

The Challenges of Offshore Outsourcing: Understanding the Risks and Hidden Costs

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INTRODUCTION

India's IT enabled services sector currently represents the premier market for U.S. offshore services, controlling 85% of the entire U.S. offshore IT market. In 2003 this trading relationship amounted to \$9.5 billion in exports. Indian IT exports to the U.S. are projected to hit \$18 billion by 2005 and \$50 billion by 2008.ⁱ

U.S. offshoring to India is being driven by a variety of factors, not least of which are the tremendous cost of labor differentials, with Indian IT compensation in some cases as low as one-tenth that of professional U.S. equivalents. As a result, U.S. businesses are viewing offshore purely as a labor arbitrage play, without regard for either risks or hidden costs.

Without a complete and proper understanding of offshore's genuine complexity, hidden risks and costs will blindside IT decision makers and prevent attainment of anticipated wage rate savings.

This whitepaper seeks to explore the hidden costs and risks of offshoring so that IT decision makers can formulate realistic offshore expecta-

tions *before* making the decision to go offshore. Establishing a preliminary baseline of such expectations will help position IT decision makers for best practices in both the pre-contract planning and post-contract project management phases. Global IT management is complex, but realistic expectations and proper planning will increase the probability of achieving your service delivery goals without sacrificing either higher quality or lower total costs.

The Reality of Savings

With labor rates as much as ten times higher in the U.S. than they are in India, the ability of U.S. firms to capture overall offshore cost savings of 50% or more would not seem to be unreasonable. In fact, 50% is frequently marketed as a best case possible cost reduction.

But offshore cost savings aren't coming in anywhere near 50%. In "*Controlled Offshore Outsourcing with an Active Process*," Svante Lidman and Ivar Jacobson claim that while cost savings of 50% are in fact possible, typical offshore savings are no more than 10-15%.ⁱⁱ A study by Deloitte Consulting corroborates these conclusions. In a survey of companies

with at least two years of experience in offshore outsourcing, Deloitte discovered that, despite potential cost savings of 47%, the average reduction in total cost of ownership was more in the range of 10-15%.ⁱⁱⁱ Diamond Cluster International, a Chicago based consulting firm, studied approximately 200 companies involved in offshore outsourcing and came up with the same results: although buyers initially expected gains of 50%, expectations were now declining to the 10-20% range.^{iv}

What all of these reports underscore is the fact that significant misperceptions still remain around the subject of offshore cost savings, the maturity of the offshore model, and the challenges involved in planning and managing an offshore relationship. Such challenges are by no means limited to the inexperienced. In 2003, CIO Magazine actually reported that United Technologies was saving only 20% on their own Indian outsourcing projects.^v United Technologies is an acknowledged leader in the development of offshore best practices.

Challenges of Distance

Although much has been made about the communication barriers

and cultural obstacles that increase offshore overhead while lengthening the planning, development, and implementation of offshore services, the story behind degraded cost savings is much more complicated.

Transition, for example, is considered to be the most expensive part of an offshore endeavor. Conventional explanations tend to revolve around vendor selection and due diligence costs, both of which are exacerbated by long distance separation and correspondingly higher travel expenses. However, it's also during the transition phase that companies frequently find themselves restructuring their delivery pyramids to resolve operational complications brought on by the shift from a traditional to an offshore business model. A Global IT Services report by Goldman Sachs actually asserts that CIOs should be developing traditional outsourcing strategies first, with local vendors, before trying to manage such complexities.^{vi} The danger here is that unprepared-for restructurings will catch IT departments off guard, boosting project costs significantly and in unexpected ways.

Transition also requires the importing of foreign knowledge workers from the offshore entity to learn how applications work, to query onshore staff, and to create any required documentation^{vii}. A foreign workforce may actually need to remain onshore permanently, even deep into the life of the engagement, in the form of project manager liaisons and business analysts.

