

INFORMATION TECHNOLOGY: MANAGEMENT ISSUES IN THE INITIATION PHASE OF OUTSOURCING CONTRACTS

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This article concerns the investigation of management issues in the initiation phase within information technology outsourcing (ITO) contracts. The ITO life cycle is used as the flow structure for the investigation. The user expectations that occur in the initiation phase of the ITO life cycle are identified. The "*Coetzee solution framework*" is used to ensure that the identified management problems are addressed in a structured approach. The initiation phase of the ITO life cycle, with its expectations and problems, are discussed in the context of the solution framework.

Key phrases: information technology, information technology outsourcing, initiation phase, management issues

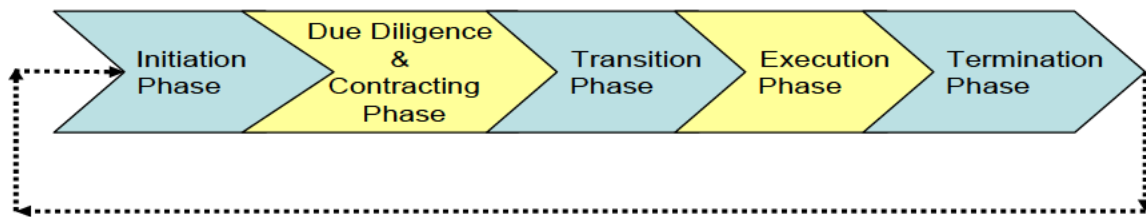
BACKGROUND TO MANAGEMENT ISSUES IN THE INITIATION PHASE

Information technology outsourcing (ITO) is being viewed as more than merely a cost reduction mechanism for organisations. Organisations now view ITO as a vehicle to increase competitiveness. A research report of the Outsourcing Institute (Casale 2001:3) states that "although the traditional drivers of IT outsourcing still stand (e.g. to reduce operational costs, improve information systems (IS) flexibility, focus on core competencies, and increase operational efficiency). There is mounting evidence that organisations have turned to outsourcing for more strategic reasons, including getting access to and keeping up with cutting-edge technology, building partnerships, creating value for the organisation and its customers, and broadening infrastructure and operations". While this is the case, ITO is associated with service failures, cost overruns, and relationship issues that sometimes have disastrous effects on the profitability of organisations.

There are many failures and successes when it comes to ITO, and the failures can often be tracked to the way in which an ITO was approached and the immediate management of problems that arise during the ITO lifecycle. The Outsourcing Institute indicates in their research (Casale 2001:6) that they found that the "key concerns with buyers and vendors (are) that governance issues are usually top of mind". The institute also states that "a lot of people used to think that once you have outsourced, the tough part was over, when in fact, just the opposite is true. Now, people are giving a lot of thought to managing the relationship over time".

There are essentially five main phases in an information technology (IT) outsource contract life cycle as is depicted in Figure 1. Each of these phases will be briefly described in order to give context to the ITO life cycle phases. This article will only focus on the initiation phase of ITOs to describe the management issues, user perception problems and the relevant solutions that are available to address the management and user perception issues.

Figure 1 – Information technology outsourcing phases



Source: Siemens Business Services 2003:1; Simmons 2004:1 (adapted)

Initiation phase – This is where the organisation has decided that they need to streamline the IT environment and as such start looking at the components they wish to outsource, co-source or run internally. The organisation will also at this stage typically prepare a request for information (RFI) to see what the vendors in the market can offer.

Due diligence and contracting phase – Once the organisation has identified the vendor or vendors that they wish to continue working with, they open up their environment to the vendor to investigate the environment thoroughly in order to come up with the best and final offer (BAFO). Thereafter the organisation evaluates the BAFOs and decides on the final vendor. Contract negotiation is entered into to finalise the outsourcing agreement.

Transition phase – Most of the vendors then enter into a transition phase whereby the services, possibly the staff, assets, and management is handed over to the vendor.

