

PLUGGING THE VALUE LEAK

How to
Improve the
Governance
of Outsourced
IT Contracts
While
Reducing Cost

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INTRODUCTION

Governance costs account for a considerable proportion of post-signature outsourcing spend. The role of the governance organization is to ensure effective collaboration between the customer and service provider(s); specifically, the interaction of IT supply with demand. This presents a significant challenge for client organizations, as approximately 30 processes can be identified within the area of contract governance services that are traditionally retained and managed by the client's internal organization.

This ISG white paper examines the governance issues faced by all organizations that outsource IT services, and presents an alternative solution to retaining the governance of those contracts in-house. That alternative: Outsourcing the non-strategic processes to an independent third party. The financial and non-financial benefits associated with this approach, which many organizations are starting to recognize, are also considered.

A RETAINED GOVERNANCE ORGANIZATION CAN CONSUME 15 PERCENT OF TOTAL CONTRACT VALUE (TCV)

'Third Generation Outsourcing' is commonly defined by the existence of multiple service providers, whereby, for example, Desktop Management and Application Management/Maintenance are delivered by different service providers. Since their service delivery processes are closely linked, these providers must work together (such as in problem resolution) as well as develop their relationships not only with each other but with the customer, which in turn need to be managed. These demands can lead to an exponential increase in complexity as an organization interfaces with an ever-growing number of service providers.

The governance organization is heavily focused on administrative and repeat activities surrounding the management of the outsourced relationships. For example, invoice management forms a significant proportion of these activities, together with contract and service level management. Generally, whole armies of people are involved in audit functions, such as checking whether agreed services are charged appropriately, are transparent and understood, and whether they have any contractual basis. A large degree of effort on both sides tends to be invested in the continual search for data and "evidence" to support invoices.

Often, the costs associated with governance are hidden due to the fact that people involved in this function are no longer on the IT payroll. Instead, they are re-assigned to procurement or other business areas and, as a result, their costs are 'lost' from the IT budget. Therefore, in order to review the full effect of an outsourcing exercise, the 'total cost of outsourcing' should be measured, including staff costs from other parts of the business.

Over the life of a contract, the retained governance organization grows dramatically with a significant number of people employed to handle these complex processes. Generally, a maximum of 8 percent of TCV should be attributable to the retained organization; in reality, however, this figure is commonly as high as 15 percent.

COMMON IN-HOUSE GOVERNANCE ISSUES

During the days following the outsourcing of IT services, retained staff struggle to answer the bewildering array of questions relating to the appropriateness, transparency and contractual basis of service charges. Inaccurate data can be a problem, as can the fact that staff are either over- or under-qualified for the task, having occupied more technical roles prior to outsourcing.

During the contract term, constant changes occur in the form of extensions, reductions or additions to the originally contracted services. Usually, however, governance processes to handle these changes are not adequately defined.

As a result, change requests are often not placed, nor are contract extensions or service level adjustments documented prior to the changes being carried out. Additions and reductions in capacity are just verbally 'agreed' but not documented, so that consumption proliferates unmanaged and unchecked.

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USERS AND SERVICE PROVIDERS OFTEN LOSE SIGHT OF THE 'BIG PICTURE'

These developments lead to a situation whereby the client, during the course of the contract (normally 3 to 7 years), often loses sight of the full extent of services, volumes and projects within the agreement. The same happens for the service provider. Over an extended time period, a great number of invoices are submitted and very few people know whether they are actually accurate.

THREE CONSEQUENCES OF POOR GOVERNANCE

1. Staff are not utilized to optimal advantage:

A significant portion of highly-qualified employees are focused on purely administrative activities, which raises costs, fuels job-dissatisfaction, and fails to employ peoples' skills to the best advantage. Staff time would be more productively spent furthering the discussion around agreed innovation, process improvement support and the definition of solutions to address future challenges. Meanwhile, an appropriately-skilled and lower-cost workforce could be used to manage the routine governance tasks such as invoice checking.

