Outsourcing

- Outsourcing is the process of obtaining services from vendors, rather than from within the organization.
- The decision to outsource usually considers two factors:
  1. Which source is less expensive?
  2. How much control is necessary?

Outsourcing Theory

- outsourcing theory is based on a number of key concepts
  - an organization should concentrate on the things it does best
  - an organization should maintain its focus on its key business objectives
  - networked organization are structurally more efficient than the old hierarchical organizations
  - NB: it does not follow that these concepts always apply

Business Factors

- business factors fuelling the drive towards outsourcing include
  - a drive for greater efficiency
  - the search for new forms of cost control and reduction
  - management fashion
Divesting Government Functions

- power and gas
- insurance
- banking
- air transport
- prisons and policing
- water
- telecommunications
- jobs
- defence (Switzerland)
- these are all supposedly non-core activities

First K on the Block

- Eastman Kodak has become the "classic" outsourcing case (late 1980s) with the total divestiture of all IT activities to three external companies
  - the data centres went to IBM
  - PC activities went to Businessland
  - the telecommunications networks went to DBC

Core Business

- core functions exhibit all or some of the following
  - “best” characterize and distinguish the organization
  - provide or constitute strategic organizational assets
  - tend to evolve slowly through collective learning and information sharing
  - cannot be rapidly enhanced through additional investment
  - cannot be easily imitated
  - are not easily transferable

Core Business

- Hoyts Theatres Ltd
  - theatre owners
    - manage, maintain, staff
  - concessions
    - manage, staff, purchase
    - supply
  - film distributors
    - merchandisers

Outsourcing

- Since the late 1980s, many organizations are outsourcing the majority of their IT functions rather than just incidental parts.
  - In the mid-1990s, IBM, EDS, and Computer Sciences Corp. were winning approximately two-thirds of the largest outsourcing contracts.

Offshore Outsourcing

- Offshore outsourcing of software development has become a common practice in recent years.
  - About one-third of Fortune 500 companies have started to outsource software development to software companies in India.
  - India has fifteen of twenty-three organizations worldwide that have achieved Level 5, the highest in SW-CMM ratings
Offshore Outsourcing

- In addition to the traditionally outsourced services, Brown and Young (2000) identify two more scenarios for future outsourcing:
  1. **Creation of shared environments** (e.g., exchanges, portals, e-commerce backbones)
  2. **Providing access to shared environments** (e.g., applications service providers (ASPs), Internet data centers).

Outsourcing Advantages

- **Financial**
  - Avoid heavy capital investment, thus releasing funds for other uses.
  - Improve cash flow and cost accountability.
- **Technical**
  - Be freer to choose software due to a wider range of hardware.
  - Achieve technological improvements more easily.

Outsourcing Advantages ctd.

- **Management**
  - Concentrate on developing and running core business activity.
  - Delegate IT development (design, production, and acquisition) and operational responsibility to supplier.
- **Human Resources**
  - Draw on specialist skills, available from a pool of expertise.
  - Enrich career development and opportunities for staff.

Outsourcing Advantages (cont.)

- **Quality**
  - Clearly define service levels.
  - Improve performance accountability.
- **Flexibility**
  - Respond quickly to business demands.
  - Handle IT peaks and valleys more effectively.

Deciding to Outsource

- outsourcing a function is justified in one or more of the following circumstances:
  - the function is available as a commodity (a skills issue in IT)
  - the function is not critical to the organization’s competitive edge
  - the function does not represent a special organizational competence
  - the organization lacks the necessary skills and/or expertise to meet functional requirements

IT Sourcing Options

- **total outsourcing**
  - transfer of responsibility for 80%+ of the total IT budget to one or more third-party providers
- **total insourcing**
  - retaining internal control over 80%+ of the total IT budget
- **selective sourcing**
  - locating responsibility for 20-80% of the total IT budget with external suppliers
Selective Sourcing Options

- **buy-in** (selected vendors provide resources to meet short-term needs as required)
- **contract-out** (vendor delivers a specific system or other requirement)
- **preferred supplier** (ongoing relationship in which the vendor provides resources as required)
- **preferred contractor arrangement** (joint ventures with costs sharing arrangements)

IT Outsourcing Risks

- IT structures are not homogeneous ("islands" of computing)
- IT capabilities continue to evolve and change
- There is no fully reliable way to establish IT economics
  - Shifts in price-performance ratios can occur at any time
  - Some IT costs are hidden with internal suppliers
- Efficiency is dependent on effective application rather than technology per se

Complicating Factors

- Outsourcing will rarely if ever correct problems caused simply by poor management
- The quality of outsourced staff and the scope of their expertise is difficult to assess and hard to control
- There are often some hidden monetary costs in an outsourcing arrangement
- There can be a loss of organizational memory and knowledge

Success Factors

- Set contractual performance measures and guarantees
- Management of the organization’s dependence on the supplier
- Establishing a mutually beneficial business relationship
- Allow flexibility for goals to evolve
- Provide a contingency capacity
- Maintain an effective residual IT organization

Outsourcing Recommendations

(e.g., Marcolin and McLellan, 1998)

- **Write short-period contracts.**
  
  Outsourcing contracts are often written for five- to ten-year terms. Because IT changes so rapidly, it is very possible that some of the terms will not be in the customer’s best interests after five years.

- **Subcontracting.**
  
  Vendors may subcontract some services to other vendors. The contract should give the customer some control over the circumstances, e.g., choice of vendors.

- **Selective outsourcing.**
  
  This is a strategy used by many corporations who prefer not to outsource the majority of their IT (like Kodak), but rather to outsource certain areas (such as connectivity or network security).

Opportunistic Behaviour

- Either party may be in a position of power - eg
  - The vendor may know how hard it is to shift suppliers
  - The customer may be the vendor’s major client
- These issues are driving the current trend towards partnership-style deals (preferred supplier and preferred contractor arrangements)
Long-Term Outsourcing Costs (intangible)

- reduced learning capacity (systems knowledge and IT knowledge will be acquired by the supplier rather than the customer)
- reduced organizational capacity to respond flexibly to change
- reduced understanding of long-term IT trends and possibilities
- loss of the benefits which stem from the more informal arrangements possible with internal groups
- loss of organizational knowledge and memory

Residual IT Organization

- even with a total outsourcing arrangement, there should be a vestigial IT organization remaining
- an effective small IT organization should be able to minimise a number of the long-term impacts

Ongoing IT Roles

- business/IT strategist
- systems planner
- systems integrator
- informed buyer of IT services
- contract monitor/manager
- vendor relations manager

Outsourcing

- the logic of IT outsourcing is increasingly compelling - all firms will outsource some aspects of IT
- the key questions concern what is retained

Reference

- Turban, Leidner, McLean & Wetherbe Chapter 13.