



Deloitte.

Deloitte Consulting Outsourcing Advisory Services

Why Settle For Less?

Deloitte Consulting 2008 Outsourcing Report

Audit • Tax • Consulting • Financial Advisory

Foreword



Businesses are constantly following the latest developments in outsourcing. They are monitoring the financial benefits that can be attained, the opportunities to obtain other, non-financial benefits and the risks associated with implementation.

Why Settle For Less? Deloitte Consulting 2008 Outsourcing Report is a just released global survey report that addresses these questions. The survey team polled over 300 business and IT executives representing outsourcing buyers, outsourcing vendors, and legal firms. The purpose of the survey was to document the respondents' experiences and uncover insights that could be applicable across all industries when undertaking an outsourcing program.

The survey found that a large percentage of the companies that implemented outsourcing reached their financial objectives and averaged a strategically-important ROI of over 25%. However, a much larger than expected level of company-outsourcer conflict was reported, and many of the companies expressed disappointment with the outsourcers' overall ability to provide continuous process and technology improvements.

It appears as if companies that view outsourcing in a broader strategic context, and implement it systematically with proper financial analyses, governance, and methodologies, can gain greater business value. This, potentially, could provide a competitive edge over those that take a more traditional procurement-oriented view.

The report documents the respondents' outsourcing experiences and lists five dimensions through which companies can achieve greater value from their outsourcing efforts.

I hope that you find the findings presented in this report directly relevant to your own situation and welcome your feedback and comments.

Sincerely,

A handwritten signature in black ink, appearing to read 'P. Robinson'.

Paul Robinson
Principal
Global Leader, Technology
Deloitte MCS Ltd
London

Executive Summary

While outsourcing is generally recognized as a strategy for producing cost savings, few surveys to date have utilized a large enough sample of respondents to provide an accurate estimate of the actual amount of these savings. Deloitte Consulting has attempted to overcome this by surveying a group of 300 executives who are actually involved with outsourcing services worldwide. Our findings were striking — fully 83% of all respondents reported that their projects had met their ROI goals of slightly above 25%! Despite this apparently positive result we believe that the true potential of outsourcing is still not being fully achieved, hence the title of our report, “Why Settle For Less?”

Not only had the great majority of the respondents achieved their ROI goals, but a majority (70%) stated that they were “satisfied” or “very satisfied” with their arrangements - the highest level we have ever seen reported.

However, there were also some surprisingly negative findings in the data. Strikingly, 39% of the 300 respondents reported that they had terminated at least one outsourcing contract and transferred it to a different vendor in their careers and, of those who reported that they were “Dissatisfied” or “Very Dissatisfied” with their largest contract, fully 50% had brought the function back in-house. In addition, 61% reported that they had escalated problems to senior management in their contract’s first year, with 15% reporting five or more such escalations. 53% continued to have to escalate in the second year. Clearly, outsourcing is working financially for most of the respondents, but their relationships with their vendors have not been without problems, with escalations common and terminations and cancellations real possibilities.

We were struck by this seeming paradox. Consequently, we dug deeper into the survey results to identify any underlying causes for these findings and their implications.

On further review we found that, while 70% of the executives surveyed had reported that they were either satisfied or very satisfied with their outsourcing deals, their responses in several other areas indicated that they felt that they could be achieving more from their outsourcing arrangements. For example:

- Only 34% of the executives reported that they had gained important benefits from innovative ideas or transformation of their operations
- 35% of executives, including 55% of executives who were not very satisfied with outsourcing, wished their companies had spent more time on vendor evaluation and selection
- Asked what they would do differently if they were able to start their outsourcing projects over, 49% of the executives surveyed said they would define service levels that aligned better with their companies’ business goals
- The dissatisfied respondents noted underestimated scope; higher-than-expected costs; and poor quality communications, service, and reporting from their service providers

Our survey included 31 service provider executives, who suggested that companies may not be positioned to realize the full benefits of outsourcing. By a 3-to-1 margin, these service provider executives felt that their client companies were not prepared for outsourcing — that is, the companies didn't have a solid plan, didn't have the operational data needed to make sound outsourcing decisions, and/or didn't understand how the to-be organization would really work. In addition, many of these service provider executives noted that companies are often unable to dedicate enough time or adhere to the processes required.

The themes of unrealized potential and lost opportunities echoed throughout the survey results, and we believe these may have been the underlying causes of the escalations and contract terminations that were reported. The surveyed companies recognized that they should be receiving more than just financial benefits from outsourcing and that they should be receiving them with less effort and conflict.

Aiming Too Low and Short-Cutting the Process

These lost opportunities may possibly be the result of the surveyed companies setting their outsourcing goals too low. They may have initially perceived outsourcing primarily as a tactic to reduce costs as opposed to a means to fundamentally transform their operations and drive dramatic improvements in efficiency, productivity, and reliability. Then, only after having observed the results, did they recognize that they should have wanted more, with, as mentioned above, only 34% of survey respondents reporting that they had gained important benefits from innovative ideas or transformation of their operations. Service provider executives surveyed agreed that most clients didn't recognize the opportunity to use outsourcing as a catalyst to reengineer their operations and help achieve a wider range of business goals. Instead, most of these companies transferred their existing operations — “lift and shift” — to a service provider in the hopes of benefiting from specialization, economies of scale, and lower labor costs, especially in offshore outsourcing contracts. We have seen that such cost-cutting strategies can limit executives' view of the possibilities. They can be quickly duplicated by competitors, and they often fail to take advantage of outsourcing's potential to significantly change the way processes — and businesses — operate.

Even more fundamentally, we have seen companies typically fail to follow well-established, disciplined outsourcing procurement and management processes that support the organization's business goals. By short-cutting these processes, they may achieve cost reductions but fail to take advantage of the opportunities that outsourcing provides to incorporate innovative new approaches that can fundamentally transform their operations. And in some cases, these shortcuts in the process can have more serious consequences by creating a cascading series of problems that ultimately doom the outsourcing project to failure.

Transformational Outsourcing: Getting From Here to There

From our experience, simply transferring dysfunctional functions to a service provider in the hopes of reducing costs through economies of scale or labor arbitrage can reduce or even eliminate opportunities to reap the significant benefits that outsourcing can provide. Outsourcing CAN BE transformation. Through outsourcing, the dynamics of the business are very likely going to change, so why not capitalize on all of the benefits? Accordingly, service providers should not be seen merely as sources of low-cost labor but as partners in innovation.

Although we have seen many white papers and studies that have examined the benefits and drawbacks of outsourcing, most stop short of addressing why it is important to approach it differently and how to correct course — mid-stream if necessary. We believe our survey goes that extra distance.

Although there is no single “right way” to use outsourcing that will work for every company in every situation, this paper outlines five key dimensions of an outsourcing deal and examines the factors within each that we believe must be considered and executed properly if you are to seize lost opportunities and position yourselves for a high return from your outsourcing investment.

In an ever more competitive world, companies need to fully take full advantage of the tools at their disposal — and outsourcing is a significant one. Yet, by following a traditional cost-focused approach to outsourcing, we believe most companies are under utilizing this key strategy, and missing opportunities for tremendous benefits. But companies that view outsourcing in a broader strategic context, and implement it systematically, can gain a competitive edge over those that remain stuck in a traditional procurement mind set.

Why settle for less?



Research Overview

Deloitte Consulting undertook a comprehensive research effort to analyze the outsourcing approaches that companies are currently taking, and identify the leading practices, common pitfalls, and lessons learned from the outsourcing experience.

