

December 27, 2004

Offshore Outsourcing: Internal Preparation, Not Labor Rate, Is Key To Savings And Success

by Stephanie Moore

BEST PRACTICES

BEST PRACTICES



December 27, 2004

Offshore Outsourcing: Internal Preparation, Not Labor Rate, Is Key To Savings And Success

by **Stephanie Moore**

with William Martorelli and Adam Brown

EXECUTIVE SUMMARY

Companies outsourcing offshore do not sufficiently invest in internal preparation and organizational change management activities. Most rushed into offshore outsourcing to take advantage of the savings opportunity — an opportunity that proves elusive to all but 35% of companies surveyed. The savings, mostly available because of the difference in labor rates, quickly disappear when the complexities of an outsourcing relationship are realized. To reap the benefits of offshore outsourcing, companies must alter their processes, expectations, and employees' skills, roles, and responsibilities. In addition, they must develop an outsourcing strategy that defines their objectives so that organizational changes accommodate these objectives. Companies that neglect internal preparation requirements will not achieve the savings or efficiencies available in offshore outsourcing relationships. Furthermore, they may lose money and damage the relationship between the business and IT.

TABLE OF CONTENTS

- 2 **Offshore Outsourcing Efforts Are Compromised By Failure To Prepare**
- 3 **Case Studies: Ill-Defined Objectives Affect Program Success**
- 4 **Internal Due Diligence: How To Successfully Outsource**

RECOMMENDATIONS

- 11 **Offshoring Must Start With Internal, Not External, Due Diligence**

ALTERNATIVE VIEW

- 11 **Process Optimization Change Obviates The Need For Offshoring**

NOTES & RESOURCES

Forrester worked with several user companies that are struggling to optimize their offshore outsourcing programs.

Related Research Documents

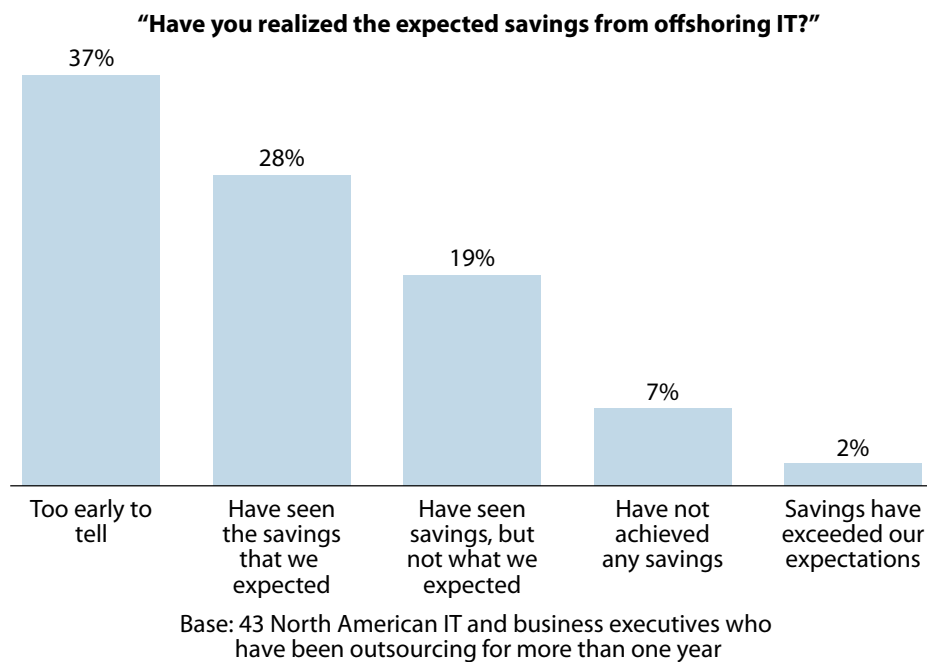
- “Lost In Translation: Why Business Users And Offshore Outsourcers Can’t Communicate”
September 15, 2004, Best Practices
- “Cultural Challenges In Offshore Outsourcing”
September 14, 2004, Quick Take
- “Assessing Your Offshore Outsourcing Readiness”
March 31, 2004, Trends
- “Client School: The Key To Successful IT Outsourcing Engagements”
March 23, 2004, Quick Take

