Vendor Management of IT Outsourcing Contracts: An Audit Perspective

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What is Vendor Management?

A lot of people are familiar with the contract management process; the defined steps, the requirement specifications, the RFT etc. Usually, once the contract is signed, the bulk of the work is complete. Vendor management includes contract management but is a much broader process and is ongoing. These days it commonly relates to IT services but a lot of services can be outsourced, including financial services, HR, internal audit, property management etc. It deals with intangibles which can be hard to define. You are no longer dealing with pens or widgits which are easily measurable. A key element is the management of the ongoing relationship between the client and the vendor and this is the key to success. This relationship is long term, commencing before handover and finishing with the transition out.

Why Audit Vendor Management?

Vendor management is a particularly topical issue at the moment given the value of outsourcing contracts arranged in the last 18 months. As well as being material in terms of its cost, it has also attracted the attention of organisations such as the Senate and the ANAO and a lot of reputations are at stake. Projects such as Bruce Stadium and the Canberra Hospital implosion are examples of what can happen.

IT outsourcing in particular carries a very real risk because of the high dependence most organisations have on their IT systems. Risks are increased by the rapidly changing nature of technology and the fact that contracts are often vague in an attempt to provide sufficient flexibility to cope with the rate of change.

Public servants are new to this environment. They are not generally used to dealing closely with commercial organisations on a day to day basis. Business is driven by profit but the public service has other drivers and this will cause tension. Adding to the tension is the fact that many vendors gained their contracts with a low bid and now face considerable pressure to make a profit. This will create a tendency for them to want to move from a fixed price SLA towards new projects which are costed on a time and materials basis wherever possible. There can be a tendency for the public servants to focus on the low level detail, not on the big picture, and to lose sight of what outsourcing was intended to achieve.

This is a good time to audit IT vendor management because most IT outsourcing contracts are now out of transition and in a steady state phase - this is as good as it gets.

What is the Auditor's Role?

The whole area of vendor management is not well understood. Even the ANAO Better Practice Guide focusses mainly on the establishment of the contract and its termination. They don't have a lot to say about how to live with a service provider for 5 years or more. Nor is the process of auditing vendor management well understood. The important thing to keep in mind is that you are not auditing the vendor. You are auditing the ability of the Vendor management Unit to manage the contract. Anything else is a recipe for disaster.

Stay targetted and keep it simple, particularly at first. Set up indicators which are as clear cut and quantitative as possible.

The Performance Indicators

One set of possible indicators that can be used. These are generic and not exhaustive, but before you add items, consider whether they will materially improve the client's understanding of the issues.

The Team

Look at the structure and capabilities of the team. Is there an appropriate mix of skills - financial, project management, contract management? How motivated are they - do they see vendor management as a career path or is it just a temporary stop? What is the turnover like - if it is more than 50% per year it will be hard to maintain a strategic focus. If the service provider staff stay longer than the vendor management staff then the balance of power will tend to be in favour of the service provider.

The biggest danger is to have a process focus rather than a strategic focus. Is the team well aware of the goals senior management have set in relation to the outsourcing process? There has been a tendency to over-service clients in the public service environment where costs were invisible. The costs and trade offs are now out in the open. Some teams think it is their job to send the service provider broke. Others think the service provider doesn't know what they are doing and that it is the vendor management unit's job to educate them. Another problem may be that the vendor management unit are trying to rebuild the internal IT capacity that once existed. What is the senior management agenda and does it line up with that of the vendor management unit?

The problems are made worse by the public service cost cutting agenda. Typically many contracts are supported by vendor management units that cost around 2 1/2% of the contract costs. Gartner and other benchmarking organisations say it should be around 6 - 8% of contract costs. Cutting costs on vendor management is false economy, nevertheless, is the vendor management unit making the best use of its resources.

The Contract

Read the contract. What are the responsibilities of each party. What are the deliverables? Does the vendor management team understand the contract, particularly their roles and the client organistion's rights?

Is the contract into the transition stage? Should it be, eg has it transitioned too soon? Too soon and too late both have dangers. SLAs are not enforceable until transition is over, until then services are usually priced on a time and materials basis.

