Rethinking IT Application Outsourcing Contracts

With IT application development and maintenance outsourcers fighting to hang on to business, now is the perfect time to revisit outsourcing contracts.

By Bob Haas, Arjun Sethi and Venkat Tummalapalli

With the economy in turmoil, growth in the once-booming outsourcing sector slowed down in 2009. As U.S. and European unemployment hovers near 10 percent, the political reaction to offshoring is likely to be negative—and possibly even punitive.

Yet the turmoil makes this an ideal time for firms to launch or expand their outsourcing initiatives. It is well known that outsourcing can lead to substantial cost savings and improve operational efficiency. A good example is IT application development and maintenance (ADM) outsourcing. With competition rising among ADM vendors and prices falling, companies can improve existing contracts, find bigger cost savings, and restructure supplier relationships to increase process efficiencies.

Communicating the importance of these cost-reduction methods to stakeholders will be crucial to the success and acceptance of these initiatives.

Adapting to the New World Order

The economic crisis has challenged the status quo for IT ADM vendors, who have seen their steady and substantial growth suddenly slowed.

In response to the turmoil in the United States, these vendors are diversifying—both to new regions, such as Europe, Asia and the Indian domestic market, and to new industries, such as media, healthcare, retail and telecom. At the same time, vendors may be willing to offer more competitive deals to new and existing clients. As their staff utilization sinks, many are focused on retaining their existing clients (and maintaining market share) by providing more value. For example, many vendors are willing to offer subject matter experts to support a client’s innovation efforts.

While companies can take advantage of current market conditions to reduce costs and enhance the quality of service, they ought to proceed cautiously. Although market conditions are favorable, they need to perform due diligence to help identify vendors who may be trying to undercut their competition without offering any advantages. For example, one of our financial services clients recently rejected an outsourcer with the lowest rates because the firm could not sustain high-quality service or maintain efficiency gains.

Firms can improve their outsourcing initiatives by following these four guidelines:

1. Simplify structure. Overabundant, redundant and inconsistent job titles often cause confusion about what each role does and leads to unnecessary costs. For example, one firm’s relationship with an IT ADM vendor evolved into more than 150 different roles. Intended as a way to ensure accurate pricing for each role, the arrangement instead resulted in unwieldy complexity, poor allocation of resources and, ironically, difficulty in assessing price competitiveness. Our analysis revealed that the 150 disparate roles (given arcane names such as ProphIT Architect and ICM Design Lead) could be simplified to
a standardized set of functions. Once the roles were condensed to a manageable number, the company could align the roles with industry standards and still meet its business needs. These changes alone saved between 10 to 25 percent of addressable spend.

2. Engage in joint process-improvement activities. Adhering to system development life cycle best practices improves collaboration and process discipline with vendors while reducing potential implementation delays. Most vendors are willing to invest their available resources to help their clients improve internal processes for mutual benefit.

3. Analyze and benchmark cost drivers. Examining both personnel and non-personnel costs of IT ADM vendor agreements can lead to cost savings. Leading companies are using the current market downturn to obtain more transparency into their contracts and thus better understand vendors’ costs. Once competitive rates have been established with a new contract, this transparency, coupled with strong benchmarking clauses, will make it easier to maintain competitive rates and usage patterns.

The target mix of onsite vs. offshore personnel is 20 percent and 80 percent, respectively. But many companies struggle to manage 70 percent or less offshore staff because of political issues and concerns about data security, among other things. In flat-fee or blended-rate structures, vendors often move their own work offshore to increase their profit margins. Maintaining a transparent and competitive rate in each area of operation ensures that clients are paying the right amount in these cases. The same diligence is necessary to curtail unnecessary costs such as program licenses, telecom, vendor overhead, training and travel.

4. Negotiate better terms. Given the economic downturn, IT ADM suppliers have less demand and are therefore competing for existing jobs. Firms are in a prime position to negotiate for deeper discounts, innovation support, and additional subject matter experts. For example, a recent client negotiated a new seven-year contract with its existing provider that fixed rates for its ADM labor and offered protection against wage increases and currency changes.

An aggressive negotiation strategy balances collaborative restructuring to reduce costs and improve service—and introduces competitive market pressure if objectives are not met. For example, vendors that meet long-term contract objectives are rewarded, while those that do not meet objectives or refuse to provide concessions are denied the business. Regardless of the strategy, though, contract language should always encourage continuous improvement and competitive pricing.

Performance metrics will ensure that projects meet all stakeholder expectations. For example, productivity can be measured by the cost of systems maintenance, price per change in function point, the cost of reworks or bug fixes, and turnaround time. Services can be measured by reviewing the quality of the application (the time-to-failure and fault-defect ratio), change management processes, accurate estimates and on-time delivery of projects, and whether or not vendor personnel have software engineering certifications.

Other performance measurements might include tracking projects that stay within budget, overall budget variance, hidden or one-time costs charged to the client, and flexibility in the contract so the client is not locked into outdated solutions or technology. Client satisfaction can be measured through customer-satisfaction surveys and by gauging how quickly problems are resolved, what escalation procedures are in place, and if innovation or support produces tangible business results.

Despite the seemingly negative economic and political environment, companies are likely to continue developing and maintaining their IT applications. Renegotiating vendor contracts will ensure more advantageous relationships, and improving outsourcing strategies will help mitigate risks. While the road ahead will continue to be bumpy, companies can manage risks successfully by improving their outsourcing strategies.