Outsourcing Contracts: Trends and Best Practices

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What is Outsourcing?

The term "outsourcing" sometimes carries a negative connotation, as it invokes images of American jobs being shipped overseas. However, outsourcing is just another form of subcontracting, a practice widely accepted by most companies. Like subcontracting, outsourcing involves the delegation of certain jobs to others who can perform the jobs more efficiently. However, outsourcing goes further than subcontracting, because outsourcing often involves the delegation of a company's core business functions. In fact, the term "outsourcing" is generally defined as a contract to perform core functions or services that a company might otherwise employ its own staff to perform (e.g. IT administration).

Outsourcing Trends

Outsourcing contracts are generally categorized as either Information Technology Outsourcing (ITO) or Business Process Outsourcing (BPO). ITO contracts cover a broad range of outsourced IT functions, including ASP/system hosting, applications development, data base management, maintenance/support, e-commerce and network administration. Spending for global ITO services is projected to reach $267 billion by 2009.

BPO is growing at a faster pace than ITO, with an estimated annual growth rate of more than 10%. BPO includes services such as data entry and processing, finance/accounting, customer call centers, staffing and training, product engineering, procurement and facilities management. Global BPO spending will reach $650 billion by 2009.

Companies based in the United States account for almost 50% of ITO/BPO demand worldwide. U.S. demand for ITO/BPO services is growing rapidly in all industries, particularly in health care, financial services, insurance, manufacturing, energy, transportation and retail.

Outsourcing reflects a permanent change in the way U.S. companies are conducting business. While outsourcing offers operational savings of 20% to 80%, oursourcing is not simply a response to economic conditions. Companies are selecting outsourcing vendors that can meet their needs for better technology, scalability, enhanced operations and regulatory expertise.

Outsourcing impacts companies of every size. Traditionally, larger companies have been the biggest buyers of outsourced services. However, demand for outsourcing is growing among small to mid-sized companies as outsourced services become more accessible through Internet-connectivity and better technology. These small to mid-sized companies use outsourcing to gain economies of scale and "best of breed" IT/IS solutions that are often beyond their internal resources. Indeed, 60% of U.S. companies with 500 employees or fewer report that they will sign outsourcing contracts within the next 12 months.

Outsourcing and the Health Care Industry

Although the prospects for outsourcing are strong in every industry, the health care industry provides an example of the growing need for outsourcing. Health care spending in the United States exceeds $1.5 trillion, or an average of $5,500 per person. Spending on health care continues to grow at twice the rate of the U.S. gross national product (GNP) and will increase to $2.2 trillion in 2008. Approximately 24% of this amount will be spent on health care administration.

The changing demographics of an aging U.S. population will accelerate the increase in health care spending. It is predicted that as baby boomers age, higher demands for patient care will increase health costs to unprecedented levels, potentially outstripping the capacity of the U.S. health care system. By 2011, health care spending could exceed 20% of GNP.

At the same time, the largest health care insurers, the federal and state governments, are faced with shrinking budgets and rising costs. States are facing severe shortfalls resulting from the worst decline in tax revenues since World War II. These shortfalls, now exceeding $70 billion, are expected to increase further, due largely to the skyrocketing costs of health care benefits.

The increasing costs of Medicare and other public health programs are being shifted to health care providers, such as hospitals. Health care providers are receiving lower reimbursements for patient care while also facing increased demands by patients for better care. In response, many health care providers are employing outsourcing solutions to combat rising costs, as well as to address new technology requirements and an ever-changing legal and regulatory environment.

Best Practices for Outsourcing

As outsourcing grows, the size and complexity of outsourcing contracts also grows. As a result, the models for outsourcing transactions can vary. Models for outsourcing transactions include full outsourcing, which involves a single contract with a single vendor; selective outsourcing, involving multiple contracts with multiple vendors; and shared service models in which the customer and vendor share IT or operational responsibilities. More complex models for outsourcing transactions also exist.

The challenge in achieving a successful outsourcing relationship requires that companies and vendors address the full scope and complexity of outsourcing decisions. Contracting issues can include:

• IT system selection/licensing, system testing and acceptance, access requirements, configuration/interface responsibilities, system upgrades and support;

• Turnkey or shared business models, project management, operational/process responsibilities, project scope and change orders, dedicated staffing requirements and management reporting;

• Intellectual property rights and proprietary ownership of work product, business processes, applications and customer data;

• Data back-up and storage, data privacy/security, cross-border data protections, hard document retention, emergency mode operations and disaster recovery;

• Service level agreements, performance monitoring and penalties, auditing and on-site inspections;

• Bundled or transaction-based pricing models, volume fluctuations and pricing assumptions, special fees/charges, gain or risk sharing arrangements and benchmarked pricing and adjustments;

• Exclusive or nonexclusive vendor relationships, opportunities for in-sourcing or re-sourcing, transferred employees, subcontracting and offshore disclosures and change of corporate control and assignment;

• Contract remedies, warranties and indemnification, downstream and third party liability, regulatory compliance penalties and dispute escalation and resolution;

• Contract length and exit clauses, early termination penalties, triggering or cumulative termination events, data migration and transition services upon termination.

Despite the complexity of outsourcing issues, it is often necessary to finalize outsourcing transactions quickly, usually in six months or less. This underscores the importance for companies to effectively evaluate and structure the best outsourcing contract. Companies also want integrated solutions and more control over outsourced functions. When outsourcing is handled correctly, many executives report that their control over outsourced functions is better than their control over in-house operations. Better IT/operational controls also enhance Sarbanes-Oxley compliance for public companies and similar requirements for nonpublic companies.

Managing the outsourcing process can be a particular challenge for mid-sized companies that may not have dedicated teams to monitor the vendor selection process, or to negotiate the best contract. As a result, many companies consult outside experts to assist them in managing their outsourcing relationships. If managed effectively, outsourcing will yield significant operational benefits and financial success to those companies that embrace this growing trend.

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