Payoff

To be effective, outsourcing must be judged purely as a business issue. This article is designed to help management determine the business case and merits of outsourcing. Whether an organization decides for or against outsourcing one or more of its IS functions, the process of examining the pros and cons of the outsourcing alternative can, in the end, foster greater IS efficiency.

Introduction

Many organizations have begun to take an interest, ranging from mild to enthusiastic, in outsourcing. The need to reduce expense, coupled with the opportunity to rid the organization of at least some aspects of the IS function, can be a powerful incentive to company executives to seriously consider outsourcing. The increased interest in the topic among clients and vendors ensures that IS managers can expect to spend more time dealing with the issue in some form in the future.

In some instances, outsourcing may improve the inadequate performance of certain IS functions, or it may offer opportunities to cut expenses. For example, the current marketing efforts of many of the leading outsourcing vendors are focused on the data center because the data center expense is a large and highly visible item. The data center is, however, by no means the only candidate for outsourcing. Systems development and integration work is outsourced by some organizations.

Correctly managed, outsourcing may improve IS operations, customer service, and credibility. However, the organization considering outsourcing should think about the potential long-term effects that can result from turning over control of the business's various IS functions—or even the entire function—to outside managers.

An organization's sudden interest in outsourcing may, in some cases, be indicative of a more basic problem or set of problems in the organization. Whatever the issues are that prompt management to look at the outsourcing alternative, an objective analysis of the source of the problem is in order. Pinpointing the problem source may present opportunities to make improvements in the organization and, in the process, perhaps eliminate the need for outsourcing.

The Long-Term Effects of Outsourcing

A typical justification for outsourcing is that a particular IS function does not appear to be an integral part of the business. Management questions the efficacy of devoting scarce resources and management effort to a function that can be fulfilled more effectively and less expensively by an outside vendor.

Although this promise of more efficient service at reduced cost is appealing, outsourcing is more complex than is readily apparent. Organizations frequently enter outsourcing agreements without proper analysis and thought.

In some situations, outsourcing is at best a short-term solution to a long-term problem. If an organization begins to outsource for the wrong reasons, its mistake may not be realized for several years. Even if the mistake does become apparent relatively early, the
customer probably has little recourse other than to abide by the outsourcing contract. The option of disputing the contract is likely to be an expensive proposition.

The long-term effects of any outsourcing agreement—no matter how appealing—must be carefully considered. The organization should examine the realistic business implications of removing the functions from its direct control. Again, these effects may not be immediately apparent and may not even surface for some time; however, the possible long-term implications of outsourcing, including all the disadvantages, must be acknowledged. **Exhibit 1** summarizes the pros and cons of outsourcing that must be fully explored before the contract is signed.

**Outsourcing Pros and Cons**
Pros

-- The organization is relieved of the responsibility for management of those IS functions that are taken over by the outsourcing vendor.

-- The outsourcing agreement should reduce expenses for the organization, at least in the near future.

-- If carried out selectively, the outsourcing arrangement allows the IS department to concentrate on the most critical issues in the organization. The sections requiring less high-level expertise (e.g., technical support and the data center) can be relegated to the outsourcing vendor, allowing the in-house IS staff to focus on applications development concerns.

-- The outsourcing contract can generate some revenue for the organization indirectly, through the sale of data center assets (e.g., disk drives and the mainframe).

-- The contract provides an opportunity to reduce the IS department head count.

Cons

-- Outsourcing removes some control of the information processing function from the IS department, which could seriously affect that department's mission-critical functions.

-- The short-term savings provided by the outsourcing contract could be negated in the future, should the organization decide to reintegrate the outsourced function.

-- The outsourcing vendor may not feel obligated to keep the outsourced function up to date and may use outdated technology to save money.

-- Outsourcing can create morals problems in the IS department, particularly if in-house employees begin to fear that their function will be outsourced as well.

-- Any contingency not addressed in the original agreement must be renegotiated. Post-contract negotiations are likely to be troublesome and costly for the client.

