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MANAGING BUSINESS SERVICES SOURCING FOR PROFITABILITY

A White Paper Prepared for Digital Fuel
May, 2005



**ENTERPRISE MANAGEMENT
ASSOCIATES**



Managing Business Services Sourcing for Profitability

EXECUTIVE SUMMARY

IT needs a new paradigm—a model that emphasizes business needs and priorities and reduces operational costs. This new paradigm has been emerging over the past few years driven in part by economic demands and in part by the evolving maturity of IT organizations and the businesses they serve. Wise IT and business executives understand that sourcing opportunities for IT functions must be carefully considered with respect to cost, strategic importance of the particular function, and options for outsourcing and in-sourcing or any combination thereof.

A top-down approach is the best way to understand the importance of business services and the level of service quality necessary to meet corporate goals. Metrics should be defined in business service language, such as transaction completions and end-to-end performance—rather than technical measures, such as packets dropped or throughput. Tracking and managing business’s key performance indicators (KPIs) help make IT or the service provider more accountable to the business, as well as better aligned with overall goals.

Once priorities are understood, services can be “sourced” in any number of different ways. Decisions about sourcing should be driven by the strategic value to the company balanced with costs that will be incurred to meet required service levels. In the end, the characteristics of the service, not the needs of IT, should be the driver of internal and external sourcing choices. Services that are good candidates for outsourcing are those that are not core competencies or mission-critical, and have standard and well-defined procedures. Another key consideration is the opportunity cost involved in keeping services in-house—using IT personnel to address day-to-day IT functions as opposed to developing or supporting new, revenue-producing services. Both cost and the ability to provide the required level of service must factor into the final decision.

Options are many and no matter what the right choice, the resulting services need to be managed effectively to ensure that service quality meets the needs of the business. Executives and IT leaders who envisioned a scenario where they outsourced services to completely relieve their responsibility for them have found themselves the subject of articles on failed IT outsourcing. Monitoring services, whether internal or external, requires the ability to create SLAs, manage services to meet commitments in those SLAs, provide notification when there is a breach or potential breach of the service objective, and analyze and report on the profitability of those services or the cost of the providers. Digital Fuel’s ServiceFlow suite does all of that, and more. It also automates many of the tasks required for good governance of IT services and service providers, and leverages expensive investments in enterprise management solutions.

SOURCING THE NEEDS OF THE BUSINESS

IT is under growing pressure to directly support business goals and objectives. Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) has gotten the attention of executives focused directly on IT, and they are not entirely happy with what they see. While SOX is mainly focused on financial accountability, there are provisions for auditing and better IT controls. The increased scrutiny has also gotten executives wondering how they can improve IT’s contribution to the bottom line. In many organizations, IT is still supporting largely itself—the hardware, software, databases, networks, etc. IT’s understanding of the business services it is supposed to sustain is often tenuous, at best. IT is also facing considerable budget restrictions. More services and higher levels of service are being requested, yet the money to provide them is often tightly controlled. For each service, IT needs to have an accurate measurement of the level of service currently being provided, and the cost of each service. Corporate business executives are demanding to know where IT investments are going,



TABLE OF CONTENTS

- 1 Executive Summary
- 1 Sourcing the Needs of the Business
- 2 Managing Business Services in Sourcing Relationships
- 4 Elements of Outsourced Governance
 - 4 Establishing Meaningful Service Level Agreements
 - 5 Business-Centric Metrics
 - 5 Tracking and Reporting
- 6 Digital Fuel and ServiceFlow Profile
- 6 EMA Perspective
- 7 About Digital Fuel



and whether that investment is aligning with corporate goals and objectives.

Business and IT must come together to jointly define the business services the company requires, and the level of service that is necessary to meet business objectives. Strategic, mission-critical services must be given the highest level of service, with written service level agreements (SLAs), and the highest remediation priority when problems develop. Services that are not as important to the competitive survival of the company should receive a level of service congruent with their relative priority. In this paradigm, services are managed, rather than simply managing the infrastructure.