*Photo:
Shun Hing Square
Shenzhen, China*

In addition to a survey and in-depth interviews, the research was supplemented by Deloitte Consulting's own experience in assisting clients with the design and execution of their outsourcing initiatives.

The research analyzed outsourcing from multiple perspectives, including:

- A survey of 300 senior executives at mid-size and large companies headquartered in a variety of countries that engaged in a substantial amount of outsourcing. Respondents were senior leaders in their corporations and had significant decision-making authority over outsourcing deals. The IT leaders included CIOs, CTOs, Directors and Managers; business executives included CEOs, Presidents, CFOs, Vice Presidents, Line of Business leaders, Directors, and Senior Managers
- In-depth interviews with senior executives at 31 major outsourcing service providers; a majority of these were Tier 1 service providers
- In-depth interviews with senior partners and partners at 11 legal firms that have significant outsourcing practices
- Interviews and workshops with Deloitte Consulting leaders and practitioners who specialize in advising clients on outsourcing

Profile of Study Participants

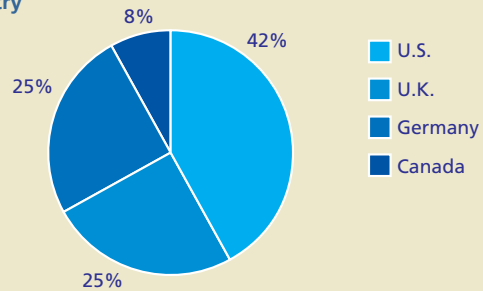
Company Survey

Deloitte Consulting conducted a survey of 300 executives at companies that spend at least \$50 million annually for IT outsourcing initiatives or at least \$30 million annually for Business Process Outsourcing deals. The executives surveyed were split between senior business executives (53%) and senior IT executives (47%). Exhibit 1 provides a more detailed profile of the respondents and their companies.

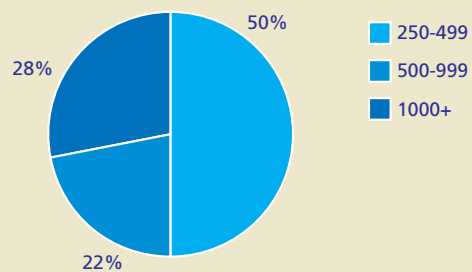
As a key point of reference in the survey, executives were asked detailed questions about their largest outsourcing contract.

Exhibit 1 Company Respondent Profile

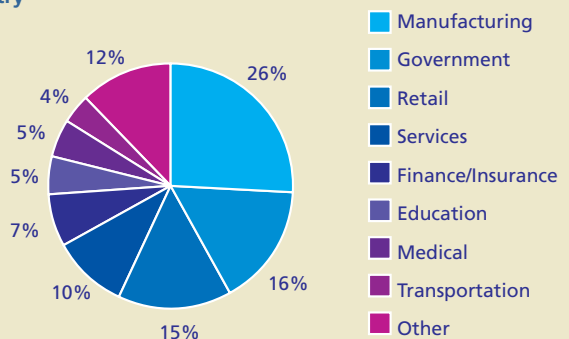
Country



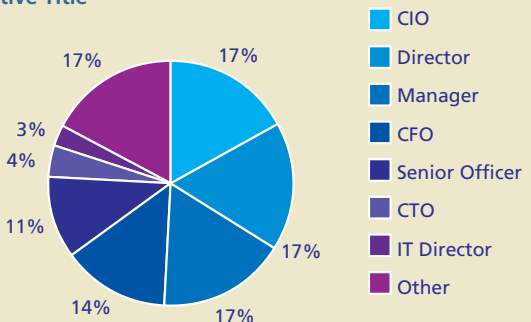
Number of Employees



Industry



Executive Title



Service Provider Interviews

Deloitte Consulting conducted interviews with executives at 31 major outsourcing service providers in order to gain insight into their experiences and gather recommendations and opinions regarding the outsourcing lifecycle.

	IT Services	Business Process Outsourcing	Infrastructure Outsourcing
Offshore Vendors	15	7	2
U.S. Vendors	6	5	5

*Matrix Totals exceeds 31 as there are vendors with more than one area of outsourcing & therefore these vendor discussions are counted more than one.

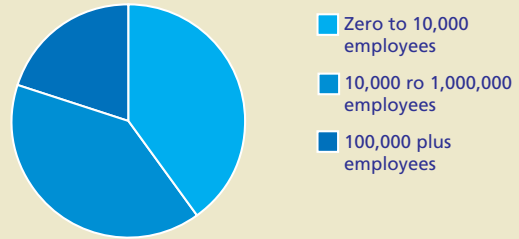
Legal Interviews

The participating law firms represented a broad range of expertise:

- 60% have global outsourcing experience
- 40% only provide legal support to U.S. - centric deals
- 60% only represent companies/clients
- 30% represent both companies/clients and service providers
- 10% only represent service providers

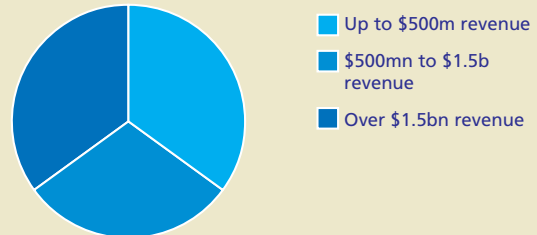
Exhibit 2 Vendor Respondent Profile

Number of Employees



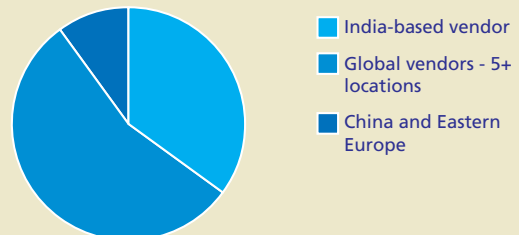
- Average number of employees (excluding Tier 1 vendors) is 18,000
- Average number of employees across all interviews is 56,000

Revenue



- The average revenue excluding Tier 1 vendor is \$1.1 billion
- Average revenue across all vendors is \$15 billion

Vendor Locations



- The majority of vendors have operations in India
- Global vendors were classified as those with significant presence and delivery capability outside of India



Introduction

When asked how they would rate their largest outsourcing initiative, 70% of executives surveyed said they were very satisfied overall (rating it 4 or 5 on a 5-point scale).

*Photo:
Sears Tower
Chicago, Illinois*

Among these executives, fully 89% said that their outsourcing initiatives had met their ROI goals. The remaining 30% of executives said they were less than very satisfied with the results of their largest outsourcing contract. Surprisingly, even among these executives, 63% still said their initiatives had achieved their ROI goals.

At first glance, these statistics may seem like headline material for those wishing to promote the benefits of outsourcing. Yet we at Deloitte Consulting believe that these numbers don't tell the whole story. The survey results also suggested that companies have been shooting too low in setting their outsourcing goals and have been less than precise in defining what constitutes acceptable ROI. In other words, the outsourcing initiatives of both groups — those that were satisfied and those that weren't — could have achieved far more if they had been designed with more ambitious, strategic objectives and followed each step of a proven outsourcing process. Instead, most companies bring a procurement mind set to outsourcing — focusing narrowly on cost reduction and labor arbitrage, rather than leveraging outsourcing for transformation and a broader range of strategic objectives. And all too often, that mind set leads companies to skip key steps in the outsourcing process or take shortcuts that undermine the results that could be achieved.

