AccM
Advanced Contractor Cost Management

Challenges to Managing External Services

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Introduction

Every business is under pressure to find ways to increase revenues while at the same time reduce costs. One opportunity that has evaded businesses is in how they manage their external services. With the inherent difference between services and goods management most companies have adopted the philosophy that the service provider is the expert and requires little over sight.

Empirical evidence has shown that top performing companies that have embraced a process to manage their external services have increased the quality of the deliverables and reduced costs over 10%. Up to now most companies expend little effort towards managing their External Service Providers. What time is spent is addressing issues after the services have been performed and invoiced. Leading edge Companies realize the risks and costs that non management represents and have chosen a different direction.

How much does mismanaging external service providers really cost?

Using the traditional methodology, an External Service Provider is hired, work is performed, a manual invoices is received and processed by AP for payment. The methodology contains minimal management process steps directed towards ensuring the right work was done for the right price. The submitted invoice may only receive a cursory review before it is “rubber stamped” approved.

The cost of non management is poor quality, time delays, cost over runs, repairs and re-work and lost reputation. Taken singularly or combined, all these symptoms erode the profitability of the Company and destroy the value of hiring the External Service Provider in the first place.

Poor management of External Services Providers can also siphon money from the Company in other forms:

- Lack of real time information forces business decisions to be made on incomplete data,
- Poor cash flow management and the heavy dependency on accruals
- Redundant or ineffective business processes creating inefficiencies within the Company and Service Provider.

Most companies understand the basic rational about why they should manage their External Service Providers. The interesting question is why we see limited activity in actually managing their service providers. There must be one or more obstacles preventing the management to occur.

This paper presents a discussion on why most companies do not actively manage their External Services Providers to optimize their investment. It is directed towards those individuals who want to learn more about the management of External Services.

Does your Company ever…

Struggle with selecting the right External Service Provider

Been dissatisfied with Contractor Performance

Overpaid Vendor invoices

…Then you understand the value of Managing External Services

Executive Summary

Key obstacles to managing External Service Providers

- The mind set that External Service Providers do not need to be managed because they are experts at what they do
- The paradigm that managing External Service Providers costs more than the risk of not
- The idea that nothing is broken so don't fix it
- Company managers do not recognize the value of managing External Service Providers
- Certain Employees do not want transparency in how they perform their business
- Belief that they have automated the issuing of purchase orders and nothing else is required
- No clear process to manage External Service Providers has been established

All the obstacles presented above are challenges because they represent ideas that are controlling some ones behavior. Compelling data, factual arguments and the guidance of senior leadership is needed to change people's opinion on this subject.

Reasons to start managing External Service Providers

- Recognizing that the use of External Service Providers is increasing
- The percentage of company expenditure directed towards external services is increasing
- The potential value of using External Service Providers is being undermined by the lack of management activities
- The cost penalty of non or ineffective management can represent millions of dollars annually

Benefits of Active External Service Provider Management

Immediate ROI opportunities

- Minimize functional unit down times
- Leverage the buying process through Master Service Agreements
- Improved quality and workmanship
- Improved cost visibility for better decisions
- Improved cash flow management
- Take advantage of early payment discounts
- Reduce invoice reconciliation issues with vendors
- Reduced the use of estimated services accruals
- Reduced legal disputes on service acceptance or payment
- Process to validate the External Service Provider's costs against contract rates
- Only pay for accepted work. No more, no less.
- Transparency and accountability of stakeholders
- Improved credit rating

Challenges of Managing External Services

Changing the paradigm

Changing the culture in a company to understand why they should actively manage their External Service Providers takes the concerted effort of key influential people in an organization. The catalyst to start the behavior change must be compelling in nature. The reasons for change could be based on poor service received, financial costs, audit results, health and safety or reputation. Whatever the reason, the Company now realizes that maintaining the status quo is not providing the desired benefits. Senior management must provide the leadership direction to change the old paradigm. Without leadership engagement the rank and file workforce has no incentive to change

Who is responsible?