OFFSHORE OUTSOURCING EFFORTS ARE COMPROMISED BY FAILURE TO PREPARE

Preparing for offshore outsourcing relationships is not just an activity for companies new to offshore outsourcing. During the past three years, many companies entered into offshore outsourcing relationships with less preparation than required. Starting in 2002, executives began to think that low-cost, remote labor in the IT organization was a silver bullet for containing costs and improving productivity and quality. Offshore outsourcing became a management trend. Executives not outsourcing offshore weren't considered fiscally responsible or innovative. This, unfortunately, led many companies, which were clearly not prepared, to enter into offshore outsourcing relationships. Today, these companies are suffering the ill effects of this preparatory shortfall. These effects include: no savings; inability to determine whether offshore outsourcing delivers any cost benefit; productivity losses; service degradation; quality degradation; disgruntled and dissatisfied IT employees; disgruntled and dissatisfied business users; project delays; and project failures.

Companies are demanding information about how to outsource offshore correctly. They have, they believe, selected the right vendors and the right countries and put the right security processes and technologies in place, but still they are struggling to find the promised benefits of offshore outsourcing (see Figure 1).

Figure 1 Offshore Savings Are Not Guaranteed



Source: Forrester Research, Inc.

Internal Preparation Delivers Better Value Than Vendor Rate Negotiations

The companies we surveyed have had vastly different results. The deviation illustrated is not caused by a \$2 per hour variation in Bangalore labor rates, but rather by how well a company uses offshore resources, what type of work it is doing offshore, and how mature its processes are. For example, the degree to which poor business user and IT processes affect overall offshore outsourcing savings cannot be underestimated. UAT delays, multiple iterations of the same deliverable, high deliverable rejection rates due to misrepresented requirements or specifications, and changes after code is in development are very expensive in an offshore outsourcing relationship. Companies that don't understand this and don't put processes in place to fix these issues are never going to exploit offshore outsourcing benefits.

CASE STUDIES: ILL-DEFINED OBJECTIVES AFFECT PROGRAM SUCCESS

The following case studies highlight the problems that occur when companies don't map their offshore strategy to well-defined and realistic business objectives.

- **A high-tech company cut permanent staff.** At this high-tech company, the CEO told his CIO to cut 20% of his IT staff and replace them with offshore resources. The CIO had eight months to achieve this goal. To do this, the CIO asked his 13 direct reports to cut 20% of their staff. There was no advanced preparation by qualified IT and business executives to first determine which functions, applications, projects, or roles were best suited to a remote sourcing model. No cost benefit analysis was done to determine which functions, applications, projects, or roles would save the most money. And no analysis was done to determine how or if offshore outsourcing would actually degrade service and quality rather than improve it. Each manager made cuts according to her best guess, without the benefit of recommendations from an internal or external body with remote sourcing experience. In addition, there was no recognition of the internal process changes/improvements required, and no central person or team monitored the vendor or the delivery across engagements to ensure standard service at an acceptable price point.

As a result, the wrong things were initially outsourced, such as the level-one end user help desk. The relationship between IT and the business deteriorated; the company spent more money on on-site contractors (who, of course, are much more expensive than the internal staff that had been cut); IT manager productivity plummeted as they struggled to prop up the failing outsourcing efforts; and IT suffered budget overruns.

No money was saved, because saving money was not the explicit goal. The goal of reducing permanent head count was achieved but there was no ultimate benefit. Costs rose, service degraded, and IT and the business were more dissatisfied than ever.

