OUTSOURCING A COMPANY'S IT DEPARTMENT, IS IT TOO RISKY?

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ABSTRACT

This paper discusses the importance of analyzing the benefits and risks associated with outsourcing a company's Information Technology (IT) department. Each of the risks are described and discussed in detail bringing to the forefront some of the problems that a company can run into if it does decide to outsource. If a company wants to outsource the IT department, it is important that they devise a plan of approach when deciding whether or not it is in their best interest to do so. This paper outlines one of these possible outsourcing plans that would help a company weigh the benefits and risks associated with outsourcing, as well as how to decide which supplier is their best possible choice for outsourcing. Additionally a plan to evaluate the performance of the program is outlined.

Introduction

Companies outsourcing information technology (IT) departments are not a new revelation, but it is an idea that has grown in the last five years. Companies have moved more toward outsourcing their IT departments because they can save manpower and resources, they can reduce costs by leveraging assets and achieving economies of scale, they can advance internal technology, and it can bring about reform and increase competitiveness in the corporation (Hsu, Wu, & Hsu, 2005). With more companies moving IT departments overseas, it is vital that the company looks into the risks involved in moving these departments outside the company. While looking at these risks, it is important that each company plans, oversees, maintains, and evaluates their outsourcing program in order to thwart any possible problems that might keep the program from being successful.

Unfortunately an evaluation performed on outsourcing information technology in Taiwan shows that 52.4% of the large Taiwanese corporations do not perform evaluations on a regular basis (Hsu et al., 2005). Hsu goes on to say that only 10.3% evaluate performance every 6 to 12 months and 15% do no evaluations at all. This lackadaisical approach is extremely inefficient, opens companies up to many risks, and is an approach that may cause many short-term and long-term problems for a company.

The objectives of this study are (1) to discuss the benefits along with the reasons that companies move their IT department outside the company and for the most part overseas, (2) to present the risks of moving a company's IT department outside the company and to overseas companies, and (3) to discuss possible programs for planning and evaluating programs in which a company outsources its IT department. The purpose of this study is to research the risks of outsourcing IT departments abroad and determine if the benefits of outsourcing can outweigh the possible risks associated with it. Secondary data were collected from the Business Source Premiere database located in the Newton Grisham Library on the campus of Sam Houston State University and includes only peer reviewed data.

Background of IT Outsourcing

Outsourcing has become an increasing trend since the 1990's. It originated from the professional services and facility management services as well as the financial and operation support areas during the 1960's and 1970's (Xue, Sankar, & Mbarika, 2004). Webster's Dictionary defines outsourcing as the subcontracting of manufacturing work to outside and foreign and non union companies. Another definition states that outsourcing is the purchase of a good or service that was previously provided internally (Xue et al., 2004). These definitions have expanded over the years to include all aspects of a business, including the information technology (IT) and information systems departments. According to Xue, these departments include: system programming, application development, system and application maintenance, network management, end user computer support, and technical support services. So, in simplified terms, outsourcing is a process in which a company delegates some of its in-house operations and processes to a third party company.

In the 1960's IT outsourcing focused on hardware with the approach geared at services and facility management (Xue et al., 2004). In the 1970's this focus changed to software outsourcing with the approach of facility or operation management. The focus again changed in the 1980's to include both hardware and software standardization with an approach on customization management. Since the 1990's, however, the focus has been on outsourcing the whole IT department with an approach on asset management (Xue et al., 2004).

Generally, companies outsource departments that are not the main focus, or core competency, of their business. Most companies do this for a variety of reasons including: improved performance; the difficulty in recruiting, training and retaining good IT professionals; the costs of continuous upgrades in the IT department; to reduce application management; and because they believe that it will save money. Companies see outsourcing as a chance to improve their performance because they can spend more time and resources on their core competencies. They also see it as a chance to improve their non-core competencies by outsourcing them to another firm that is more specialized in dealing with that department (Earl, 1996). In accomplishing both of these tasks, the company is able to become more focused and stronger in their core competency, and if a company can do this, they have a greater chance at increasing their market share and their profits.