Many companies have trouble answering this question. Depending on whom you ask, or which part of the organization they work in, answers will vary. In many cases, answers are dependant on knowing the processes that influence managing External Service Providers. Common responders will say that the responsibility to manage External Service Providers belong to either procurement, human resources, project management, finance or health and safety. In truth the responsibility is spread over many company departments. Unfortunately, this fragmented approach leads to a dysfunctional and inefficient set of processes that leaves the Company and Vendors confused and disgruntled.

What is the problem?

When a company decides to engage External Service Providers to supplement their work force they have made the decision based on economic reasons. The value proposition demonstrated a reduction in costs if the action was taken. The problem in most cases is that the company is ill prepared to actually manage the external work force. They soon realize that managing services is completely different from managing goods.

There are two dynamics working at the same time. First, the Company wants to make sure that they are receiving the requested services. These services could range from construction to an overseas service desk. If no one is managing the deliverables the quality of the output will suffer and the value of the service will degrade.

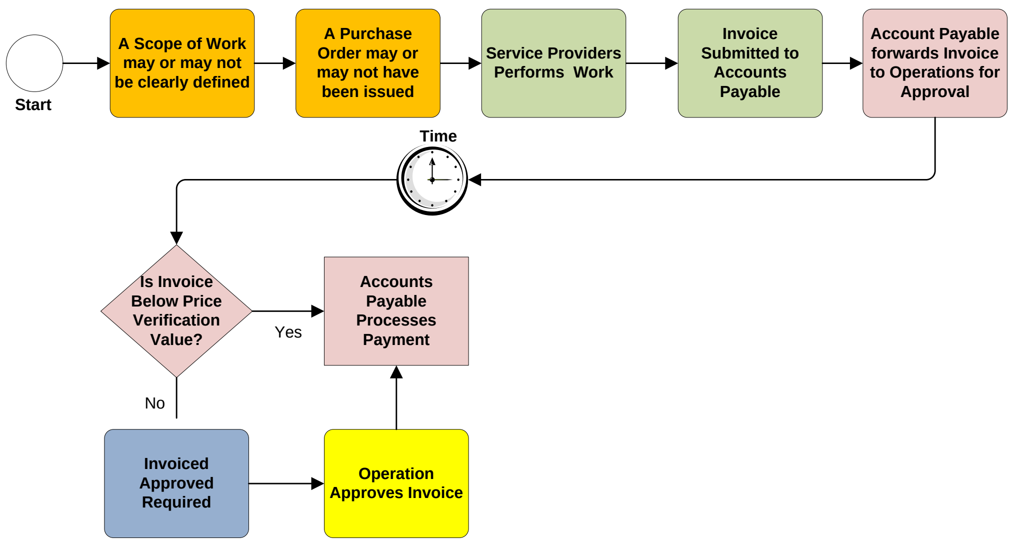
The second dynamic is costs. If the current practice is to simply pay External Service Provider invoices at face value because there is no process to validate the fees, the Company is again loosing value in the form of excessive costs. To achieve the desired level of control a defined process need to be established and people trained to use it.

If there is no clear process for managing External Service Providers at a Company, it is a statement that they do not recognize the costs being incurred on the business caused by their inaction. It is analogous with asking a service provider to deliver on a poorly described scope of work and leaving the check book on the table and telling him to pay himself when he leaves.

