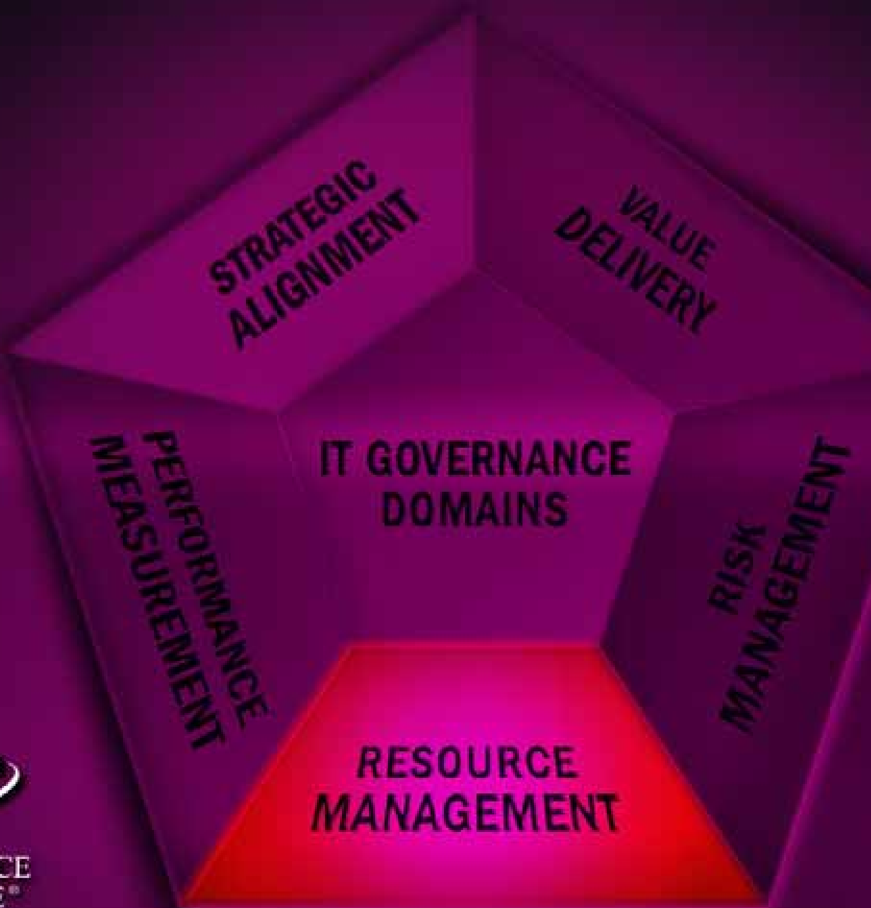
IT GOVERNANCE DOMAIN PRACTICES AND COMPETENCIES

EXCERPT

Governance of Outsourcing



IT GOVERNANCE INSTITUTE®

The IT Governance Institute®

The IT Governance Institute (ITGI) (*www.itgi.org*) was established in 1998 to advance international thinking and standards in directing and controlling an enterprise's information technology. Effective IT governance helps ensure that IT supports business goals, optimises business investment in IT, and appropriately manages IT-related risks and opportunities. The IT Governance Institute offers original research, electronic resources and case studies to assist enterprise leaders and boards of directors in their IT governance responsibilities.

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Note: This publication is part of the IT Governance Domain Practices and Competencies Series from the IT Governance Institute. The titles include:
Information Risks: Whose Business Are They?
Optimising Value Creation From IT Investments
Measuring and Demonstrating the Value of IT
Governance of Outsourcing
IT Alignment—IT Strategy Committees

This excerpt, provided exclusively for free download, includes the executive summary and the succeeding chapter. The full table of contents is included so that readers can see the other topics covered in the book.

1. Executive Summary

Outsourcing is a US $180 billion-plus industry with more than 75 percent of IT organisations using it in some form.[1] Outsourcing of some or all of the services within larger companies is seen as a way to contain, if not diminish, costs and simultaneously increase control over revenue utilisation. The increasing costs arise, to a substantial extent, from the difficulty of retaining internal technical expertise in a 24x7x365 global, dynamic market. A strategic organisational response is to disaggregate the value chain and push the service provision out to third parties.

There is a perception that the result will be quicker, faster service that will cope more expeditiously to gain advantage from technological evolution. Another hope is that the specialist suppliers will adapt more readily in the face of regulatory pace and evolution, especially in the global environment where regulations with outwardly similar intent may require substantially different, and sometimes conflicting, enablement. The only way to ensure a consistency of service provision is to implement an approach that regulates and assists the interface between client and supplier. This is the function of the governance of outsourcing.