-- Vendor stability cannot be guaranteed.

-- Predicting the future of an organization is at best difficult, and predicting the effects of a current outsourcing contract on the basis of unknown future changes is even more difficult.

-- Hidden agendas can create a disadvantageous situation for the unwary client. The organization should exercise extreme caution when examining an outsourcing contract, paying special attention to possible ulterior motives on the part of the vendor.

One pitfall for many organizations is that a smooth marketing effort aimed at the highest level of the organization can create a climate in which decisions are made without an understanding of their practical ramifications. To forge an effective and appropriate outsourcing arrangement or to find alternative solutions for organizational problems, the decision-making process must involve those directly affected by the outsourcing. Toward this end, the IS staff must contribute actively to the solution of the problem at hand, whether or not the final scheme involves outsourcing.
The Management Issues

Although outsourcing may seem the logical solution for cost-related problems, other measures to resolve problems can be taken before outsourcing becomes a necessity. For example, facing up to the issue of poor management in the data center (or any other IS function) and taking the appropriate action to strengthen management may be a much better solution in the long term than outsourcing. Outsourcing should not be undertaken as a reaction to poor management in the IS department.

Furthermore, sometimes the problems associated with the performance of the IS function have more to do with factors outside the department than within it. There may be a lack of interest in and attention to the function at the senior management level. The difficulty may stem from strong resistance to change on the part of the departments the IS function is attempting to serve. In short, the causes of dissatisfaction with information processing may be beyond the control of IS management. If that is the case, it is questionable that the introduction of outsourcing will bring about much in the way of improvement.

Under certain conditions, however, outsourcing may prove to be the most efficient solution to an organization's information processing needs. For example, an organization may find itself with a growing backlog of requests to make enhancements to existing production systems. If the level of both technical and business knowledge is so low within the IS department that little or no progress can be made without a dramatic increase in staff, the organization may discover that the most it can do is move to a set of packages that would eventually replace the existing systems.

Managing both a greatly accelerated maintenance effort and the movement to a portfolio of new packaged systems to run a large portion of the business would require additional talent. In this example, outsourcing the enhancement backlog may clear the way for movement to the new systems with the existing staff. Therefore, IS managers should realize that outsourcing is not inherently detrimental to the IS department.

The Role of IS Management

Developing a knowledge of outsourcing issues sufficient to be able to present relevant issues to senior management in a businesslike manner is only part of the IS management team's responsibility. The team must also be able to formulate a plan to address those issues that an outsourcing contract proposes to solve. If IS management perceives that the improvements targeted by outsourcing can be addressed in-house, the team must be prepared to provide workable alternatives to the outsourcing contract.

The vendor, who wishes to capture an organization's outsourcing business, will likely talk about the issues of service levels and problem and change control. The members of the IS management team must also be able to address these issues.

Because many organizations may not view IS as a mainstream business function, IS managers must be prepared to counteract this attitude from senior management. The IS function is indisputably critical to the business; relinquishing control of the function, no matter how attractive it might appear to the organization's business managers, must be approached with caution.

Senior management may see the role of IS management, in light of the outsourcing decision, as a purely defensive stance. Although this may not be the case, objections raised by IS managers can appear to be protectionist. To overcome this hurdle, the IS group must build the strongest and most realistic case possible, which it should present in an unemotional manner. If outsourcing does not make sound business sense, that case should
be developed and presented; conversely, if aspects of outsourcing are appropriate and in the best interests of the organization, they should be recognized.

**Developing a Counterplan for Keeping IS In-House**

When building a case against outsourcing, the marketing and business skills of IS managers will be tested to the extent that they find themselves dealing with experienced sales and marketing people who have probably negotiated contracts in the past. The IS department might, given the staff’s relative inexperience, consider using an outside party to help present its case. A consultant to assist in the development of the case can bring a different perspective to the issues. In addition, someone with strong marketing skills could be particularly effective in convincing the organization's senior management to retain the work within the IS department.