In reality, successful outsourcing — and in particular, outsourcing that drives transformation and helps achieve broad strategic goals — requires companies to follow a disciplined process that keeps them focused on taking the right steps and making the right decisions. In short, outsourcing initiatives succeed by design, not luck.

This report explores the key dimensions of that design — five main dimensions of the outsourcing process that companies must progress through, as well as the factors that must be considered within each in order to reap the full benefits of the outsourcing. These dimensions are:

- Rightsizing the Deal
- Build a Solid Foundation
- Vendor Selection Now Means Something Different
- Striking the Deal
- After the Deal is Signed

While we will speak of these dimensions as a logical progression, companies need to think holistically about the entire outsourcing process and recognize that employing best practices, or instead making mistakes, in one dimension will have important consequences that ripple through all the rest.



*The Petronas Towers
Kuala Lumpur, Malaysia*



Dimension I: Rightsizing the Deal

Are you outsourcing the right things for the right reasons?

Most outsourcing initiatives are motivated by cost and based on a “lift and shift” mentality.

*Photo:
Central Plaza
Hong Kong*

But transferring a dysfunctional operation to a vendor in the hopes of savings costs through economies of scale or labor arbitrage is simply a case of “your mess for less.”

The survey results (See *Exhibit 3*) confirmed that cost reduction is the primary factor motivating most outsourcing decisions. 64% of executives surveyed said a desire to reduce operating costs was a key driver of their decision to outsource for the largest outsourcing contract they were involved with, while 49% cited the related objective of obtaining less expensive labor. The second most important reason was to gain access to technology expertise, cited by 56% of executives. In contrast, other strategic objectives were rated far lower. For example, only 37% of executives said a primary driver in their outsourcing decision was to improve customer value and only 27% said they hoped to gain competitive advantage through outsourcing. Overall, the emphasis on cost reduction and access to a vendor’s skilled workers reveals a procurement-oriented mind set that takes a narrow view of the potential benefits of an outsourcing relationship.

Move Beyond a Cost-Driven Strategy to Reap More Benefits

Executives should look at cost reduction as a basic requirement in an outsourcing arrangement — as a “given” — rather than as a primary driver. Why? While the cost savings that companies have achieved from outsourcing are not to be minimized, most companies are foregoing the much greater benefits that would be generated with a more transformative approach.

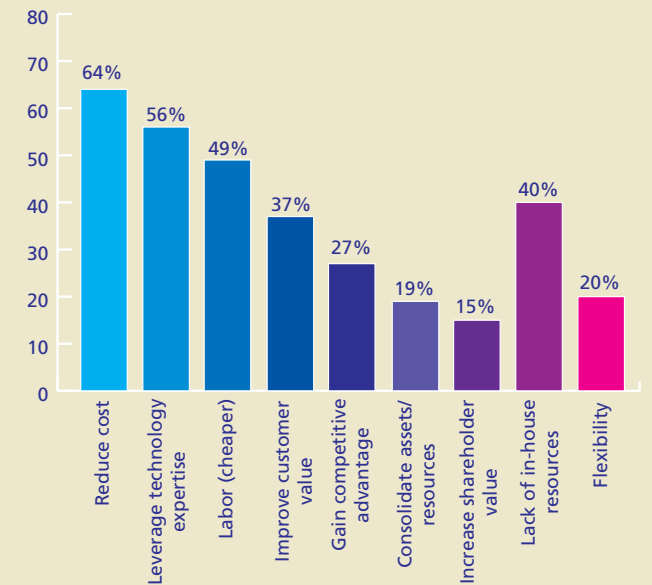
To date, few companies have intentionally set out to leverage outsourcing as a catalyst for transformation. For instance, only 34% of executives surveyed reported significant benefits from innovation/transformation, and just 28% of executives had seen benefits from business process reengineering as a result of their outsourcing contracts. In addition, many of the vendor executives interviewed felt most companies didn’t recognize the opportunity to use outsourcing to transform their operations.

Companies can reap substantial benefits when they do recognize this opportunity and when they explicitly establish transformation as the basis of their outsourcing strategies. When aligned with the company’s greater business goals, transformational outsourcing can be used as a tool to improve the company’s competitiveness and performance across finance, marketing, customer satisfaction, R&D, and other critical areas.

The results of a more transformational approach can be dramatic. One global media company used outsourcing with a major vendor as a way to reengineer its finance and accounting processes to create a single shared financial system, consolidating 11 stand-alone systems. As a result, it was able to slash internal trading volumes by 75% and reduce financial management costs by 50%.

Exhibit 3
Cost Reduction and Access to Expertise Key Drivers

Primary Drivers of Outsourcing Initiative



In another case, a major U.S. retail company was concerned that its multi-platform IT infrastructure would inhibit its strategy to increase market share, and turned to outsourcing. The vendor provided a single platform that increased customer satisfaction by reducing processing time, increasing system performance, substantially improving the ability to analyze merchandising trends, and reducing infrastructure costs.

However, companies must take into account any trade-offs that may be involved when taking a transformational approach. Transformational outsourcing initiatives are by definition more ambitious than simple lift-and-shift engagements since they entail new ways of doing business. As a rule, they typically take longer and require more management attention. Timeframes for achieving results may be a year or two, as opposed to a few months with a traditional approach — but the results will be far more significant in the long run.

Align the Outsourcing Strategy With the Business Strategy

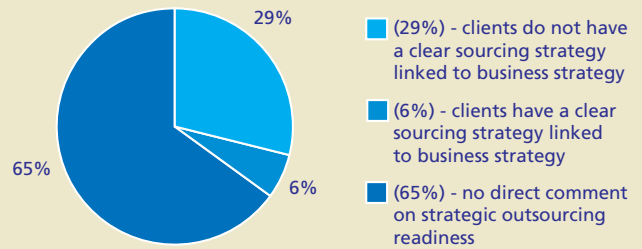
All too often, outsourcing initiatives, transformational or otherwise, are designed in isolation — without articulating a clear outsourcing strategy and linking it to the broader business strategies and goals. Indeed, only 6% of the vendor executives surveyed said that clients had a clear outsourcing strategy that was tied to their business strategy (See *Exhibit 4*). This alignment is a prerequisite for success. When asked what they would do differently if they had to do their outsourcing effort over again, 49% of the executives surveyed said they would do a better job of defining realistic service levels that are aligned with business goals and 39% said they would better define and align business goals with outsourcing strategy.

Understanding Business Themes and Drivers

Developing an operational case that takes a look at current processes and describes the changes that will take them to the desired “to be” state is an important part of aligning the outsourcing strategy with business goals. The operational case should spell out the expected benefits in areas such as application uptime and availability, improved order fulfillment, and reduced call center handle times. The alignment of business strategy and outsourcing objectives is one of the most challenging aspects of outsourcing, and the operational case makes that essential link. In order to enable this alignment, companies must understand the business themes that are the basic reasons for outsourcing, such as the need to manage costs, improve service, provide scalability, or enable new lines of business. They must then address the underlying business drivers that will affect those themes. Examples of business drivers include transactional volumes, call center volumes, and amount of time to close at month-ends. Understanding both the business themes and the business drivers is essential to developing an outsourcing solution that is aligned to the business strategy.