- **A healthcare organization establishes offshore outsourcing spend targets.** This healthcare company has an offshore outsourcing mandate from its CEO. The CEO said that in 2002, IT must spend \$5 million on offshore outsourcing; in 2003, IT must spend \$10 million on offshore outsourcing; in 2004, IT must \$15 million on offshore outsourcing; and in 2005, IT must spend \$30 million on offshore outsourcing. The spend is measured by the value of invoices from the company's two offshore outsourcing vendors. The spend requirement is divided equally between the CIO's five direct reports.

The problem with this approach and this outsourcing objective is that clients, which individually negotiate with the approved vendors on a per project basis, are incented to pay higher prices for offshore labor so that they can reach their goal faster. The company had no problem reaching its spend target, but it also had to increase its IT budget to accommodate the offshore outsourcing mandate. And because IT managers are not motivated to make each project as efficient as possible, they don't care about cost overruns due to rework, changing business requirements, or poor specifications. The result of this offshore approach is that the company has increased costs and decreased efficiency.

INTERNAL DUE DILIGENCE: HOW TO SUCCESSFULLY OUTSOURCE

Companies outsourcing offshore typically focus on external due diligence first: vendor stability, offshore country stability, security, how to get the lowest labor rate, etc. However, they often fail to focus on internal due diligence, including developing an outsourcing strategy, setting up a governance structure, evaluating their offshore outsourcing readiness, and initiating an organizational change management program to prepare staff and systems to outsource. To realize offshore outsourcing benefits, companies must follow some preparatory activities. Companies that are unwilling to invest in this preparation should not attempt to outsource offshore.

The Sourcing Strategy: Identify Outsourcing Objectives

Companies should not outsource offshore for offshore outsourcing's sake. They must identify their outsourcing objectives and map a strategy to those objectives. Different objectives require different approaches. For example, companies interested in improving productivity or quality will approach outsourcing very differently than companies whose main objective is to cut costs. Companies that want to cut costs may be willing to give up flexibility or service levels to achieve the needed cost benefits. Companies outsourcing to improve service levels may be willing to pay more for the service-level improvements. The sourcing strategy should answer the questions: Why are we outsourcing offshore? What are our offshore outsourcing goals? How do we plan to measure our success? How will we manage the outsourcing efforts?

More often than not today, companies that outsource offshore don't know whether they are actually achieving their objectives — either because they don't know what the objectives are at the execution level — or because they can't measure their savings, productivity improvements, or quality levels due to a lack of a relevant baseline for comparison. In some cases, IT executives are being told to do offshore outsourcing, but the objectives of this outsourcing are either unclear, ambiguous, or wrong.

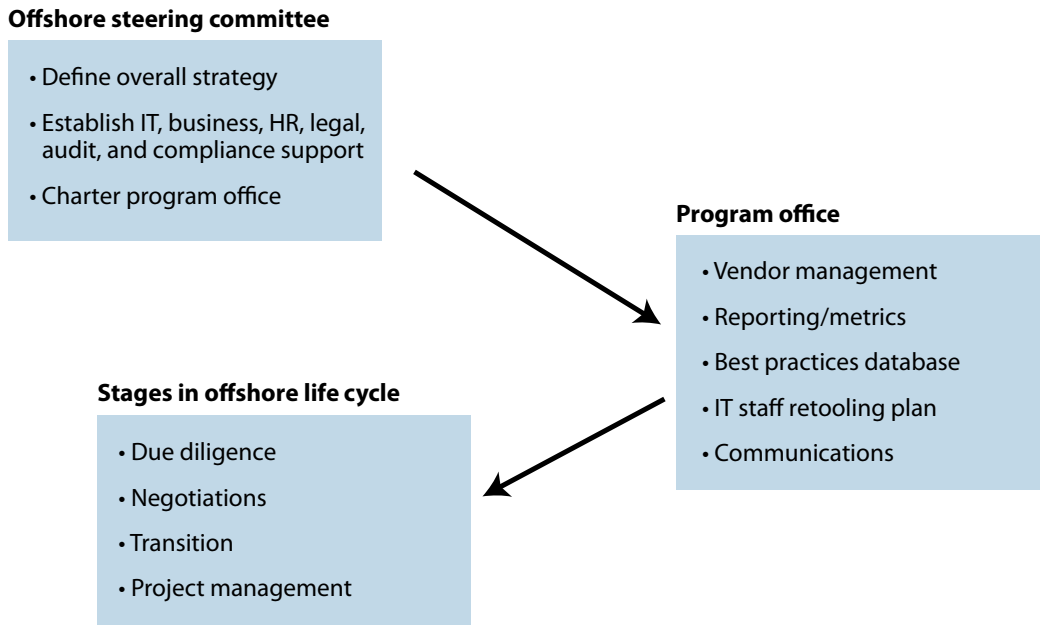
Implement Governance And Program Management