It is in the best interest of IS management to develop a plan for those areas in which outsourcing seems inappropriate. Outsourcing may prove to be more beneficial in some sections of the department than in others, yet decisions about these areas should also be made by the installation's management, not by an outside party. This is particularly important when the outside party has a vested interest in the outcome.

**Presenting the Alternatives to Outsourcing**

A plan to improve efficiency by keeping IS work in-house should include a strategy to address the issues that have been identified. The scope of this effort must be stated in order to understand what needs to be accomplished on the part of senior management. Each component of the plan must be assigned a priority so that those pertaining to the business issues can be addressed immediately. Details must be provided about the required human resources and other expenses required to accomplish the plan's goals. A schedule that is based on the items identified and the priorities assigned in the plan should also be devised to lay out what is to be accomplished and when.

When this preliminary work has been completed, IS management should present its plan to senior management. The IS management team must assure senior management that it can deliver what is required and acknowledge that its performance is to be measured against what it has proposed in the plan. IS management must further commit to specific objectives developed as a result of the issues identified. Some examples of objectives might include:

- A reduction of information processing expense (e.g., of 3% of the existing budget) without a reduction in current processing service levels to be implemented within six months of approval of the plan.

- The establishment of a joint application development (JAD) process to improve the manner in which applications systems are developed and implemented to take effect within four months of the plan's approval.

- The establishment of a set of well-defined customer service levels for the data center operation. This could include:

  - Network response time goals.
- A reduction of total production jobs rerun in a month to a certain percentage of all production jobs.

- Improved response time to all help desk calls and the resolution of 95% of all calls within five working days.

The installation of a concise applications project management and reporting and control system to identify all approved projects, their completion dates, and current status.

If, after examining the conditions that have created the need for improvement, outsourcing is judged to be the most effective solution, specific decision points should be developed so that a series of tests can be conducted throughout the vendor selection process, both to define how specific items are to be addressed and to determine whether the answers provided by the vendors are adequate and realistic. The success of the outsourcing venture depends more on the management and negotiation skills of the customer than those of the vendor. Everything must be in writing, clearly spelled out and fully understood by all the parties to the agreement.

Outsourcing Technical Support

In many instances, a reasonably strong case can be built to support outsourcing IS technical support. Although this function is important to the continuing operation of the business, its operations do not have to be performed entirely by the organization's employees or conducted wholly on site at the particular location. In addition, there is usually a limited business relationship to the function. The work is technical and is, with limited variation, the same in all organizations.

There are sound business reasons for considering outsourcing the technical support function. Technical support personnel, who are expensive, can be difficult to find and retain. Because of the common characteristics of the work within the structure of a particular operating system, the skills of the individuals are readily transferable. In addition, because much of the work can be accomplished from a remote location, having several people on site may be unnecessary.

Three factors that should be considered when an organization contemplates outsourcing technical support are training, service, and control.

Training

Because effectively managing the technical support section is difficult for many organizations, transferring the function to an agency with the appropriate management skill and experience could prove to be a sound decision. Training is expensive and must be ongoing to remain current with the changing technology. Some organizations, unwilling to make the required training investment, allow the technical support function to lag behind; consequently, morale suffers because employees are not able to continually upgrade their skills.

Improved Service

In addition to the more obvious benefits of reduced cost and simplification of the associated personnel issues, outsourcing can improve service levels. If the chosen outsourcing vendor has a competent and experienced staff, these staff members will introduce new techniques and approaches. Extensive experience with several organizations is a factor that should recommend a vendor to an organization.
Assigning Control
If an organization decides to outsource its technical support function, it should consider the issue of ultimate control over the function's operations. Although technical support is not a mainstream business function, the decisions regarding the use of technology cannot be made outside the organization. The vendor should be encouraged to offer suggestions and present proposals, but final decision-making authority must remain with the IS staff. To meet this need, some members of the IS department must stay current with developments in the operating software world. As an alternative, an independent consultant could be engaged to periodically review the work plans of the technical support outsourcing vendor. Control, regardless of the function being outsourced, must be recognized as a prime consideration. Relinquishing control could pose serious problems for the organization. If the vendor retains too much power, the consequences of the contract can be disastrous to the organization. Discovering that control resides in the inappropriate hands after an agreement has been reached will not help the organization much. If all power is held by the outsourcer, it may prove difficult and expensive to raise the levels of service provided by the vendor. Particularly in the context of data center outsourcing, which is discussed later in this article, the contract must be regarded as a long-term arrangement.