Another reason why companies have shown more of a trend towards outsourcing the entire IT department is because it is extremely difficult and drains a lot of resources to recruit, train and retain good IT professionals (Hsu et al., 2005). From the 1960's to the 1980's IT professionals in the United States were not as numerous as they have become since then (Xue, et al., 2004). As the information technology boom hit the United States, many companies found it hard to keep their technology up-to-date with the latest upgrades. This became especially true in the mid 1990's when continuous upgrades were coming out every six months, and almost any system was considered outdated after less than two years. The cost for these continuous upgrades became very time consuming and costly for companies. So much so, that some of the companies that were already outsourcing increased it and many of those who were not either decided to outsource their IT department, or at least, seriously consider it.

And finally, the main reason companies outsource their IT department is they see the huge difference in pay that IT professionals in the United States receive verses what IT professionals in lesser developed countries receive. For instance, the average pay for a software engineer in the United States is $40-$120 an hour, and $15-$20 in India (Xue et al., 2004). Companies benefit from outsourcing their IT department in several ways, including: saving manpower and resources which in turn can reduce costs; lower wages, resulting in reduced costs; it can bring reform and increase competitiveness in the corporation; and it can give the corporation the ability to focus its resources on its core competencies.

Finally, by outsourcing the IT department to a company that specializes in it, the company can focus its time, energy and resources on its core competencies. By being able to spend more of its resources on these core competencies, the company can increase money spent on research and development to improve its products and services, as well as spending more time to get in touch with their customers and see how they can gear their products and services to more individuals. This greater focus on doing what the company is most comfortable doing can enable them to be more thorough and increase its business know-how, which can bring about reform and increase competitiveness in the corporation (Brody et al., 2004).

Types of Risks and Their Implications

Outsourcing has the potential to help overcome IT professional staff shortages and reduce costs, but only if it is handled correctly. In a survey of fifty companies, about 14%, or seven, of the outsourcing operations were deemed failures (Xue et al., 2004). They were most likely failures because they did a poor job of identifying and managing the risks associated with outsourcing an IT department or any department within a company that is essential to the success of that company. Some of the risks associated with outsourcing a company's IT department include, but are not limited to: management risks, staffing risks, client and business information risks, the loss of innovation and learning within a company, the possibility of high hidden costs, the possibility that a company's supplier might be using outdated technology, and the fact that outsourcing is seen as unpatriotic if the company outsources jobs to another country.

If the IT department of a company is considered to be doing poorly on the operational performance dimension, a company will clearly be tempted to outsource it to another party, whether the poor performance is real or imagined. There is more than one possibility or cause for the poor performance that should be considered. If the poor operational performance is due to inadequate economies of scale, then outsourcing can make sense for the company (Earl, 1996). But even if this is the case there is still a need for capable IT executives that know how to manage IT operations, so they can be informed and demanding of their suppliers. In addition to this, if the company decides to outsource its IT department, these managers will also need to know how to manage contracts with third party companies (Earl, 1996). In other words there will be a lot more expected of those executives managing the IT department and the overall company. The possibility of weak management is not an option. Even after the outsourced department has been in place for a while, there are still issues that IT managers can run into. In order for a company to reduce these risks, they will need to be sure that they can already manage their own internal services, or they will not succeed with an outsourced department (Earl, 1996).

Another long-term issue a company may run into if they decide to outsource their IT department is the fact that future IT executives will have to come from outside the company, an idea that a lot of IT companies are not thrilled with. By moving the IT department outside the company these professionals will no longer be brought up through years of IT development within their own company which can mean time and money for the company as they get adjusted to the company's practices. (Hsu et al., 2005)

Many people believe that if a company does outsource its IT department to a specialist IT Company, they are likely to have better IT specialists. This may be true of well developed and long established IT companies, but not true for all of them and is less likely to be true for IT companies that are relatively new to the market. New IT companies may not have the best expertise or solid work experience that the company is looking for (Earl, 1996). When a company signs a big outsourcing contract with a third party company, the base company will most likely send some of its employees to that third party company to insure as much continuity and uninterrupted service to its customers as possible. This is necessary because the company does not want the overall services to their customers to change; thus, they are possibly transferring their previous in-house problems to an outside company, which may be harder to monitor than when it was in-house. So, the quality of the outside work may not be immediately noticeable, or may never be what the company intended it to be. If a company does not choose to send employees overseas, or even if it does, the base company will have to endure handover costs and parallel running costs as the supplier gets set up (Earl, 1996).