Companies need to have a governance structure and an offshore program management office dedicated to facilitating the efficient use of offshore resources and monitoring the success of these efforts. The strength of a company's governance capabilities will determine the value of everything that the company does going forward. As in the example of the high-tech company mentioned earlier, it is risky and expensive to allow random IT managers who use offshore resources to make their own rules and develop their own offshore outsourcing processes and standards. It is vastly more efficient to have one small group or team — the offshore program management office (PMO) — that develops and sets offshore outsourcing standards and processes, facilitates the use of offshore resources, and monitors offshore outsourcing projects. It is critical that this organization report to the most senior IT executives, so that it has the visibility and authority required.

A centralized offshore PMO office, in conjunction with the executive steering committee for some tasks, should perform the following activities for the entire IT organization (see Figure 2): Determine which functions, applications, projects, or roles are best suited to a remote sourcing model; establish standards and processes; maintain best practices databases; establish training programs; establish cultural communication programs; develop metrics for evaluating the success of offshore relationships; monitor vendor performance and ROI; evaluate and select vendors; develop standard service-level agreements (SLAs) and contracts; set pricing with the vendors; and act as an intermediary between individual project teams and the vendor.

During offshore program establishment, the program office collaborates with an executive steering committee to set standards and strategies. Other senior non-IT executives either participate in or provide part-time support to the executive steering committee and the offshore program office (see Figure 3).

Figure 2 Governance Provides Adult Supervision



Source: Forrester Research, Inc.

Figure 3 Global Sourcing Program Management: Who Participates?

The global PMO should be staffed by one or more people (FTE) with the following skills/characteristics:

- ✓ Management background
- ✓ Project and relationship management
- ✓ Communication — written and oral
- ✓ Contract negotiation experience
- ✓ Outsourcing experience
- ✓ Credibility with business and IT
- ✓ Organizational skills

But, advice and council are required from the following areas:

- Legal
- IT management
- HR
- Finance
- Security
- BCP/DR
- Risk management
- Procurement
- CSO/CRO
- PR

During offshore program establishment, the program office collaborates with an executive steering committee to set standards and strategies. Other senior non-IT executives either participate in or provide part-time support to the executive steering committee and the offshore program office

Source: Forrester Research, Inc.

Determine What To Outsource

Companies need to conduct an application portfolio analysis and a skills inventory to determine what makes the most sense to outsource. Today, all categories of development and support are being sent offshore for all categories of business systems. From leading-edge technology development to COBOL and PL/1 support to mission-critical wealth management applications to noncritical applications awaiting sunset, the sky is the limit for the types of work that can be done remotely. However, companies must understand their risk tolerances, their internal skills portfolio, the costs associated with supporting and developing their systems, and their outsourcing process maturity before they can decide what to send offshore. Companies need to understand which IT assets are the most critical or valuable to them, which applications support strategic initiatives, which applications are the most expensive to support, and which systems will be the easiest and most cost-effective to support remotely. To determine ease of remote support, there are general guidelines that should be applied to project selection. Certain types of projects or systems are much easier to support remotely than others, for example: projects with well-defined requirements; systems that don't require significant and ongoing end user interaction; systems with documentation; stable systems; noncritical systems; and systems for which support skills are hard to find.