2. The relationship between demand and supply-side IT is strained:

In two-thirds of outsourcing relationships we find a latent or overt dissatisfaction with 'the other side.' Reciprocal 'finger-pointing' between both parties escalates the discontent, leading to a situation where 89 percent of clients believe bad or unsuccessful outcomes are the fault of the supplier. Conversely, 81 percent of suppliers are convinced that the demand-side is at fault.

3. The original business case for outsourcing is gradually eroded:

Over the long term, ISG research shows that between five and 30 per cent of the expected value of a transaction will be lost due to ineffective governance.

HOW TO AVOID THE PITFALLS

The best way for organizations to avoid these pitfalls is to apply the lessons learned in the IT domain. In recent years, IT operational processes have gradually been standardized and outsourced to allow companies to improve efficiency and concentrate on their core business. If the administrative processes within the governance arena consume significant levels of resource, the logical next step is to similarly outsource them as standardized services.

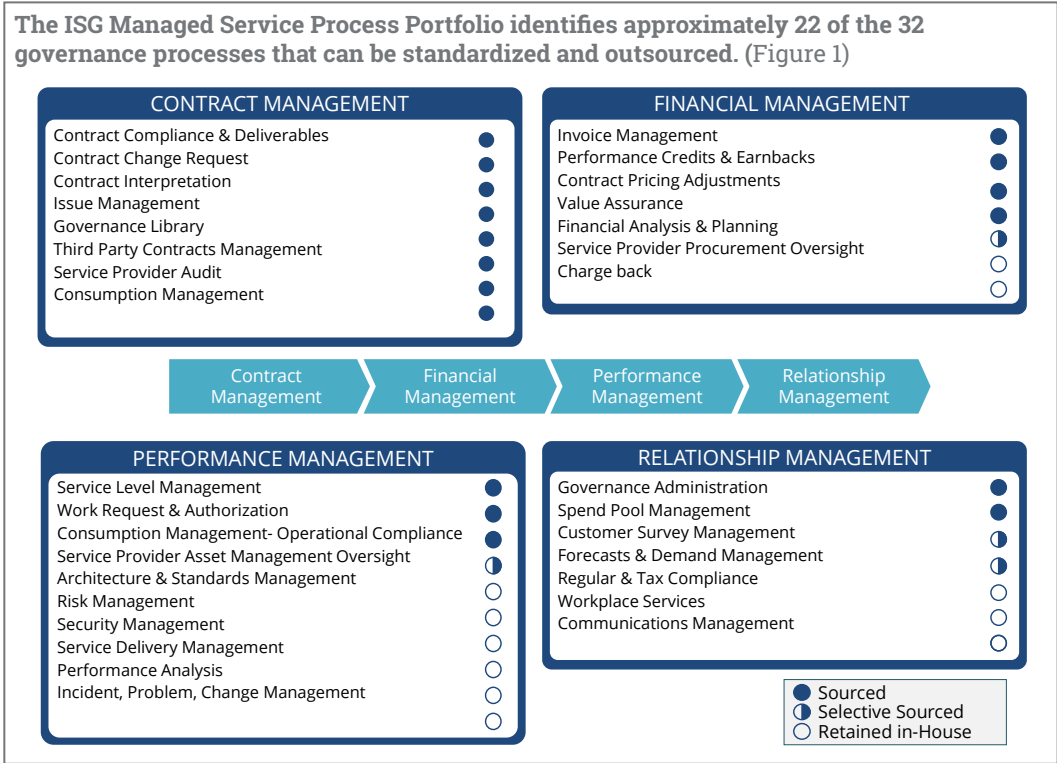
ISG has identified approximately 22 of the 32 governance processes that push up costs (Figure 1). These can be standardized to free up resources, and can potentially be delivered externally by a third party. The 'Managed Service Process Portfolio' is flexible and can be tailored to meet the needs of the client.

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The strategic, content-rich areas, such as service provider relationship management, decision-making and approvals remain with the client. However, by outsourcing the more routine activities, the client benefits from eliminating the ‘resource-burn’ associated with them. External, independent service providers such as ISG, whose core business is to deliver these processes, can also lower costs through standardization, economies of scale and the use of off-shore delivery models.