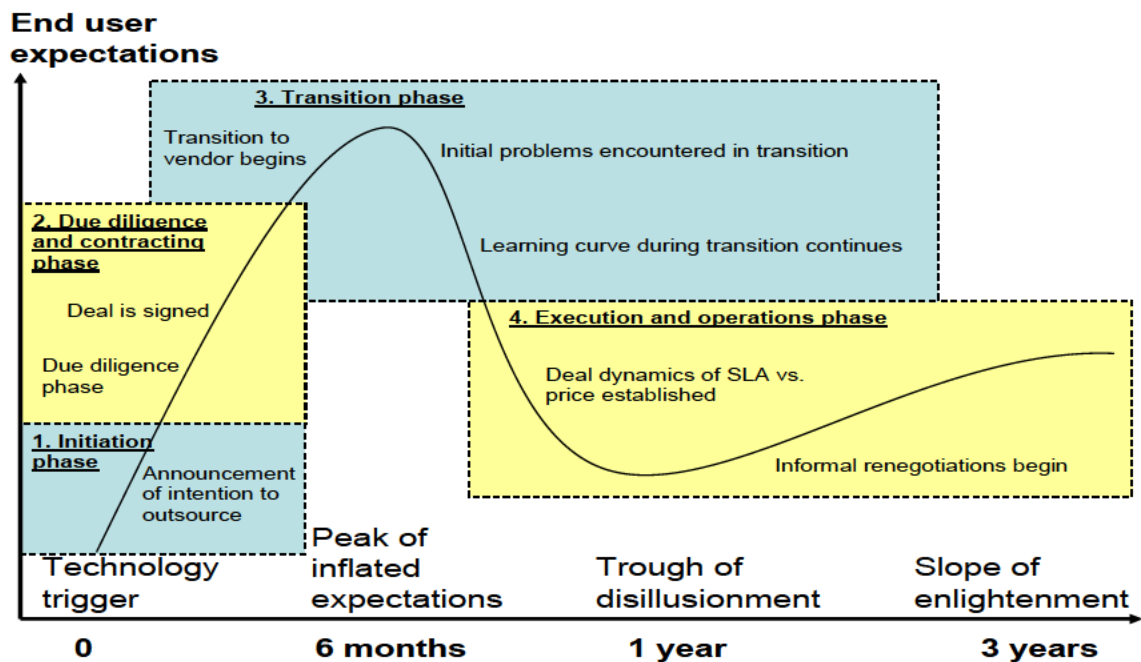
Execution / operations phase – Once the transition is complete the vendor assumes the responsibility for the operations of the contracted services for the organisation. This carries on for the full term of the contract period.

Termination phase – When the contract period reaches its end, the contract is either renewed or terminated. In the event of termination, the services are either transitioned back to the organisation or to another vendor depending on the organisation’s experience regarding outsourcing.

Each of the above-mentioned phases has a set of problems that arise and seem common to all outsource contracts. While many of the problems are brushed away initially, they often have significant influence in the longer-term relationship and ability to deliver service between the vendor and the organisation.

The problems associated with the ITO lifecycle can be linked to the Gartner expectation curve on ITO (GartnerGroup 1999:4). The expectation curve is based on the expectations that are set by the vendor at the beginning of the ITO, but also by the end users within the customer who believe that dramatic improvements in service levels can be expected in very short times. Figure 2 illustrates the user expectation curve with the first four phases of an ITO mapped to the various stages in user expectation.

Figure 2 – End-user expectation curve



Source: GartnerGroup 1999:4 (adapted; phases 1 – 4 shown)

In this article the initiation phase is discussed in the context of the problems that typically arise as time progresses. This is not meant to be an exhaustive discussion on the issues, but merely a short overview of some of the main problems that do occur.

TYPICAL PROBLEMS WITHIN THE INITIATION PHASE

The initiation phase is probably one of the most important phases, but sadly and very often the most neglected phase as well. This is often the core source of IT outsource problems that arise later during the due diligence, contracting, transition and execution phases. At this stage the foundation for the ITO is created and the user expectations start forming. If the specifications and expectations are not clearly understood internally, then there is no way it can be understood or actualised once engagement with the vendor starts. Most organisations are guilty of not actually *understanding* what they want to do and therefore end up relying on an external party (very often the vendor) to try and define this for them. Gartner researchers (Caldwell & Young 2003:28) have identified that “upfront conversations with straightforward disclosure of goals and objectives for both parties are mandatory”.

This leads to the question of the *strategic intent* for the ITO. Organisations have to be clear as to why they are considering entering into an ITO. The GartnerGroup (1999a:3) indicates that organisations must ensure they have established a clear sourcing strategy before embarking on an outsourcing project. Organisations that fail to do this, risk project delays and even project failures. The typical situation is one of a vendor initiating a programme of convincing the executives that ITO is a business imperative. Another typical reason is that a competitor has entered into an ITO arrangement and the organisation does not want to be left behind. The organisation might feel that the cost of IT is too high and that they wish to reduce this. The organisation might not be satisfied with the service they are receiving from the internal IT department and they might believe that they wish to focus on core business and not be involved in managing something they are not expert at.