Executives have lots of choices when it comes to sourcing IT services: in-sourcing using existing internal resources, outsourcing to a service provider, or a hybrid decision—which is becoming a norm at larger corporations, that combines these alternatives. While many IT professionals fear turning over control to any kind of external provider, some understand how the concept of specialization can work to maximize IT dollars, assigning each service to the source that can best meet the cost and service level constraints. Even if IT has the capacity to source all its services internally, does that leave any time for developing new strategic services—the kind that maximize revenue, over and above minimizing cost? Only internal IT can focus on creating revenue-generating opportunities.

Of course, outsourcing should not be approached without a thorough review of each business service. Not all services are created equal—some have strategic value to the company and form part of the organization's core competency, while others are support processes. A manufacturer of finely machined optical parts would never outsource its unique manufacturing processes; however its payroll processes may be quite standard. Some questions to consider in determining how to source a service are: Does this function form part of the core competency of the business, or is it a supporting function? Is this function fairly standard, or does it have many unique components? Can internal IT easily provide a high level of service at a cost effective price, or can I get better service for lower cost from an external source? And finally, does IT have the capacity to source this function, or should IT be focusing instead on other, more strategic initiatives?

MANAGING BUSINESS SERVICES IN SOURCING RELATIONSHIPS

The concept of business service management (BSM) is helping to change the role of IT within the business.

BSM takes a top-down view to first identify the business services of each of the organization's functional areas, and then map those services onto sources. These sources can be internal IT staff and infrastructure, external providers, or a combination of both. However the sourcing arrangement is made, that service must then be managed to ensure service quality is maintained. Sourcing is a win-win situation, where both IT and the business can improve their bottom line and satisfaction.

The task of managing services must take place at several different levels in an organization. At the most basic level, the services must be available, and meet their agreed-upon service levels. Information

BSM takes a top-down view to first identify the business services of each of the organization's functional areas, and then map those services onto sources.

required varies according to the sourcing approach. The most basic management information would alert staff when a problem arises with a service, and provide a map to determine how that service is sourced. If the service is sourced internally, a service map will identify what components of the infrastructure are potentially involved. If the service has been outsourced, the map will simply identify the service provider. When a hybrid approach has been used involving a combination of internal and external resources, the map will identify the intersection of internal and external, as well as the probable location or responsibility for the problem. Basic management includes drilling down to the infrastructure involved and identification of root causes of outages and decreasing performance. This information needs to be provided for each of the multi-vendor components found in today's complex IT environment.

If a service is starting to trend toward violating an agreement, now is the time to take action to repair or alleviate the problem—not once a violation has occurred. An SLA for an employee healthcare cost reporting system must meet HIPAA regulation reporting requirements and the penalties for violation of those regulations can be severe. Tools that prevent outages and avoid productivity reductions pay for themselves quite rapidly. However, occasionally even the best management will not be able to prevent SLA violations, in which case this group should immediately contact the end users affected, and actively communicate information on the problem—workarounds, plans for repair, and estimated time of



Managing Business Services Sourcing for Profitability

reactivation of the service. This group is responsible for identifying, ameliorating, and resolving issues, regardless of the source.

Above that day-to-day level of management, a tactical level of management must review the services. This is sometimes done by IT itself, or as Enterprise Management Associates (EMA) believes is a growing trend, by a self-standing unit for managing services. At this level, working jointly with the lines of business (LOBs), new services are identified, prioritized, and costed, and services are mapped to sources. One of the biggest challenges for this group is determining how to calculate the cost of internal shared services. Chargeback mechanisms as well as decision-making for outsourcing depend on accurate cost measurements. Various financial models may be used for this determination, including CPU cycles utilized, number of users, or a percentage of revenue generated. While many IT and business groups would prefer to have costs/charges be based on actual consumption, many do not yet have software that can address that functionality.

