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Guiding principles to service level agreements

Business process outsourcing: Finance & Accounting

Introduction

Many buyers soon realize that the service levels defined in their outsourcing contracts are not aligned with business circumstances, do not encourage desirable vendor behavior, and miss critical parts of the process — what is not measured, does not get done.

Buyers of Finance and Accounting Business Process Outsourcing (F&A BPO) services typically invest significant time in negotiating and implementing service levels — measures of performance — with external service providers. However, these agreements often end up on a bookshelf, rarely referenced again and often not understood by changing business stakeholders. Moreover, service levels are typically developed to meet tight timelines needed to complete an outsourcing deal and are frequently not reviewed, refreshed, or fully evaluated by operational leaders until after problems arise.

Many buyers soon realize that the service levels defined in their outsourcing contracts are not aligned with business circumstances, do not encourage desirable vendor behavior, and miss critical parts of the process — what is not measured, does not get done.

In order to help avoid costly errors in developing BPO service levels, we have developed a set of seven guiding principles for the development of F&A BPO Service Levels.

Guiding principles for developing BPO service levels

The following section describes seven guiding principles for developing service levels to manage F&A BPO agreements. These principles are not designed to be mutually exclusive, and collectively exhaustive. They do, however, represent lessons learned through advising many of the world's largest users of F&A BPO services. Some of these principles were developed to address common pitfalls faced by buyers of these services, while others are forward-looking and developed with the intent to help manage a buyer's risk and determine quality delivery of services. These principles recognize that buyers and vendors can, and often do, have conflicting interests in managing costs and risks.

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Principle 1: Business requirements should form the foundation of service levels

The first principle is that service levels should reflect the current and future requirements of the buyer's business. A common shortcut when work is being outsourced from an existing captive shared service environment is for the BPO vendor to simply baseline the current performance and then be measured at 6 or 12 months to confirm compliance with existing SLAs. The fundamental mistake in this approach is existing SLAs often sets the bar too low and keeps it there for the life of the contact. Unless specifically negotiated, there is no incentive for the BPO provider to increase productivity or improve quality since their objective is to decrease cost while meeting bare minimum contractual obligations.

While formal improvement goals may not exist in many captive shared services environments, as a captive, there is an inherent bias to improve quality, timeliness, responsiveness and/or reduce cost since those benefits flow back to the organization. Understanding and defining business requirements and objectives up front is often time consuming and does require significant business input, but this investment can be more than repaid through year over year improvements generated by aligning goals and incentives of both the BPO vendor and the buyer.

Principle 2: Service levels should be prioritized by the circumstances of the business

A common approach to first-generation F&A BPO service levels was to have as many of them as possible, measuring each part of the business process, within the tightest possible tolerances. This approach not only sets vendors up to fail, but is inherently bad for buyers — diverting focus from the critical outputs, and those specific leading indicators of process health.

Effective service levels should measure the business outcome, not the process. A helpful strategy to focus is to prioritize service levels into those that are (1) critical, (2) leading indicators of process health (KPIs), and (3) require regular reporting.

Using a framework like the one described in Table 1 can help focus buyers and vendors on those that are critical in managing the outputs of a process, with only a manageable few number Critical Service Levels (CSLs) being subject to financial penalties. In many cases, buyers can also develop CSLs that measure whether KPI's and PRs are being delivered, effectively determining that financial penalties apply collectively.

Principle 3: Service credit regimes should be designed to cut into the fat, not the bone

Service credits are pre-defined penalties enforced when vendors miss minimum performance standards. Service credits exist to incentivize the desired performance. Typically, parties agree to put a certain amount of monthly fees 'at risk' (usually 12-15%) from which service credits for CSL failures can be drawn. This 'at risk' amount is important because it is roughly a proxy for a vendor's profit margin — the fat, so to speak. Structuring the 'at risk' amount is an important tool for the buyer to determine the vendor has skin in the performance game. However, buyers also need to determine that vendors are not punitively punished for occasional failures with no hope of profitable delivery, and retreat to the bare minimum requirements and cost — the bone.

Allowing vendors to earn back paid service credits should be carefully considered so as not to undermine the credit regime, and require sustained performance at or above the expected amount, usually over several months, to earn back an individual service credit.

