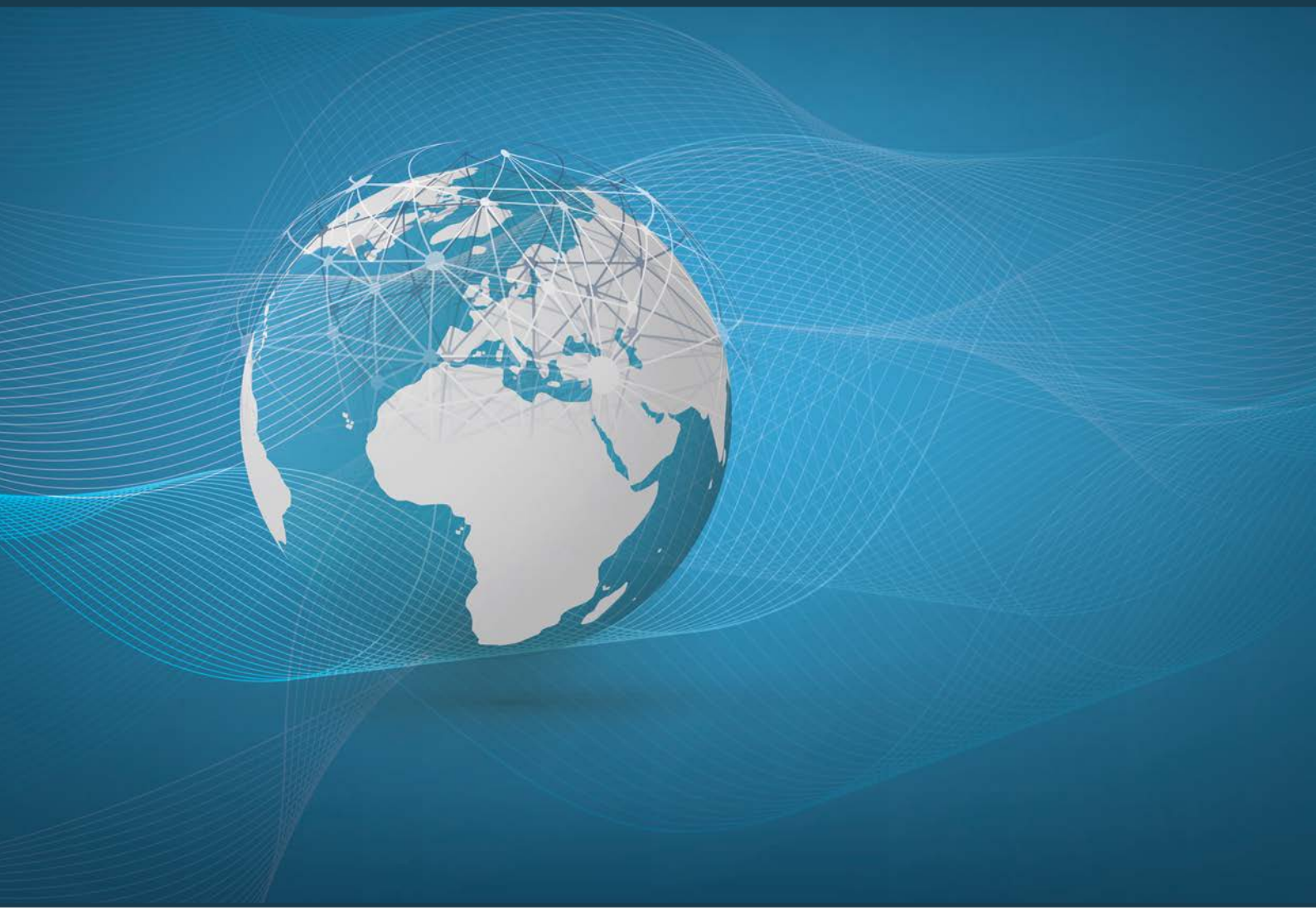
Boardroom Insights: The risks & rewards of outsourcing

Special Report from *Board Agenda* in association with Mazars



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Overview

IN RECENT DECADES, few developments have been as influential on business as outsourcing. For boards around the world the benefit of outsourcing has moved from simply reducing costs to providing the opportunity for competitive advantage and strategic transformation.