Lack of proactively managing your External Service Providers can result in the following:

Issue	Impact
Selecting a Service Provider	• Poor quality • Lack of schedule compliance • Cost overruns • Safety violations
Procurement Process	• Poor Scopes of Work • No clear definition of work acceptance criteria • Increased work load
Daily Control of Work	• No process to review daily work performed • No process to review daily cost incurred • No documented history of work performed • No record of changed conditions or Scope
Manually Receiving Work after Invoice	• Delay in visibility of job costs • Receiving document dependant on Vendor Info • Any corrections will be more expensive • Company reduced to a weak defensive position
Lack of Visibility and Transparency	• Cash flow management and accruals • Poor Internal and external audit results • Decisions based on incomplete data • Disagreements with vendors • Late payments • Work stoppage

Traditional External Services Management / Pay Process



The traditional method of managing External Service Providers entails engaging a firm to provide services without clearly defining a scope of work. The work performed is based on the service provider's interpretation of the scope of work. Please note that a purchase order may or may not have been issued at this time. (If not, the Company has not recognized a financial commitment on their books) The invoice for services rendered is submitted to Accounts Payable for processing. In particular cases, if the invoice is below a specific dollar amount, no approval are required and the invoice is paid. If approval is required, the service invoice must be routed for approval before the processing can be completed.

The point of interest in the case presented above is that the actual definition of the work was left to the service provider. Also, the process flow does not indicate that there was any active management of the work. The only review step occurred during the payment approval process. Using this process the Company is at risk of 1) not receiving the desired services and 2) incurring a financial liability greater than expected.

Selecting a Service Provider

The phone book or internet is full of service providers offering all the services your company needs. When you review the service vendor list at most companies you will be amazed at the number of established vendors in the system. It is obvious that there are no controls in place to qualify vendors based on quality, skills, financial rate structure or for that matter, does the company actually need additional resources. At the basic level, it costs the Company money each time they set up a service vendor in their system. Before this work is undertaken, the first question that should be asked is what is the cost benefit to the company for doing this?

Selecting a service provider should be based on an established set of prequalifying guidelines to address performance, experience, insurance levels or health and safety policies. Choosing the right service provider can make or break the job.

Risk Management

If External Service Providers are being brought into the work area without first going through a formal purchasing / contract process, the Company has opened itself up for potential liability. Without having in place agreed rates, standard terms and conditions, insurance and indemnification clauses, the company is exposed to the full values of any liability caused by the service provider. If employees are allowed to use service vendors before the purchase order/ contract is finalized, then it brings into question who in the company has the right to legally commit company funds to outside service providers.

Payment Approval

After the External Service Provider has completed the work, they expect to get paid. An invoice will be submitted to the Company to initiate the process. At this point Accounts Payable must review the invoice and determine if it can be paid directly or if the document must be routed to an operational / functional area for authorization to proceed.

If the Company does not have a process to oversee the External Service Providers activities and associated costs, they will have very few options but to agree to the invoice as presented and pay the bill. This becomes more problematic if there was no scope of work or firm determination on the cost of the work. Unfortunately, there is an attitude within most operational groups that their primary focus is keeping the plant running and there is little concern for the cost of the services. Thus, there is a tendency to rubber stamp the approval of the invoice and return it to Accounts Payable for final processing. No wonder companies have difficulties managing their spending on services.

How large is the problem?

In discussion with external auditors and CFO’s the majority of companies do not manage their service activities to an acceptable level, and the problem is getting worse. Increasingly, more companies are turning to External Services to augment or replace their existing workforce. Unfortunately, few companies have developed processes or adopted automation to improve their ROI. Some companies have resorted to a risk based process that allows them to blanket pay all service invoices under a certain dollar amount without any verification process at all.

These decisions are predicated on the existing paradigm that the service provider is the expert and no management is required and that the system is not broken so don’t fix it. The implementation of a process can reverse the trend. Not addressing the management of External Services is costing companies millions of dollars due to work not meeting specification, inaccurate payments, excessive internal labor costs, missed discounts and litigation.

Procurement Process

Procuring services is not the same as buying goods. You can’t just go to the catalog and select the item and quantity (unless you use service masters). Before procurement starts the RFQ process the scope of work must be drafted. The scope of work contains the who, what, where, when and how the work is to be performed. It should also contain how the work is measured for payment and what deliverables must be achieved to receive payment.