Without the strategic intent being clear, it is nearly impossible to get full *buy-in* from all business stakeholders within an organisation. This immediately leads to *internal politics* that substantially affect the future service relationship with a potential vendor. Buy-in is critical, as ITO affects all parts of an organisation and as such must be an overall organisation decision that should not be taken lightly. Harris (2002:31) indicates that it is critical to “build consensus, and gain strong and explicit

administration backing - if the project goes off-schedule or over budget, broad support will be critical”.

Once the strategic intent is established it is important that the *objectives to be achieved* are clearly identified. These will form the basis by which the ITO is measured and evaluated and assist in setting the expectation across the organisation. The management team within the organisation should define this to ensure full understanding and context across all areas. Harris (2002:4) indicates that it is vital to “identify goals and objectives very clearly, and communicate them explicitly and to clearly define your expectations, and ensure that the organisation and the vendor clearly understand those expectations”. This is very often driven by an individual such as the chief executive officer (CEO), chief financial officer (CFO) or chief information officer (CIO), and is not fully explained to the rest of the organisation. This will once again result in a lack of buy-in and internal politics.

As these ITO contracts often span many years, full buy-in is required upfront as it is very likely that some of the management team might leave the organisation (Casale 2001:3), and it will be the rest of the team’s problem to ensure that the context within which the ITO was decided on, be transferred to new members. Many an outsource decision is questioned and “attacked” by newcomers, as the business reasons for entering into the ITO arrangement is not understood.

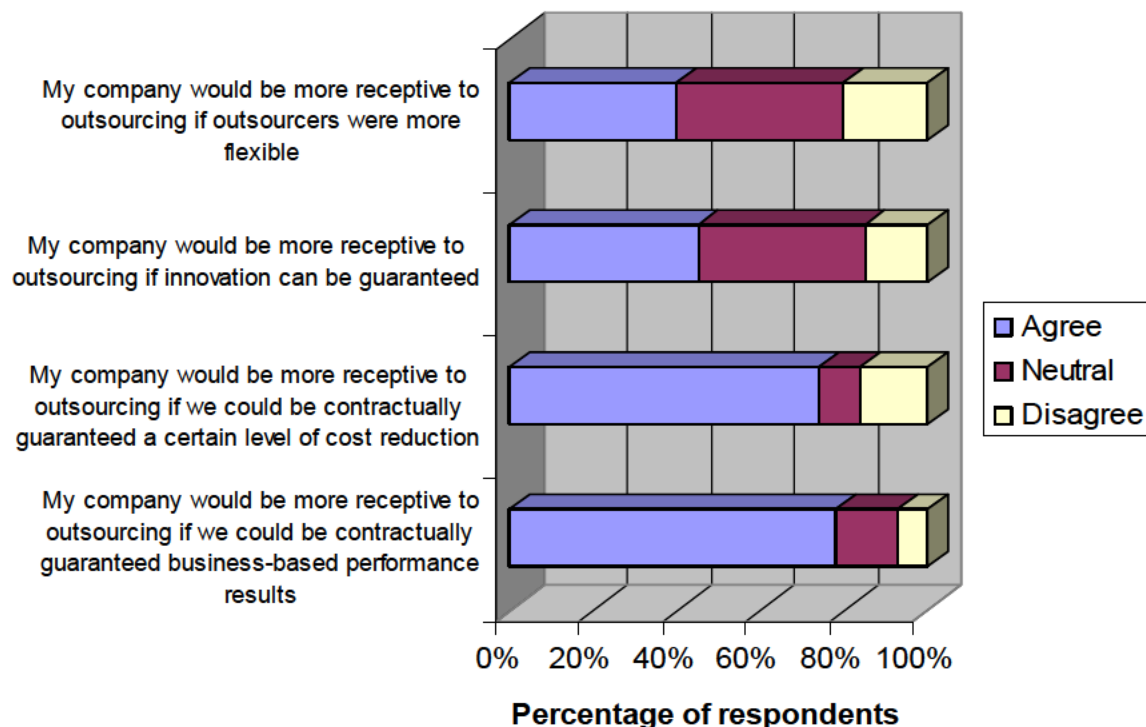
As one of these objectives, it is important for the team to identify exactly what *additional value* they are expecting to be added by outsourcing. Caldwell & Young (2003:28) indicates in Figure 3 that most organisations want more business-based results and that they would like more innovation. However, while this expectation exists, little effort is ever made to quantify what the expectation actually is.

