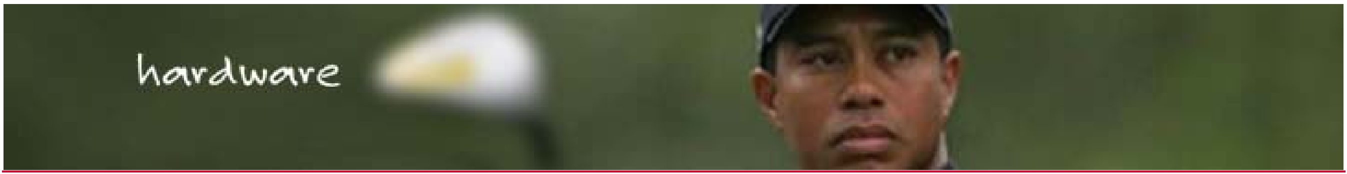

The Seven Deadly Sins of Outsourcing

These are the transgressions that can doom you to outsourcing hell. Here's how to avoid them.

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May 8, 2006 (Computerworld) Outsourcing is a source of stress, struggle and angst for many IT managers, and no wonder: More than half of outsourcing agreements end up prematurely terminated, according to a study released last year by DiamondCluster International Inc., a Chicago-based consulting firm. That leaves a lot of companies far from outsourcing nirvana, but it doesn't have to be that way. We asked IT experts and veterans to talk about the bad decisions and faulty assumptions that can cause your outsourcing project to fall from grace. They came up with seven deadly sins.

1. Feeble governance

Vice: You assume that your organization will auto-matically fall into a smooth working relationship with your outsourcing vendor. Three months later, you encounter management snafus that seem to have come out of nowhere. One large retailer outsourced a project that was supposed to take six months, but 18 months later, the CIO was still waiting for results. Why? "There was no governance plan other than a target for the end date," says Atul Vashistha, chairman and CEO of neoIT Inc., a consulting firm in San Ramon, Calif. "If they'd had a governance plan with milestones in place, they would have realized early on that targets weren't being met."

Virtue: Before you sign with an outsourcer, nail down an organizational structure, establish methods for keeping tabs on the work being done, and spell out how you will manage the outsourced project on a day-to-day basis. "Your governance system should provide continual feedback to the organization regarding how the relationship is working, what value you are getting, how you are solving problems that have cropped up," says Michael F. Corbett, executive director of the International Association of Outsourcing Professionals in LaGrangeville, N.Y.

Build the management costs into your budget. The average cost to manage an outsourcing contract is 3% to 6% of the size of the contract, according to Julie Giera, an analyst at Forrester Research Inc. in Cambridge, Mass.

2. Overblown expectations

Vice: You choose an outsourcing company for its ability to meet your primary goal, but later the company falls short in other areas. For example, one of Europe's largest manufacturers was so eager to trim expenses that it negotiated an outsourcing contract purely on cost. As the project progressed, the manufacturer complained that the outsourcer wasn't innovative enough. How bad was it? Less than two years after signing the contract, the manufacturer terminated the agreement -- a move that carried a steep price tag in penalties and legal fees.

Virtue: Don't even approach a service provider until you have prioritized what you expect to achieve by outsourcing. If you're shopping based on cost, you may have to give a little on service level. Keep in mind that a cost-based contract might be appropriate for standard services like infrastructure management but not for specialized skills such as application development. "You don't necessarily want the cheapest brain surgeon," says Giera.

When considering vendors, look beyond the sales pitches. "People select suppliers based on marketing and size rather than a true capability evaluation," says Vashistha. He suggests that you focus on the location where the work will actually be done. Ask the vendor about its resource pool. Are its employees experienced in your industry? Do they have the appropriate technical skills? How much training does the vendor provide? Talk to clients that the vendor has served from that location for at least 12 months.

3. Blindly banishing projects

Vice: You have offshored critical areas of your business to overseas suppliers that are inexperienced in your field or otherwise ill-equipped to handle the task, and customers are up in arms. For example, after Dell Inc. outsourced its technical support to offshore providers, the company was inundated with complaints from U.S.-based customers who reported that they couldn't understand the service providers because of their accents. Dell had to move a chunk of its technical support services back home to Texas.

Virtue: Use common sense and send projects offshore only to countries where your industry is mature. India and the Philippines, for example, while good choices for services like health insurance data entry, are poor choices for jobs that require decision-making related to health insurance, says Vashistha. That's because in-depth knowledge of the field is still scarce in those areas. "Health insurance wasn't prevalent even 10 years ago in those locations," he says.