Based on the scope of work required, the Company then can address the issue of work force planning. This is the point in the process where labor resources are assessed and the determination is made to keep the work in house or the use an External Service Provider. If the option to use external services is selected, then it is up to the procurement group working along side the facilities / operational or support staff to determine the prequalification requirement for potential service providers.

Daily Control of the Work

Many companies make the erroneous decision that the External Service Provider has a complete understanding of the work assignment and requires no over sight once the work begins. Companies who fail to perform regular (in most cases daily) work inspections will soon find them selves at a disadvantage in terms of work and cost management. It is expensive to correct deficiencies after the work has been completed. The time to review the work is not after the invoice has been received but as it is being performed.

In many cases, the work may not be conducted on company property. For example, the company has retained an engineering firm or an offshore service desk. The challenge is to manage the services remotely. Does the Company have a process established to facilitate the routine passing of information pertinent to managing the outcome? How does the company know that they are receiving the specified services at the negotiated price in real time?

A key understanding in the relationship between the Company and the Service Provider is that the service provider is in business for themselves. Their goal is to put as much of the Company's money in their pocket as fast as possible… then ask for more. Don't get the wrong impression. Most External Service Providers are not out to take advantage the Company, but human nature being what it is, if no controls are put in place, the Company is at a higher risk level of not receiving the requested service for the agreed price.

People generally do better work when they know their work output is being watched. This phenomenon is called the Hawthorne Effect. An External Service Provider will soon realize that the Company is paying attention to their work through the routine interactions and accordingly quality, schedule compliance and safety all improve.

Some companies think that the cost of managing their External Service Providers outweighs the risks. The premise ignores the fact that more and more service providers are working in critical areas of the company and capable of disrupting operations or services. The cost of those disruptions can far exceed the basic cost of the service. Additionally, experience shows us that the cost incurred in managing External Service Providers is returned many times over.

Manually reviewing work after Invoice

In industry, there is a common practice that reviewing a service vendor's work at the end of the job and when their invoice has been received by accounts payable. This practice results in the lost opportunity to actively manage the work to ensure the contracted service being delivered meets the specification. Few individuals have the discipline to maintain sufficient records to accurately review a vendor's invoice that references work performed days, weeks or even months in the past. The lack of accurate job records places the company at a disadvantage when reviewing the invoice. For this reason, many vendor invoices do no receive the level or scrutiny they deserve. The end result is the acceptance of vendor invoices that contain errors that cause overpayments.

Manual invoice processing

Manually processing paper invoices is a time intensive process. Documents must be processed and data manually entered into the system. The supporting documents must be matched against invoice documents. Mismatched invoices must be sent to other departments for price adjustments or reconciliation. Each one of these steps consumes time and money and is frustrating for all involved.

Managing the External Service Provider while the work is being performed reduces the amount of effort expended by accounts payable.

Lack of Visibility, Transparency and Reporting

Well run companies understand that access to accurate and timely information is critical to their business's success. Good decisions can not be made using poor data. Waiting for invoices to be received from a service provider before understanding the cost liabilities on a job causes deficits in information. It is paramount that everyone, including External Service Providers, are using the "Same Version of the Truth". Compliance with internal and external audit reviews is dependant on being able to follow the linkage between purchase orders, work performed, work received, invoices for work received and the corresponding payments.

Using an accepted process to mange External Service Providers can support a consistent method of reporting. All too often, the details on an External Service Providers costs are maintained on a spreadsheet stored on an employee's computer. The Company's only opportunity to update its current liability is when vendor invoices are posted into the system.

The First Step

The first step in managing External Service Providers is the recognition that there is a strong business case to undertake such action. Institutionalizing a process that provides the framework to manage these vendors reinforces the business improvement initiative of transparency, control and accountability. In this financial climate, prudent management of vendors will only improve the profit on the bottom line.