Another staffing problem that a base company may run into is the integrity of the individuals belonging to the supplier company. When a company hires staff within their own organization here in the United States, they go through background checks to reduce the chance of hiring someone who lacks integrity (Brody, Miller, & Rolleri, 2004). But can a company be sure that the supplier they outsource their IT department to goes through the same lengths to check their employees? Brody states that a lot of times the managers who work at the base company never meet the employees of the vendor company, so they can never be sure of the level of integrity that they hold.

The thought of this should make a company stop and think about the risks of having employees with low integrity they are unable to monitor. One problem that might exist is that one cannot be assured that their client's names, addresses, Social Security numbers, and financial information are not being sold or used indiscriminately (Brody et al., 2004). Most clients would not feel comfortable knowing that there is an increased risk of their information being used or their identity being stolen.

Another question that a company outsourcing its IT department may want to ask themselves if they are not sure about the integrity of the employees of the supplier company is: can the computers in the supplier company write information to removable media drives, send it to a printer, e-mail it, or send it to others? If the answer to this question is yes, the base company may be at risk of valuable corporate information being stolen or used by these employees. This could cause problems that range from the loss of trade secrets to hackers corrupting the companies system causing long-term delays in service, something that all companies want to avoid at all costs (Earl, 1996). One aspect of outsourcing that some companies tend to overlook includes the loss and misuse of client and business information. Who is to say whether or not client and business information will remain confidential overseas? One possibility that was touched on earlier was the integrity of the staff, and another is the security of the servers and storage devices used to maintain confidential information. The company outsourcing their IT department may use their best efforts to keep such communications secure in accordance to the laws within their company and the United States, but they would have no control over the unauthorized interception of these communications once they have been sent to the supplier company (Brody et al., 2004).

The uploading of client information to a secure server relies on secure connections and proprietary software (Brody et al., 2004). The assumption would be that the security would be dealt with on the side of the outsourcing supplier, the company with the most IT experience, but is this assumption safe? Brody believes that another question a company may want to ask themselves is: if there was a security breach, which company would be responsible, the base company or the supplier company? (Brody et al., 2004).

No matter what department a company is outsourcing, the security of a company's information, and client information should be one of the most important issues that is discussed before that company decides to outsource the department, but especially when talking about the IT department of a company. Because the IT department can hold some of a company's most private and important data, the security of both the base company and the supplier company must be of the highest level.

One long-term risk that can easily be overlooked, because it deals with the future, is the loss of innovation and learning by the company and its employees. This loss can include: the loss of learning to manage IT, seeing further opportunities for development through IT applications, the ability to maintain an innovative capacity in IT, and the company can also become more one-sided than it wants to.

“Since most learning about the capability of IT is experimental, individuals and organizations tend to learn to manage IT by doing it and cannot appreciate the challenges until they have experienced them for themselves" (Earl, 1996). So a company that does outsource its IT department today will have a hard time finding the leaders of tomorrow for their company that have the experience in dealing with IT first hand. If the company ever intends to or needs to bring their IT department back within the company, this problem might be magnified ten-fold (Earl, 1996).

Other Risks

The risks above are some of the more costly risks associated with outsourcing a companies IT department, but there are other risks associated with outsourcing that a company should take into consideration as well. Some of these additional risks include: hidden costs, outdated technology and technology skills, and the growing trend that outsourcing jobs outside the United States is more and more becoming seen as unpatriotic and causing economic shortcomings.