We are therefore pleased to provide a special report from *Boardroom Insights: The risks & rewards of outsourcing*, in conjunction with our partner Mazars, exploring in detail the key questions boards must address to exploit the opportunities provided by a service that emerged almost 40 years ago but has evolved significantly in that time.

The idea of transferring in-house processes and functions to an external provider, driving cost benefits by efficiency and specialisation, began to take hold in the 1980s. By the turn of the century the model had become widely established across the world, with the buying of outsourced services mainly conducted by large organisations pursuing significant labour arbitrage opportunities.

Indeed, as outsourcing began to mature, labour arbitrage became an increasingly important element of the model. Offshore outsourcing (or "offshoring", often confused with "outsourcing") then spurred a remarkable degree of development in lower-labour-cost nations—most notably India—where much of the work was being carried out.

As the outsourcing mantra of "do what you do best and outsource the rest" was increasingly adopted by organisations in both public and private sectors, the initial focus of the outsourcing trade was on high-cost functions not necessarily viewed as being core to business activity. One example is IT, where the ability to transfer the burden of investment in hardware to a specialist provider, and to move as much IT spend as possible from capex to opex, was a key growth factor.

However, as provider capacity and capability grew, along with understanding of the concept and its benefits, outsourcing solutions were developed for almost every imaginable part of business operations. Expansion also brought the appearance of much smaller organisations to compete with the large enterprises that were outsourcing's original market.

The acronyms that now pepper outsourcing glossaries—ITO, BPO (business process outsourcing), HRO (human resources outsourcing), LPO (legal process outsourcing) and countless more—demonstrate the extent to which the outsourcing model has penetrated organisational structure.

Successes notwithstanding, outsourcing has recently experienced a seismic shift. Wage inflation in key offshore provider locations (in particular India) has undermined the attractiveness of labour arbitrage. This has been compounded by a rise in anti-offshoring rhetoric in much of the West, persistent consumer scepticism of service quality, and by a number of high-profile data security failures involving offshore providers.

Significantly, new developments such as automation have influenced how and where services are delivered, and the type of work that can now be offered by providers.

In a nod to how their services have outgrown the original definition of "outsourcing", providers typically use other terminology such as "business transformation" to describe what they do for customers. At the same time, providers have sought to redefine the philosophy of the provider-customer relationship itself to better reflect the genuine partnership that is required when one party has become so profoundly embedded in the operations and organisational structure of another. For their part, increasingly savvy buyers have driven new and more sophisticated contractual models, moving away from the FTE-based structures that have dominated since outsourcing's infancy.

While cost savings remain paramount, buyers of outsourced services now require and expect a great deal more. Providers have therefore made huge investments, especially in technology, to deliver as much as possible on every front.

"In previous years, cost was certainly the primary driver to outsource but clients are increasingly looking at other factors," says Toby Stanbrook, outsourcing partner at Mazars UK.

"With the breakneck speed of development in the finance function and the need for medium and large organisations to constantly evolve their finance organisation through acquisition, merger or growth, outsourcing can provide a speed advantage to reach the desired target operating model."

Florence Pinot, outsourcing partner at Mazars France, concurs. "Cost is definitely a driver, but not the only one. When we meet with potential clients, they often reveal negative experiences with in-house teams," she says.

"These include difficulty maintaining control over the quality and knowledge of their own financial information, or difficulties managing teams belonging to business units over which they have no direct hierarchical authority.

"Clients look for a guarantee regarding continuity of service and delivered quality. They can formalise KPIs and put in place regular monitoring. These criteria are described in service level agreements, which can be consistently enforced in several countries and legal entities."

- Outsourcing began in the 1980s and has risen to become a global industry worth hundreds of billions of dollars annually.
- "Do what you do best, and outsource the rest": outsourcing solutions are now available for almost every business function and for a wide range of organisation types and scales.
- Cost savings remain at the top of the agenda, but buyers now want a broad range of services and new more flexible contractual models.

Technology and innovation in outsourcing

The outsourcing value proposition has always rested on the ability of a provider to identify and remove inefficiencies in a customer's processes. To a certain extent, labour arbitrage was traditionally able to accomplish this, with labour becoming more efficient by being deployed in lower-cost locations.