Once the decision is made to outsource, then the organisation has to do a significant amount of *internal homework* in order to ensure that the *scope* of the outsource is clearly delineated in terms of precisely what is included with regard to services, products, people and assets. Caldwell 2003:10 indicates that outsourcers should carefully look at an analysis of their environment in order to assist in balancing their own risk exposure and assisting in understanding their environment in terms of assets, costs and service levels. The GartnerGroup (1999a:10) also states that organisations should take the opportunity during the strategy and initiation phase to thoroughly evaluate the financial, organisational, delivery and technical status of their

current environment. This will be needed throughout the process to contract signature. Proposals based on vendor *assumptions* about an organisation are not a good basis for vendor evaluation.

It must once again be stressed that as much detail as possible be put together internally at this stage so that the exact nature of the areas to be outsourced is understood from a financial, service and efficiency perspective. This will clarify and sort out many issues that typically arise around the understanding by vendors once the request for information (RFI) and request for proposal (RFP) is issued. If this is not done properly, it is very likely that assumptions are made on the part of the vendor that will result in confusion once contracting starts as to what is in and what is out of scope in terms of the contract. It must be remembered that the *RFI and RFP detail* is the only information the individual vendor will have in understanding the environment they potentially will take over. Any vagueness results in dysfunction later during the contracting and execution phases and is often the reason why outsourcing is viewed as not working.

Figure 3 – What outsourcers can do to increase receptivity to outsourcing



Source: Caldwell & Young 2003:28

The organisation needs to be clear on the *service levels* that they will be expecting. They thus need to understand their existing service environment in order to, later in the contract, measure service objectively. A major mistake when entering into ITOs is to do so without *service levels being fully defined* upfront. Research (Caldwell 2003:10) also points this out as the absolute need to obtain data for negotiation on service levels, pricing and requests for additional or new services. Often the organisation does not have any service level arrangements in place with their own IT and they leave it to the vendor to define at a later stage. This will create disagreement between the vendor and the organisation and will affect user perception on delivery.

It is important that the organisation clearly understands the cost associated with existing service levels and scope of services as this will set the *cost expectations* for the RFP responses. Vagueness can result in the wrong decision being made regarding the ITO. Caldwell & Young (2003:28) show this clearly in their research that “client expectations for cost reduction have escalated – this has created what the vendor repeatedly referred to as the ‘major tension’ in contract negotiations”. In addition to this, the organisation management should carefully think about the *pricing mechanism* they want to use to drive the potential ITO: e.g. price per user, fixed or variable costing, business unit billing or central billing, sliding scales depending on user volumes. This is often neglected and creates friction between the organisation and the vendor during future phases.

The *contract structure and flexibility required* should also be investigated at this stage and guidelines should be included in the RFP. Figure 3 showed that most organisations would prefer that outsourcers were more flexible, but once again the quantification of what is meant by flexibility is not properly defined or investigated leaving room for uncertainty, doubt and wrong expectations.

While the organisation will take a business perspective with regard to an ITO, the people involved are often forgotten and left till last to deal with. This creates *uncertainty* with the internal IT staff that often results in hesitance to support the ITO once the people become aware that ITO is being considered. It is critical that the ITO intention is shared within the organisation as soon as possible. Caldwell & Young (2003:29) state that “being candid and honest about job security is mandatory, communications with employees during outsourcing is critical”. ITOs sometimes fail purely because proper *communication* does not take place during all phases of the

ITO and uncertainty and a lack of understanding cause personnel to try and “hijack” the process.

Lastly, many organisations do not always realise the impact that an ITO might have on the cost structures of an organisation. They very often do not consider or perform a *long-term impact study* as they have not properly investigated their own environment. Caldwell (2003:10) says that organisations would do well to track the internal and external contract activities to help manage risk in terms of financial exposure, security, pricing, management and to obtain detailed data for rigorous service levels in order to protect themselves.