Simply packing up and shipping specs overseas is not a viable or cost effective alternative to the liaison approach. That's primarily on account of the language and cultural barriers at the heart of the offshore relationship, but it's compounded by the lack of proper processes on the onshore side, too. All of this is exacerbated by geographic dispersion across multiple time zones, which makes it harder to function as a coherent team, along with decreased visibility into task assignments, missed requirements, rework, and project delays. The net result of such difficulties is a 20% decline in application development efficiency during the first two years of an offshore contract.^{viii}

Reliance on Non-Immigrant Visas

Importing foreign knowledge workers, project managers and business analysts will address many of these core, communication related difficulties. In fact, most offshore business models are already heavily dependent on a non-immigrant component, in the form of either H-1B or L-1 visa recipients^{ix}. These workers have played, and continue to play, a significant role in the overall cost effectiveness of the offshore delivery model through smoothing up the requirements process, improving communications, and reducing rework—all at rates well below the prevailing wage.^x

To put this in perspective, a year 2000 study conducted by the GAO discovered that the salaries for H-1B

programmer/analysts between the ages of 31 and 50 were lower, on average, by about \$11,000 to \$22,000 than the salaries reported by U.S. citizens for the same occupation.^{xi} The L-1 visa lacks prevailing wage guidelines entirely.

Partly motivated by such findings, Congress has since introduced 8 distinct legislative measures aimed at substantially restricting H-1B and L-1 visa use. Each of these measures reflects an aggressive commitment to begin restoring proper oversight to non-immigrant visa programs while closing legal loopholes and strengthening enforcement mechanisms. Specific recommendations include a permanent yearly cap of 35,000 on the currently cap-less L-1, the imposition of prevailing wage rates on the L-1, broader audit authorities for the Department of Labor, and a permanent yearly cap of 65,000 on the H-1B program.

A study conducted by CIO Magazine of the effects of non-immigrant visa reform on the offshore outsourcing model reported that such curtailment could force offshore providers to completely rethink their current business models. According to the same study, such restrictions could even cause U.S. projects with offshore outsourcing partners to collapse.^{xii} A similar report by Goldman Sachs states that “the most tangible risk is still at the visa level. Perhaps the greatest vulnerability for offshore companies is their reliance on non-immigrant visas for completing work that requires an on-site presence.”^{xiii}

While it is impossible to predict the final form of any of these legislative proposals, it is important to note that such bills pose a significant risk to the cost effectiveness of the current offshore model. If passed into law, the direct financial risk to offshore service providers includes: (1) potential onsite wage pressure against the cap; (2) limitations on onsite headcount which could limit volume growth; and (3) an uptick in visa processing costs along with longer cycle times for receiving new approvals. Indirect financial risks include higher costs resulting from degraded communications, missed requirements, greater rework, and increased project delays.

Importance of Process

Since the importing of foreign knowledge workers to smooth up the requirements process, improve communications, and reduce rework may not be a sustainable long-term strategy, a key question arises: how can the risks of distance, language, and culture be mitigated on a regular basis? The question is significant. And the solution can be found in the raising of onshore maturity levels through the implementation of solid IT processes, tools and methodologies.

According to a 2003 Forrester Research survey of 145 senior IT and business executives, 51% said that their lack of a good process for specifying work posed a major challenge to their offshore success.^{xiv} A similar survey conducted by VA

Software concluded that the lack of solid processes, combined with resultant inefficiencies between offshore and onshore teams, could erode up to 20% of an enterprise's overall offshoring budget.^{xv}

Most U.S. firms fall short when it comes to institutionalized processes and methodologies. Indeed, fewer than 100 companies in the world have ever been assessed at a CMM (Capability Maturity Model) level 5 rating, the highest CMM rating possible. And yet, more than half of the Level 5 CMM companies in the world are located in India.^{xvi}

That's a large part of the draw behind offshore outsourcing. The problem, however, is that the CMM level of offshore vendors will mean nothing if it is not complementing similarly rigorous processes in house. Vendors can only operate, at the most, two levels higher than their customers.^{xvii} Resultant lags in productivity will increase costs and undermine anticipated savings. That's of particular concern when it comes to the articulation and stabilization of requirements.