For each service, this service management group will review how well the level of service is being met, and develop new services. The tactical level is responsible for the continual improvement and expansion of the services that are managed. Oversight of the service providers and

their contracts will also occur at this level. The governance of outsourced services will be discussed further in the following section.

At the executive level, overall measures will examine how well the enterprise is providing its services. The overall financial success of each service should also be ascertained so that executives can assess the relative cost/benefit of its sourcing decisions. It must also facilitate and measure the strategic alignment of IT and business goals. This level also needs information to proactively plan its future goals. IT's performance and capacity will impact those plans.

While this paper has focused on the needs of the enterprise in defining and managing services, the service provider also faces the same challenges. A service provider must be able to define services and varying levels of service quality. All companies need to identify and track costs for services, but this is the lifeblood of the service provider. Similarly, service providers also have internal and external, multi-tiered sourcing arrangements that they must track and manage. Service providers also require day-to-day management of services, tactical management of SLAs and contracts, and executive oversight to see that costs are being managed and the business is meeting its goals.

A Case for Six Sigma in Service Management

Six Sigma, named after the standard deviation or error rate equivalent to approximately 3.4 defects per million, is a combination of numeric measurements and strict processes. While not every company is yet capable of that level of perfection, the methodology used can help reduce and resolve problems in processes. Both BSM and SLM fit in well with the Six Sigma approach, which identifies five steps for managing any process or service:

- Define
- Measure
- Analyze
- Improve
- Control

For example, an accounts receivable process may **define** its business goal as reducing its error rate to 6 errors out of every 1000 statements created, or "four sigma." IT puts in place a method to **measure** and record inaccuracies and finds that its scanning process currently averages four errors out of 1000 scans. IT **analyzes** the scanning process and finds that the problem is largely due to checks that are not in alignment with the reader. IT puts a device on the reader to reject any check out of alignment for human processing. This fix **improves** the error rate to 1 out of 1000 scans. Further processes are put in place to formally measure the scanner error rate quarterly, which will make sure that the process stays within **control** boundaries.

An SLA with the A/R department will specify a service level objective (SLO) for accuracy of 99.4% or better. Other SLOs would include the number of checks processed per month, the end-to-end availability of the A/R processing system, and other contributors to A/R's view of their IT services.



Figure 1 shows the multi-level, multi-source characteristics of service management. Within the enterprise, the sources can be either internal or external; therefore management will cover either enterprise service delivery, or outsourced service delivery. On the service provider side, there is a need to manage the services delivered to customers, as well as the internal services it consumes and the services it contracts to have provided. These three areas all need to be managed effectively, by the three levels of management.