The initiation phase is critical to the proper introduction of ITO into an organisation. If any of the issues discussed are not considered and managed, the assumption on which the ITO is based will not be clear and user expectation will be distorted in terms of what the reality is and what the expected services are to be within the contract.

The initiation phase (refer to figure 2), sets a high user expectation and unless proper context is given, the expectation can border on being unrealistic at this early stage, which will affect the entire life cycle of the contract.

When organisations determine the return on investment for an outsourcing program, they should augment the traditional calculations they employ, such as internal rate of return or net present value analysis, by considering other important cost or saving issues that they might otherwise overlook. Failure to do this can lead to the wrong expectation being set within the organisation and to outsourcing contracts that end in disappointment.

COETZEE SOLUTION FRAMEWORK: INITIATION PHASE

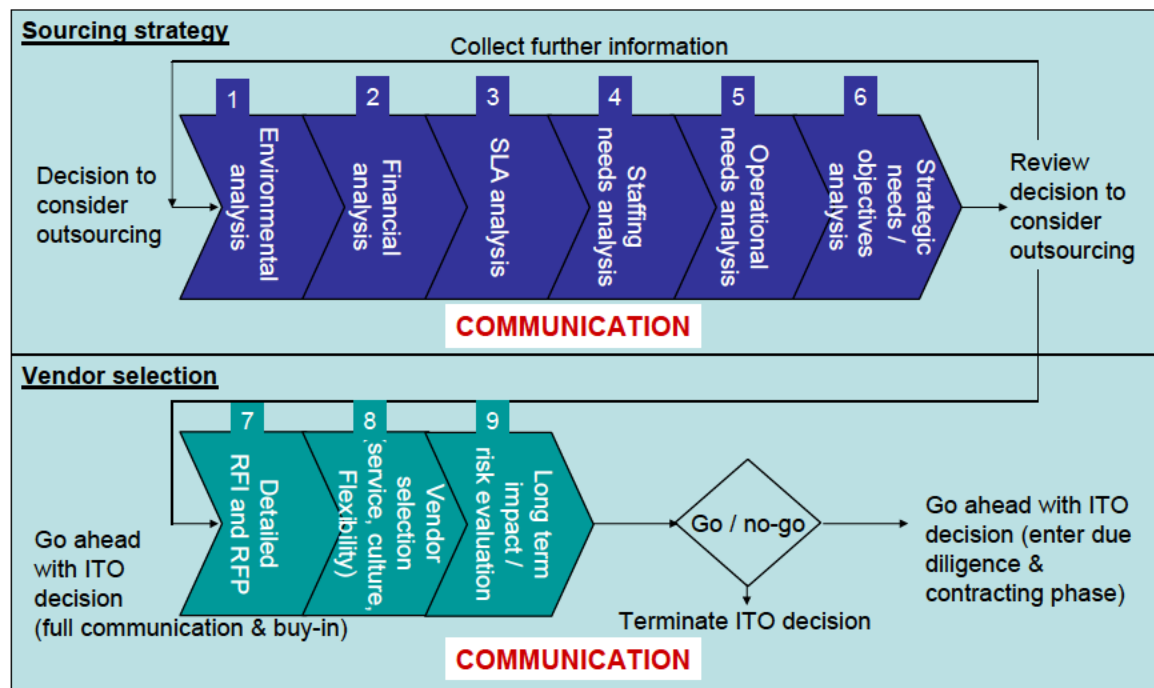
The initiation phase is the most critical for any ITO contract. If the foundation and expectation is not carefully formed in the initiation phase and communicated to end users and stakeholders, the ITO is doomed before it starts. However, if the correct analysis of the environment is done, the objectives and expectations combined with the strategic intent and required long term flexibility is clearly formulated and agreed by business, then the foundation is solid on which to start building the ITO relationship, contract and the governance structures.

Deals that are undertaken for the wrong reasons are destined to fail. This is not a weakness of outsourcing; it is the failure of management to place outsourcing in context with the type of value it can deliver (GartnerGroup 1999a:5).

An interesting observation is that few of the outsource vendors seem to have a proper mechanism or checklist in place to cross-check that the organisation actually has a clear sourcing strategy with the associated objectives and a detailed analysis in place. Many vendors assume that this has been done, which is dangerous, and just as many may be using the vagueness factor to their benefit.