With regard to the SLAs, is the vendor management unit tracking these, how are they dealing with any deviations? They should have done a "contract strip" and produced a list of deliverables. Are the costs of services within budget? If not, what is being done about it?

There is a need to understand the trade-offs, risks etc behind the contract. The vendor management unit have to demonstrate that they are on top of this and understand the risks. Have the risks been documented and signed off?

A good vendor management unit understands what the organisation wants in the longer term and drives towards that, keeping management advised of the risks associated with this direction and the stated goals. Vendor management people are often technical and may not be good communicators.

Initially a lot of the organisation's IT staff may find work with the service provider but over time this will change and may cause friction. Some people forget that they are buying a service not a particular person and may become concerned about losing these skills in the service provider.

Financial Management

Is the payment process working? If vendor invoices are not settled promptly they will try to recover the money in other ways.

Are budgets being prepared and are they realistic? Are they being met? Are variance controls in place, are these reported, and how often?

Is the client a CAC or is it subject to the Financial Management Act?

How are the financial records are being maintained?

Relationship Management

The vendor management unit must be the communications channel between the service provider and the organisation. The relationship must be underpinned by a Communications Plan. Typically if the vendor management unit staff are not functioning well in communicating then the service provider will bypass them and go direct to the individual business units who do not have the expertise to manage aspects of the contract.

The relationship with the service provider needs to be open and healthy. Find out how often the vendor management staff meet with the service provider staff. Are all meetings minuted and actions assigned to particular individuals for action by a due date?

How does the vendor management unit communicate with the user community? High user expectations from pre-outsourcing period can lead to low levels of user satisfaction so user surveys are not necessarily useful as a performance measure, although you can sometimes get metrics from users about whether SLA's are being met.

Does the vendor management unit have a long term strategy agreed with senior management? Essentially, is the vendor management unit getting the service provider to deliver what they said they would for the agreed price?

<u>Change Management</u>

This is a very difficult area given the rate of change and the tendency for the service provider to want to classify changes as new projects. After 3 years or so most of the goals and standards have changed.

Issues must be identified as they arise and must be managed. A strategic plan is necessary to keep the service provider focussed and the client realistic. Out of scope projects represent a significant risk to IT cost blow-out.

With regard to quotes for new projects the vendor management unit should be reviewing these and doing benchmarking. They can get industry figures on typical costs - and as a general rule IT costs reduce by 7 - 10% each year. The only component that usually goes up is labour. The vendor management unit has to understand the service provider's cost model.

<u>Document Control</u>

Good documentation is essential to limit the risk to the client. There should also be document management plan. Documentation must be collected and filed to ensure that the client is protected should litigation arise and to ensure the sustainability of the vendor management role in the event of staff turnover.

The quality and accuracy of service provider reports is one issue. Internal audit can check to see that reports are correct.

A Procedures Manual must be developed and maintained to ensure that quality processes are in place and to guard against loss of corporate knowledge.

A Issues Register should be maintained and up to date.

Conclusions/ Comments

There is a right time to audit vendor management but you need to target it well.

What does senior management expect from the vendor management unit and how well is it meeting these expectations?

The communication flow is crucial.

The market has been immature on both sides of the fence but is maturing now.

The service providers had to acquire a lot of new staff in a hurry. Many of these laster around 12 months then left the service provider.

On the client side, the vendor management unit is often an afterthought. Over time management will understand the value of putting resources into vendor management and people will opt for vendor management as a career path and the market will mature.

An increasing trend now is to outsource individual projects including applications. In this case the user acceptance testing process is critical.

There are few experiences yet for reversing the process or of changing service providers.

The real fight and the real dollars are about outsourcing of applications. Clients feel much more ownership of this, but currently in many cases they have long term contractors working to develop applications in house. This means they are wearing all the risk, paying a lot of money to contractors and doing it on a time and materials basis. This is bad economics.

Most contracts handle issue of intellectual property well so this probably won't be a problem.

In some cases the costs of providing services are greater than the penalty clauses and so the contractor may be better off refusing to provide the service. If a contract is not structured well the contractor can deliver nothing but still claim a proportion of the fee.

One of the biggest risks is of sending the service provider broke by enforcing service credits etc. This is probably not be in an organisation's best interests given the cost of re-tendering etc. Keep in mind the contractor can also decide to walk away.