When companies decide to outsource a department, the first thing they see is the reduced cost in wages paid to employees, but they often miss some of the hidden costs associated with moving their department overseas. There are two costs that are of major concern. The first of these is, the underestimated costs of getting setup which can include redeployment costs, relocation costs, and longer than expected handoff or parallel running costs (Earl, 1996). Earl showed that these costs have been known to add up to over $700,000 in the first year. So, these costs are not something to be taken lightly. The second of these concerns is that companies often underestimate management costs. This cost usually adds up in amount of time spent which adds up in money costs as well (Earl, 1996). These two costs often go unnoticed but can cost the success of outsourcing to stall for a period of time and might even cost the success of outsourcing all together.

There is another hidden cost that a company should consider when they decide to outsource their IT department. Over time simple economics start to drive prices up and eventually offshore operations, originally undertaken to keep costs down, will start to become more expensive (Kilroe, 2004). One must also consider that in order to keep jobs in the United States, the government may eventually raise the costs and fees associated with sending jobs overseas in order to keep the economy stable.

Another aspect that a company can never be sure of is if the supplier company will keep their technology and the technology skills of their employees up to date. The hope is always that the current costs of updating can be further cut, and over time, there are further cost reductions due to learning and technological advancement (Earl, 1996). But in order for this to be the case, the vendor company must keep their technology and the technology skills of their employees continuously improving. In addition to this, if the supplier company sees keeping their technology up to date as costly as the base company did, they may in time raise the prices they charge to the base company for their services (Earl, 1996).

Over the past few years, outsourcing has more and more become seen as unpatriotic especially for people in the United States looking for jobs. With the outsourcing of jobs to overseas companies, the unemployment rate has significantly increased and employees are more and more afraid of losing their jobs to a person overseas who will work for less than half of what they will. Even if outsourcing is not the only reason for the unemployment rate rising, people may always blame outsourcing as the main cause, and this is something that a company may be hurt by in the future. If the company chooses to outsource they might find themselves labeled as an outsourcing company, which could in turn cause people to not buy a company's product and in turn lower their market share**.**

Outsource Planning

If a company decides that it is in their best interest to outsource their IT department, they should do so with extreme caution. In addition to exerting extreme caution, a company should outline a detailed plan of analysis and selection as well as a specific evaluation plan to monitor the success or failure of the company's outsourcing program. These are two important steps to help increase the possibility of success when outsourcing their IT department.

The outsourcing plan is a detailed plan to aide in the decision making process of whether or not to outsource, as well as, who to outsource the company's IT department to if they in fact do decide that it is in the company's best interest (McIvor, 2000). The outsourcing plan as outlined by McIvor is a seven stage process including the following stages: (1) initial analysis, (2) risk analysis, (3) identifying potential suppliers, (4) capability analysis, (5) cost analysis, (6) business case decision, and (7) supplier selection. The seven stage process is further outlined below.

Stage 1, the initial analysis is a step in which the company identifies all of the overall objectives of outsourcing the IT department. In this step, the purpose of the program must be aligned with and support the business strategy of the company (McIvor, 2000). In this stage, the company should determine the role that the potential supplier is to carry out in order for them to be chosen for the program. (McIvor, 2000).

Stage 2 is the risk analysis of the program. In this stage, the company should analyze all of the risks it can identify and decide if the projected outcome of the program is worth taking all of the potential risks. The risks to be analyzed should include: management and staffing risks, data security risks, future risks, as well as workforce reaction and the over reliance upon one supplier (McIvor, 2000). If the company believes that the risks are minimal compared to the rewards then they can choose to move on to the next stage.

In stage 3, the company identifies a list of potential suppliers that it believes it can trust and have a successful partnership with. This should involve identifying potential sources that meet the initial qualifying criteria including quality, delivery, service and price.

Stage 4 is the capability analysis. The purpose of this stage is to assess whether or not the potential suppliers identified in stage 3 are capable of performing the roles determined in stage 1 (McIvor, 2000). This evaluation process may include the supplier's capability to cover logistics, warehousing, process design and quality systems as well as manufacturing systems.

In addition to checking the capability of the suppliers the company needs to check the costs associated with each supplier. Hence, stage 5 is cost analysis. This stage involves measuring all of the actual and potential costs involved in outsourcing the IT department; both internal and external costs should be included in this stage (McIvor, 2000).
Stage 6 is the business case decision. In this stage the company will make a policy decision in which they decide whether or not going ahead with the program is a viable option (McIvor, 2000).