In ISG’s experience as a governance provider, the involvement of a third party is particularly powerful when the invoice checking process is offered in conjunction with service level management and contract management. On behalf of the client the Governance Services Provider (GSP) can take on the contract management of the IT Service Provider (ITSP). The ITSP sends their invoices to the GSP for validation to ensure a contractual basis exists for the invoiced services, and to determine if a change request or contractual adjustment is relevant. If not, the GSP notifies both parties and returns any invalid invoices supported by a suggested resolution, if needed.



NO PROOF NO PAYMENT

Transferring standardized, non-core processes to a third party can be an efficient move because the GSP introduces discipline to the relationship. By adhering to the principle of ‘no proof, no payment’ the GSP ensures that demand and supply-side IT work together to address past failings and establish clear agreements, as well as revisit missing contract documentation. Furthermore, the GSP assumes responsibility for the management of the core governance

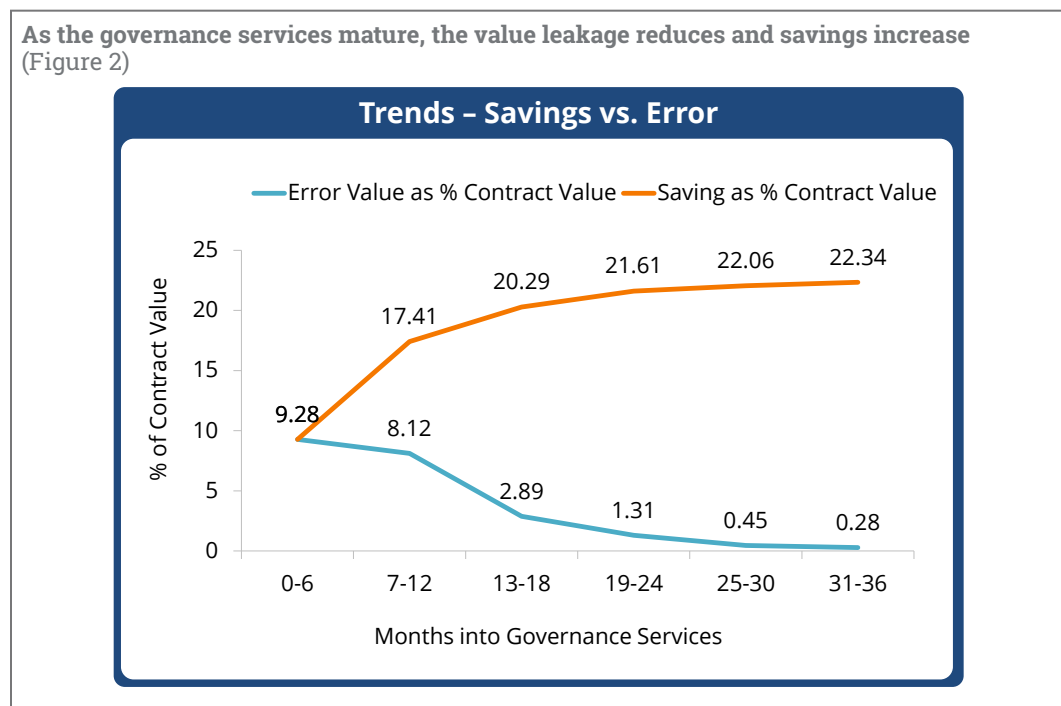
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processes with the aid of Key Performance Indicators (KPIs), a powerful tool to ensure transparency.

'HARD' SAVINGS

The formal outsourcing of governance services delivers significant 'hard savings' for the client. In working with clients as a third-party governance provider, ISG has consistently been able to reduce the number and value of errors. Figure 2 below demonstrates how ISG can deliver savings equivalent to around ten per cent of the Annual Contract Value (ACV) by using its unique approach to focusing on error reduction. That constitutes a significant savings, considering that outsourcing deals of 300m Euro Total Contract Value (TCV) or more are not uncommon in large organizations.



'SOFT' SAVINGS AND OTHER BENEFITS

In addition to reaping direct cash savings, the client will also benefit from indirect 'soft' savings, because the IT service provider's invoicing is based on frequently flawed assumptions, as explained above. For example, in the service level management process, a service quality target of 99.85 percent availability may be contractually agreed, whereas only 99.6 percent was actually achieved. Were the invoice value to be reduced to reflect the reduced availability actually provided, then further cost savings would ensue.