Exhibit 4 Few Companies have Strategic Readiness

Result of Vendor Interviews



Jin Mao Tower
Shanghai, China

Taking Future Expertise Into Account

An outsourcing initiative should take into account the current and future possibilities for the business, and design the scope and degree of transformation around those possibilities. For example, executives should consider which processes are core to the overall business strategy, what expertise must be retained in-house, the planned and potential growth of the company, and the differentiators that provide the company its competitive advantage. Based on this assessment, they can then define the desired end state to be achieved, and understand the risks and trade offs involved in getting there.

As companies assess how outsourcing particular functions can support their business goals, they need to consider each in the context of the following types of business strategy.

- **Operational Strategy.** Given their focus on cost reduction, most outsourcing initiatives are designed to support a company's operational strategy. But companies should also think about other aspects of operational strategy beyond cost, such as productivity, the quality of services or products, and time to market. For example, a major manufacturing company outsourced its ERP system to remedy work delays due to frequent errors and problems with its existing systems
 - **Competitive Strategy.** Companies need to examine how outsourcing will affect their competitive position. Outsourcing initiatives need to be designed carefully so that they don't undermine the company's strategic positioning
 - **Financial Strategy.** The impact of outsourcing on the company's financial plans is a key consideration. Companies should consider items such as financial engineering, financial risk management, allocation of capital, evaluation of project financing options, financial leverage (e.g., debt/equity ratio), and working capital. Outsourcing allows firms to gain more financial control by turning large fixed capital costs for new technology into variable costs in service provider contracts, thus reducing debt, improving liquidity, and lowering risk. Relying on outside specialists can also provide a more predictable IT budget than is possible with the uncertainties of internal application development
- **Marketing Strategy.** A company should examine how outsourcing can support its marketing of products and services, pricing strategy, pace of product or service introduction, and customer service. For example, after moving its technology-support operations to India to reduce costs, a computer manufacturer found that it had damaged its image and lost revenue due to poor product knowledge and communication skills among the offshore service provider's employees
 - **R&D Strategy.** Outsourcing can support a company's efforts to develop innovative products to meet current and anticipated future customer needs. For example, a pharmaceutical company outsourced parts of its R&D operations to a service provider in an emerging market to reduce its product-development cycle. Through its outsourcing contract, many more additional R&D professionals worked on its projects than it could have afforded to hire in the United States, and work could be conducted around the clock by taking advantage of time differences

Having a clear strategic focus makes it easier to determine what capabilities to look for in a service provider, and to define realistic service levels that are tied to company business goals. Lack of a distinct strategic focus can completely skew the entire initiative and dramatically lessen results.



Dimension II: Build a Solid Foundation

Have you defined and quantified what you expect from your outsourcing initiative?

The creation of a business case should not be given short shrift — but in practice, it too often is.

*Photo:
The Taipei 101 Tower
Taipei, Taiwan*

Only 37% of executives surveyed said that their companies had used a business case/strategy assessment during their outsourcing initiatives. Companies may feel that they do not have the internal resources or time to develop a business case, or that they have a clear enough understanding of the potential benefits that they do not need to go through the formal business-case process. And that is a mistake.

Before reaching out to vendors, a company must develop a sound business case laying out the business value of outsourcing, and how the outsourcing initiative will support the company's strategic objectives.

The business case should define and compare the current "as is" state of the process with the eventual "to be" state. And it should provide a solid foundation for the request for proposal (RFP) that will be sent out to service providers. Without this type of clarity and preparation, the outsourcing initiative is at risk of stalling out due to lack of internal buy-in, or even worse, of going completely off course because of poorly chosen objectives and unrealistic expectations of what the vendor and the retained organization can deliver.

Calculating ROI

The business case should delineate both the desired state of the process after outsourcing and the expected business benefits that will result. Ideally, it should quantify these benefits in the form of an expected return on investment (ROI), taking into account increased revenues and cost savings, as well as the costs involved.

The calculation of ROI should pay special attention to "hidden" costs that are often overlooked. For example, in offshore arrangements, it's particularly important to factor in the costs of remote management and travel, more complex reporting, and the impact of language and cultural differences on productivity. Similarly, companies considering multisourcing arrangements involving several service providers need to factor in the costs and complexity of managing numerous partner relationships.

The costs beyond the actual contract costs can be substantial. Severance costs can add 3% to 5% to project costs, the additional complexity in offshore contracts can add 6% to 10%, and initial software development can add from 1% to 10%.

On average, surveyed executives anticipated an ROI of 25.8% from outsourcing, and 83% reported that their contracts had met their ROI expectations. In reality, however, many companies are relying on guesswork in making such calculations, since more than one-third of the surveyed executives said they had not conducted a total cost of ownership analysis before outsourcing.

Many companies simply do not have a clear grasp of their current costs. "Lack of data quality delivered by clients often means that service providers are not able to make valid offers," said an executive at one major outsourcing service provider. Not surprisingly, among executives who were less than highly satisfied with their outsourcing contract, 40% felt they should have conducted a more thorough TCO financial analysis prior to outsourcing.

As important as financial assessments are, they should not be the sole focus. Instead, the business case should also look at less tangible benefits and provide an understanding of the total economic value that will be generated by the outsourcing initiative, based on factors such as improved management focus, quality, and reliability.

Many Uses Beyond Immediate Justification

Developing a strong business case that describes in detail the costs and benefits of an outsourcing initiative is, of course, sound management practice — but the business case can have a long life beyond the immediate justification of the outsourcing effort. It can be used to support decision-making throughout the outsourcing process and on implementation and ongoing operations. It can provide a mechanism for objectively developing the scope of services and service level agreements (SLAs) during the service provider selection and contracting stages. It can be used to help companies understand the impact of changes discussed during negotiations. And it can provide a shared view of the outsourcing effort that helps build consensus among key stakeholders across the organization.



Dimension III: Vendor Selection Now Means Something Different

Have you chosen the right service provider?

When things don't go well in an outsourcing initiative, most companies automatically scrutinize the vendor, but this is often not where the real fault lies.

*Photo:
Two International Finance Centre
Hong Kong*

In order to succeed, companies must select the right vendor for their needs right from the start. This is another area where companies tend to shortcut the process, and in so doing, leave significant value unrealized. This tendency was clearly reflected in the survey results. When asked what they would do differently if they could go back to the beginning of their outsourcing initiatives, 35% of executives surveyed said they would spend more time on the service provider selection process. That figure rose to more than half among executives who said that they were not very satisfied with their outsourcing arrangements. As many have found, a rushed or ineffective vendor selection process can lead to mismatched expectations between the company and the service provider as well as ongoing communication issues — and quite possibly, the selection of the wrong service provider altogether, which can lead to years of frustration and disappointing results. (See Exhibit 5).

The RFP

The selection process begins with the creation of an RFP that incorporates the company's strategic requirements and should be based on the outsourcing business case. There is significant room for improvement in this area, with roughly half the vendor executives interviewed saying the RFPs they receive tend to be poor guidelines of what companies truly want. Many vendor executives felt that clients often lack a clearly defined outsourcing strategy, which is essential to developing a solid RFP.

