Journal of IT Financial Management

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IT Financial Management Association: This membership association was founded in 1988 to educate and unite professionals employed and interested in the financial management of information technology organizations.

Journal: The Journal is the official publication of the IT Financial Management Association. It provides members with specialized financial literature for this unique profession and keeps them informed about Association activities. The Journal is published in the Spring, Fall, and Winter.

Membership: Association and membership information is available on our web site (www.itfma.com) or by calling ITFMA at (805) 687-7390. The annual fee for the January to December membership is $100 per person or $500 for each 15 members.

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Author Information: The *Journal of IT Financial Management* (ISSN 1532-3870) invites submission of articles of interest to our Association membership. For information about authorship, write to or call the IT Financial Management Association (ITFMA), Post Office Box 30188, Santa Barbara, CA 93130; (805) 687-7390.

Subscription: Association membership dues include a free one-year subscription to the Journal. This publication is an exclusive publication for members and is not available to the general public.

VOLUME 5, NUMBER 8 SUMMER 2007

Cost-Effective IT Outsourcing

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Two schools of thought dominate assessments of outsourcing information technology: outsourcing works and outsourcing doesn't work. The division boils down to a single question, did the effort save money or not? If outsourcing saves money, executives laud it – and you – as a success. If outsourcing causes cost increases, the blame game begins.

Despite the seemingly 50-50 odds, as Thomas Friedman's The World is Flat and Brafman and Beckstrom's The Starfish and the Spider make clear, the alliances and networks of outsourcing will continue to grow and shift for the foreseeable future. Pitfalls, however, do exist. Companies that have been unable to adapt, or that put in place ineffective outsourcing arrangements, have seen their costs skyrocket and marketplace shares decline.

From my work with clients, and from my own experiences as Chief Information Officer of a *Fortune 50* subsidiary, I've identified three key tactics that dramatically improve the odds of success and consistently increase the bottom line. I have also seen, albeit sometimes painfully after the fact, the warning signals of outsourcing efforts ready to swerve off the road and into the red. To implement a strategy that avoids these missteps while taking advantage of these tactics, the broader information technology (IT) outsourcing trends need to be briefly examined.

Growth of Outsourcing

A 2006-2007 study of information technology outsourcing by *Computer Economics* revealed several interesting trends:

- By almost a 2-to-1 ratio across the board, outsourcing is outpacing its decrease (or, "insourcing")
- The rise of off-shoring work has grown to nearly 20% of all outsourcing
- 32% of companies now outsource their data center operations
- 61% of all software development is outsourced; this is also the fastest growth area

Increasingly, companies around the globe are taking advantage of currency strengths and weaknesses to outsource IT jobs to offshore locations. Historically, in the U.S., we think of IT jobs going to southeast Asia, but today, given the historical high of the euro against the dollar, European companies are looking to the U.S. as a viable offshore location, while firms in India, flush with cash from U.S. firms, look to other Asian neighbors like Indonesia and Vietnam.

Interestingly, the lowest outsourcing adoption rates exist for two categories of IT work that directly touch people on a daily basis, desktop support and help desk support. While one can argue that other technology areas such as network operations and website functionality are important to people on a day-to-day basis, only desktop and help desk services are relied upon by people in a vulnerable state – something is wrong, the person cannot accomplish a particular task, and the emotions of frustration, anxiety, and even embarrassment, come into play. As anecdotal evidence in the consumer marketplace has made clear (think of Dell outsourcing its help desk to a firm in India and then back to North America), this volatile mix of emotions and vulnerability can result in a costly backlash on a company – either through its external consumers or internal customers – if the outsourcing results are not effective. Recognizing this combination of emotions and vulnerabilities is the crucial step to understanding how to cost-effectively outsource and where to avoid going off on the wrong track.

Tactic 1: Business-Driven Strategy

Strategy is dictated by goals, and outsourcing is not a goal but a means to an end. Thus, the first tactic is to examine your company's strategies and identify which strategies will be most impacted by business enablement from outsourcing. For instance, if the business strategy is to grow your company's sales and market share, then an outsourcing contract for help desk support will not provide a high degree of business enablement to achieve that strategy. However, outsourcing the sales tracking system and sales force support might have such a strong impact and is thus more likely to be seen as successful by the business client. The logic underlying this is simple: the more impact your outsourcing can have, the higher its value, which then improves the cost versus investment return ratio resulting in a higher level of cost-effectiveness.

Mistake 1: Confusing Cost-Effectiveness and Cost Cutting

The mistake that I see over and over with my clients is confusing cost-effectiveness with lowering overall costs. Cutting costs is a means to an end, an operational tactic. Cost-effectiveness is more strategic, taking into consideration the short-term and the long-term, broad relationships, and so forth. Cost-effectiveness may save monies, but it always allows reinvestment in high impact activities such as customer service and interaction, innovation and improved competitiveness. Outsourcing risks running off the track when the logic behind it is restricted to "higher impact equals lower costs."

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Tactic 2: Clear Business Case

Once the areas of impact to business strategy have been determined, a brief business case needs to be drafted. Even if the company's executive management team has already signaled their approval of IT outsourcing, the business case is important for two reasons:

- Clearly stating how the outsourcing supports the business initiatives will provide long-term guidance for selection of vendors, management of vendors, metrics, contracts and so on; and
- Clarifying how the outsourcing will improve operational and strategic effectiveness is the core information you must have to provide measures for the outsourced provider and structure incentives within the contract.

The business case need not be overly long, only sufficient to draw out this information to allow it to support a request for proposal (RFP) and to obtain any final buy-in from the business units.

