Information Technology Outsourcing: Issues and Future Analyses

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ABSTRACT

Outsourcing, as time has passed, has changed its formats and patterns from simple specialization to Business Process Outsourcing or Application Service Providers. As the outsourcing industry grows, it becomes more complex than before and more cases of failures coming into existence. This paper intends to discover the reasons for these failures and the steps that need to be taken to make the outsourcing process a success. Also, different issues of outsourcing and the future trends in outsourcing are the major focuses of this paper.

INTRODUCTION

The business environment changes frequently. The business managers are constantly looking for ways to improve business operations and processes, reduce costs, and enrich the profitability. They thirst for ways to improve the profit that motivates the business researchers to come up with new ideas and technologies. Different businesses use different strategies, like vertical integration, horizontal integration, outsourcing, mergers or acquisitions to keep the show running at minimal cost and maximum profit. Within them, the latest trend in businesses is to outsource business functions to specialty vendors. Historically, the industrial sector to be first outsourced was manufacturing. A lot of manufacturing companies found cheaper manufacturers for their products and outsourced their manufacturing components to these specialty vendors.

China is one of the major low-cost markets for manufacturing outsourcing since its labor, one of the major factors of production, is readily and cheaply available there. The service sector in the United State has recently been hit by the outsourcing fever. Its information technology services and financial services jobs are going outside of the U.S. to cheaper foreign firms. It is expected that financial services companies will move more than 500,000 jobs outside US in the next five years (Thottam, 2003) and India is by far the top destination.

More and more technology jobs are going outside of the U.S. With the increased numbers of these jobs leaving the country, a number of questions have been raised in the minds of the intellectuals. Some of the issues that this paper intends to cover are the following:

- Whether the technology outsourcing option is a viable option in the long run
- Value proposition of technology outsourcing option
- Are there any hidden costs to this option
- What kind of jobs is being outsourced
- What kind of trends is seen in information technology outsourcing

OVERVIEW OF OUTSOURCING

Outsourcing practice has been moved from a niche technology management tool to a mainstream and a strategic weapon for many firms. Due to the ever-growing gap between supply and demand of technical talent, the business players are attracted to the vast pool of technical labor available overseas. It not only helps the firms to find the right persons for the right job, but also helps in cutting down costs as the labor overseas is cheaper. Offshore outsourcing allows organizations to successfully overcome the worldwide shortage of qualified IT resources, providing their users with a competitive edge and critical time-to-market software solutions (www.dci.com, 2005). We first define the concept of outsourcing.

Defining Outsourcing

Different authors have different views toward outsourcing. Some define outsourcing as a cost cutting tool; others relate outsourcing with the core competencies of the firms.

According to Human Resource Outsourcing Association (2003):

> *"Outsourcing is defined as the contracting of one or more of a company's business processes to an outside service provider to help increase shareholder value, by primarily reducing operating cost and focusing on core competencies."*

According to Daniel Minoli (1995), IT outsourcing is defined as:

> *"Turning over of information systems and/or communications functions, as a whole or in part, to a third-party contractor as a solution to the challenge, problem, and expense of creating and running a corporate information enterprise."*

According to ADP.com website (http://www.adp.com), outsourcing is defined as:

> *"Outsourcing is the contracting out of a company's noncore, nonrevenue-producing activities to specialists. It differs from contracting in that outsourcing is a strategic management tool that involves the restructuring of an organization around what it does best - its core competencies."*

In the Unisys U3 Conference in 1993, Geoff Kilby of Duesburys defined outsourcing as:

> *"A contractual relationship where an external organization takes responsibility for performing all or part of an agency's Information Technology functions. This can involve a partial or complete transfer of staff and/or resources."*

According to Dianne Northfield (1992), outsourcing is identified as:

> *"An arrangement whereby a third party provider assumes responsibility for performing information systems functions at a pre-determined price and according to predetermined performance criteria."*

The above definitional statements highlighted the features of the essential aspects of outsourcing. These features can be collectively identified through the following three areas:

- Size and duration of contract;
- Transfer of assets; and
- Breadth of responsibilities.

Outsourcing idea can be related to the concept of specialization. The concept of specialization has been progressed and evolved over time. Specialization is originated from economic discipline. It explains how the market forces stipulate the need for the "division of labor", how this "division of labor" is structured, and how it leads to societal wealth. Outsourcing is a utilitarian concept used in business and accounting. From the accounting point of view, it is defined as "the transfer of an internal service function to an outside vendor" (Wagner, 1992).

Since outsourcing tends to lower costs as a result of specialization, it is widely encountered in business operations. Cases of outsourcing in business world include manufacturing in the auto industry, the prefabrication of building blocks in civil engineering and home construction, and the gathering of financial information by banks and brokerage institutions.