Keep in mind that offshore projects cost more to manage than projects that are sent to domestic outsourcers. That can make small projects especially costly to send offshore. "A lot of people look at the money they'll save per hour but ignore that they'll probably have a 20% to 25% increase in administration costs," says Rich Hoffman, president and CEO of Hyundai Information Services North America LLC in Fountain Valley, Calif.

4. Dumbly disowning projects

Vice: You've outsourced so much of IT that your outsourcer knows almost as much about your customers, your products and your industry as you do. According to Hoffman, the IT department of another major automotive manufacturer recently realized that it outsourced too aggressively and is now trying to rehire nearly 150 former employees who went to work for the outsourcer. "When they outsourced all of those people, half left because they didn't want to work for an outsourcer, and the other half ultimately got transferred by the outsourcer to other companies," he says. "So they lost all the people who knew their customers, products, the automotive industry and business processes."

Virtue: Don't outsource functions that require you to provide outsourcing vendors with strategic information about your company and your industry. Also, Hoffman advises keeping most of your internal help desk activities in-house and discouraging other business units from outsourcing customer-facing activities. You will have more control over which processes get outsourced if you insist on being involved in all discussions about outsourcing. "Run an analysis ahead of time, and get a consensus with business leaders about what must stay in versus what must go out," says Hoffman.

5. Bad assumptions

Vice: Your five-year outsourcing contract failed to take into account that technologies and business requirements would evolve within those five years. Now you can't move forward with new technologies. Giera notes that because of changes in server technology, for example, many companies will need fewer, but larger, servers down the line. If your contract is based on a per-server, per-month formula, you may not be able to change that without being penalized financially, she says.

Virtue: Write a contract that gives you the flexibility to reprioritize projects and resources without a major penalty.

"Technologies change so fast and the needs of clients change so fast, most parties should go into the contract expecting that after the first two years there is a pretty high likelihood that they'll have to renegotiate the contract," says Robert M. Finkel, an attorney at Milbank, Tweed, Hadley & McCloy LLP in New York.

Also, be sure the contact compels your outsourcer to keep costs in line as the market evolves. "Include benchmarking clauses every two to three years so that you can look at what's gone on in the market and make sure that the outsourcer is still competitive," says Giera.

6. Sloppy service levels

Vice: You've signed a contract that gives you minimal leverage on service levels. Now the outsourcer's poor service is interfering with your business, but you've got nothing to back up your demands for improvements.

Virtue: Define service levels in the contract and stipulate penalties for missed service levels. Having the service levels in hand not only helps ensure that you get the quality of service you expect, but it can also help when negotiating the contract's price tag. "It's hard to fix a price without knowing what the service levels are," says Finkel. But he says that it's not uncommon for vendors to want to wait until after the contract is signed before agreeing to specific service levels. That takes away your leverage and makes it less likely that you will reach a satisfactory agreement.

The penalties should escalate based on how frequently service levels are missed and how much the resulting disruption affects your business. "You shouldn't have penalties for one miss, but the penalties should get exponentially larger the more frequently a service level is missed," Giera says. And your contract can stipulate that you have the right to terminate or take back part of the service that the vendor is providing if the number or severity of the service-level problems reaches a certain point, Finkel says.

7. End-game myopia

Vice: You didn't include a transition plan in your contract. Now, as it draws to a close, your efforts to move to another outsourcer or bring the work in-house are stymied. An even worse case: Your outsourcing relationship ends abruptly. One of Giera's clients, a midsize manufacturing company, outsourced all of its payroll functions to a firm that suddenly went out of business. "My client couldn't pay its hourly workers on time that Friday. There were no provisions in the contract to get the data and employee records back, so they had to go to a manual payroll system," she recalls. The manufacturer ultimately spent eight months rebuilding its payroll system, including manually reconstructing tax, unemployment insurance and benefits records.

Virtue: To minimize disruptions to your business, make sure your contract calls for the outsourcer to be involved with the end-game transition. "Otherwise, what's the incentive for the vendor to help you?" says Finkel.

Your contract should stipulate that you may offer jobs to people on the outsourcer's staff who have developed knowledge critical to your company. You should also be able to buy at a reasonable price the hardware and software that your outsourcer is using on your behalf. In addition, be certain that the contract gives you usage rights to any software that the outsourcer develops for you.

And be sure to give yourself enough time to make the transition. "When you terminate an outsourcing contract, you'll probably need more time than you think," Giera says. "Specify in the agreement that you can extend the agreement with appropriate notice at your existing terms, conditions and price for up to 90 days."

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