The challenge is instilling the belief in the Company employees that managing service providers has a direct effect on the Company's profitability and conversely, non management of service providers is equivalent to giving them a blank check.

Having an accepted process for managing External Services helps organizations breakdown the traditional silo culture. As mentioned earlier in this paper, the responsibility of managing External Services is different depending on where you work in the organization. A cohesive process ties together the interests of procurement, operations, accounts payable, financial management, human resources and health and safety. The following summary highlights the outcomes in these areas.

Procurement	• Prequalifying providers based on guidelines not relationships • Use of Master Service Agreements to leverage rates • Use of past performance ratings
Operations	• Using a common process to eliminate confusion and inconsistencies • Real time review of services rendered and costs • Ability to see variances and forecast costs • Simplified documentation • Manage of change orders or scope changes
Accounts Payable	• Reduce disagreement with vendor over payment amounts • Reduce time spend on price / purchase order adjustments • Take advantage of early payment discounts
Financial Management	• Improved cash management • Real time cost liability • Reduction of accruals for services
Human Resources	• Visibility of service vendor skill usage
Health and Safety	• Visibility of service vendor safety performance • Visibility of service vendor man hours

External Services Management

How it works

The External Services Management methodology encompasses all aspects of the work. The ACCM methodology breaks down the silos that exist between Human Resources, Procurement, Project Management, Health and Safety, Accounts Payable and finance. Each group can see how they contribute to the ultimate success of increasing value and simultaneously reducing costs. The methodology allows for:

Workforce management: How the company determines when to use of External Service Providers. Is the decision based on covering peak loading, change is required skills or responding to economic pressures.

Prequalifying potential service providers: How to make sure that the service providers being used provide the best skills, performance and HSE program at a competitive price.

Master Service Agreement: Optimize the time and skill of the procurement team by negotiating multiple year contracts that leverage the buying power of the company. After you have created a short list of qualified providers, take advantage of the competitive bidding environment to reduce price points. Use the Master Service Agreement across multiple purchase order with the same vendor.

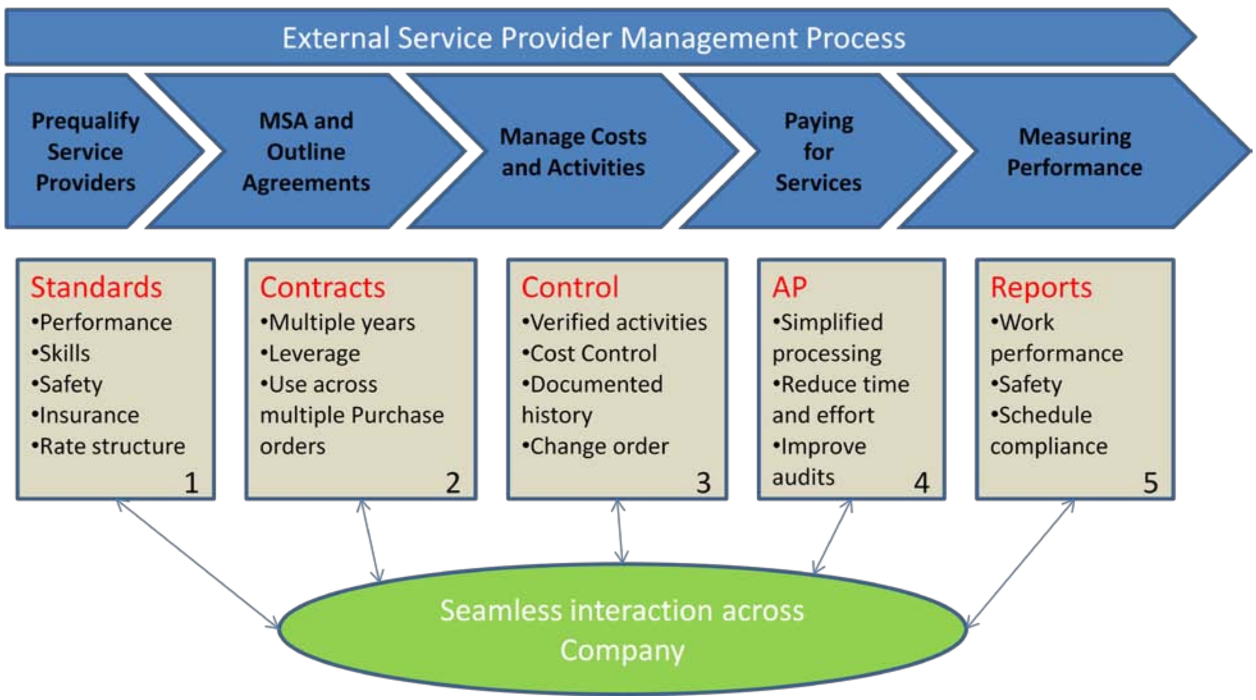
***Manage the service provider work activities*:** Don't make the mistake that the service provider understands the scope of work as thoroughly as you do. Taking an active management role can avert mistakes before they happen. It is always easier to have the work done right the first time before potential issues lead to lost productivity. The act of documenting the work as it is being performed provides information that can be used when planning and budgeting related projects plus a basis for contesting vendor overcharges if necessary.