However, greater gains stand to be made by the deployment of a new wave of automation and related technologies, including robotic process automation (RPA), artificial intelligence (AI) and the hinterland between them, sometimes described as intelligent automation (IA).

Such technology is not only making processes more efficient but allowing for vastly superior reporting as well as a better understanding of processes themselves, their flaws, how they connect with the rest of the business and the consequences of making improvements or alterations.

The ability of a provider to offer end-to-end process delivery (and enhancement) in which human intervention has been kept to a minimum, and which can boost compliance efforts and analysis more broadly via the near-instant provision of vast reams of accurate data, is obviously of huge interest to many organisations.

Meanwhile, the "robots" (in the form of licensed software) carrying out this work do not require breaks nor holidays, do not get sick, have no children, experience no personal difficulties requiring absences and need no promotions or bonuses or motivational awaydays. These benefits form compelling arguments for an automated workforce, even before considering typical pricing on the part of vendors of around one third the cost of an offshore employee (which is in turn typically calculated at around the same discount on an "onshore"/home country employee).

Such automation can be developed in-house or purchased directly from a specialist supplier. The latest technologies—traditional automation, RPA and AI—are quickly adopted by most outsourcing providers with the aim of achieving benefits such as a more efficient workforce and improved service delivery. Indeed, many providers now have heavy investment in new tech on their priority list. These providers also deploy tailor-made in-house RPA, or tech teams, to play an important role during client engagements.

"In this era of continuous technological advancement on a global scale, organisations have to keep pace in order to not be left behind," says Consuelo Sedney, outsourcing partner, Mazars Netherlands.

"Competitors and new entrants to the market have developed new technological advantages, which force the current organisations to keep up with all these developments.

"In all different sectors within the market, the majority of medium and large organisations have already implemented process automation and headcount-reducing technologies and are now beginning to investigate how AI can contribute to their business.

"Organisations need basic competence in all of the above-mentioned capabilities to get started on process redesign projects and need greater competence if they are to progress with them."

The more transformative automation and AI may prove, however, the more profound and urgent are the questions they prompt. Organisations contemplating robotic process automation and/or AI solutions need to consider the contractual mechanisms governing who owns the processes and data in question. They should also examine what the consequences are for the business of any future separation from the provider.

Another key issue is the danger of deploying such comparatively nascent technology across vital components of the business, and the appropriate security mechanisms required. Companies should also evaluate the legal and corporate social responsibility (CSR) ramifications of taking so many people out of operations.

Lastly, how do providers look to maintain margins while still delivering fair gains to customers, given automation software vendors have claimed as much as 90% savings compared with maintaining human employees? And how does an organisation continue to innovate when the deployment of new technology means fewer human minds involved in the relevant processes and functions?

As Florence Pinot explains, getting the right contractual and structural mechanisms in place from the start is crucial.

"Innovation includes all changes implemented in the business processes, bringing new benefits. These are often related to efficiency and to the internal cost of the business processes, but it can be also a better-quality result. When taking over a new client, the first challenge is to specify all the tasks to be done on a like-for-like basis.

"After the takeover, when the processes are stabilised, it is possible to work on efficiency and innovation. To make sure this really happens, it should be forecasted and planned from the beginning in the contract. If resources are dedicated to efficiency, and if milestones are fixed in advance, there is always room for improvement."

- Automation and artificial intelligence are transforming outsourcing offerings—and the back office generally.
- Software "robots" work at a high standard 24/7/365, boosting compliance and reporting, at a fraction of the cost of traditional human workers.
- Retaining the ability to innovate after an automation implementation is key: "There is always room for improvement."

Industry risks and challenges

Typically, boards that have been seen as being "outsourcing-averse" have been so because of fears over loss of control. The question, "How much control of our internal workings are we prepared to give another company?" lies at the heart of any outsourcing decision.

Indeed, the formulation of a general outsourcing strategy typically rests upon the extent to which leadership desires to retain, or cede, control, bearing in mind the trend toward providers becoming ever more embedded in their customers' structures. Boards need to ask which parts of the business are ultimately, core, and of necessity, beyond the reach of even the most capable provider.