Another indirect effect of outsourcing the contract governance function relates to employee costs and satisfaction. Employees of retained governance organizations typically consist mostly of qualified personnel who held more technical roles prior to outsourcing.

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Post-outsourcing, these individuals are utilized in administrative functions and assigned tasks that are often unpopular because of their repetitive nature.

By virtue of its business model, ISG is able to not only offer these services at lower cost, e.g. by utilizing off-shore resources, but also to increase employee engagement and satisfaction by re-focusing qualified staff on value-added activities such as innovation, product development, analysis, process optimization and service quality improvement. By boosting employee satisfaction, the client achieves gains in productivity and return on investment.

Although lower delivery costs may result in a decline in contract value, the IT service provider should still welcome the efficiency gains that standardization offers, as these ultimately make their services more competitive.



Nowadays, an IT service provider devotes a very considerable proportion of spend to the delivery of non-value-enhancing processes such as invoice query handling, enquiries, and data consistency checking.

THE ADVANTAGES OF INDEPENDENT GOVERNANCE FOR IT SERVICE PROVIDERS

Nowadays, an IT service provider devotes a very considerable proportion of spend to the delivery of non-value-enhancing processes such as invoice query handling, enquiries, and data consistency checking. These tasks result in unnecessary, costly and time-consuming meetings. More importantly, they prevent service providers from focusing on providing innovative solutions and moving towards becoming a strategic partner or 'enabler' – the aspirational destination for many providers of outsourced services.

Excessive time and effort spent on reviewing and resolving inconsistencies is why service providers increasingly seek independent support with the validation of invoices prior to submission, and service levels prior to any contractual commitment.

FUTURE DEVELOPMENTS IN GOVERNANCE

The issues discussed here have assisted in moving governance services to center-stage in the outsourcing value debate. Since software management, as well as infrastructure management services, are increasingly being offered in the form of standardized components, (evident in cloud computing), the range of IT services will likely decrease further and facilitate additional outsourcing. The degree of governance required between the demand and supply sides of IT will grow in magnitude and importance, along with the continued focus on reducing costs and increasing value through outsourcing.

CLIENT CASE STUDY: GLOBAL AIRLINE CHANGES GOVERNANCE ENGINES MID-FLIGHT

Overview

As a mature outsourcing client with long-standing relationships with Tier 1 service providers, the airline sought a higher level of governance maturity and cost effectiveness.

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Airline executives turned to ISG to take on many of its contract management processes and to free up commercial and financial managers to focus on value creation with business customers. ISG now functions as part of the airline’s team in charge of contractual and financial compliance processes.

Business Need

The airline was mid-contract with a number of application services and infrastructure service providers. In a drive for cost and staff efficiency across the organization, the IT commercial and financial management teams were being asked to reduce costs and to do more with less staff. Specific objectives included tightening IT services supply governance as well as introducing new IT-enabled services both in the air and on the ground. In short, they needed to change engines while the plane was in flight.



A partner to guide the airline’s work with service providers to ensure end-to-end improvement in the procure-to-pay process, thereby establishing the right payments for the right services at the right time.

To address this challenge, seamless staff augmentation, clear processes and cost effective management of the supply side were essential. Another key was a partner to guide the airline’s work with service providers to ensure end-to-end improvement in the procure-to-pay process, thereby establishing the right payments for the right services at the right time.

ISG Solution

Understanding the challenge of reengineering processes and service provider relationships that had been running for many years, ISG worked closely with the airline to define the processes (balancing efficiencies from standard ISG processes with customization to the client environment), embed the onsite team into the client team, and build effective communications with the ISG offshore support team as well as the eight external service providers.

After implementing the core processes of invoice management, financial reporting and contract changes, ISG helped the client to review and refine other processes such as value assurance (which tracks actual costs back to the adjusted business case) and surveys of service provider performance and relationship to ensure best fit to the airline’s priorities.