Understanding the Outsourcing Agreement
If an organization decides to further explore an outsourcing arrangement with an outside vendor, it should take every precaution to safeguard its operations against all possible contingencies. Although most vendors want to render high levels of service to their outsourcing customers, they may hesitate to raise issues that might jeopardize their chances of obtaining a contract. In addition, they are not likely to raise issues that will make management of the contract more difficult after it has been signed. The customer therefore must be attentive, careful, and knowledgeable. The burden to protect the organization rests with the organization, not with the vendor.

Contract Negotiations
Members of the IS management team who may become involved in the negotiations with outsourcing vendors must perform the necessary detail work to develop the best contract. Nothing should be left to chance: anything that can affect the processes involved in the outsourcing contract must be analyzed, and the implications resulting from actions with regard to these processes must be clearly understood. After these areas have been identified, the contract should be written to preclude future problems. This can be an onerous task, but it is necessary.

Should a dispute arise, the vendor will rely on the language of the contract to settle the debate. IS managers cannot rely on a handshake or a verbal agreement to work out the details at a later date. Usually, after an agreement has been reached, the original vendor representatives are replaced by technical or operations managers. These managers have a different perspective and set of interests from those of the salesperson; as a result, the relationship between the organization and the vendor may change. During the negotiating stage, IS managers must consider all the details and ensure that all conditions are stated in writing.

All too often, organizations make decisions in response to strong sales pressure from vendors. There are many instances of sales made at some level above the IS department—these situations frequently become IS nightmares. Even sales made at the IS department
level can ultimately deliver much less than the original agreement seemed to promise. Caution in these areas must be exercised by both business and IS management.

The organization should consider seeking assistance outside the managerial group when examining the outsourcing contract. Consulting legal counsel and seeking outside assistance from another organization are actions that can significantly help preclude contract problems.

**Legal Expertise.**

To avoid disadvantageous situations caused by unclear wording or legal loopholes, the organization's attorneys should carefully review the outsourcing contract before proceeding with the agreement. IS managers should not ignore the legal expertise provided by these attorneys, which is to their benefit to follow.

**Outside Assistance.**

The organization should ensure that the contract is formulated so that the vendor can deliver the services promised in the agreement and earn a profit. If the vendor, whether through inexperience or some other reason, has agreed to conditions that do not allow it to cover necessary costs, the vendor may renge on the stated services in the future. Organizations would be well advised to consider consulting someone with experience in outsourcing contracts to avoid creating this situation. Although every contingency cannot be anticipated, taking this precaution is a prudent approach.

**Outsourcing the Data Center**

When an organization seriously considers outsourcing its data center, one crucial aspect of the contract is the way in which service levels will be set and monitored. Another important point is determining what will occur in the event of a dramatic change in the workload or setup of the data center. The organization must also ensure that the contract addresses increases in outsourcing fees. These and other considerations are discussed in the following sections.

**Setting and Monitoring Data Center Service Levels**

The question of service levels to be rendered by the outsourcing contract has a decided impact on the efficacy of the data center. The organization should determine what penalties, if any, to charge if the outsourcing arrangement fails to meet the agreed-on service levels. An organization that has a set of service levels in place that it is working to strengthen may be managed well enough to determine its own service levels. By contrast, organizations without an adequate understanding of service levels may be at the mercy of the vendors in defining the data center's performance standards.