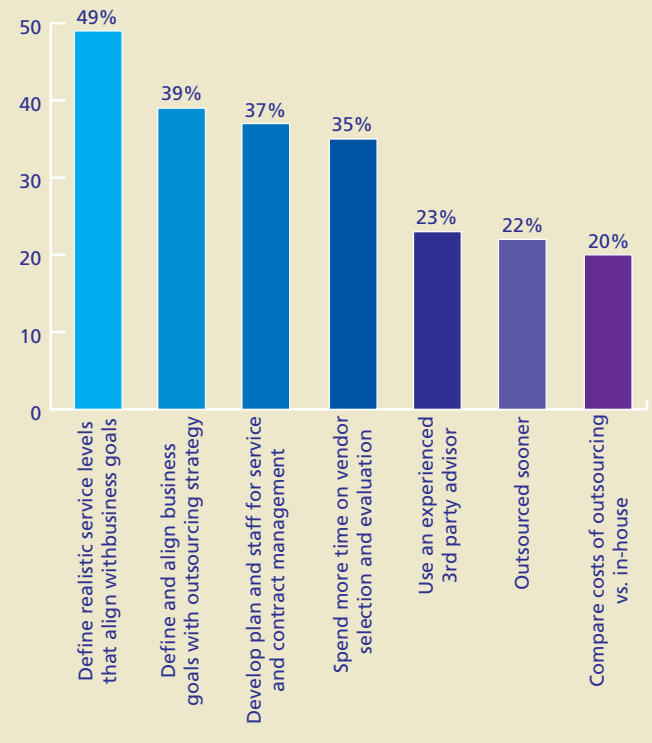
An RFP should be detailed enough to give vendors a clear understanding of the company's goals and the critical capabilities and skills required — without burying them in detail. If it leaves too much open to interpretation, different vendors are liable to come to different conclusions as to what it means, which can lead to off-target and difficult-to-compare responses.

In addition to describing the scope of services to be outsourced, the RFP should also help vendors "push the envelope" in their responses by:

- Defining both the operation's current state and its goals for a desired end state, so that service providers clearly understand the company's needs
- Emphasizing the results the company wants to achieve, rather than prescribing how things should be done, which inhibits innovation
- Requiring service providers to demonstrate their understanding of the company's needs and how they can provide innovative options
- Defining for the client how the service provider plans to manage change during the course of the contract

Exhibit 5 Lessons Learned: better Alignment with Business Goals is Key

What companies would do differently if they had to re-do their outsourcing initiative



In addition, it's important to incorporate service-level targets into the RFP. In defining their service-level targets, companies should not blindly accept the service provider's "boilerplate" service levels, or turn over the writing of service levels to the legal team. Instead, they should develop service-level targets that address their specific business needs.

Defining service-level targets early on in the selection process can help to pre-qualify vendors. While rigorous service-level requirements may increase costs, it is better to discover the extra cost early rather than to be surprised after the service provider has been selected.

Personal Motivations Often Drive the Process

Many companies do not devote sufficient attention or resources to the selection dimension of the outsourcing process. Executives may have a service provider in mind from the start, feel they don't have time, or let personal relationships and political considerations drive the process. For example, when asked about their service provider choice in multisourcing arrangements, 34% said it was due to existing relationships with some of the new service providers, while the same percentage said it was due to an existing relationship with the incumbent service provider. Those kinds of subjective judgments can cause companies to conduct only a cursory evaluation of prospective vendors.

Hence, careful selection of the employees who participate in the evaluation process is critical. Do not underestimate the potential desire of current staff to prefer less qualified service providers for personal reasons. It's also important to keep senior management involved. While more senior-level executives tend to design the outsourcing strategy, mid-level managers often create the RFP and evaluate the service providers. However, be cautious about giving mid-level managers too much decision-making power. Experience has shown that they may be likely to skew the evaluation process by sticking to what they know about how the operation has functioned in the past, rather than being open to fundamentally rethinking its design. They may also be biased due to concerns about job security or other personal issues. Having significant executive input helps ensure that the evaluation is not limited by too narrow a viewpoint and that it is based on appropriate criteria.

The criteria for selecting a service provider should naturally depend on a company's specific needs. For example, the survey found that executives involved in transformational outsourcing arrangements focused less on price, cited by 36% of those executives, and more on gaining access to expertise, cited by 55%.

Overall, executives cited a variety of qualities that they felt differentiated the service provider they had selected. At the top of the list, 67% of executives cited industry or business expertise, followed by 60% who named the service provider's willingness to customize, and 59% who named price competitiveness. IT skills and customer service were service provider qualities named by roughly half the executives. Along with such considerations, companies should examine the service provider's ability to address the transition to the future desired state, as well as its ability to scale and adapt as the business evolves. Companies should also consider selecting a service provider who not only delivers a service, but can also manage change.

Collaboration, Flexibility and Time Required From Both Sides

The selection process is not a one-way street. Service providers should review relevant data, ask educated questions, and provide thorough proposals demonstrating their expertise and describing the recommended solution, including a detailed plan for how the solution will be attained.

The service providers and the company may well need to go through several iterations of proposed plans. As service providers gain more data and insight into the operation, they will usually revise their cost estimates, recommended solutions, and expected results. Based on what it learns from these discussions, the company can refine its requirements and expectations. It's essential that any new information or revised assumptions be shared with all service providers to ensure that the final evaluation is done on a consistent basis. At the end of the process, each service provider should submit a "best and final offer" that describes the assumptions, business goals, desired end state, and the service provider's approach to reaching that state. Naturally, it is imperative that the final proposal be easily transferable to the contract format.



Dimension IV: Striking the Deal

Is your contracting process mutual and flexible?

Negotiation of the contract is a pivotal point in the outsourcing process.

*Photo:
Empire State Building
New York City, New York*

Too often, however, the spirit of the deal is lost as the contracting document gets mired in “legalese.” Or the outsourcing contract flat out fails to capture a company’s key expectations specified in its RFP, especially if those expectations focus on strategic and transformational benefits. When the process is mismanaged, companies can lose sight of their strategic objectives; inadvertently develop a document with a narrow, cost-oriented focus; and ultimately damage the relationship with their service provider and, in so doing, lose opportunities for innovation and collaboration.

Continued involvement by senior executives in the contracting process is important to guard against having the procurement department narrow the focus exclusively to cost-oriented, transactional issues — or having legal counsel develop a dry, complicated document that overrides the intended spirit of the service provider/company relationship.

The Contract Is Not Just About What the Vendor Will Do; It’s Also About What Your Company Will Do

An effective outsourcing contract should accurately reflect the strategic goals that have been established for the initiative and clearly define expectations — for both the vendor and the company, encompassing both the pre-transition and the post-transition environments. The challenge is to make these goals and expectations operational. If improving reliability or service quality is an outsourcing objective, then the contract needs to incorporate specific performance metrics to assess whether the service provider is meeting these goals. The expectations for improved service then need to be captured in SLAs that are realistic, feasible, and measurable. And a company should be ready to revise its SLAs as needed to ensure they remain relevant.

Establishing appropriate SLAs is an important part of the contracting process. Among the executives surveyed, 69% reported that their largest outsourcing contract contained service guarantees based on specific metrics.

However, establishing the right service levels is not simple. Companies often lack baseline data on the current performance of the operation being outsourced. Among the executives surveyed, 67% said their companies’ service levels were developed specifically for the outsourcing initiative. The fact that some companies develop their SLAs in collaboration with their service providers is also worrisome because it raises the possibility that the SLAs may be set below what could reasonably be achieved.

In addition, SLAs have traditionally tended to focus on cost-related metrics, such as cost per transaction. However, if companies are pursuing more strategic goals, then it is essential the SLAs reflect these broader objectives. SLAs can include metrics that track such items as responsiveness, customer satisfaction, reductions in defects or errors, or the time needed to implement a new process.

The Multisourcing Option

One outsourcing approach that is gaining in popularity is multisourcing — drawing on several service providers in an outsourcing agreement and dividing the work among them, rather than working with a single service provider that handles it all.

