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Outsourcing Risk - What should every client of outsourced software know about mitigating the risk of project failure?

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Scope of this Report

IT Governance is about defining what decisions need to be made, who should make them and how they should be made. One of the biggest decision areas that business and IT providers should exercise strong governance over is outsourcing.

Many books and articles have been written about IT outsourcing. The business and social impact of outsourcing and, particularly, offshoring have been huge in the 21st century. It seems that for every success story, there is a story of a painful transition. In 2008, when we published "The Business Value of IT", we believed that there was no turning back and that the future masters of IT would necessarily be masters of outsourcing. Six years later, we still believe that there is no turning back although we would modify that stark assertion today with the observation that companies including some of our clients have recognized "Total Outsourcing" of software development represents a significant corporate risk to some business.

This reviews the most significant risks of outsourcing software development and offers up some mitigation strategies.

Outsourcing Risks & Mitigations

No clear, shared goals: Why are we outsourcing?
Risk:
It is very important that the business and IT Providers are crystal clear on why they are starting to outsource or why they are continuing to outsource if they have already started. If not, there is a "me too" risk (outsourcing only because competitors are doing it) or an "inertia" risk (we outsource because we've always outsourced).

Mitigation:
This reason for outsourcing should be revisited to ensure that all assumptions are still valid in an annual review meeting between the business and the IT providers. Clearly, the business goals can and will change over the duration of a typical outsourcing contract. Businesses should arrange for regular reviews with their IT Providers to ensure that the sourcing choices are still valid and that the outsourcing is being conducted effectively.

Not Paying Attention to Changing Market Conditions
Risk:
While you want to avoid the "me too" risk, it is very possible that your competitors are gaining a competitive advantage through their approach to outsourcing. In particular, One or more of your competitors may have better knowledge or understanding of changing geopolitical or economic conditions in certain vendor regions than you. For example, if you see a major competitor shifting resources from India to Eastern Europe or country A to country B, they may know something that you do not.

Mitigation:
The specifics of markets are changing continuously. Research will be needed to find out what your competitors are outsourcing and monitoring will be required (of press releases, conferences, etc.) to stay in touch with changes. Our advice is to validate your own ideas about market changes against current information from sources such as the International Association of Outsourcing Professionals (www.outsourcingprofessional.org) or websites such as www.cioinsight.com annually, at least.

A review of changing market conditions must include a review of geopolitical risks associated with particular countries or regions. This can never be an exact science as we can all think of political upheaval that has seemed to happen quite suddenly. Further, not all such upheavals affect business in the medium term – some can be resolved relatively quickly. The lesson here is that it is advisable to have a risk mitigation plan for sudden geopolitical change that impacts your offshore software development.

Management lacks prior experience with outsourcing or lacks skill at overseeing outsourcing vendors
Risk:
While it may seem surprising, there are still a large number of software development managers who have not had experience (or have had bad experience) managing outsourcing vendors. We have referred elsewhere to the desirability of onsite visits but it may not be possible to arrange those in the critical first 3-6 months of the contract or the managers time in that role on an existing contract. Much damage can be done that period.

Mitigation:
Many organizations are developing the necessary knowledge, skills and above all, experience to address these challenges. From our own experience, for organizations that are not where they need to be yet, we recommend training, consultants and coaches. While all three are important, the latter can make all the difference because a coach can provide situational, context-specific help for those unforeseen or rare situations that are not covered by the training.

Outsourcing vendor lacks experience with providing outsourcing services
Risk:
Sometimes new or small outsourcing vendors can look like an attractive option because they will do anything for their first big contract. The risk is that they will be learning how to do outsourcing when they should be learning about your application or project.

Mitigation:

Firstly and fairly obviously, don't work with them. However, if they are so special that you must work with them – be cautious and start small and with low risk projects. These new suppliers may be your best option for a number of reasons (culture, time zone, skills) so you shouldn't rule them out, but test the water first before committing to them on a longer term.. Protect yourself contractually from becoming their lowest priority for time and skilled resources if they get another, better contract after yours.

Management lacks skill at writing and negotiating outsourcing contracts

Risk:

We have been involved in several engagements where an IT organization has become the victim of unforeseen circumstances in its long-term IT outsourcing contract.

Mitigation:

The point here is that there will be unforeseen circumstances. The skill is to negotiate a way of dealing with them into the contract. If this means the initial contract costs a little extra, pay it – it is money well spent! Every article and training class on outsourcing recommends, extols, and exhorts you to govern the contract. The requirements include ensuring that:

- Changes to the statement of work, terms and conditions, and commitments should be documented and reviewed with all affected parties. This gives you additional leverage when approving (or not approving) vendor-initiated changes.
- The outsourcing manager conducts various reviews with the service provider:
    - Periodic status/coordination reviews
    - Periodic technical reviews and interchanges
    - Formal reviews to address the accomplishments at selected milestones
    - Performance reviews
    - Acceptance tests
- Various other quality groups have a requirement to review the service provider's quality tasks, which include monitoring their quality assurance and configuration management activities.
- Measurements are made and used to determine the status of activities for managing the contract.