For U.S. firms considering a move offshore, it's difficult to overemphasize the importance of structuring and defining such processes state side, while also putting tools and metrics in place to measure the performance of these processes. Clear and repeatable processes should include effective governance measures as well as common platforms for communication, collaboration, and real time "dashboard" visibility into project details. If processes are al-

ready in place state side, new modified processes may be required to manage the new relationship.

Additionally, offshore projects will need new, joint management structures to define the roles and responsibilities of each party and to direct and control the outsourced activities. According to the same 2003 Forrester Research survey referenced above, 53% of respondents stated that, in addition to process inadequacies, their company's lack of project management skills presented a significant obstacle to offshore success. Such skills are critical and making sure they are in place will increase costs. At GE Real Estate, managing the vendor became so formidable that GE had to hire a manager on a half-time basis at a \$50,000 per year salary.^{xviii}

Narrowing Indian Wage Gap

Although the implementation of processes for improved offshore management and optimized savings is something that onshore firms can begin taking control of immediately, the narrowing Indian wage gap is not. In 2003 Indian IT workers reported average wage growth of 13-14%.^{xix} These numbers reverse a six year decline in Indian pay raises.

What's of greater concern is the higher level of wage inflation seen at the mid-level and senior-level. Some U.S. companies are paying as much as 50% in premiums to recruit senior level Indian employees.^{xx} This is a result of pure demand. The situation could actually worsen as large

U.S. firms continue aggressively to recruit both this year and next.

The conventional view of Indian labor is that it is cheap, high-skilled, and in abundance. However, of the roughly 4,000 engineering campuses in India, only about 10% meet the minimum standards of western countries.^{xxi} Since these campuses graduate approximately 300-400 students each year, that translates into a yearly pool of 150,000 engineers.

That's still a large number. By comparison, the U.S. only produces 50,000 software engineers each year.^{xxii} However, the top tier Indian firms only interview at the top 40 universities, thus reducing the pool of desired graduates even further. Not surprisingly, Indian technology trade association NASSCOM was expressing concerns as early as 2003 that India would be falling short of demand for professional workers by as many as 235,000.^{xxiii}

While all of this may put upward pressure on Indian wages for some time to come, a more important consideration is the related turnover of key personnel. With most of the wage inflation stemming from aggressive poaching of mid-level and senior-level talent, turnover in this area is climbing as high as 35%.^{xxiv} Most vendors have avoided publishing these statistics by providing numbers on overall turnover, as opposed to key personnel turnover, but it's the turnover in key personnel that matters. Such instability increases costs for an IT organization by increasing the time needed for

knowledge transfer and personnel training.

To mitigate these risks, and to keep such costs limited to the first year of an engagement, onshore firms should create contractual terms around turnover rates, terms that place a liability on the vendor for replaced personnel. Additionally, onshore firms will want to retain in-house—over the life of the engagement—a portion of their development, analysis, support and management personnel to ensure against persistent and costly knowledge transfer risks.

Compliance Risks

The Indian government has identified the growth of offshore IT and BPO as a strategic priority and is continually reviewing and streamlining bureaucratic clearance requirements for U.S. businesses. This has resulted in an investor friendly environment that is contributing to the rise of wholly-owned subsidiaries, build-operate-transfer operations, and existing India-domiciled acquisitions (as opposed solely to U.S.-India strategic partnerships).

However, there are inherent disadvantages to the Indian environment. In May of 2004, the U.S. Trade Representative placed India on the Special 301 Priority Watch List for inadequate levels of intellectual property protection and enforcement. Under the trade related aspects of intellectual property rights ("TRIPS"), India has until January 1, 2005 to begin providing proper

protections in this area. Until then, U.S. firms evaluating offshore should reduce their IP risks by identifying IP exposures and making sure such work remains onshore.