IT Outsourcing

IT outsourcing has existed for a while, yet it has suffered from some limitations in the breadth of offerings, service quality, flexibility, and enabling technologies. Timesharing was one of the first types of IT outsourcing services introduced in the 1950s. Computers were expensive then, and even large companies opted to buy processing cycles in lieu of computers. Timesharing was popular for almost 25 years. But as technologies evolved, other outsourcing ideas emerged. In the late 1980s, large consulting firms like Andersen Consulting, CSC, EDS, SHL Systemhouse and vendors like IBM invented remote management services. Customer's systems, networks, and applications were monitored and managed remotely from a Network Operations Center (NOC), and the customer was assured high service guarantees through the implementation of Service Level Agreements (SLAs). Customers liked these services and bought them mostly to ensure availability for their systems and networks. Then the phenomena of Business Process Outsourcing arrived. Consultants generated this idea as well. It offered customers professional assistance for streamlining and managing their operational business processes. Finally, IT

outsourcing - which was almost a total takeover of a customer's IT environment - emerged as an offering around 1990.

The current form of outsourcing is completely different from the traditional form of outsourcing. In the past, the users and developers of information technology were using different computer platforms and incompatible proprietary architecture. So the client and the customer needed to have the same computer platforms in order to do business. The computer world was dominated by mainframes, and the networking infrastructure was of very low quality and very costly. All these factors led to the form of outsourcing where the service provider had to be inside the firm in order to provide the services. Most of the firms entered into agreements where the service provider would sit inside the firm, work under the same environment as the firm and provide the service.

But in today's business world, the usage of converging computer platforms and open architecture have made it possible for the firms to outsource its IT function to service providers who may be sitting in some other country far away from the firm. The networking quality and speed has improved so dramatically that it takes only few seconds to transfer tons of gigabytes of data from an offshore service provider's server. This has helped the business to get the information faster and thus has helped the corporate world in cutting down the cost.

DRIVING & IMPEDING FORCES

Outsourcing has lured the corporate world since the advent of business. But exactly what are the driving forces behind this love for outsourcing? Is it just the low cost or is it the specialization or, further more, is it a combination of many different factors? Also, are there any impeding forces that can hinder the growth of business in the long run? Some of these forces are listed below (www.Exportmichigan.com, 2005):

Driving forces:

- Lower labor cost for companies seeking outsourcing.
- Companies can focus on their core business after outsourcing.
- Acquiring multilingual workforce for global services to world customers.
- Improve sales channel and post-sales service to global market.
- Overall cost savings for outsourcing projects.
- Access to needed skills and technology easily.

Impeding forces:

- Some transaction and hidden costs may prohibit the opportunity of offshore outsourcing.
- More strict labor laws on outsourcing, especially in EU.
- Potential political risk involved in offshore outsourcing.
- Company may worry about lock-in, vulnerability and dependence after pursuing outsourcing.
- Uncertainty on quality control and decision-making to outsourcing projects.
- Other legal issues involved in offshore outsourcing.

FORMS OF INFORMATION TECHNOLOGY OUTSOURCING

In order to describe the value proposition of information technology outsourcing, the forms of outsourcing reveal many characteristics of outsourcing process. We can clearly classify them into three different types: information technology outsourcing, data entry and call center outsourcing, and business process outsourcing (BPO).

Information Technology Outsourcing

This type of outsourcing deals with corporate IT projects contracting to an outside contractor. Almost all types of business nowadays need an IT department to fulfill their Information Management requirements. For example, quite a few firms spend tremendous amount of money on acquiring ERP packages in order to meet their information requirements. These packages are costly and it is hard to hire trained people to work on these systems. To cut the extra cost, a lot of firms outsource their IT department to a specialized contracting firm. This contracting firm takes care of all information processes inside the firm. This type of outsourcing is seen throughout all types of business, except for the IT companies. The contractors do all kinds of work, including coding customized software for their clients, taking raw data from the firm and generating all kinds of MIS reports for the management use. This allows the firm to cut costs on expensive software, server space, IT maintenance and labor costs.

Data Entry and Call Centers Outsourcing

Data entry and call centers operators who work in a corporate data center are equipped to handle high volume digital- and paper-based data entry in any form. Sometimes, e-business data entry operators may assist the database design and management, SGML/HTML coding for the Internet, and a host of other related e-commerce services. An easy way to cut down costs and increase production is to outsource IT work to cost-effective service providers, no matter wherever they are. This way also cuts down expenses on research, development and marketing. India is growing as a steady source of outsourcing provider. Data entry operators at call centers in the country can input any type of data, develop and update databases and accurately handle a high volume of data at high speeds.