If an organization has not clearly defined its own service requirements, it may encounter difficulty in its dealings with the vendor. The vendor's presentations concerning service levels and the benefits the vendor can provide will likely sound appealing to senior-level executives of the business. When these promises of improvement are coupled with the ability to reduce data center expense, the interest of the business executives will be heightened. A vendor who presents a contract without defining service levels implies the absence of problem-tracking and change-control agreements. In this case, a business executive who is unfamiliar with data center operations may perceive such agreements as
offering considerable savings in hardware maintenance charges. The organization should beware of such agreements, which are usually much more desirable in theory than in practice.

**Anticipating Changes in Data Center Work Load**

The organization should define the effects of a change in the work load of the data center on the outsourcing fee. The organization must determine whether (and by how much) the outsourcing fee will be affected by an increase or a decrease in the load.

Similarly, the organization should ask who will define the work load and the criteria for determining the change in fees. In addition, it is important to ascertain whether the appropriate fees have been clearly addressed in a schedule or left for later consideration. These factors must be clearly understood and discussed before the contract is signed because they may make the difference between the organization's receiving a fair amount of services for the fees charged and paying too much. Senior management must recognize the inherent risk connected with a dramatic work load increase in the data center processing schedules. Although an increased work load will most likely be accommodated by the outsourcer, it is not advisable to allow the vendor to determine the increases in the charges, especially on an ad hoc basis.

For example, an insurance company with an outsourcing agreement in place decides to expand to three new states in the following year. This change is estimated to increase the online processing load by 30% and the batch processing load by 15%. If such a situation has not been anticipated and adequately addressed in the contract, a difficult condition may arise—although the new states may be accommodated, the organization may have no choice but to process the work generated by these states through the outsourcing vendor.

Given this scenario, in which the circumstance has not been thought out in advance and covered in the contract, the vendor controls the important decisions concerning the organization's information processing operations. Even if the outcome is of no particular consequence, the inherent risk is too great to leave to chance.

**Controlling Fee Increases**

The organization should ensure that the contract contains a provision to cap annual increases in outsourcing fees. An organization cannot expect to retreat from any type of outsourcing agreement—and data center outsourcing in particular—without undertaking some expense. The vendor is going to take steps to protect itself against the effects of inflation; the organization must likewise guard against inordinate or inappropriate expenses that are left to the vendor's discretion.

**Provisions for Downsizing the Data Center**

Radical equipment changes and downsizing efforts can wreak havoc in an organization when plans are not made before the contract is signed. Downsizing deserves considerable thought.

Many people working in mainframe environments have strong feelings against downsizing, a sentiment that is based largely on the fear of losing their jobs. That concern, though perhaps unjustified, is understandable. Downsizing is nonetheless becoming increasingly popular, particularly as an expense-reduction strategy, and should be recognized as a possible eventuality. The organization should ask questions regarding the possible need to move to a new hardware platform and who makes the decisions about the
equipment. The organization should question whether it will have the option to downsize and, if so, at what cost. The vendor's experience in downsizing should be determined as well as any possible ulterior motives. The vendor may be unenthusiastic about downsizing if the move is not in the vendor's best interest.

For the outsourcer, a downsizing effort is likely to be attractive as a means to reduce outsourcing costs. However, if the organization does not want the outsourced function to be downsized and the outsourcing vendor disagrees with the decision, the organization may find itself at the mercy of the vendor.

Senior management must be made aware that moving to a different hardware platform, whether a different vendor or smaller hardware, is by no means a small or risk-free task. If the outsourcer decides arbitrarily to make such a move, the consequences to the organization could be unfortunate. Unless the contract is very clear in this area, the majority of the risk is going to rest with the customer, not with the outsourcer. For example, a contract may state only that the vendor will provide information processing hardware sufficient to accommodate the processing requirements of the customer. Further, the contract may contain a clause stating that the customer is liable for any expense incurred by the vendor's decision to convert to different equipment. It is the responsibility of each organization to safeguard against such incidents by thoroughly examining its situation and the outsourcing contract.