More than half of the service provider executives interviewed said that most of their clients are adopting multisourcing approaches, particularly for larger contracts. Several service provider executives said that they see clients using sole sourcing at a business unit level — where they are looking for a service provider to fill a specialized need — while tending to use multisourcing at the company level. In the survey, 29% of executives said they used multiple service providers.

Multisourcing adds additional complexity to both the service-provider-selection process and ongoing performance management. This is especially true when a company chooses to have a direct relationship with each service provider, which is the model employed by 81% of the executives who reported using multisourcing. A range of factors, including the contract, service level agreements, reporting and the role of the retained organization, will need to be designed to support the multisourcing model. As one law firm partner said, “Essentially you become your own general contractor, and [the service providers] all have to be integrated. You have to have a well-organized staff and know what you need from these different charters.”

Choosing instead to contract with one prime service provider, who will then manage the relationships with the sub-service providers, can reduce the complexity somewhat. However, under this model it is essential to select a primary service provider who is capable of serving effectively as a prime and managing the sub contract relationships.

Some companies may see multisourcing as a way to keep prices down by playing one service provider off against another. Instead, they should look at multisourcing as a way to foster innovation through the cooperation of diverse service providers.

Many companies, however, see multisourcing primarily as a way to access specialized capabilities. Indeed, 76% of the executives who reported using a multi-service provider approach said they believed that no single service provider could meet all their requirements (See *Exhibit 6*). Just under half of the executives using a multi-service provider approach said that the mitigation of risk was a driver: With mega-deals split into smaller pieces, performance problems with one service provider are likely to have less impact on the overall business process.

To avoid any misunderstandings, both the company and the vendor should explicitly state their expectations about service levels and the benefits to be achieved. Companies also need to think in terms of managing the expectations of various stakeholders in the company, including senior executives, managers involved in the governance of the outsourcing relationship, and functional users. For example, in developing the SLAs, companies and vendors should perform a review with top executives and involve key leaders from the business unit. These reviews should document the service levels to be maintained, the actions the vendor and the company will each take to improve those levels, and what steps will be taken if levels fall below certain thresholds.

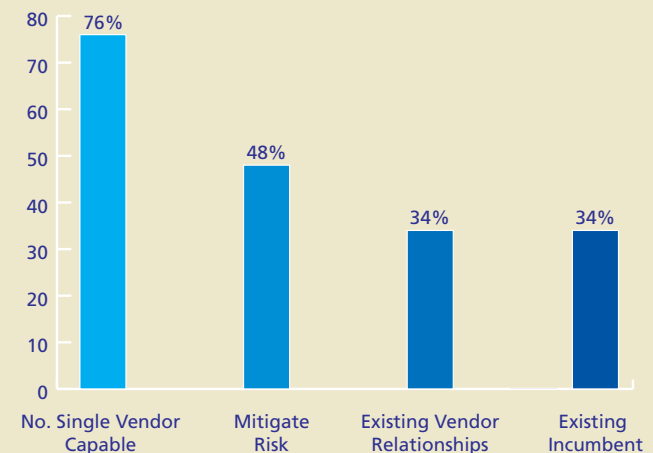
The Pricing Question

Central to any outsourcing contract is the pricing for the services. For a start, the pricing needs to be clear and unambiguous to avoid unwelcome surprises. The contract should clearly delineate the pricing for two types of activities: those required to maintain the baseline of service levels in the operation and those required to enhance services or products which would justify additional charges.

It's also important to take a long-term perspective. As technology improves, service providers gain expertise, and innovations are introduced, companies should expect prices to decrease. In fact, contracts should anticipate some cost reductions even in the short term. During the RFP process, a service provider should have identified the "low hanging fruit" that can be picked, as well as the more fundamental improvements in efficiency that can be achieved over the long term. The pricing model should clearly describe the circumstances that will lead to future price decreases over the contract term.

Although minimizing costs is always a concern, focusing solely on achieving the lowest price may be short-sighted. Companies should maintain their focus on driving business value by leveraging outsourcing to achieve their company's strategic objectives, even when this entails additional cost in the near term. Also, it's important for companies to keep in mind that the contract needs to be financially attractive to the service provider if they are to create a long-lasting relationship that benefits both parties.

Exhibit 6
Search for Specialized Expertise Drives Multisourcing



Note: Percentages total more than 100 because executives could make multiple selections.

Be "Futuristic" When Drafting Contracts

No matter how carefully constructed, outsourcing contracts need the flexibility to adapt to evolving business requirements. Consequently, more and more companies today are adopting a "futuristic" mind set when drafting contracts, using a variety of techniques to introduce the requisite flexibility for negotiating any unforeseen curves up ahead.

Among these techniques is the growing trend of entering into shorter-term contracts, which have lower risk. 64% of the executives surveyed said their largest outsourcing contract had a term of one to three years, 20% reported a length of three to five years, and only 13% reported five years or more. While shorter contracts provide flexibility and reduce risk, they also increase transaction costs. Companies that rely on shorter contracts will need to compensate for these additional costs by institutionalizing and rationalizing their outsourcing processes.

Other flexibility-enhancing techniques include:

- **Adaptable Contract Frameworks.** These frameworks provide the ability to change the scope of services, SLAs, and terms and conditions based on service provider performance and business outcomes. Along the same lines, some contracts now include a “technology refresh” clause, which requires a review of technology on a predetermined schedule, so that it remains current

Among the executives surveyed, 73% reported their largest outsourcing contract provided an ability to adjust service levels, 69% said it provided a built-in mechanism for levying additional charges, and 68% said it included an ability to change the scope of services. Half the executives also said their contract had provisions to adjust pricing based on increases or decreases in the volume of services

- **Mid-Term Reviews.** Periodic, pre-scheduled reviews of contract specifications allow companies to keep services aligned with changing business needs. Companies should consider inserting a contract stipulation requiring an annual review of the entire contract, as well as twice-a-year formal reviews of all SLAs
- **Benchmarking.** Periodic benchmarking of service quality and cost against industry standards, often by a third party, can provide a useful reality check. However, 61% of the executives surveyed said their largest contract did not have a benchmarking clause; in retrospect, 45% of these executives, including 64% of those who were not very satisfied with their contract, wished they had included such a clause. In formulating benchmarking clauses, companies should ensure they are actively involved in shaping the studies. They should also establish who will bear the cost and establish ways to resolve any issues that arise from the results

Although they can be helpful, benchmarking clauses are not an absolute requirement for success. For example, although 80% of the surveyed executives who worked with infrastructure contracts said they were very satisfied with their contract, 68% said their contract lacked a benchmarking clause.

To evaluate service providers for multisourcing arrangements, companies should:

- Assess each service provider’s cultural readiness to collaborate with other service providers. Ideally, a service provider should be able to point to past experience in working with other service providers, but relatively few have extensive experience in this area. It is, of course, in the service providers’ self interest to work together when a client company wants a multisourcing agreement, but not all service providers are prepared for or well-suited to such collaboration
- Work with service providers to create shared expectations of how disputes and operational challenges will be resolved, and how service providers will share responsibility (and penalties) when no single service provider can be singled out as the cause of a problem. Avoid augmenting your own staff as a means to resolve issues
- Ask each service provider to demonstrate how it will report on its respective piece of the process. These reporting processes should be rigorously “stress-tested” together in simulations during the transition of work to the multiple service providers. Companies also need to confirm that separate service provider reports can be integrated easily to provide a single view of the outsourced process
- Ensure that pricing transparency is maintained throughout the process. One of the common pitfalls is failing to be aware of “margin stacking,” in which a primary service provider that is aggregating other providers adds an additional margin and passes it along to the company

Finally, executives should devote the time needed to understand the service provider’s capabilities, including conducting site visits to the service provider’s operations. As much as possible, the intended service provider delivery team — not just the sales team — should be included in all meetings with the potential client for evaluation.