Table 1

Service level type	Description	Performance required	Applicable sanction
Critical Service Levels (CSLs)	• Metrics deemed critical to business operations • Defined by process tower (e.g., Procure to Pay, General Accounting) • These are critical, leading indicators of process health	• Defined minimum and expected performance levels	• Service Level Credit for each failure to meet the minimum performance level • Service Level Credit for failing to meet the expected performance level on 3 or more Measurement Periods within a rolling 12 Measurement Periods
Key Performance Indicators (KPIs)	• Metrics deemed important measures of process performance	• Defined expected performance levels	• Requires corrective action and mandatory remediation for each failure to meet the expected performance level • Failure to remediate KPI failures is a defined cross functional support services CSL, with applicable service level credits
Performance Reports (PRs)	• Required reporting items designed to provide insight into the performance of underlying process and sub-processes	• Required reporting only	• Failure to provide required reports is a defined cross functional support services CSL, with applicable service level credits

Principle 4: Effective service levels are leading indicators of vendor performance

Vendors can and do take advantage of buyers by avoiding or minimizing service level commitments. What is not measured, does not get done. Therefore, it is important to have service levels that focus on activities that are leading indicators of actual end-to-end vendor performance. Buyers should define these service levels to anticipate results from their actual business requirements (leading) versus secondarily to measure whether the service promise was kept retrospectively (lagging). This requires buyers to make a significant investment of functional business leadership time understanding and defining these leading indicators of the business.

- **Example:** A lagging indicator may be where a vendor proposes a 95% service level for issuing invoices within 10 days. If the vendor addresses this requirement, a buyer will see 'green' on their performance dashboard, but they will not see the potentially serious downstream effects of the 5% of invoices not issued within 10 days for 30, 60 or 90 days later.
- **Example:** A leading indicator may likely be to measure unbilled invoices greater than 10 days, providing the buyer with a leading indicator of future aged receivables and an increase in Days Sales Outstanding (DSO). This will also allow buyers to save on collection activities through proactive management of unbilled invoices.

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Principle 5: Trust, but verify. Vendors are paid to do 100% of the work, service levels should demonstrate it

Behavioral economists believe that organizations respond to incentives, and outsourcing vendors are no different. Unlike captive shared services organizations, outsourcing vendors tend to achieve the minimum service levels to manage their financial risk, but have little incentive to over-achieve. When a vendor is required to achieve a 95% performance rate or face a financial penalty, they will rarely miss. However, they have little incentive to provide 98, 99 or even 100%, even where this incremental quality can provide value to the buyer, or to determine the remaining 5% from a previous month is efficiently processed. This gap can often lead to backlogs which can put a buyer's business is at risk. With a simple required service level of 95%, a vendor has no incentive to determine that backlogs are cleared and exceptions are managed within an acceptable timeframe for the buyer and its end customers.

A simple solution is to replace a single target, with targets tiered to determine 100% of the work gets done within an acceptable time period.

- **Example:** Timely billing of customer accounts — 90% completed within 10 days, 95% complete within 20 days, 100% complete within 30 days

In certain cases, the converse may demonstrate to be a better measure, where, for example, instead of measuring a percentage of customer invoices billed, measuring the percentage of unbilled customers may better align to a buyer's leading financial indicators.

Service levels should also be designed to determine quality and remediate failures. Mistakes will be made — and service levels should consider also include of quality control and remediation that can be used to identify performance issues early to mitigate the risk of resulting performance failures.

- **Example:** Accounts Payable Service Level measuring the quality control checks on invoice data entry by audit — 10% of all invoices entered; 25% of all audited invoice entries for secondary audit

In many first generation outsourcing agreements, service levels only included the initial quality control, but did not require the failures to be remediated. Today, neglecting these quality control measures can limit a buyer's understanding and control over quality management and can increase the risk of not achieving required performance levels further down the value chain. This can lead to late payments, increased customer or vendor inquiries and inefficient cash flow, to name a few.

Remediation measures can be used to provide transparency on errors and mitigate the risk of subsequent damages.

- **Example:** Where a quality control check picks up an invoice error, 100% of those errors must be recorded, tracked, reported and remediated within 48 hours — getting 100% from failure to pass (invoice entry).

This approach can help both parties to identify the root cause of failures and determine that the work the vendor performs is accurate, addresses the buyer's quality requirements and mitigates downstream effort, such as dealing with angry vendor phone calls, forgone credit benefits and late payment fees. Not defining service levels for remediation of defects and failures can substantially increase the risk of subsequent damages to a buyer's business, causing real financial harm.