There are nine steps in the Coetzee solutions framework for the initiation phase (see figure 4). This is a combination of understanding the practical problems surrounding ITO as described above, and secondly based on best practise as defined by the GartnerGroup (1999a:10). The Gartner best practise is a reflection of steps 1 to 8. The Gartner matrix evaluates the current status of the environment, the to-be user needs in terms of the given dimensions, and then evaluates how the vendor can match the envisaged user needs in terms of approach and ability.

Figure 4 – Coetzee’s solutions framework: Initiation phase



After a decision has been made by the organisation, at board level, to consider outsourcing, the nine-step model for the initiation phase is as follows:

Step 1: Environmental analysis

In this step the organisation will conduct a complete internal audit on their IT environment with the view to understanding the full environment envisaged for outsourcing in micro detail. This will cover areas of staffing, hardware, software, networks, capacity usage, performance, data volumes, facilities, locations and configuration complexity. Full inventories, asset registers and application maps should be defined in detail with all interdependencies mapped.

Step 2: Financial analysis

Following the environmental analysis a full financial audit should be undertaken to identify and account for ALL costs surrounding the infrastructure, as identified in regard to step 1. Gartner (GartnerGroup 1999a:7) says that outsourcing is too costly and too crucial to business success to lack a proper financial analysis. There are often hidden costs in the IT environment with procurement taking place in various areas throughout the organisation and not necessarily being accounted for as IT. The organisation needs to understand all these elements, including all procurement channels and third party contracts, services and products. The organisation further needs to understand their financial obligations in terms of encumbered assets, depreciation values, staff benefits and contingencies. This can be done by third parties, however it should be owned and cross-checked by the organisation as any mistakes will have serious consequences.

Step 3: SLA analysis

Once the environment and finances around the environment is understood, it is simple to map the current service levels associated with the relevant costs. Although some organisations have pre-defined SLAs between business and IT, this analysis often shows the discrepancy between what is thought is being delivered versus the actual situation. It must be noted that it is critical that the organisation does not at this point define what their desired SLAs should be, but that the reality is defined and mapped in terms of actual and practical services being delivered.

Step 4: Staffing needs analysis

The staff required to uphold the SLAs as defined in step 3 must be identified and their roles and activities evaluated in relation to the envisaged ITO environment. Their full

benefit structures and incentives need to be understood as well. This is a sensitive time for the staff as they might have become aware that the organisation is considering an ITO. Communication by the organisation's management regarding intent needs to be transparent and the business reasons needs to be stated.

Step 5: Operational needs analysis

The environment, finances, SLAs and staffing needs should be understood clearly at this stage. It becomes essential to understand what the organisation expects in terms of operational excellence. All normal operational elements must be investigated in terms of what the organisation would realistically expect from a potential vendor in terms of improvements. These expectations should be stipulated in precise detail and agreed by the business. The GartnerGroup (1999:4) emphasises that organisations must evaluate and re-establish the levels of service required by their business *prior* to outsourcing; thereby developing reasonable and attainable service expectations for the vendor. The staffing requirements need to be reinvestigated as well in terms of what would realistically be required to fulfil the new expectations. This can be done by third parties, however it should be owned and cross-checked by the organisation as any mistakes will have serious consequences.

Step 6: Strategic needs and objectives analysis

This step defines the strategic intent of the ITO and should not be neglected under any circumstances. The GartnerGroup (1999a:8) shows that an effective business case looking at business value linking, stakeholder buy-in in conjunction with the tangible and intangible benefits is critical to the decision to outsource.

This step should be used to map out the strategic goals of the organisation and then to investigate what is required by IT to support the achievement of these goals. Once strategic goals and support requirements are identified, very clear long term expectations, intent, and objectives should be defined which the ITO will have to support for the duration of the envisaged contract. A clear gap analysis as to how the current IT environment performs against these strategic goals should also be detailed in order to position the real situation against the ideal situation.

This must be done to set realistic expectations for future management members to understand the history, frame of reference and context of the possible ITO, but also as a yardstick of how the ITO has complied over time to the initial intent.

The first six steps, shown in figure 4 and discussed above, reveal the sourcing strategy of ITOs. This should enable the organisation to make an informed decision on whether ITO is the correct decision to make and comprises what Gartner would call the sourcing strategy (GartnerGroup 1999a:3). The *sourcing strategy* is focused on investigating the need for, and viability of, external sourcing. It identifies the business requirements and capabilities, baselines the current IT services, determines the most appropriate sourcing alternatives, establishes the business case and gains buy-in from the stakeholders. The sourcing strategy sets the direction for the entire outsourcing project and keeps the objectives in focus.

