Outsourcing IT: Views from the Vendor's Side

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Abstract

This research will examine the risks and issues facing Information Technology (IT) companies in fulfilling their obligations in an IT outsourcing contract, and how these can be managed to achieve the desired outcome for all parties. The focus is on the business processes an IT company needs to successfully deliver the services it has contracted to supply together with the risks and issues facing the outsourcing supply company in successfully implementing these processes.

Keywords

IT Outsourcing, IT Service Management, Vendor's Perspective, Case Study

INTRODUCTION

Outsourcing of IT is not new. In the early days of computers, many companies purchased computer time from external computer bureaus, or contracted out data processing to such bureaus. These types of outsourcing were popular because of the huge capital and operating costs involved in the early computer systems. As the technology improved and the costs of computing came down, these types of business arrangements declined. However, the IT outsourcing phenomenon re-emerged in the late 1980's in response to the merger, acquisition and globalisation activities of that era (McNurlin & Sprague 1998, pp. 236-237).

Today, IT outsourcing is a significant part of the IT landscape and increasingly so. Lacity & Willcocks (2001) predicted that the world market for IT outsourcing would be $US120billion in the year 2002, growing to $US150billion by 2004. The Australian share of this business is particularly robust. Macrae (2002) quoting sources from International Data Corporation (IDC), says the Australian market for IT outsourcing will be worth $A5.1b in 2005.

Clearly, IT Outsourcing is a phenomenon that industry observers believe is here to stay. But what is the rationale behind it? Why do companies choose to outsource IT operations? Reasons can be quite varied. Hambly (2002a), cites IDC's Benson as suggesting the top three reasons to outsource are:

- to gain access to the specialist skills and resources provided
- to allow the company to focus on its core business; and
- for the cost benefit.

Aalders (2001) provides a number of other reasons why firms should consider outsourcing (one of which is not cost saving):

- it is a proven successful business process
- it allows improvements to business and IT processes that cannot be delivered by the average IT unit
- it offers better cost-management controls and certainty over costs
- it improves the quality of service
- it enables keeping pace with competitors, and
- it is a valid way of achieving cultural change.

While the case for IT outsourcing would seem to be well substantiated, the reality is that the anticipated benefits are frequently not achieved in practice. The extent that outcomes from an outsourcing contract are deemed unsatisfactory varies. Gartner (2002, p.1) claims, "Over three-quarters of IT deals fail to perform". Benson, in Hambly (2002b), says only half of Australian companies surveyed that have outsourced their IT functions are satisfied with the outcome. Lacity and Willcocks (2001) are more optimistic claiming 60% of contracts in their study met most expectations.

Obviously there are problems in determining the success rate for IT outsourcing. There is inevitably a large subjective element in this measure and each of the three sources above has drawn a different sample of companies that have outsourced their IT. However, even if the most optimistic view is taken, 40% of firms still have unsatisfactory outcomes from IT outsourcing contracts.

This is a surprising outcome, given the growing trend noted earlier towards outsourcing. Perhaps not surprisingly, the literature tends to focus on this issue and reports on lessons learned in IT outsourcing contracts. From this research, there is an emerging body of knowledge on: how to structure IT outsourcing contracts; when, what and how to outsource; how to manage outsourcing contracts; and so on.

However, this new body of knowledge:

- tends to be focused on the contractual and relationship issues with IT outsourcing,
- does not address the variability in the quality of service provided by the IT company as a factor contributing to success or failure of the contract, and
- is presented almost exclusively from the customer's perspective (Levina & Ross 1999, 2003).

"Success" or "failure" of an outsourcing contract is typically considered only from the customer's perspective and does not canvas the vendor's view. Yet, in the last two years the decline in IT spending has put significant financial strain on IT vendors. Bates et al (2003) note: "…operating-profit margins of companies in the IT services industry declined from an average of 7.4 percent in 1999 to 4.6 percent in 2002 – a 38 percent fall - valuations too have plummeted. From a peak of over 100 in 1999, the P/E multiples of the world's top 100 IT services companies fell to 30 in 2000 and then collapsed again, to 3, by the end of 2002". In a nutshell, IT services companies are hurting badly. Bates et al (2003) see a need for IT companies to reinvent their business models to survive in what they see as the new business climate for IT services.

The research proposed here will start to address IT outsourcing from the vendor's perspective and attempt to gain a better understanding of the risks and issues facing the IT vendor in an outsourcing contract. This will be of benefit to IT companies as they go about reinventing their business models to meet the new business climate.

RESEARCH RATIONALE

A preliminary review of literature on both IT outsourcing and IT service management has been carried out. The literature on IT outsourcing tends to cover the benefits and risks of outsourcing and how to go about the process of outsourcing to increase the chances of a successful outcome. Success is usually measured from the customer's perspective in terms of meeting the customer's stated objectives, or simply in terms of the customer's perception of the success or failure of the deal. The literature on IT service management tends to provide process frameworks for the provision of services within IT outsourcing contracts and to discuss issues surrounding these frameworks.