Principle 6: Fool me once, shame on me, fool me twice — incentivize remediation of recurrent performance issues

When buyers face recurrent performance issues, CSL and other failures, they are commonly associated with underlying process, people, and technology deficiencies. Until the root causes are resolved, sustained performance issues will continue, and it is important for buyers to determine, through service level credit regimes, that vendors are incentivized to address these issues early. For this to occur, credit regimes should escalate until a sustainable remediation of a singular performance failure is achieved.

These can be structured in a number of ways, but are commonly reflected by escalating existing credits where remediation of a singular failure is not achieved within a specified period. Repeated failures of the same service levels can be used to escalate defined penalties with each incremental failure, and even used to eventually void specified penalty caps. An additional strategy can be to specify that recurring service level failures automatically deem the vendor in substantive contractual breach, forcing additional penalties out of the vendor's legal liability cap.

- **Example:**
  - » Where a service level is missed just once, normal service level credits would apply.
  - » If the resulting error is not remediated within a specified period, the credits should escalate in severity until full remediation is achieved.
  - » If the same failure occurs a second time within a set period (e.g., within 12 months), the initial credit penalty may double and escalate until full remediation is achieved.
  - » When repeated failures occur, together they can automatically deem the vendor in substantive contract breach, triggering a right to terminate for cause, apply penalties beyond any defined service credit cap, and begin drawing on the vendor's legal liability agreement.

Deeming vendors in breach and drawing on a contract's liability cap can be powerful incentives to determine that buyer's interests are protected from significant downside risk. While extreme, these penalties should only apply where the resulting failures are extreme, repeated and not remediated.

As defined, this strategy can be very difficult for vendors to counter in negotiations, as they effectively argue against their ability to provide the services. While aggressive, this strategy can be used by buyers to protect themselves from repeated service failures with a high financial impact on a buyer's business, often involving Order-to-Cash activities, mitigate risk and determine a vendor's performance regime is aligned to the buyer's financial security.

Service levels are not commandments written on stone tablets, and there should be a clearly defined contractual framework for buyers to change them during the term of an F&A BPO contract.

Principle 7: The only constant is change — service levels will need to change over time

Service levels are not commandments written on stone tablets, and there should be a clearly defined contractual framework for buyers to change them during the term of an F&A BPO contract. Many current-generation F&A BPO contracts require vendor-biased provisions of 6 to 12 months or more to change and implement new service levels. Where these agreements are typically only 5-7 years in length, a full year to implement a simple service level change does not meet many buyers' requirements. This often places buyers at tremendous disadvantage in managing evolving business requirements.

Where buyers maintain the authority to change service levels, they also recognize that change cannot occur over night. Vendors use long notice periods to manage their risk, but failure to meet service levels is not in either the party's interest. Further, changes a buyer makes, should also consider a vendor's ability to manage their business risk.