ISG Governance Services Processes

Applying specialized expertise in contract and financial management to the client’s specific service provider landscape, the ISG team of governance specialists provided these functions:

| <i>Contract management</i> | <i>Financial management</i> |
|--------------------------------------|------------------------------------|
| Contract compliance and deliverables | Invoice management |
| Contract change management | Financial analysis and planning |
| Governance administration | Value assurance |
| Governance Library | Contract pricing adjustments |

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With the new governance in place, the client's commercial and finance teams are free to manage by exception and focus on enhanced upstream demand management and innovation.

Client Benefits

With the new governance platform in place, the client's commercial and finance teams are free to manage by exception and focus on enhanced upstream demand management and innovation.

Partnering with ISG has helped the client realize value in their integrated governance function, specifically through:

1. Improved accuracy and payment of invoices.
2. Savings from enhanced error and compliance checking.
3. Savings from using an offshore leverage model to perform detailed validation, analysis and reporting.
4. Improved visibility of service provider performance and relationship.
5. More mature governance of Tier 1 contracts.

ISG Governance Services

ISG has both governance advisory expertise and 'real-life' delivery experience. Governance Services is a well established, fast growing business for ISG:

1. One of three global strategic business units in ISG.
2. Focused line of business since 2004 with \$11B in TCV managed.
3. Broad spectrum of complex and successful transitions globally.
4. Significant investments in processes, systems and talent since 2007.
5. Demonstrable hard savings of 9.75 per cent and soft savings of 5.5 per cent.
6. ISO/IEC 2007, ISAE 3402 and SSAE16 (SAS 70) environments.
7. Demonstrable quality performance – accuracy of 99.93 per cent.
8. Commits to industry standard Service level methodology.
9. Unmatched experienced workforce – onshore and offshore.



If any of the following issues are on your agenda today contact our practice leaders to discuss your options:

| | |
|---------------------------------|---|
| Minimize Value Leakage | Retain value from sourcing contracts by reducing value leakage through improved governance oversight. |
| Risk Mitigation | Increased control and lower risk of failure through use of best-in-class capabilities, processes, tools and people. |
| Focus | Timely, fact-based recommendations allow your organization to focus on policies, approvals and supplier service provider relationships. |
| Compliance | Transparency into supply base compliance with regulatory and company policies allowing you to address gaps and report confidently. |
| Accelerated Savings | Utilizing our proven world-class processes, ISG's managed Governance Service can be fully operational in 12-15 weeks. |
| Scalability | Provides a cost effective platform that can easily scale as additional sourcing activity occurs. |
| Headcounts Costs | Minimize the number of employees required for governance. You pay only for the right skills doing the right work. |
| Relationship Improvement | Fact-based governance execution fosters an environment that focuses efforts on performance and relationship improvement. |

ABOUT THE AUTHOR

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ISG

Tina has more than 25 years of experience helping global enterprises make smart IT outsourcing and governance decisions. Tina's team designs and implements Governance Managed Services and technology platform solutions to help companies reduce risk, cost and value leakage. Focus on business insights, advanced analytics and business outcomes uniquely enables ISG clients to achieve maximum value from their contracts and providers. Prior to ISG, Tina worked at Siemens IT Solutions and Services where she served as Vice President of the Financial Services sector and was responsible for a 600-person global sales and delivery team managing \$120 million in annual revenue.



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ABOUT ISG

ISG (Information Services Group) (NASDAQ: III) is a leading global technology research and advisory firm. A trusted business partner to more than 700 clients, including 75 of the top 100 enterprises in the world, ISG is committed to helping corporations, public sector organizations, and service and technology providers achieve operational excellence and faster growth. The firm specializes in digital transformation services, including automation, cloud and data analytics; sourcing advisory; managed governance and risk services; network carrier services; technology strategy and operations design; change management; market intelligence and technology research and analysis. Founded in 2006, and based in Stamford, Conn., ISG employs more than 1,300 professionals operating in more than 20 countries—a global team known for its innovative thinking, market influence, deep industry and technology expertise, and world-class research and analytical capabilities based on the industry’s most comprehensive marketplace data. For more information, visit www.isg-one.com.

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