

The Real Cost of Outsourcing: The Good and Bad of Outsourcing IT

Offshore outsourcing is seen as a means to reduce costs and increase the firm's ability to compete globally. While there are very real benefits to be gained from [offshore] outsourcing, there are many hidden costs that can easily reduce or even negate many of these expected benefits. To be effective, offshore outsourcing should be very selectively focused on the specific activities and types of work that can be done more efficiently offshore; if you outsource just for labor rate arbitrage it can ultimately backfire on you.

Chasing cheap labor around the globe can result in many hidden costs that all too often are not adequately identified or measured and, subsequently, are not accurately reflected in the firm's ROI analysis of outsourcing but will surely be reflected in its long-term profitability. Some of the hidden costs include:

- Selecting an offshore service provider – There are quite a few providers who claim substantial savings and delivery capabilities in the outsourcing market. Select your vendor carefully; selecting the wrong vendor can be disastrous.
- Transitioning work from onsite to offshore – In addition to obvious costs like telecommunications and network infrastructure, there are other real costs to be considered such as the costs of training, redundant personnel during the transition phase, and travel, not to mention significant cultural, social and organizational hurdles.
- Resource "Shifting" - The most insidious of the hidden costs caused by changing resource requirements from one department to another resulting in the appearance of cost reductions while, at the organizational level, the net effect on cost savings is less than what is being measured.

Let us investigate these cost factors elaborately.

One of the typical ways that outsourcing firms are able to make their margins while charging you what appears to be less for your IT work is that they generally tend to replace your existing personnel with less-experienced personnel. By doing this, they are able to substantially reduce their staff costs. It is possible that you can enforce a minimum level of experience for certain key positions, but not all years of experience are equal, particularly when it comes to: industry-specific knowledge, generally accepted business practices that can vary substantially among cultures and countries, regulatory environments, and other hard-won expertise that may not be accurately reflected in just the number of years of experience that a person may have in a similar technological environment. Industry

expertise, intimate knowledge of your business and your customers, these things can all directly and very significantly affect the performance of your IT staff. The outsourcing staff will not have the total capability of your existing staff, and if they did they would not be able to offer substantial cost savings. To raise overall productivity, you must carefully select who does what in order to maximize the value to the organization. Your IT organization must evaluate the work to be done and be sure to allocate that work in a way that maximizes your overall IT capability.

To truly reap the benefits of outsourcing you must:

- Define the work – Analyze the work being performed in your IT department so that you can fully understand the depth and breadth of your existing IT capability. This can help you determine what must be done in-house and what can be efficiently and effectively outsourced.
- Get the “big-picture” – Look at the total “system” of your firm and how IT currently contributes to the overall ability of the organization to produce products or services for your customers.
- Be selective – Understand that there are very real opportunities to improve your IT effectiveness through outsourcing but that these opportunities are discrete and typically focused on very specific activities and types of work. Once you have done these things, you will begin to understand the way in which selectively outsourcing specific, well-defined activities can contribute to your total IT capability and, thereby, improve effectiveness and reduce costs.

Now let us consider some of the hard dollar costs that should be readily identifiable and attributable to outsourcing. It is important to address these costs because even though these costs are much more readily measured, often they are considered in isolation and not attributed to the overall cost/benefit analysis of the outsourcing initiative. These costs include:

- Vendor Selection – The cost to identify and engage an appropriate outsourcing service provider
- Infrastructure – The costs involved in establishing the technological and process environment necessary to enable and sustain your outsourcing initiative
- Transition – The inevitable costs required to transition work from in-house to outsource or from one outsourcing vendor to another.

As the outsourcing vendor's sales pitch may not match

their execution process, it is critical that the vendor selection process be rigorous, which translates into additional costs. Vendor selection costs can commonly run from one to three percent of the value of the total outsourcing contract. This means that if you expect the total value of your outsourcing contract to be \$10 million dollars, you can reasonably expect the process of selecting an appropriate vendor to cost between \$100,000 and \$300,000 dollars. It can be very difficult to accurately obtain significant data regarding the cost of vendor selection because most organizations do not track these costs effectively.

Infrastructure costs include specific changes or investments that you will need to make to your environment in order to enable your ability to outsource. This concept of “enabling” your environment is important - it speaks to the fact that there are very real physical, structural changes that must be made in order to allow your organization to successfully outsource work. Some of these changes will affect your network architecture, telecommunications, internal processes, tools, and licensing agreements and other contractual arrangements.

Once you have put your own house in order by establishing the appropriate infrastructure: creating the necessary network and telecommunications; enhancing your internal process capabilities; enabling your environment with the appropriate tools; and addressing the legal and regulatory issues, you are ready to start the process of moving work offshore - the “transition” phase of the offshore outsourcing process. During transition, existing staff will be tasked with training vendor staff, monitoring their progress, and progressively turning over duties and responsibilities. This means that there will be some degree of overlap of existing employees and vendor staff who will, for some period of time, be assigned work in parallel. This can put enormous pressure on the teams, both employee and vendors, as they try to maintain service and service levels while battling the inevitable shortages of office space, supplies, and equipment. Besides the obvious costs of having two people doing the work of one, additional costs during transition can include travel and temporary living, retaining of staff, severance, onsite differentials etc.

The costs relative to offshore outsourcing are highly variable and dependent on the specific requirements of each individual engagement. Because of this, it is critically important to carefully analyze the individual applications and types of work you are considering outsourcing as well as the organizational and structural characteristics that must be in place. Only after such analysis is performed will you be able to make an informed decision as to the efficiency and effectiveness of outsourcing on your organization.