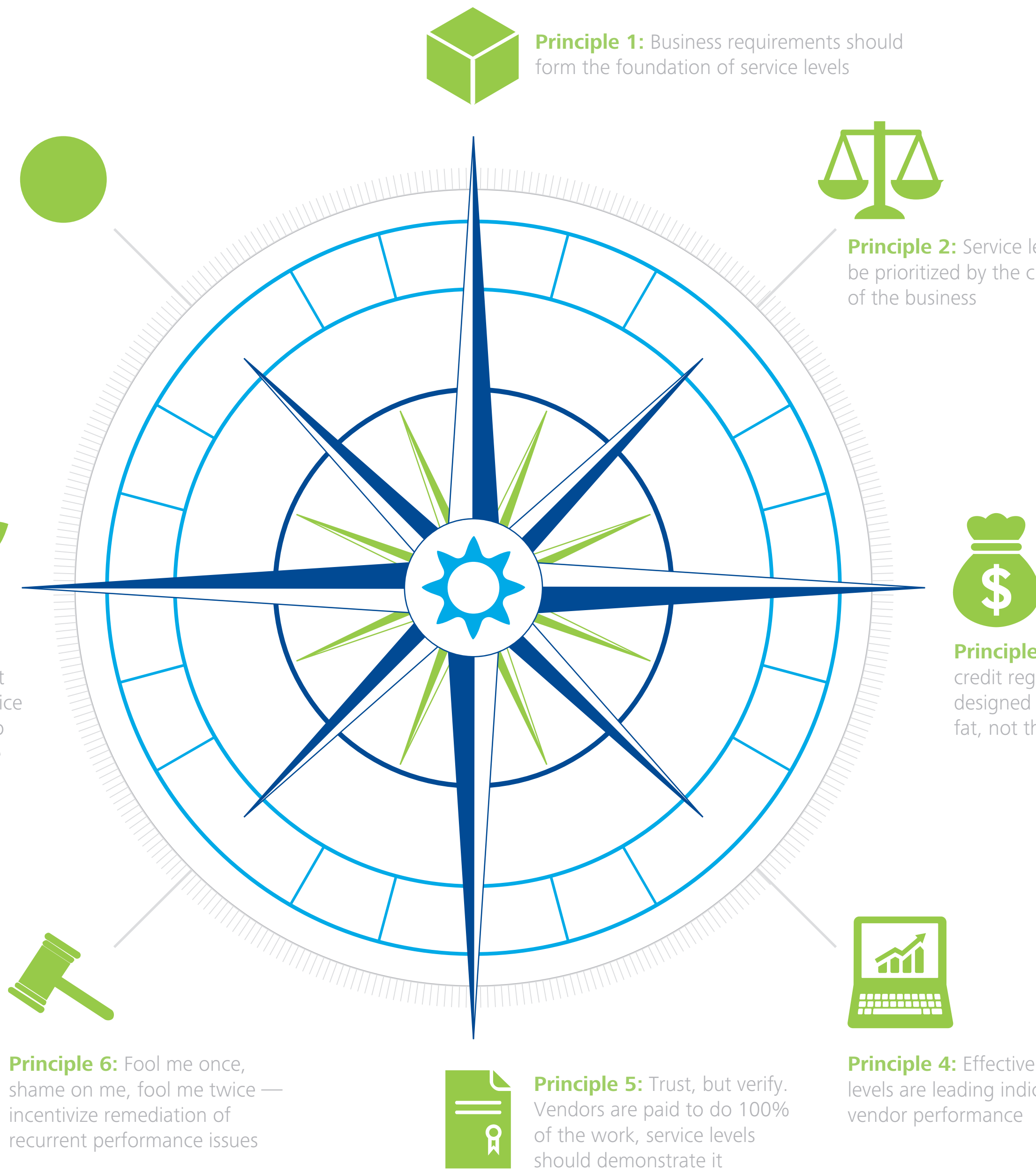
One approach to determining that changes to service levels are implemented within a timeframe relevant to a buyer's business requirements, is through a phased implementation period. Implementing changes or improvements to service levels can follow a realistic and achievable path from initial performance (reflecting today's reality) to end-state performance (reflecting buyers and vendor's ability to change/improve). A path consisting of a pre-defined change or improvement steps, should be aligned to a buyer's business requirements, versus time-based (usually 6 or 12 months) requirements found in many current-generation agreements. This approach is generally easier to negotiate with vendors, in that it allows buyers to define their preferred end-state with a reasonable path a vendor can realistically achieve.

Such a path should consist of different performance targets over time.

- **Example:** Timely billing of customer accounts within 20 days:
  - Min 75% for the first three months (1-3)
  - Min 85% for the next three months (4-6)
  - Min 90% after month six (6+)

When drafting service level change methodologies, both parties can agree that changes to service levels will be fully implemented within a set period, unless otherwise agreed, but that both parties will agree to a stepped path to the buyer's end-state performance requirement. While new service levels are typically developed in a consultative manner with a vendor, formal notice and implementation of the initial steps can and should occur within 3 months, with the stepped glide path taking 6-12 months, depending on complexity, for full implementation. This concept can also be applied to new BPO agreements, where buyers seek incremental improvements in quality over time.