If the company decides that the program will enhance their current status, they will move onto stage 7, the supplier selection. In this stage the company will assess the compatibility of the potential supplier identified in stage 5. The analysis centers on qualitative factors, both immediate concerns and the long-term ramifications associated with dealing with the source (McIvor, 2000). If the company decides that the supplier will most likely be a compatible partner, then the company may decide to go ahead with the program. However, if the company does not believe that the supplier will be a compatible partner, then the company may decide not to go ahead with the program. While this process does not guarantee the success of outsourcing a company's IT department, it will improve the chances of the program being a successful one.

Evaluation Plan

Although the outsourcing plan is a good initial step for having a successful outsourcing program, it is not the only step to be considered. In addition to the outsourcing plan, the company should also implement a continuous plan to evaluate the performance of the outsourcing program to ensure that the program runs as smoothly as possible for the entire length of the program. According to one study, most large domestic companies do not commonly evaluate the performance of outsourced IT; over 50% of these large corporations evaluate outsourced IT at random, and 15% do not evaluate their program at all (Hsu, 2005). Hsu's study goes on to state that of all the companies that do perform evaluations regularly, the most commonly used frequency is once every six to twelve months. The second most used frequency to evaluate the performance of outsourced IT is every three to six months (Hsu et al., 2005). There may not be a standard for evaluating the performance of the outsourced IT department, but it is very important for a company to perform regular evaluations in order to recognize large hidden costs and to help prevent anything that may cause the program to fail.

When evaluating the performance of the outsourced IT department, Hsu believes that the company should emphasize organizational strategy. The evaluating process should include the overall impact on the organization of the outsourced system, the consistency between "system planning and the company goal" and the "managerial system", improvements in cost saving, an analysis on the benefit of the investment, and the quality of the decision-making (Hsu et al., 2005).

When deciding the overall impact of the program on the organization the company should include looking at the morale of the employees, in addition to how the company is perceived by outside individuals, and how well the organization is performing since the program started (Hsu et al., 2005). The consistent evaluation should help determine whether or not the company and the supplier are sticking to the original program, and help identify any potential problems with it.

Hsu believes that another point that the evaluation should focus on is the improvements in cost savings. If the company is not saving the money it had planned to save, it should reevaluate the plan and identify the costs that are causing the inaccurate cost plan. Once these costs are identified, the company should readjust the costs in its program and continue to evaluate based on these new adjustments.

The company also needs to evaluate the benefits of the investment according to Hsu. The company should revisit the benefits that their plan identified and see if the current benefits are in line with the actual benefits. The benefits may not be exact, but if they are way off track, then some adjustments may need to be made in order to get them where the company wants them to be (Hsu et al., 2005).

And finally Hsu states that the company should determine the quality of the decision-making of the supplier company and the managers overseeing these companies in order to make sure that they are in the best interest of the base company.

Summary and Conclusions

A company choosing whether or not to outsource their IT department faces an extremely important decision. It is so important because if they in fact choose to outsource, and they do so unprepared or they do so when it is not in their best interest, they face the possibility of damaging their entire business. When they are making this decision, it is important that the company closely analyzes the benefits and risks of outsourcing such an important part of any business, the IT department. If the business cannot honestly say that the risks are minimal compared to the benefits that the company will receive, it is probably not the best idea for the company to outsource the department.

From a business standpoint, outsourcing a company's IT department can make a lot of sense and may be a good idea for the company. But it is important for any company that is thinking about outsourcing to develop a detailed outsourcing plan in order to insure that it is in the best interest of the company. If they in fact do decide to outsource, it is also important that they find the supplier that will be compatible with their company and create a strong partnership with the company. Once the outsourcing program is initiated, it is also important to evaluate the performance of the outsourcing program on a regular basis in order to insure that the program is not straying to far from the way it was planned to go. If the company does all of these things there is a much greater chance that they will remain on track and have a successful outsourcing program.

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