Business Process Outsourcing (BPO)

BPO is a step beyond IT outsourcing. It increasingly becomes a strategic choice for companies that look to achieve cost reductions while to improve their service quality, increase shareholder value and focusing on their core business capabilities. The BPO market is predicted to have a global annual growth rate of 22% for the next 4 years (www.csc.com, 2005). The BPO trend is shifting dramatically from IT outsourcing to HR, accounting and finance components with business organizations. BPO can be treated as an investment strategy for sourcing business value chains, including the customer relationship management, supply management, organizational productivity management, and innovation management (www.csc.com, 2005).

EXPERIENCING IT OUTSOURCING: FAILURE AND SUCCESS

According to a report from the market research firm of Gartner Inc., half of information technology outsourcing projects will be considered unsuccessful in 2003 because they have not delivered the expected value. Some of the problems with outsourcing contracts are discussed below.

Reasons of Failure

According to a survey conducted by Barometer, global spending on outsourcing increased by 25 percent in 2000 alone, reaching US$1 trillion annually. However, Barometer also found that 25 percent of all firms' functions reported an outsourcing relationship failure within the past two years (www.firmbuilder.com, 2005). Another study, published by Dataquest, reported that more than half (that is, 53 percent) of all outsourcing customers said that they had renegotiated an outsourcing contract. Within nearly one-quarter of these renegotiations, the service providers lost the account (www.firmbuilder.com, 2005).

When outsourcing relationships fail, it is most often due to a disconnection between the customer's expectations and the perceived results. It may be a matter of overly high expectations or overly low performance. However, both customers and providers need to set a rational expectation at the beginning of the relationship. Later, outsourcers need to be realistic on measuring the outsourcing outcomes.

The failure of many outsourcing relationships can be attributed to three reasons (Fong, 2004):

- *"The initial approach to outsourcing is tactical rather than strategic";*
- *"The scope of work is ill-defined"; and*
- *"The management of the contract is adversarial rather than cooperative."*

One drawback inherent in outsourcing contract negotiation is that costs tend to be the center of the discussion. The outsourcer may forget the fact that the original objectives should be strategic in nature. Another drawback is that outsourcer may enforce two contradicting objectives onto the service provider. Hence, identifying specific benchmarks or measures of business "value" can be difficult. Another possible failure occurs while contracts are signed that are based on mutual intent to enhance IT value, but short on specific work requirements. Outsourcing organizations also tend to hand over their responsibility and place the responsibility onto the service provider. In the worst cases, clients may consider the outsourced IT function to be no longer part of their problem (Fong, 2004).

Successful Outsourcing Relationship

The final result of an outsourcing relationship lies in the service provider's ability to successfully help the clients achieve their goals. The essential rule of relationship building is to avoid static relationships at all costs. What is crucial today may be immaterial after six months from now. The deception is to build in mechanisms that allow the relationship to adapt to changes. Organizations need to get the common theme of business value established to be met by the service provider. A steering committee should be established that comprising financial,

marketing and IT people from within the organization, and a few senior representatives from the outsourcing partner, should monitor the project results together.

TRENDS IN INFORMATION TECHNOLOGY OUTSOURCING

With the passing of time, outsourcing has changed its format from single activity outsourcing to business process outsourcing. In order to save costs and to provide better and more efficient services to the clients, service providers have crossed the international borders and continue to look out for new emerging markets. During 2002 U.S.-Russia Technology Roundtable, outsourcing participants identified five major trends in IT outsourcing (Bob, 2002):

1. *"More and more IT jobs will move overseas in the coming years."*
2. *"More corporate giants are opening dedicated software development centers in places like India and Russia."*
3. *"The gradual acceptance of Western intellectual property (IP) standards."*
4. *"Offshore sourcing moves up the value chain."*
5. *"Stratification of offshore countries based on cost and skill sets."*

The global outsourcing becomes a major outsourcing trend in recent years. In the U.S. and European countries, outsourcing IT jobs to countries like India and China is already visible in the business world. Comparing India to China, India apparently has an advantage over China since it has English-speaking labor force. Chinese government has acknowledged this comparative disadvantage; therefore, it shifts its focus on manufacturing sectors, such as computer hardware and automobile industries.

CONCLUSION

From the discussion above, it is clear that the option of outsourcing information technology has both pros and cons. If not properly handled, outsourcing can, instead of reducing the costs, actually increase the costs and negatively affect the bottom line. Outsourcing should not be imagined to be a panacea solution to all perceived IT problems. Consistent and continuing evaluation of IT operations and services are important. IT outsourcing is also a risky decision to most organizations. These risks arise due to the large project scale, the long lead times to complete the project and the potential loss of services across governments.

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