“Benchmarking takes time and money and is nothing more than an opener for pricing conversations. Benchmarking is nice to have in the agreement, but I just tell my clients to think about signing up for a shorter deal.”

Companies that decide not to include provisions for a benchmark review should consider several other options that can provide many of the same benefits. In addition to periodic contract reviews, they can conduct a root cause analysis of any failure to achieve SLA metrics and require the service provider to explain the variance and develop permanent remedies. The inclusion of productivity-improvement clauses and requiring the service provider to keep documentation current can also increase contract flexibility.

- **A Well-Defined Exit Strategy.** Contract provisions should specify an arbitration procedure to be used in case of disputes in order to avoid costly litigation whenever possible. The provision should require the use of an arbitrator with appropriate business expertise. In addition, a clearly outlined exit strategy helps the company assess its options and make sound decisions and plans about moving to a new service provider or bringing a process back in-house. An exit strategy should include a plan for transitioning the service to another service provider and define the current service provider's responsibilities in effecting that transition
- **Multisourcing.** By drawing on several service providers in an outsourcing agreement and dividing the work among them, companies can have the flexibility to hire the skills needed for specific tasks. Indeed, many companies see multisourcing as a way to access specialized capabilities; 76% of the executives who reported using a multi-service-provider approach said they believed that no single service provider could meet all their requirements. Just under half the executives using a multi-service provider approach said the mitigation of risk was a key reason. By splitting up mega-deals into smaller pieces, performance problems with one service provider are likely to have less impact on the overall business process

Don't Overlook the Value of the Contracting Process Itself

Regardless of the ultimate contract duration or other specifications, the contracting process itself can play a positive role in clarifying expectations and building trust. Many of the legal interviews in the survey expressed this view. As Michael Mensik of Baker Mckenzie LLP put it, "Deliverables ought to be viewed as setting the tone and the framework for having a collaborative relationship. Signing the contract here is not the end but the beginning." John Brockland of Cooley Godward LLP agreed: "Contracts become tools for governance as well. There's a trend toward including more in the way of governance in the agreement to make sure that the right people are talking to each other and get involved in the resolution process."



Dimension V: After the Deal is Signed

Are you getting what you paid for?

It can be tempting to think the signing of the outsourcing contract is the culmination of the outsourcing process. But in reality, effective performance management is the crowning component of a successful outsourcing initiative.

*Photo:
The Bank of China Tower
Hong Kong*

Most of the executives surveyed said their companies had instituted a variety of measures for managing contract compliance, including periodic reviews of compliance with contractual agreements (68%), a process for managing the service provider relationship (65%), specially designed processes (63%), and monitoring key business metrics (60%).

Despite these efforts, many companies still question whether they're getting what they paid for. Among all the executives surveyed, roughly two-thirds reported experiencing problems that had to be escalated to the level of senior management over the past year. Communications-related issues, particularly reporting and transparency, were some of the most commonly cited challenges. 29% of the executives saw inconsistent communication between the company and its service provider as a problem, 24% cited problems with reporting, 23% cited the lack of a communications plan, and 20% cited a lack of transparency (See Exhibit 7).

From Outsourcing to Competitive Advantage

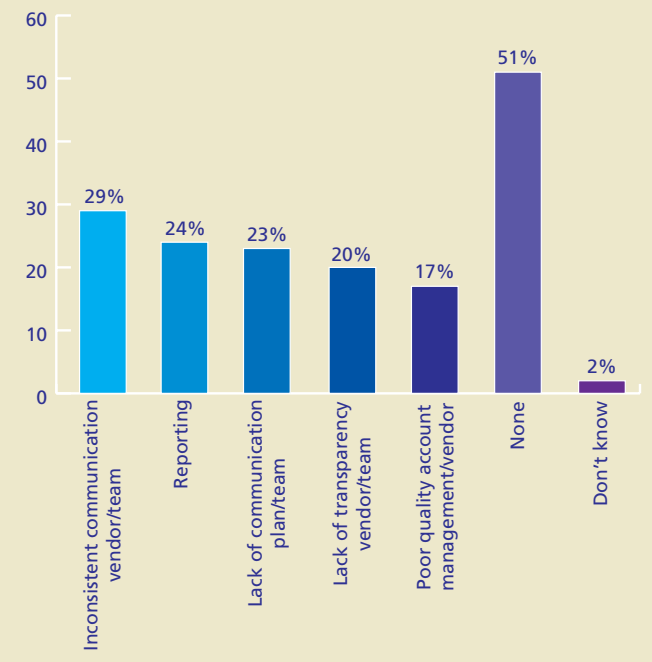
Transformation outsourcing is a buzzword that is increasingly being heard in the industry, but in reality, all outsourcing deals are to some extent transformational in nature. Some affect daily operations, while others affect the strategic direction of the organization. In a very real sense, the evolution of the outsourcing market is leading to a new approach that emphasizes this transformative aspect — one in which companies are looking not just for cost savings but also for ways to gain competitive advantage.

To date, most companies have not set their sights on achieving strategic benefits from outsourcing, with only one-third of surveyed executives reporting significant benefits from transformation in their outsourcing initiatives. In practice, most companies approach outsourcing with a cost-cutting, procurement-based mind set that doesn't look at the value of transformation. Or they consider transformation to be a follow-on activity that will occur more or less automatically over time, and thus fail to target transformation up front in their outsourcing strategies. The result, too often, is disappointment.

This disappointment, however, can — and must — be avoided. As global, competitive pressures intensify, companies will have little choice but to leverage outsourcing as a strategic tool. To do so successfully requires commitment, discipline and a great deal of forethought about what the organization is trying to accomplish. The outsourcing process, transformational or not, is built on trust and two-way communication, and it requires a holistic perspective in order to integrate its five dimensions. Shortcuts along the way lead only to dead ends.

Companies that truncate the process and continue to focus primarily on cost are destined to miss opportunities and to leave significant value on the table — and quite possibly even lose their competitive footing. But companies that view outsourcing in a broader strategic context, and implement it systematically, can improve their returns as well as gain a competitive edge over those that cling to a traditional procurement mind set.

Exhibit 7
Problems with Communications and Relationship Management



Such problems were noted even more often by executives who were less than very satisfied with their outsourcing contracts. Inconsistent communications were cited by 57%, a lack of transparency by 48%, and poor quality reporting by 47%. Other areas of risk included quality of the service provider's work, concerns about performance, service management, and staffing and attrition.

Problems such as these are prevalent because performance management is often the most difficult part of the outsourcing process — one that requires ongoing, daily management as opposed to periodic "procurement or sourcing" oversight. The survey results reflected a growing awareness that performance management requires a significant, and often underestimated, commitment. When asked what they would do differently if they could start their outsourcing initiative over again, 37% of executives said they would do a better job of planning and staffing for service and contract management, and this figure rose to 55% among executives who were less than very satisfied with their outsourcing initiatives.