Perhaps the most obvious risk keeping decision-makers awake at night is related to data. Data breaches and resultant scandals can cause huge bottom-line impact, not merely as a result of the savage penalties (up to €20m, or 4% of annual global turnover, whichever is higher) mandated by GDPR (General Data Protection Regulation), but as a consequence of any consumer backlash resulting from the leak of confidential details onto the open market. Here the integrity of the supply chain is key. Some of the largest and most costly data breaches have resulted not from activity on the part of the customer, nor the provider, but third-party suppliers possibly two or three links down the chain.

While GDPR now extends responsibility to encompass provider as well as customer, the existential threat to the latter means that in practice, responsibility for data security is shared. No matter how insignificant they may seem, the mechanisms in place for ensuring secure systems should be considered a board-level responsibility.

The challenges associated with data are not limited to its potential leakage. The legal framework governing data storage and movement—both within and outside the EU, and particularly (since this constitutes such a large proportion of this kind of data movement in many industries) between the EU and US—is imposing and convoluted, having a significant impact upon where and how certain data must be stored and therefore upon an organisation's choice of outsourcing provider.

Non-compliance here can be catastrophic, which makes the rise of cloud computing (currently dominated by American firms) reliant upon very widely distributed data storage even more potentially problematic. On the flipside, the advantages posed by the cloud model are so clear and compelling that it has now been adopted to one extent or another by the vast majority of organisations.

José Caneda, managing partner at Mazars Switzerland, believes that the "cloud question" is a matter that demands board-level attention. The risk and opportunities of cloud computing should be a boardroom question not least because, though once considered a cost issue, it is now part of strategic decision-making.

"When it comes to the use of cloud computing, it is crucial that the board establishes an adequate IT strategy together with a data governance policy," says Caneda.

"With the strong trend of migrating IT infrastructures and applications from on-premise to cloud computing, the risk of a contractual lock-in situation becomes highly relevant, not only with leading cloud computing providers. Offers from small, local cloud service providers are also increasing and sometimes represent underestimated risks.

"A strong dependency on cloud providers could lead to serious implications for an organisation. The unavailability of a service provider, or the lack of data security, may put the business at risk. Change to another service provider might not be possible in the short term or come only at a high price due to contractual obligations."

Clearly, the risks associated with applying outsourcing across borders are not limited to data: issues such as tax regulations and trade agreements can also determine the extent to which outsourcing can be deployed and which providers can carry out any such deployment. In this area an outsourcing provider, with potentially vast expertise in handling similar situations for clients, could be a board's best friend, being able to leverage that expertise in a manner that not only boosts compliance but could help open up new markets for customers.

"For global client organisations," says Toby Stanbrook, "the compliance landscape is increasingly challenging. Enhanced global regulation in areas such as cross-border tax is now being overlaid and, in some cases, superseded by a renewed focus on national priorities and local compliance requirements.

"For many global organisations having local experts in each jurisdiction in which they operate is not affordable and so using a quality partner to support on the hybrid of global and local compliance is essential."

- An effective outsourcing strategy requires a board to find the right risk/reward balance while being comfortable with ceding a degree of control.
- GDPR creates very significant liabilities in case of data breach—but outsourcers can help buyers navigate the data labyrinth.
- "When it comes to the use of cloud computing, it is crucial that the board establishes an adequate IT strategy together with a data governance policy."

Ethical considerations

While outsourcing can help drive effective compliance, those utilising the model must also bear in mind the requirement to comply when doing so with any applicable workers' and human rights legislation, as well as to abide by the strictest ethical standards.

Although issues such as human rights might be thought of as more relevant to manufacturing and other blue-collar outsourcing and offshoring than to front and back-office service delivery, ensuring an ethical supply chain and compliance with workers' rights legislation—even modern slavery laws—is of paramount importance.

Organisations need to be mindful not merely of potential legal ramifications (which in some jurisdictions could, theoretically, affect the client organisation) but also of the cost of negative PR, increasingly damaging in today's environment of rapid and ubiquitous social media attention.

As the decision to outsource almost always results in at least some job losses (though these can often be absorbed by voluntary redundancies) or redeployment to a new organisation, there are also serious ethical considerations at home for buyers of outsourcing services. And again, negative PR is a concern.