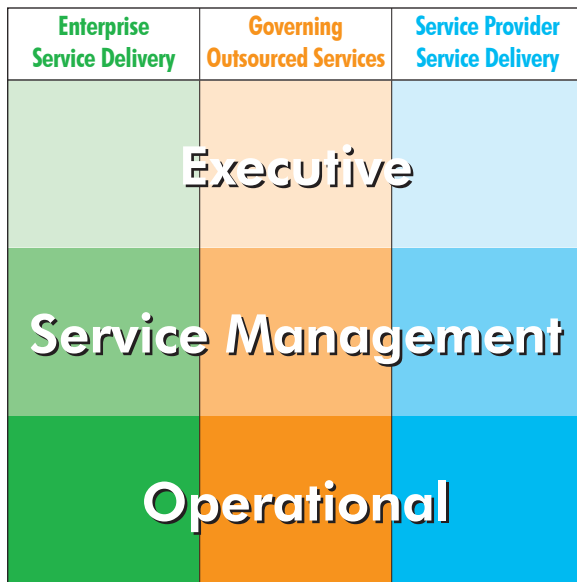


Figure 1: Managing Strategic Sourcing Relationships

The business implications of strategically sourcing a company’s services are broad—including both reducing costs, creating new sources of revenue generation, gaining expertise, and improving the satisfaction of both IT and business employees. When each service is assigned to the most cost-effective source, it is receiving the necessary quality of service for the lowest overall cost. This can reduce the growth of capital expenditures for both hardware and software fees. Commodity services are the best candidates for outsourcing, keeping strategic services for the in-house IT group. This frees IT to focus its resources on services that truly differentiate the business, as well as on developing new services. This arrangement of in-sourcing and outsourcing allows new technologies to be brought quickly on-line, even if the expertise is missing in-house. It provides greater flexibility to an organization, and helps IT more finely tune its training programs, eventually moving some outsourced services in-house as expertise is gained.

ELEMENTS OF OUTSOURCED GOVERNANCE

The key to service management of any kind is to have a process by which services are defined, agreements are developed, services are managed and reported on, and groups are held to their agreements. Management must develop solid working relationships with stakeholders involved in delivering and receiving services. Having both in-sourced and outsourced services, with multiple agreements across multiple organizations, does generate complexity, and complexity is best dealt with by setting up good processes. Without a fully defined and functional process, the difficulty of many tasks can be overwhelming. A good process divides a large task into discrete steps, taken at regular intervals, with definite measures, and outcomes. Crossing the cultural barriers that often exist inside and outside of organizations also takes work that involves cultivating ongoing relationships that will ease the burden of dealing with this complexity as it arises.

When choosing a service provider, cost is only one of the criteria that must be examined. The ability of any given source to meet the desired level of service is even more important. Talking with references that have similar service and service quality requirements can help to assess the capabilities of a service provider. The provider should also have the same type of geographic coverage as the enterprise. If the enterprise has a limited regional office base, then a local provider can work well; however, if the enterprise is a national or international concern, then the service provider needs to be able to provide support in all office locations. Similarly, the service provider should be able to meet the firm’s hours of service, whether they are 8x5 or 24x7. The provider should be able to offer different levels of service to meet higher and lower service needs. Finally, the provider should have an established presence in the market—the last thing an organization wants is to have to scramble to replace a failing provider. Of course, newer providers can undertake a limited and low-risk set of services at a lower price than their “big league” competitors.

Establishing Meaningful Service Level Agreements

The SLA is the contract that dictates the relationship between the business and the service provider—whether the provider is internal or external. In some cases, generally in agreements between IT and its LOBs, the agreement may be less formal than an actual contract. However, it is important to have a written document that specifies the services to be provided and the target level of service, or



Managing Business Services Sourcing for Profitability

quality of service, agreed to. The metrics used to measure service must also be specified. The written document helps to limit expectation creep by the service users, and serves to hold providers accountable.

In some cases, a multi-tiered SLA may be required. Here the service provided by one organization is dependent upon a service provided by another group. As an example, IT may have an SLA with the Human Resources (HR) department, for a Web portal allowing employees to view, update and modify their insurance choices. The Internet services underlying the portal may be provided by an Internet service provider (ISP), and IT would have an SLA with that service provider. Meaningful SLOs for the HR department might include end-user response time gathered through active or passive monitors; while an appropriate SLO for the ISP might be number of packets dropped. When managing that SLA, IT would need to be able to differentiate where any problem originated, whether in the application or in the network, and then get the appropriate resources (internal or NSP) to resolve the problem.

Business-Centric Metrics

The SLA must be created with an eye toward specifying services and service levels in ways that can be understood, measured, and managed by both parties. One common downfall EMA has seen in working with enterprises is the tendency for services to be defined by technical metrics, such as packets dropped or throughput; rather than in business service language, such as transaction completions and end-to-end performance. Technical SLAs were easy for IT to manage, but the business units could not equate those measures to their real service needs—an end-user does not care about the number of packets through the system, only if a transaction is completed in a reasonable amount of time. Response time and performance are the lowest level of metric that should be included, and true business service management moves toward metrics related to the business focus itself such as the number of stock trades in a given time period or the delay in processing insurance claims. These key performance indicators (KPIs) help make IT or the service provider more accountable to the business, as well as better aligned with the business's goals.