Managing the Relationship

Managing the service provider relationship and monitoring performance is a full-time commitment, not a matter of simply reviewing periodic reports — which means that companies need to invest in the service provider management function, and factor those costs into their plans. In fact, the cost of the retained organization can range up to 7% or more of the annual contract cost. Companies often underestimate — or fail to consider — these ongoing costs. Among the executives surveyed, 85% said that they had 10 or fewer staff dedicated to managing their largest outsourcing contract, which may not be enough for many contracts.

The retained staff — those that remain in house to manage the service provider relationship and monitor performance — must have the right skills for their new role, which is oversight and strategy, as opposed to day to day operations. In addition, more planning is required when introducing new work into an outsourcing relationship than would normally be required when an operation was managed in house. Companies may find they need to retrain their current employees for the new demands of the retained organization or else fill positions with different professionals entirely.

What's more, existing employees often don't fully support the decision to outsource, and sometimes begin to micro manage and second-guess every step the service provider takes. Establishing a bonus structure based on the success of the outsourcing initiative can help alleviate such problems.

Senior executives in the retained organization need to be a unique blend of skilled negotiator, salesperson, and strategist. Service provider management requires people and relationship management skills, along with legal, financial, and planning skills. Finding executives with this set of skills is not easy. In many cases, it will be necessary to recruit aggressively to fill these senior positions, either within or outside the organization.

As previously mentioned, good communication is often a problem in an outsourcing relationship. To avoid such problems, companies need to establish a formal function to manage communications with service providers. At the very least, there needs to be a clear communication process with frequent calls and meetings, and ongoing written communications provided in a consistent format.

Monitoring Performance

A critical component of performance management is Service Level Management (SLM) — the monitoring of compliance to service levels specified in the contract, and reporting on the performance of the outsourced activity.

In essence, SLM is the process of determining whether a service provider is meeting expectations. SLM should be based on a holistic view of the relationship, looking at SLAs, costs, quality, and other factors to present a single view of service provider performance. These factors should be clearly understood by both parties. As one service provider executive said, "If the right expectations are set, service delivery is not a problem." Among the reporting issues that need to be considered are timing/frequency, format, whether real-time data are needed, and the threshold values for determining success or sub-par performance. The goal of reporting is not simply to record past performance, but to provide insight into the steps that can be taken to drive higher levels of service.

Among the executives surveyed 45% said their contracts included provisions for penalties if the service provider fails to meet agreed-upon service levels. However, it is important to avoid the tendency to "manage by penalties." When performance is not adequate, the company and the service provider should work cooperatively to identify and remedy the cause of the problem. It is also important to remember that problems in an outsourcing initiative are not always the service provider's fault. Often, the company shares some or all of the responsibility for inaccurate information or poor management.

Although SLAs are an essential tool, they need to be augmented by a broader set of methods to ensure that the initiative is meeting the company's business goals, such as increased customer satisfaction. "SLAs are not comprehensive indicators of the health of the engagement. Customer satisfaction surveys done at regular intervals help capture the softer issues that can then be addressed," said one service provider executive.

Some companies are also considering the use of balanced scorecards, which are designed to give executives an integrated and sophisticated assessment of service provider performance across multiple perspectives. These perspectives typically fall into four broad areas: financial, internal business processes, customer, and learning and growth. However, balanced scorecards are most feasible when a company already employs them across its organization. Creating a balanced scorecard solely for an outsourcing initiative may not be possible, since assessing the impact on business outcomes requires a linked series of scorecards all the way up to a company-level scorecard.

Governance

Governance structures and processes give the company and the service provider a mechanism both to manage daily operations and also to deal with the unpredictable issues and changing business realities that inevitably arise. Strong governance allows a company to ensure that the service provider's operations remain well aligned with the company's outsourcing strategy. The ultimate goal of outsourcing governance is not simply to monitor performance, but to leverage data to drive process improvements. Overall, noted one service provider executive, "Governance plays a very important part and makes or breaks a deal — especially in a distributed environment."

Outsourcing governance encompasses both strategic issues, such as managing decision-making about corporate investment, and tactical issues, such as the systems used to monitor the service provider's activities. The governance system should ensure that there is senior management buy-in, as well as ongoing consultation with all stakeholders to make sure their needs are being met, escalations are timely, resolutions of outstanding issues are reported, and success is communicated.

Making the Transition

One of the key factors in outsourcing success is the readiness of an organization to transition a process to a service provider. However, in the survey, 75% of service providers said that clients are not operationally well prepared for an outsourcing initiative. The service providers cited a lack of maturity in processes and the inability of many clients to clearly articulate their goals and needs. Client companies, they say, often lack a clear understanding of current volumes, throughput, staffing levels, service levels, and localization requirements, and often have little or no process measurement in place. Service providers also note that clients generally fail to fully understand the current process flow, how that will change with outsourcing, and how their processes will integrate with those of the service provider. These issues tend to become painfully apparent later on in the outsourcing process – during contracting, the transition dimension, and ongoing operations. Service providers call these issues change orders; companies call them hidden costs.

To smooth the hand-off, special reporting during the transition dimension is often needed to allow both the company and service provider to understand the underlying drivers of quality and cost, and how those affect broader

business outcomes. It is not realistic for companies to expect that they will be able to leap instantly from having little or no service level measurement to full contract service levels that are meaningful when viewed in conjunction with drivers and outcomes.

It is also important to carefully design the retained organization — the staff and structures that will remain with the company after day-to-day operations have been transferred to the service provider. The retained organization provides guidance to the service provider and acts as an intermediary between the service provider and the in-house business units that rely on the outsourced service. Given its central role, the retained organization should be considered from the outset of an outsourcing initiative.

In reality, many companies enter an outsourcing arrangement without a clear plan for the retained organization, and many struggle as they attempt to create process management on the fly. With a dedicated account manager and team, the service provider typically has superior visibility into the interactions and transactions that take place with the company, while the client organization is often fragmented and lacks a single perspective.

Governance structures need to involve a spectrum of stakeholders from both the company and the service provider, and yet be streamlined enough to be responsive. "Large and complex governance models do not work well. What is required is a lean and focused governance structure comprised of people who are in tune with the business," said one service provider executive. Governance structures should be established at three levels:

- **Executive Committee.** This should include executives from the company as well as the service provider's account executive. Its role is to review service provider evaluations, review critical issues, and resolve important service provider management issues. The role of the outsourcing initiative's sponsor should be formalized and filled by a senior executive who is responsible for overseeing the initiative and ensuring buy-in both from senior management and business units
- **Program Management Team.** This should include the company's program manager and the service provider's engagement manager or program manager. Its role is to review critical status reports on progress and to review reports on the financial impact of the initiative. Companies often establish a program management office (PMO) to coordinate technology, process, and human capital initiatives involved in outsourcing a major business function. The PMO facilitates communication throughout the firm, minimizes risks that could result from a lack of coordination among projects, and resolves any issues that arise

- **Service Delivery Management Team.** This should include the company's project manager, subject matter experts, and professionals in training, technology, and quality control. Participants from the service provider should include the project manager, and professionals in technology, training, and quality. This group's role is to monitor status of the initiative and compliance with the SLAs

While a company should remain in close contact with the service provider, it must be careful not to micro-manage. This can be difficult to avoid, especially when executives who used to be responsible for directly managing the operation are placed in charge of managing the service provider relationship. But micro-managing undermines the fundamental rationale for outsourcing — namely, to bring in specialized expertise, gain from the innovative ideas of the service provider, and free management to focus on more strategic issues. And it destroys the trust that must form the basis of a successful service provider relationship.

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