Unfortunately, few companies have systems that meet more than one of these requirements. And, if they do, these systems are sometimes inexpensive to support, so outsourcing them offshore may not deliver a cost benefit. In other words, if a stable system only costs \$100 per year to support internally, why bother outsourcing it offshore? The overhead costs associated with this outsourcing would be greater than the internal support costs. Thus, companies must develop a project selection framework that takes all relevant factors into account (see Figure 4).

The offshore PMO usually sets standards and makes recommendations about what can and cannot be outsourced. In some cases, an executive steering committee will decide what to outsource. For example, the steering committee may decide to outsource an entire SAP implementation or a large, expensive custom system. In other cases, individual stakeholders or IT managers are given access to an evaluation framework and scoring methodology and they decide what makes the most sense to outsource.

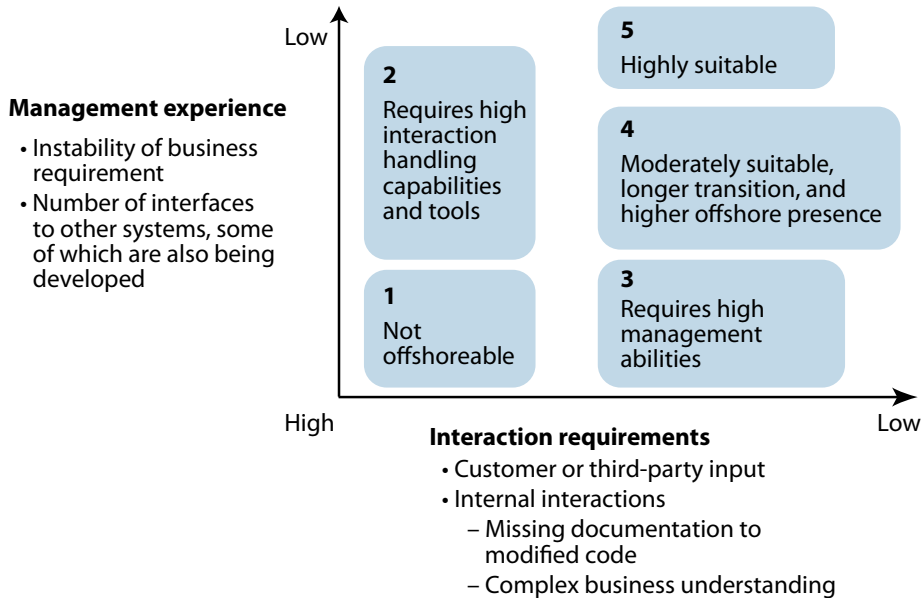
Figure 4 Plotting The Applications' Offshore Outsourcing Suitability

4-1 Application evaluation framework

	Application A	Application B	Application C	Application D
Support costs				
Interaction requirements				
Stability				
Size				
Dependency rating				
Complexity rating				
Documentation quality				
System criticality				

- | | |
|--|---|
| 1. Doesn't satisfy the criteria at all | 4. Satisfies a majority of the criteria |
| 2. Satisfies a few aspects of the criteria | 5. Satisfies the criteria |
| 3. Satisfies a minority of aspects of the criteria | |

4-2 Application suitability requirements



Source: Adapted from NASSCOM-McKinsey Report 2002, National Association of Software & Service Companies, 2002

Source: Forrester Research, Inc.

Invest In Organizational Change Management

Finally, and perhaps most importantly, companies need to change processes, expectations, the IT organization, and even the business to accommodate the demands, rigidity, and complexity of a remote-sourcing relationship. This initiative starts with an as-is assessment of the company and its offshore outsourcing readiness.¹ Only when a company understands its current level of preparation, can it identify the changes required to get to the desired end state. Companies that do not invest in organizational change management cannot outsource offshore successfully.