### Use of Old Technology

Should the vendor propose to use old equipment to cut costs, the client must be able to determine whether such a change will be advantageous to the organization. It can be argued that the outsourcer is seeking to fatten profits by continuing to use old technology well past its useful life. In such an event, the customer could end up having to depend on a collection of obsolete and inefficient equipment.

In addition, there are competitive considerations. The continued use of obsolete technology might preclude the organization from entering new business areas or being able to match competitors' new product or service offerings. The expense of upgrading the technology might turn out to be prohibitive, regardless of the benefits to be derived.

Another issue has to do with the particular vendor chosen for the process. Some hardware vendors who have entered the outsourcing business may require that clients use their products. Such a contract could require that any and all subsequent hardware (and software, if applicable) decisions about the course of growth or change be based on the vendor's products. This may or may not be acceptable to the organization; however, the ramifications must be carefully weighed.

### Reintegrating Outsourced Resources

In some instances, an organization may need to bring an outsourced function back into the organization. This contingency should be acknowledged and planned for during the initial contract considerations. Because outsourcing is a service in which the vendors usually have more experience than their customers, IS departments that outsource often fall into difficult situations caused—at least partially—by their incomplete understanding of the implications of entering a contract. For example, the vendor, in an attempt to obtain business, might underbid a contract, which it later finds itself unable to honor, or a vendor may after some time decide to withdraw from the outsourcing business because it no longer seems practical.
In addition, an organization's circumstances change. What effect will the old contract have on the newly changed organization? The majority of outsourcing contracts being written today require long-term commitments, and it is difficult to predict changes in an organization's configuration in five or six years—not to mention in a decade or more.

**A Lesson from the Past**

Some years ago, several organizations found themselves facing unanticipated problems and loss when a large third-party vendor of mainframe hardware failed to support its product. In those instances, difficult as they may have been, the losses were limited to hardware expense and some legal fees. Prospective outsourcing clients should heed this example. Should a similar fate visit the customers of an outsourcing supplier, the resulting losses could be much more severe, depending on the extent of the particular arrangement. Rebuilding an entire data center function could be a monumental task, and rebuilding a large-scale IS function quickly enough to smoothly resume operations might be nearly impossible. Again, the short-term gains must be carefully weighed against the potential risk.

**Protective Measures**

Although the costs of keeping a function in-house may seem to outweigh the risk of an outsourcing vendor's default, the possibility always exists that an outsourcing vendor may be unable to support a contract. Some important issues must be thought out to protect the organization should the vendor renege on its agreement. For example, if the organization finds it necessary to bring the outsourced function back in-house, it should determine how the transition back to in-house processing, or to another outsourcing vendor, will be handled.

Before the contract is signed, a series of potential situations, or business contingency plans, should be drawn up to highlight for the organization the negative impact of a vendor default. The customer must carefully consider the issues involved and then protect the interests of the business to the greatest possible extent.

**Necessary Expense.**

In the event of a default, the customer is certain to encounter additional expense. The organization should ensure that the contract obligates the vendor to cover such expense. Should the vendor default, obtaining compensation at that time will probably be impossible; therefore, the organization should ensure that some sort of protective provision exists in the contract—for example, protection might be provided by an escrow account.

**Conclusion**

Outsourcing can be regarded as either an onus or a challenge. Although outsourcing may be an inappropriate plan of action in certain cases, simply investigating this option can be advantageous to an organization by causing the organization's employees to examine their own effectiveness and productivity.

An outsourcing investigation can encourage managers of the IS department to look carefully at the way the function is being managed. This investigation, in highlighting areas for improvement, can help improve the organization's operations without the need for
outsourcing. The investigation can, for example, identify those areas of operation that are redundant, unnecessary, or wasteful.

The investigation can also indicate those organizational functions that are performing efficiently. Turning the outsourcing investigation into a positive challenge should be an incentive to IS managers to approach the process with an open mind. Whether or not an organization decides to outsource a particular IS function, a well-conducted analysis of all aspects of outsourcing as it relates to the organization can produce positive results.

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