It is no longer a company's ownership of capabilities that matters but rather its ability to control and make the most of critical capabilities.

These factors contribute significantly to a reduction in the increasing risks of regulation. The global trend is that regulations 'see through' the body corporate and specify individually identifiable accountable agents. There is thus a personal protection aspect such that corporations seek to protect their individual employees, notably at the board level, by shifting certain functional responsibilities to third parties. In 2004, the IT Governance Institute, in conjunction with Lighthouse Global, surveyed 200 IT professionals from 14 countries in the Americas, Asia-Pacific and Europe. This survey found that the required levels of governance are not reliably extended into the relationships with the service provider when service provision is outsourced.

The findings of this survey are consistent with other research showing that outsourcing benefits are no longer just about price. They include service quality improvements, scalability, better risk management and the freeing up of internal resources to focus on core, value-adding activities.

> It is no longer a company's ownership of capabilities that matters but rather its ability to *control and make the most of critical capabilities*, whether or not they reside on the company's balance sheet.[2]

[1] META Group, *Proactive Planning: A Prerequisite for Successful Sourcing*, 2004

[2] Gottfredson, Mark; Rudy Puryear; Stephen Phillips; 'Strategic Sourcing: From Periphery to the Core', *Harvard Business Review*, February 2005

It is therefore necessary that the outsourcing initiative be cognisant of the potential changes to the risk profile of the new organisation and its operations. This publication highlights how, through the formalisation of the governance of outsourcing, this becomes integral to the outsourcing transaction and therefore supports continued operations that position the organisation competitively and with controlled risk.

2. Why Is Governance of Outsourcing Important?

Outsourcing is the mechanism that allows organisations to transfer the delivery of services to third parties. Fundamental to outsourcing is accepting that, while service delivery is transferred, accountability remains firmly with the remit of the client organisation, which must ensure that the risks are managed and there is continued delivery of value from the service provider. Transparency and ownership of the decision-making process must reside within the purview of the client.

The decision to outsource is a strategic, not merely a procurement, decision. The organisation that outsources is effectively reconfiguring its value chain by identifying those activities that are core to its business, retaining them and making noncore activities candidates for outsourcing. Understanding this in the light of governance is key, not only because well-governed organisations have been shown to increase shareholder value,[3] but, more important, because every organisation is competing in an increasingly aggressive, global and dynamic market.

Establishing and retaining competitive and market advantage requires the organisation to be able to respond effectively to competition and changing market conditions. Outsourcing can support this, but only if the organisation understands which parts of its business truly create competitive advantage. Disaggregating these and giving them to a third party must in themselves become core competences, because outsourcing is a strategic mechanism that allows the organisation to focus its efforts and expertise constantly.

As a strategic resource, outsourcing must be governed accordingly.

As a strategic resource, outsourcing must be governed accordingly.[4] This is not just about purchasing but about effective management and ensuring that both parties benefit.

Governance of outsourcing is the set of responsibilities, roles, objectives, interfaces and controls required to anticipate change and manage the introduction, maintenance, performance, costs and control of third-party-provided services. It is an active process that the client and service provider must adopt to provide a common, consistent and effective approach that identifies the necessary information, relationships, controls and exchanges among many stakeholders across both parties.

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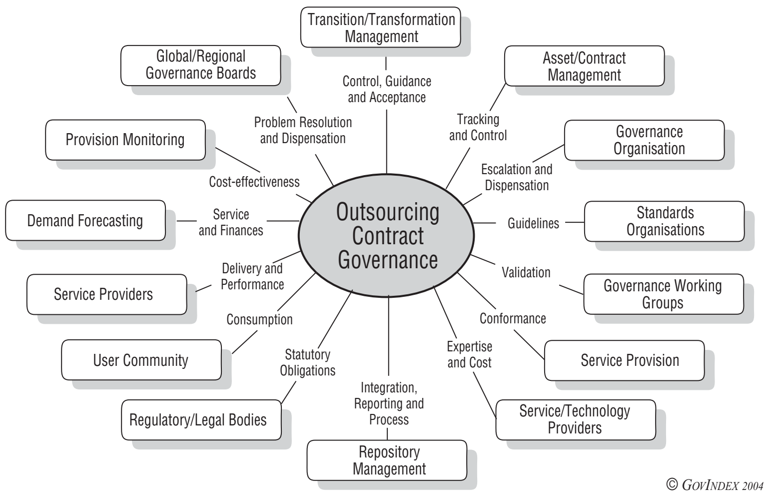
[3] Felton, Robert F.; Alec Hudnut; Jennifer van Heeckeren; 'Putting a Value on Corporate Governance', McKinsey Quarterly, 1996