It is also useful to create composite indices made up of several metrics that track the health of one area of the overall service map. These indices give a high-level

indication of the overall health of the company's IT services. They can be presented in a scorecard or dashboard view, giving senior management an at-a-glance picture of the state of business. These often include financial measures, allowing executives to see in an instant the financial effect of downtime or downgraded service. The flexibility to group these indices according to service provider, geographic area, line of business, infrastructure element, etc. gives much greater granularity in measuring the value of each group.

Technical SLAs are easy for IT to manage, but the business units cannot equate those measures to their real service needs.

Tracking and Reporting

Defining the SLA is not the only aspect of managing sourcing arrangements; once defined they must also be tracked, managed, and reported. Managing SLAs is done on the three levels mentioned earlier in Figure 1: executive, service management, and operational. If IT has an SLA with the payroll department to resolve or escalate inquiries within 30 minutes, IT needs to assess whether IT is meeting or coming close to violating that SLA, provide a periodic report to Payroll on its service, examine the service for improvement opportunities, and determine whether the cost of maintaining payroll in-house is less than outsourcing that function.

Operational management means proactively examining on a real-time basis whether those SLAs are being met. Trending information helps operations determine if there is a problem which may end up in an SLA violation. From there, the source for the service is contacted, the situation explained, and resolution undertaken. The process is the same whether the service is sourced internally or externally. Trends, violations, notifications, actions, and resolutions should all be recorded, providing a history for improvement, trending, capacity management, SLA evaluation, and penalty/reward calculations, as well as providing a potential database for increased resolution expertise.

The next level of administration, the service management group—either within IT or a separate group—is responsible for working closely with end users when problems occur, working with the providers to improve service levels, and reviewing the SLAs against the actual



level of service provided. SLAs should be reviewed at least monthly. Service providers will generate reports; however, these should be compared against the firm's own measures for accuracy. Many firms fall into trouble by not taking this step in accountability. While there is additional time and expense in maintaining a duplicate set of tools and generating duplicate reports, this prevents the wolf from being the sole guard of the sheep. Due diligence must be undertaken with any service provider to keep the system honest.

Monthly reviews may require penalties to be assessed, or providers may need to discuss how changes will be made to better meet the SLAs. Annual reviews may spur changes in the SLAs. Metrics may be changed to give better measurements of business function. Areas for better service or new service may be identified, or the provider may be terminated for poor performance. It is important to spell out exit strategies in the contract.

Executives will review composite indices to evaluate the quality of services, the strategic value of services, ROI on the services as well as on the providers, and areas for necessary upgrades. Upgrading must be evaluated as a purchase of internal infrastructure vs. paying more for higher service from an external service provider. Again, when services are sourced strategically all changes undergo this internal vs. external scrutiny to guarantee the best service levels for the best overall cost.

Digital Fuel's ServiceFlows™ suite is a solution designed to address the management of strategic IT sourcing and governance. The solution's capabilities are highlighted in the next section.

DIGITAL FUEL AND SERVICEFLOW PROFILE

ServiceFlow from Digital Fuel is a broad service management solution that suits both large enterprises and service providers. ServiceFlow has been designed from the ground up to be a business service management solution. Digital Fuel views managing business services in a broad context that crosses internal and external customers as well as internal and external providers. ServiceFlow provides both business service delivery management and service governance management across that continuum.

Digital Fuel software applications enable a top-down business-level focus on business service management, providing the key functions that allow managers to track, analyze, and act on the operational performance and costs of any contractual obligation, IT/business measure, or business process.

Digital Fuel ServiceFlow business solutions for SLA management, cost control, chargeback, invoice reconciliation, and regulatory compliance standardize and automate the critical management tasks that drive the business value of business services.