- **Process changes.** Companies that have immature or nonstandard software development and IT customer management processes will have to alter their processes to outsource successfully. At a minimum, the IT organization has to clean up or optimize its processes so that it can effectively communicate and collaborate with offshore outsourcing staff that use very mature software development processes. It is very difficult to have two distinct sets of resources working on the same systems using different languages and processes. The miscommunication and misaligned priorities and processes can cause project delays, coding and testing errors, and, ultimately, cost overruns.

In addition, IT's customers usually have to become more specific and detailed in the way they express their requirements. Gone are the days when an IT customer can sit on the shoulder of his favorite developer and specify requirements as the developer is coding. In an outsourcing relationship, end user requirements have to be considered and detailed enough so that a business analyst, a technical writer, internal IT, the offshore vendor, or some combination thereof, can interpret them and write a specification based on them.

When companies run into a process conflict, they often demand that the offshore vendor dumb down its processes to accommodate their own weak or immature processes. This is waste of business value. One of the primary benefits of using offshore resources is the internal process improvement that necessarily takes place. This process improvement is responsible for some of the savings delivered by offshore outsourcing. Ignoring this benefit not only reduces overall savings, but it also likely negates the value of the relationship.

Companies uncomfortable with executing the process improvement effort alone can call on any number of external consultants for support. First, the top-tier offshore vendors have strong process and quality consulting practices. In some cases, the vendors will deliver process consulting for free along with a larger engagement or as part of a larger relationship. Companies that prefer to use an unbiased third-party vendor can look to vendors like IBM, Accenture, BearingPoint, Keane, and DiamondCluster.

- **New roles and responsibilities.** IT organizations that do outsourcing of any kind must retool themselves. Programming skills, for example, are viewed as commodity skill sets that can be outsourced without negative impact to the IT organization. Skills that support outsourcing and the effective running of an IT organization, however, need to be nurtured, developed, and retained. The most important skill sets today are those of architects, business analysts, technical writers, vendor management experts, program and project managers, and QA experts. These higher-value skills are required to make the IT organization more efficient and to make outsourcing work. Companies, challenged to find the new skills, are realizing that their existing IT staff, particularly the top performers, are often best-suited to move into these new roles and/or take on some of the new responsibilities.
- **Training.** Internal staff, both on the IT and the user side, must be prepared to make the shift to an offshore outsourcing model. Roles and responsibilities, expectations, and perceptions about external and/or foreign staff must change. Staff must learn how to engage in an offshore outsourcing relationship.

First, as discussed above, companies will have to provide formal training to transition staff to new roles.

Then, companies will have to provide an introductory course to offshore outsourcing. This training is meant to teach all relevant IT and business staff about outsourcing, what to expect from an offshore outsourcing relationship, and how to behave in an offshore relationship. It should present best practices in vendor management, communications, specification writing, requirements gathering, QA, sign-offs, code reviews, service-level monitoring, and expectations management. Without this training, staff simply will not understand the processes, context, market, best practices, or potential pitfalls. Companies that are successful with offshore outsourcing do intensive training sessions to help their staff learn how to do outsourcing correctly by avoiding common mistakes and knowing best practices.

Finally, companies must provide cultural training. Culture clash or miscommunications can derail any collaborative IT project. Indian culture, for example, is very different from American culture. Speaking in broad generalities, American developers are more assertive and communicative than their Indian counterparts, who tend to be more passive. Indian developers hesitate to ask questions, because it is viewed as rude in India. They are also often unwilling to point out errors in a specification that they have been given. Rather than insult the client, they would prefer to code to the spec to save the client embarrassment.² Tier one Indian vendors provide their consultants with assertiveness training and teach them about the necessity of the question-and-answer dialog, which is obviously critical in situations where the client does not

provide firm specs or requirements and where requirements are constantly changing. Companies must train their staff to understand Indian culture and the potential for misunderstanding and miscommunication so that they can bridge the gap, or at least meet their Indian counterparts, most of whom have had cultural training, halfway.