Seven guiding principles



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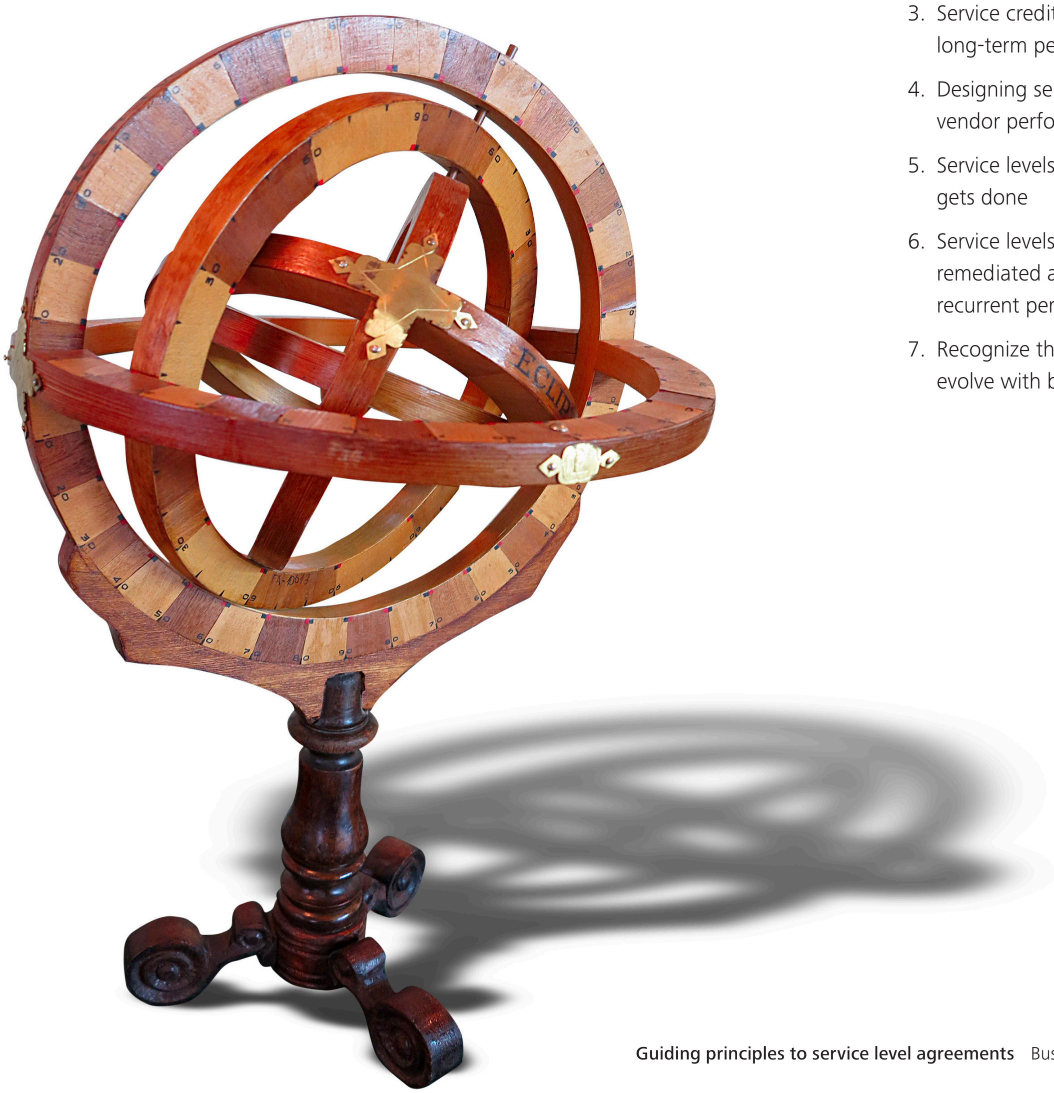
Conclusion

Fundamentally, providers of F&A BPO services have different financial interests than their customers. Buyers may feel that they have hired someone simply to do work they previously performed themselves, but the reality is that a buyer's expense becomes a vendor's revenue stream, and different P&Ls mean different interests in managing cost and risk. Following these seven principles can substantially help to mitigate performance risk in F&A BPO contracts by establishing meaningful service levels and service level credit regimes. The seven principles include:

1. Determining that business requirements form the foundation of service levels
2. Service levels should reflect prioritization of the business
3. Service credit regimes should be designed to incentivize long-term performance
4. Designing service levels to be leading indicators of vendor performance
5. Service levels should determine that 100% of the work gets done
6. Service levels should indicate that failures are fully remediated and provide severe disincentives for recurrent performance issues
7. Recognize that service levels will require change and evolve with business requirements



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