Perhaps more disconcerting is the fact that no EU directive-styled privacy laws or national privacy standards exist today in India. Notwithstanding these challenges, U.S. regulations such as those imposed by the Health Insurance Portability and Accountability Act and the Gramm-Leach-Bliley Act require U.S. companies and U.S. offshore service recipients to protect data privacy across international borders, at the risk of severe financial penalty.

In the absence of Indian privacy laws, how will U.S. offshore service recipients limit their exposure to such financial risk? U.S. firms should consider appointing privacy teams to lead both offshore and onshore parties through the assessment, planning, and transition phases of a project. U.S. firms may also want to consider putting safeguards against data privacy abuse into contractual terms.

Similar risks and considerations arise in regards to Sarbanes-Oxley compliance. The Sarbanes-Oxley Act of 2002 requires CEOs and CFO's to attest to the accuracy of their financial statements and to disclose any possible threats to continued operations. Major Sarbanes-Oxley issues include the documentation of processes moved offshore as well as records retention—including electronic records—by third parties.

Although the Indian government does not mandate similar requirements, U.S. service recipients will be liable under U.S. law if their offshore vendors are out of compliance with Sarbanes-Oxley.^{xxv} To complicate matters, the SEC has not yet released specific guidelines on how to apply Section 404—the primary article of Sarbanes-Oxley legislation—to outsourcing.

U.S. firms facing Sarbanes-Oxley uncertainty will want to factor the costs of compliance into their offshore cost benefit analysis, keeping in mind that compliance assurance can require twice the work for outsourced operations than for internal processes. Compliance estimates should include the ongoing costs of governance as well.

Legislation Risks

Although government agencies may not need to worry about Sarbanes-Oxley regulations, more expansive legislative challenges are being presented to the public sector by state and federal anti-offshoring proposals. In January of 2004, Senators Craig Thomas (R-WY) and George Voinovich (R-OH) introduced an amendment to an omnibus appropriations bill that prohibits companies awarded federal contracts under OMB Circular A-76 from performing work outside the United States. A similar bill introduced by Chris

Dodd (D-CT) would prevent nearly all federal contracts from being outsourced, would prevent states from sending contracts overseas if they were funded by federal monies, and would make the Thomas-Voinovich amendment permanent. In addition to the Dodd and Thomas-Voinovich proposals, there are currently 80 other anti-offshoring measures that have been introduced on the federal level.

Moreover, 38 states have introduced 175 pieces of separate legislation aimed at stopping or controlling offshoring on the state level, with 7 of these states having successfully passed such bills. In addition, 5 anti-offshoring state executive orders have been issued by 4 U.S. governors with one state, Colorado, currently attempting to put an anti-offshoring proposition on its November 2004 election ballot. Several of these measures have introduced language that would restrict the ability of state agencies from employing U.S. vendors whose staff consists largely of visa workers.

Will state and federal anti-offshoring bills, if successful, require that public sector work be brought back, even after contracts have been signed, transitions put into play, and projects started? In 2003 a New Jersey call center that had been offshored to India was moved back to New Jersey at an additional cost of \$1.2 million to taxpayers. Since then,

3 more states have forced jobs back onshore or rescinded contracts. Such risks must be taken seriously, on both the state and federal level, and should be carefully and regularly evaluated by public sector service recipients as well as their offshore service providers.

Conclusion

All things considered, a careful analysis of what work stays and what work goes may be the key to maximizing offshore savings and minimizing offshore's hidden costs. The reduction of privacy risks, IP risks, and non-immigrant liaison risks should all be factored into such decision making along with the minimization of high turnover related knowledge transfer disruptions and unnecessary legislative exposures. Organizations will also want to develop strategic IT plans that align IT with the business and that help determine what stays in-house at any price.

But with labor savings of as much as 30% to be had in many parts of the U.S. right now,^{xxvi} an initial evaluation of onshore and near shore alternatives may be the smartest move of all. That's something to consider in light of offshore's many risks and hidden costs.

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