ServiceFlow automates much of the work of creating, monitoring, and alerting to SLAs. It includes SLA templates to lessen the time and complexity of creating SLAs, and integrates with the database of defined services. SLAs can include scheduled downtime and business vs. non-business hours. Thresholds can be set, and automated actions can be triggered when those thresholds are in danger of being breached. These actions could include notification of IT staff by email or pager, or the creation of a trouble-ticket.

Another of Digital Fuel's strengths is that it provides detailed financial metric analysis, including financial liability to service providers, and financial what-if scenarios for service failure. This type of high-level information helps increase the overall profitability of both IT and the business itself, by examining both the cost and the profitability of services. It is also just what executives need to manage risk and fulfill IT Governance requirements.

Monitoring, analysis, and reporting form the basis for tactical service management—for both internal service management and for governance of outsourced services. Reports are Web-based for easy access and role-based for IT administrators or service providers, providing information according to permissions.

ServiceFlow allows an organization to independently verify service quality and track SLA performance from external providers; and also incorporates performance management and financial information to help IT managers align with business priorities.

EMA PERSPECTIVE

The idea of sourcing services to the best provider, whether that be internal or external, and then managing that service to ensure its success, must become a reality in today's IT environment. The old bias against utilizing service providers must be replaced with a narrower concern over poorly managed services. Digital Fuel's ServiceFlow provides management capabilities across the service continuum of internal and external customers as well as internal and external providers and can be used to manage these relationships.



Managing Business Services Sourcing for Profitability

ServiceFlow's strengths include its incorporation of financial data and analysis of the profitability and liability incurred by services. This allows executives to more easily accomplish good governance of both IT and the business services that support the business. It has broad data integration capabilities to gather both the financial data and systems and performance data from existing sources. While ServiceFlow leverages those investments, it does make ServiceFlow reliant upon underlying enterprise management software for both data and actions to remedy problem situations. This is a good product to layer over infrastructure management solutions, providing the alignment of IT actions with business goals.

Sourcing IT services is business-smart, but process-intensive. The management challenges introduced are not inconsequential. ServiceFlow can help to ease this burden by automating and supporting many of the workflow processes necessary for service management. Pre-defined services and SLA templates, automated notification of potential breach conditions, opening trouble-tickets, and predefined adaptors all reduce the overhead of managing services. In the end, service management involves people, tools, and processes to ensure a smooth-running operation in a complex environment actively managing the risk, cost, and profitability of critical business services. The reward for this investment can be found in the bottom line, customer satisfaction, and improved competitive standing.

ABOUT DIGITAL FUEL

Digital Fuel is dedicated to automating business service management and the reporting functions critical to ensuring business value, risk management, and profitable operations—whether services are outsourced or are shared with services provided internally. Digital Fuel assists corporations and service providers in working together by automatically capturing and proactively managing service level agreements (SLAs), and at a higher level, measuring the impact on business objectives.

Digital Fuel software applications enable a top-down business-level focus on business service management, providing the key functions that allow managers to track, analyze, and act on the operational performance and costs of any contractual obligation, IT or business measure, or business process. Digital Fuel ServiceFlow business solutions for SLA management, cost control, chargeback, invoice reconciliation, and regulatory compliance standardize and automate the critical management tasks that drive the quality, ROI, and strategic business value of business services.

Digital Fuel ServiceFlow manages billions of dollars in business and IT services for the Global 2000 and leading Service Providers. Customers include Procter & Gamble, General Electric, Cummins, IBM, Siemens, CSC, O2, and Atos-Origin. Digital Fuel is an SAP strategic partner and actively works with leading consulting and services organizations to meet the needs of specific customer engagements.

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Enterprise Management Associates, Inc. is the fastest growing analyst firm focused on the management software and services market. EMA brings strategic insights to both vendors and IT professionals seeking to leverage areas of growth across e-business, network, systems and application management. Enterprise Management's vision and insights draw from its ongoing research and the perspectives of an experienced team with diverse, real-world backgrounds in the IT, service provider, ISV and publishing communities.

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