Sourcing is a process which needs to evolve over time (even within one contract if that contract last for more than one year) as business needs and vendor capabilities evolve. As such, it is critical that sourcing contracts are written with clear accountability for deliverables AND flexibility in defining what those deliverables will be and how they will be measured in different phases of the contract. It should be noted that a "balance" between flexibility and accountability is not the goal and will not result in a workable contract. Instead, both flexibility and accountability must be achieved. In practice, this means both sides acknowledging that it will be necessary to define trigger points during the running of the contract that will allow for some, pre-defined, aspects of the contract to be renegotiated. If negotiators, from either side, believe in the zero-sum game approach to negotiating, this approach can often be difficult to accept. However, all too often an apparently wonderful job done by the company's negotiators in year 0 can turn into a rod for the backs of the operational side of the company in year 2 or 3. For example, one company we worked with was very concerned that the new vendor should not "reinvent the wheel" when taking over application enhancement work from an in-house team so they set rigorous code reuse goals and gave the vendor 1:1 project size credit for reused code. This was very effective in creating the desired behavior in year 1 but led to difficult discussions about the vendor's actual productivity and value for money in subsequent years.

One way to include the desired flexibility is a "benchmarking clause," so called because it gives the customer the right to assess the vendor's prices and/or performance using an independent benchmarking firm. It has to be said that vendors do not like these clauses because they often structure their pricing to absorb cost at the start of the contract knowing that they can recoup it later in the contract as their knowledge and productivity improves. Hence, a benchmark exercise in the middle of the contract is likely to show higher margins than the customer might expect.

Inappropriate governance of outsourcing

Risk:

Outsourcing must be an integral part of your strategic planning and review functions. It may be an issue in which the Board takes interest given the opportunities and risks it presents. Today, many organizations engage in "Strategic Sourcing," reflecting the importance of the effort.

Mitigation:

Choosing a management strategy for the outsourced services will necessarily require consideration of whether the outsourcing relationship will be that of customer-vendor or partner-partner. In our experience, it is very important to be clear on this from the start of the relationship because both sets of behavior will emerge during the operational engagement on both sides of the engagement. Either sort of relationship can be made to work for outsourcing. Indeed, it is even possible for both sorts to work within the same contract but the two options drive different behaviors and it is absolutely critical that all members of the same team are working with a clear understanding of whether they are operating as customer-vendor or as partners.

A pre-requisite for successful outsourcing governance is senior management sponsorship in the business, the IT Department and the IT Provider(s). Senior management has significant accountability for the outsourcing arrangement. These activities should be expected from senior management:

- To set the expectation that all outsourcing activities will be effectively managed.
- To ensure that adequate resources and funding are provided for both selecting the service provider and managing the contract.
- To ensure resources involved in establishing and maintaining these activities are trained to perform the tasks.
- Client employees who are involved in the outsourcing arrangement should receive orientation in the technical aspects of the contract.

The Loss of Innovation

Risk:

There is a risk (that we have often seen played out in practice) that robust contracts are designed to reduce risk and, almost inevitably, that stifles innovation.

Mitigation:

We argue that a better practice during the contract negotiations is to construct governance covenants that build and strengthen the capabilities of both parties. ITIL, CMMI, metrics, and scorecards typically build capabilities and at the same time mitigate risk. The choice of tools and the construction of the governance requirements are as critical as the financial portions of the contract.

Loss of intellectual properly or simply sufficient understanding of how key applications work

Risk:

Organizations run the risk of the loss of intellectual property over time. While cases exist of actual theft of intellectual property, these are few and far between. More insidious is the gradual transfer of knowledge about how the organizations applications run to the point that, while the vendor does not steal or re-use the intellectual property, most of the IT intellectual property is held by the systems and people of the vendor while little remains with the staff of the organization.

Mitigation:

Captive investments – the organization outsources to an offshore vendor that it owns wholly or partially. Low-cost onshore locations – it is possible that your own country has regions with skilled resources at lower costs due to local economic conditions who could be very accessible now that you have a distributed IT infrastructure. This is a particularly attractive option for small organizations whose ability to invest in offshore operations and then compete for scarce resources in those locations can be very limited.

Finally, always compare any potential outsourcing agreement with your best non-outsourcing option before making a commitment. It is too easy after going through all the above to be left with a set of sub-optimal options that may be worse than what you started with.

Outsourcing vendors do not share the same culture/language as outsourcer

Risk:

Most readers will instantly understand this risk to mean the cultural and language challenges associated with outsourcing to a foreign country. These challenges are real and need to be addressed. However, another part of the culture and language of the vendor that is different is associated with the goals. Your vendor is in business to make a profit, just as you probably are. That being said, many IT departments are, or have the mentality of, cost centers. This difference in goals makes for many "cross purposes" conversations.