Mistake 2: Mutual Misunderstanding

I recently worked with one client who had a wonderful business case and a detailed RFP they were preparing to send out. As an independent sounding board ("*our* virtual CIO" as the business unit head labeled my firm), my role was to act as a third set of eyes and ensure that an appropriate level of coverage existed for the business units and nothing glaring had been overlooked. In talking with the business unit management, they were very excited about an upcoming partnership currently being negotiated with an outside product development company to jointly bring a new product to market in the next year. Unfortunately, when I reviewed the RFP, and then the original business case, there was no mention of any collaborative technologies to be implemented or supported by the outsourced vendor soon to be in charge of the company's wide area network and external security.

The fault of such poor miscommunications equally belongs to both IT and the business units. The challenge to effectively share what is planned (or hoped for) over the next 18 months is a difficult one given the often different "languages" and nuances of IT and line-of-business executives. When this challenge is under estimated, the result is often a series of poor decisions, negatively impacting the outsourcing efforts. The goal is not complete agreement between business units and IT, but to translate the language of each other enough to capture and evaluate IT and business interdependencies and ensure mutual understanding.

Failing to account for, or resolve, this communications challenge will have even worse consequences once an outsourcing contract is signed. A 2005 study by several financial service firms revealed that nearly 70% of companies that had negative, costly experiences with outsourcing did so because underlying communication issues, relationship factors and process problems were not resolved prior to the outsourced vendor coming on board.

Tactic 3: Commoditize with Integrated Pilots

Wholesale outsourcing of IT, while the dream of many a frustrated business executive, is simply not a viable practice. Rather, focus on using outsourced vendors to handle commodity-based IT activities such as project implementation and break/fix support and maintenance. Tie these directly to business strategy objectives (even at a relational level, *i.e.*, outsourcing X will allow us to focus energies on Y) and give the business units a voice in selection of what to outsource.
Once the outsourcing negotiations are on their way to final selection, the best practice is to utilize a pilot program before the final services contract is signed. With my clients, I encourage the business units and the IT group to jointly select a measurable project that is not isolated and self-contained, but rather has some degree of business integration and impacts. The reasoning is three-fold:

• If the company has done its work to select outsourcing based on impact to the business, there should not be any self-contained, isolated projects available for the potential outsourced provider;
• An integrated pilot allows the company to observe and assess how the potential outsourced provider and the company's own personnel work together; and
• The company can use several such projects to try out the final potential vendors on parallel projects.

Admittedly, there is some level of risk given the pilot project's integration and relationship to business strategy impact; however, in my experience, simply by recognizing this, the company can put in place measures to monitor and control the risk – from contractual controls, penalties and incentives to using company personnel as co-project managers or hiring an independent project assurance advisor to help deliver the project, assess the teams and processes involved, and make recommendations for the final contract.

The insights gained from these types of pilots (and independent assessment) can be adapted into the contract and operating agreement with the final outsourcing vendor. In addition, if you decide to adopt a phased outsourcing approach, such pilots can serve as an initial framework for the overall effort.

Mistake 3: Failure to Diversify

Many years ago, an old colleague of mine decided that managing the various outsourced IT vendors his company had ended up with was simply too much; he was going to "put all the eggs in one basket and watch that basket." Concentration of IT activities into one or two outsourced vendors is often undertaken when the executives in charge of managing the outsourcing have confused cost-effectiveness with cost-cutting. Strategic outsourcing is really about investing wisely. A solid investment strategy, as any financial advisor will tell you, is to "diversify, diversify, diversify." There are many ways to do this when outsourcing components of IT: network infrastructure can go to one vendor, data center operations and disaster recovery to another, help desk to a third, application development and support to a fourth, and so on. In addition to mitigating the risks, you also avoid losing the value of your investment down the road.

For my colleague, the end of the road came two years later. The contracts were all concentrated in the hands of one of the big three IT consulting firms and they knew it. To my colleague's chagrin, the vendor with whom he had touted such a great relationship, raised prices during renewal negotiations. Despite panicked internal assessments of timelines and resources needed to bring the services back in-house (or to switch the services to another vendor), it was clear to my colleague that such a change simply was not feasible. Too much was at stake in the rest of his company – several new high-profile partnerships were being negotiated, two new products were in test market with a third on its way, and the reverberations and reorganizations from the last year's merger had only recently been laid to rest. The renewal turned into a seven-year contract at nearly 30% higher rates over the lifetime of the contract. Needless to say, this renewal contract also heralded the end of my colleague's career with his company.

Even if you are a small or mid-sized firm, this type of worst-case situation can be avoided by signing at least two different outsourced vendors for areas of long-term work that require high intensity, but a low level of office presence. Perfect examples include virtual private networking, website and e-mail hosting, e-commerce applications, remote sales force support, and so on. If you are not sure which IT areas might be appropriate, ask around for advice and insights, go back to your company's strategies and determine the commodity level of the IT resources required to enable the strategy.

Final Thoughts

If your firm is considering outsourcing to vendors that are offshore, or that use offshore partners themselves, pay careful head to the "deemed export" provisions of the Export Administration

Regulations under the Bureau of Industry and Security (BIS). The company ITT recently paid over $100 million in fines because it allowed an overseas vendor access to commercial product technical specifications deemed important to control by the BIS. In this heightened era of post-9/11, the BIS is the one government agency that has repeatedly, and successfully, levied the highest fines and personal criminal convictions on businesses and executives. The more technology savvy the investigators and prosecutors become, the higher the risk to IT executives ignorant of their legal obligations. Check with your legal department or an outside compliance advisor on setting up simple safeguards to prevent such costly missteps when outsourcing.

Outsourcing is not a zero-sum game or 50-50 gamble. Use the three tactics I have laid out here to create an outsourcing strategy driven by business impact and protected with warning triggers to prevent risky situations. By outsourcing cost-effectively, you directly improve your business and your bottom line.

Are you ready?

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