An outsourcing provider can work with the customer to ensure that any such process is as smooth as possible, with the minimum possible disruption to the organisation and with significant capability deployed to ease any transition for affected workers. They can also help with messaging should the PR situation turn detrimental.

As with so much else discussed here, in this area, the contract is king. While contractual mechanisms may not (and should not be seen to) completely inoculate a customer against any damage resulting from labour abuses or similar malaises, they can at least create a sensible framework providing as much reassurance as is realistically possible and place the onus upon the outsourcing provider to ensure that its own operations are visibly "clean".

There may well be a trade-off in terms of slightly increased cost of contract. But if so, this increase should be seen as an insurance payment in case of reputational damage rather than simply as an unwanted extra burden.

Once again, outsourcers themselves can prove extremely valuable to buy-side organisations looking to ensure that they can demonstrate ethical supply chains and compliance with all relevant legislation. Some outsourcers have dedicated solutions focusing on such compliance, while their expertise built up from working with other partners with similar priorities can help buyers achieve their own ethical objectives.

- Outsourcing—especially to low-wage locations—presents specific ethical challenges of which boards should be aware.
- Outsourcing providers can help directly with compliance as well leveraging broad expertise working with partners.
- Contractual mechanisms can ensure a bilateral focus on "doing the right thing".

Future issues

Trends in the outsourcing industry have seen such big developments in recent years that the term, "outsourcing" no longer truly captures the depth and breadth of the capabilities now on offer from providers.

Expertise on the part of the provider community at levels ranging from the extremely niche to the function-wide now effectively exceeds that of most in-house operations, and this will only continue as automation and AI technologies mature and become ever more sophisticated.

Developments in technology mean providers have also progressed through a change in their operating models. Consuelo Sedney points out that "headcount-based models" have been left behind in favour of automation. That work done, providers are now exploring—or already investing in—AI and the ways it could transform their services yet again.

Politically, there is always the threat of significant legislative change seriously impacting the outsourcing space. However, despite such threats becoming vocalised to one degree or another around every election cycle since the emergence of outsourcing itself, previous pronouncements of doom have all been more or less unfounded.

According to Erick Gillier, head of global outsourcing solutions at Mazars: "Outsourcing contracts can never be completely future-proofed against regulatory changes. We cannot be immune to the potential impact of legal changes; instead, we need to fully comply with them and, with the right expertise in place, the professional service providers are well equipped to deal with the rules, obligations or liabilities that outsourcing is subject to."

Meanwhile, providers of outsourcing—by whatever name—will continue to integrate as far as they are enabled into the operations of their customers and the workings of the global business machine alike, with the extent of that enablement to be defined in each case at the highest levels of each customer organisation.

- The development of capabilities and services by providers means the term "outsourcing" no longer truly reflects what is on offer. Outsourcing represents a very specialised service offering and in financial services, it ensures in-depth local compliance knowledge.
- Providers have moved away from headcount-based models to embrace automation and are now implementing the latest technologies such as AI. Outsourcing is now a more affordable option to access these technologies.
- Legislative change affecting outsourcing is always possible, but although "outsourcing contracts can never be completely future-proofed against regulatory changes", "the professional service providers are well equipped to deal" with them.

Questions for the board

1. Beyond cost savings, what do you hope to achieve from outsourcing and how does the tension between your various motives affect the choice of outsourcing provider?

2. How can you use the process of outsourcing to drive other desired changes within the organisation?

3. What resources are being allocated, and mechanisms put in place, to ensure the correct cultural fit with the provider?

4. What are the worst-case scenarios that can result from a decision to outsource and what are your mitigation strategies?

5. To what extent does any potential outsourcing decision align with the strategic vision of the organisation?

6. Do you have sufficient advisory support, right from the start of any outsourcing project?

7. Is outsourcing your only option?

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Contacts

Mazars is an international, integrated and independent firm, specialising in audit, accountancy, advisory, tax and legal services. As of 1 January 2019, Mazars and its correspondents operate throughout 104 countries and territories, of which 89 are part of Mazars' international integrated partnership and 15 are Mazars correspondent firms and representative offices. Mazars draws upon the expertise of 23,000 professionals and 1,040 partners, working from 310 offices worldwide, to assist major international groups, SMEs, private investors and public bodies at every stage in their development.

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