Many companies develop their own cultural sensitivity classes. Some vendors will also provide internal cultural sensitivity training for client staff. Providing internal staff with this training, particularly as it relates to communications, will make a *significant* difference in the success of the project.

RECOMMENDATIONS

OFFSHORING MUST START WITH INTERNAL, NOT EXTERNAL, DUE DILIGENCE

- If you're committed to offshore development or maintenance, you must first determine, through an offshore outsourcing readiness assessment, if your company is prepared to do it.
- Even pilot projects must be preceded by a sourcing strategy. Pilot projects help companies learn how to outsource and how to determine whether outsourcing is a viable strategy. Companies that don't understand what their outsourcing objectives are will not be able to determine if their pilots have been successful.
- The importance of a formalized organizational change management program cannot be underestimated. To achieve maximum benefit, the IT and business community must make and embrace the necessary changes.
- Question your vendors' abilities to support your preparatory activities. If you are already in a less-than-successful offshore outsourcing relationship, call on your vendors to help you improve your efforts.

ALTERNATIVE VIEW

PROCESS OPTIMIZATION CHANGE OBTVIATES THE NEED FOR OFFSHORING

The bulk of the savings delivered from offshore outsourcing comes from the optimization of processes in the IT and IT customer community. Unproductive staff, poor requirements management, poor project management, and dissatisfied, undisciplined IT customers all contribute to inflated IT budgets misalignment between IT and the business. If companies could fix these problems without the offshore outsourcing catalyst, then they could conceivably achieve savings equal to those delivered through labor arbitrage.

ENDNOTES

- ¹ Despite all the press and visibility, taking IT work offshore does not guarantee success or drive instant savings. Firms must understand that taking work to locations like India stress-tests their internal IT processes and challenges the company's internal culture. The maturity of internal processes and culture has more to do with success than the country or the vendor customers select. To help our clients understand their readiness for offshore outsourcing, we devised a simple 20-question assessment that measures the suitability of a company's existing IT processes and its overall cultural compatibility with the requirements of offshore outsourcing. Organizations with high readiness along these two vectors will be able to proceed more rapidly. Organizations with low readiness, conversely, must calibrate their expectations, tactics, time frames, and the selection of appropriate offshore suppliers in a manner commensurate with their readiness. See the March 31, 2004, Trends "Assessing Your Offshore Outsourcing Readiness."
- ² Companies outsourcing offshore must teach their business analysts and internal customers how to work within the confines of an offshore outsourcing relationship. The process change required is, in most cases, revolutionary, not evolutionary, for both IT and the business. But if internal IT and its customers cannot work within the new process model, companies will not be able to satisfy end user requirements, and any savings that offshore outsourcing initially promised will not materialize. See the September 15, 2004, Best Practices "Lost In Translation: Why Business Users And Offshore Outsourcers Can't Communicate."

FORRESTER®

Helping Business Thrive On Technology Change

Headquarters

Forrester Research, Inc.
400 Technology Square
Cambridge, MA 02139 USA
Tel: +1 617/613-6000
Fax: +1 617/613-5000
Email: forrester@forrester.com
Nasdaq symbol: FORR
www.forrester.com

Research and Sales Offices

Australia	Japan
Brazil	Korea
Canada	The Netherlands
France	Sweden
Germany	Switzerland
Hong Kong	United Kingdom
India	United States
Israel	

*For a complete list of worldwide locations,
visit www.forrester.com/about.*

For information on hard-copy or electronic reprints, please contact the Client Resource Center at +1 866/367-7378, +1 617/617-5730, or resourcecenter@forrester.com. We offer quantity discounts and special pricing for academic and nonprofit institutions.