These can be done by third parties, however it should be owned and cross-checked by the organisation as any mistakes will have serious consequences.

The sequence of these steps in figure 4 is not necessarily important and many of the steps could occur in parallel or in a different order. Without these steps having been performed on a detailed level, the organisation takes a severe risk of making the wrong decision. The GartnerGroup (1999a:3) says that their experience shows that organisations without a clear strategy, and facing the large volumes of data and analysis involved in an IT outsourcing project, can lose focus and develop a deal that does not meet the needs of the business. *How* an outsourcing project is managed is as critical as *what* is outsourced. The sourcing strategy in essence details the “what”.

If there are any queries in regard to the environmental analysis in terms of the sourcing strategy (outputs from steps 1 to 6, figure 4), then the required step should be repeated until a sufficient and trustworthy view of the environment and the strategic intent is defined. If this cannot be attained, then the recommendation has to be one of not outsourcing.

Once the decision is reached to move forward with a possible ITO, then the vendor selection starts (steps 7 to 9 as shown in figure 4) should be carried out. At this point full communication with a concise view of the findings from the sourcing strategy (steps 1 to 6) should be relayed to the entire organisation and buy-in needs to be confirmed prior to the next steps taking place.

The vendor selection steps will now be discussed.

Step 7: Detailed RFI/RFP

The organisation should now be in a position to issue a detailed RFI and RFP. The RFI will be a scaled down version of the RFP and must be used to filter out those vendors who do not have the capability to deliver an ITO of the nature the organisation requires. The RFP, however, must be a comprehensive description of the intent, objectives, and the full environment as was defined in steps one to six of figure 4. The GartnerGroup (1999a:10) indicates that for each solution area, the organisation needs to define their *current status* and the required benefits (the *vision*) in the request for proposal. This will enable the short listed vendors to design a proper response and solution which will give the organisation a good view of the vendor's intended approach, management style, culture and ability. This can be done by third parties, however it should be owned and cross-checked by the organisation as any mistakes will have serious consequences.

Step 8: Vendor selection

Based on the detailed RFP, vendors should come up with a comprehensive solution proposal that covers all aspects of the services that the organisation is looking for. Gartner (GartnerGroup 1999a:10) says that the vendor proposal should include the four areas of an IT outsourcing solution: financial, organisation, delivery and implementation. Vendors should be carefully selected based on the ability to deliver in terms of skills and resources (including geographical coverage required), a track record in managing ITO contracts of a similar size, the business partners the vendor uses, the business focus of the vendor and their long term direction they are planning, their financial state, and their relative revenue size in relation to the ITO (GartnerGroup 1999a:8). The vendor should also be evaluated on their ability to add value as specified in the strategic intent, their flexibility in terms of models and future adaptations that might be required, and their technology plans.

Step 9: Long term / risk impact study

Once the responses have been evaluated and the relevant vendor chosen, a full long term impact study of the solution the vendor is proposing should be undertaken by the organisation. The organisation should map out exactly what is being proposed and match this to the required SLA, operational requirements and strategic intent. The risks and assumptions highlighted by the vendor should also be quantified in order to understand the financial risk to the organisation over the full period of the ITO. Many organisations ignore this study and end up with the ITO actually threatening the future profitability and viability of the business due to the implications

not being understood in the vendor's assumptions. Gartner (GartnerGroup 1999a:12) says that organisations and vendors are seldom willing to reveal their own risks. As a consequence, they enter long-term outsourcing agreements with little or no visibility of the other party's assumptions and risk mitigation plans. Every error, misunderstanding, hidden assumption and gap in knowledge will become a risk once the contract is signed.

On completion of step 9 the organisation should review their ITO decision based on the vendor they have selected and the solution that has been proposed. This jointly with their long-term impact study should indicate the viability of the ITO for the envisaged period.

CLOSURE

The complexity of managing outsourcing transactions is often the reason for dissatisfaction. This dissatisfaction stems from the incorrect initiation of the ITO where not enough investigation was done by the sourcing organisation. This results in incorrect definition of expectations and scope of the project. The vague scope is then translated into a contract around which governance is not clearly thought through or properly implemented. Communication in regard to all facets of the ITO is not always given enough attention leading to confusion, politics and unrealistic expectations.

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