Managing the service provider's costs: Having the ability to understand costs as they are incurred allows the Company to make critical financial decisions based on accurate information. Knowing if a job is under or over budget and the cash flow demands are key to managing the work.

Paying for Services: The process of reviewing and paying External Service Provider's invoices is important in managing the company's financial stability. Without sufficient documentation on the work performed the potential exists for erroneous payments and protracted time consuming arguments with the vendors.

Measuring Service Provider performance: Significant effort will have been extended to select and manage any External Service Provider used. Establishing metrics to measure the service provider's performance should be part of the overall management system. Including the results of the performance metrics in the project documentation is useful for both the short and long term. In the short term, documentation in needed to terminate poor performing vendors. In the long term, the information is used in future prequalification exercises.

External Service Provider Management Process Overview



1. The list of potential service providers can be lengthy. Each company needs a method to filter the list using prequalification standards. Limiting the list of service providers to engage in RF(X) saves time and money.
2. The company exercises its greatest price leverage during contract negotiations. Leverage is increased by extending contract terms to a longer duration. Contract language can be referenced across multiple purchase orders to improve efficiency and reduce costs.
3. External Service Providers do not manage themselves. Active engagement in the process will result in high quality work output at the anticipated costs. Failure to manage the process will result in cost overruns and time consuming conflicts.
4. An output of managing the External Service Provider is vendor invoices which are accurate and timely. Waiting to manage the work until the Vendor invoice is received by Accounts Payable will guarantee invoices that contain errors which on average consume 300% more effort to process.
5. A significant amount of effort is put into selecting and managing External Service Providers. Retaining feedback on these vendors' performance is crucial in managing the current work and in retaining that information to be used in future selection exercises.

Key Benefits

- Provides a common platform to manage External Service Providers across Company
- Remove the silo mentality towards managing external services
- Clear assignment of responsibilities and accountabilities
- Promotes real time management of the external services to ensure the work is performed correctly the first time
- Reduces downtime costs associated with service provider poor performance
- Provides the Company with a standard process to track and manage service provider costs verse output.
- Significantly reduces confusion generated from everyone doing their own thing
- Real time visibility of external Services cost improves management decisions
- Provides improved audit trail details
- Ensure External Service Providers work efforts are documented for future reference

About AccM

AccM is a company dedicated to the efficient and cost effective method of managing company's external services. AccM is an established SAP Software Solution Partner. Our methodology is based on years of hands on experience in procurement, contract and contractor management, and cost accounting. Our team is constantly interacting with the business community to identify requirements for new and additional functionality with the primary focus to provide our customer with the best service possible.