[4] 'Estimates of resources needed to manage outsourced services effectively range from 1-7 percent of contract cost', Venner and Bays, 2002

Figure 1 identifies typical stakeholders in the relationship, which itself can take a number of forms.[5] Market-type relationships are categorised as short-term and commodity-style, where there are a number of providers available in the marketplace and switching costs are low. At the other end are the partnership form of outsourcing arrangements, which are typically longer term and require deeper understanding of the client organisation. The decision to outsource and subsequently manage that relationship demands effective governance to succeed.

Figure 1—Outsourcing Governance Stakeholders



Most people who conduct outsourcing contracts include basic control and service execution provisions; however, one of the main objectives of the outsourcing governance process, as defined in the outsourcing contract, is to ensure continuity of service at the appropriate levels, profitability and value-add to sustain the commercial viability of both parties. Experience has shown that many companies make assumptions about what is included in the outsource proposition. Whereas it is neither possible nor cost-effective to define contractually every detail and action, the governance process provides the mechanism to balance risk, service demand, service provision and cost.

Reminding ourselves of the IT Governance Institute's definition of IT governance as 'the leadership and organisational structures and processes that ensure that the organisation's IT sustains and extends the organisation's

[5] Klepper, R.; W.D. Jones; *Outsourcing Information Technology Systems and Services*, Prentice Hall, USA, 1997

strategies and objectives',[6] the governance of outsourcing extends both parties' (i.e., client and supplier) responsibilities into:

- Ensuring contractual viability through continuous review, improvement and benefit gain to both parties
- Inclusion of an explicit governance schedule[7] to the contract
- Management of the relationship to ensure that contractual obligations are met through service level agreements (SLAs), outsourcing level agreements (OLAs),[8] service credit regimes and gainshare
- Identification and management of all stakeholders, their relationships and expectations
- Establishment of clear roles and responsibilities for decision making, issue escalation, dispute management, demand management and service delivery
- Allocation of resources, expenditure and service consumption in response to prioritised needs
- Continuous evaluation of performance, cost, user satisfaction and effectiveness
- Ongoing communication across all stakeholders

This concludes this excerpt. If you wish to read the entire volume, please return to the IT Governance Institute web site, *www.itgi.org*, and click the links provided for the book. The sale of hard copy and e-books is handled through the ISACA Bookstore, *www.isaca.org/bookstore*. ISACA members may download the book for free; nonmembers may purchase an e-book or hard copy book for a minimal price. Thank you for your interest in IT Governance Institute's research. We hope you have enjoyed this excerpt, and we encourage you to review the excerpts of the other publications in this five-volume series as they are released. And, if you have not already, we invite you to view ITGI's many (complete) research publications available for free download from the site. A list, with links, is available on the About ITGI—Recent Publications page.

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[6] IT Governance Institute, *Board Briefing on IT Governance, 2nd Edition*, 2003, *www.itgi.org*

[7] The schedule contains the definition of the assets and processes to which the legal agreements apply.

[8] An SLA defines the support relationship between a service provider and its customer. The agreement describes the products and/or services the customer receives, each party's responsibilities, the financial agreement (if any), and how the service provider measures and reports services. The objective of the SLA is to present a clear, concise and measurable description of what the service provider does for the customer.

For example, an SLA might include: Network and server responses will be such that 98 percent of screen queries turn around in 1,500 milliseconds and will be available 99.998 percent of the time, with scheduled maintenance periods measured on a calendar monthly basis.

An OLA defines the interdependent relationships among the internal support groups working to support an SLA. The agreement describes the responsibilities of each internal support group toward other support groups, including the process and time frame for delivery of their services. The objective of the OLA is to present a clear, concise and measurable description of the service provider's internal support relationships.

For example, an OLA might indicate: Network and server responses will be such that 100 percent of screen queries turn around in 1,500 milliseconds in the payroll department on the first Tuesday of each month regardless of any other considerations, because payday is sacrosanct.

Definitions are sourced from the Duke University (North Carolina, USA) Office of Information Technology (2005), *www.oit.duke.edu/oit/sla/*. Examples were provided by GovIndex.