Mitigation:

In some ways, the mitigation for both of these is the same – seek as much staff interaction and knowledge sharing, physical as well as virtual, that the budget will allow. We have not met the manager whose appreciation of how best to make the outsourcing work has not been improved by spending time at the vendors premises. For the "different goals" issue, the mitigation is the same but the managers need to be equipped with the right agenda for conversations and this may require some training about how the vendors approaches their business to make money.

The Dashboard lights are all green but we are not getting quite what we want

Risk:

All too often, contract personnel without a thorough understanding of process or metrics develop governance processes. This lack of process or metrics knowledge is exacerbated when the principles are championed by parties on one side of the table or the other. But if each side of the negotiation does not have a metrics advisor, agreements could be governed by requirements that incent unbalanced behavior, do not add capabilities, and do not strengthen the relationships between parties to the contract. Examples of this inequity range from contracts that pay penalties and bonuses on a single metric (typically indexed productivity or time to market) to contracts with scores of embedded metrics.

Soliciting input from your organization's process and metrics personnel (or outside consultants if you lack these capabilities in-house) is a best practice that does not find its way into many contract negotiations.

Be aware that suppliers and internal executives both have incentives to make the outsourcing deal appear successful and may collude knowingly or unwittingly to meet targets set by senior management. We have seen examples where certain productivity targets imposed on executives have been met by suppliers, simply by playing the metrics to make it look like they are achieving the required performance. Since this enables the in-house executives to meet their targets examination of the results is not encouraged, though the value actually delivered by the supplier is not in fact improving.

Mitigation:
You can use many techniques to develop a balanced approach to using metrics in the governance process. Goal-driven metrics techniques are processes for developing useful metrics for the core of contract governance. One technique organizations have found useful is the Goal-Question-Metric technique. Without using a goal-driven approach, it is possible that the contract will reward behavior that does not accurately reflect the goals, targets, and objectives of executive management. As an old adage points out, "You get what you measure."

Dashboards and scorecards are excellent techniques to summarize data; however, they are inadequate for developing knowledge or directing action. A more granular level of detail provides organizations with the facility for event-centric and experience-based interactions with their data that generate actionable insights not purely reliant on personnel interactions. Granular, sliceable data allows you to defeat "the tyranny of the average," in which you lose the ability to identify special cases - good or bad. We uncovered an example of a client auditing vendor’s project sizes (in function points) in batches. If the average audited size of each project in a sample batch was with +/- 10% of the average size counted by the vendor then the batch “passes” for payment without any consideration of the standard deviation of sizes across the batch or, indeed, the other batches that were not sampled.

Service Level Agreements (SLA’s) are not driving the desired behavior
Risk:
The old adage, “If you can’t measure it, you can’t manage it,” has been extended for Service Level Agreements (SLA’s) to “if you can’t measure it, it won’t get done.” The job of an SLA is to ensure that everything that needs to get done, gets done and (ideally) nothing else.

Mitigation:
In ““Outsourcing the SME Way,” Keil provides a good, simple definition of what a good SLA does:

- Defines the scope of services that are to be covered by the contract:
- Describes either acceptance criteria or thresholds for different levels of quality that the included services most meet or both
- Defines means to measure and monitor these services
- Describes actions to be taken if service levels fall below acceptable levels

SLAs are one of the most critical components of an outsourcing arrangement. When properly designed and executed, SLAs drive desired behaviors, monitor performance and guide the governance of contractually agreed objectives. Numerous other factors can also contribute to the ultimate success of the outsourcing relationship. For example, consider the importance of establishing clearly defined business goals, or the critical importance of effective communications and contract management. The ultimate success or failure of an outsourcing arrangement cannot be attributed to a single element; but as we will soon see, service level agreements can have a significant impact on desired outcomes.

Of course, it is necessary to define priorities within SLA's because, while every customer wants the highest quality, ahead of schedule at the lowest cost, it is not possible to maximize performance on all three dimensions of quality, cost and schedule simultaneously. In deciding these priorities, it is also important to understand that the dimensions are not as independent as is sometimes supposed. For example, poor quality can increase cost and delay schedule. Schedule slip always costs more money.

Keil suggests the following metrics as a starting point:

- Problem Size (as a normalizer for the other metrics)
- On-time delivery
- Cost-effectiveness or productivity
- Total cost of ownership
- Service availability
- User satisfaction
- Processing time
- Defect rates
- Technical quality
- Rework rates
- Acceptance rates

Conclusions

Outsourcing agreements are negotiated with good intentions and high hopes. However, once the contract is signed and service delivery begins, it is the service level agreements that govern the success of the outsourcing arrangement. They help to set expectations and they are critical to the proper monitoring and governing of the contract. It is important to remember:

- SLAs should follow a proper and well planned framework
- Service level measures should focus on the strategic direction of the business and drive desired behaviors
- An adequate baseline period should allow for both quantitative and qualitative performance measures
- The accuracy and integrity of the service level measurement data is key to the monitoring of performance
- Plan for reasonable and fair adjustments

Sources

1. "The Business Value of IT," Harris, Herron and Iwanicki, CRC Press, 2008.
2. "Outsourcing the SME Way," Steve Keil, Sciant AG, www.sciant.com.