Writers in the first of these areas tend not to consider the quality of service being provided in their analysis. It is as if the researchers assume all IT companies are equal in this regard and all provide a satisfactory level of service. This is after all, what they do for a business so it is probably not unreasonable to make this assumption. However, this would seem to be a most important factor in the success or failure of an IT outsourcing agreement..

The first author recently worked for the one of the world's largest IT outsourcing companies, in a role that involved the regular review of existing IT outsourcing accounts within Australia. His experience in that company provides a different perspective to that of the industry observer and academic. While supporting the importance of the framework and environmental factors, this experience suggests the quality of service provided by the IT company, relative to that expected by the customer, is also a significant factor in the perceived success or failure of an IT outsourcing contract. In this author's experience, the quality of service does vary from account to account; and the customer's level of satisfaction and perception of success of the contract increases with the quality of service.

However, it is not simply a matter of increasing the quality of service to the point at which the customer is satisfied. Higher levels of service come at a cost to the IT company – usually in the form of additional resources that eat into the profit margin. Inevitably, there is a trade-off between the level of service provided to the customer and profit.

The IT company needs to meet this challenge by identifying the key activities it must perform to meet its obligations and to learn how to do these activities well. There is a body of knowledge in the literature on how to successfully deliver IT services with suggested processes and organisational entities identified for the IT company to put in place. But typically this knowledge is provided in isolation of the overall outsourcing framework and environment. This research will make an attempt to identify these key IT outsourcing activities, together with the risks and issues that the company typically faces in carrying out these activities, and how it might manage these risks and issues.

CONTEXT AND SCOPE OF RESEARCH

The context of this research will be from the viewpoint of the IT company focussing on what it needs to do to make an outsourcing deal work. The scope of this research needs to be clarified in terms of the types of outsourced IT activities covered, and the types of outsourcing contract

IT outsourcing covers a variety of IT activities. However this research will cover only those IT activities that are traditionally outsourced, for example:

- Operations at data processing facilities, from basic facilities to network services
- Software application development, maintenance and management
- Business recovery and disaster recovery services
- Desktop and help desk services
- Program management services
- Telecommunications and network operation.

This research potentially considers all these "mainstream" outsourcing activities. It will not address the new emerging outsourcing areas of Applications Services Provision (ASPs), and Business Process Outsourcing (BPOs).

Concerning the type of contract under which the outsourcing activities are provided, Lacity and Willcocks (2001) identify three main types of outsourcing contract:

- Fee-for-service contracts
- Strategic alliances/partnerships, and
- Buy-in contracts.

Strategic alliances/partnerships are based on the notion that the two contracting parties have more to offer each other than can be achieved through a conventional business arrangement. The relationship between the parties in these situations extends beyond the immediate IT activities.

Buy-in contracts are where a customer purchases supplier resources to supplement in-house abilities. In a sense, it is not really outsourcing but a form of insourcing.

Fee-for-service contracts are characterised by detailed contracts specifying detailed requirements, service levels, price and so on. The majority of outsourcing contracts fall into this category and consequently, are the category to be examined in this research. In the experience of the first author, despite the frequency of this type of contract, IT companies still have a lot to learn in the delivery of services under these types of contract.

PROBLEM DEFINITION

The research problem can be stated as:

Both businesses and governments are increasingly outsourcing their IT functions to external IT vendors. Yet industry analysts and academics alike are reporting on the high level of dissatisfaction with this process and researching ways that IT outsourcing might be approached to improve the chances of success. This research has tended to focus on the overall framework and environment for outsourcing – host preparation for outsourcing, the contract, selection of vendors, governance of the contract, and the like. While it is important to get the framework and environment right, it is also important that the service provider identify and master the business processes that it must have to contribute to the success of the contract.

This research will start to address the problem of understanding the importance of perceived quality of service in IT outsourcing success, the business processes that the IT company must master to provide the contracted services, and the risks and issues the IT company faces in delivering these services.

The research is based on the idea that success in IT outsourcing requires an appropriate response in each of three broad areas: the outsourcing framework, the outsourcing environment, and the business processes used by the IT service provider.

The overall objective of this research will be to identify what the IT service provider should do to successfully deliver services in an IT outsourcing contract, given a favourable outsourcing framework and environment in which to work.

Specific objectives are:

- To identify the key business processes that are required to deliver the various elements of an IT infrastructure outsourcing contract.
- To identify the risks and issues to be managed in providing these services.
- To determine how these risks and issues might be managed.

The unit of analysis for the research will be the set of business processes required by the IT service provider to successfully fulfil an IT outsourcing contract. This will be taken to mean processes for both technical and support functions – in other words, the set of activities that an IT company must undertake to successfully deliver an IT infrastructure outsourcing contract.

Delivery in an IT outsourcing contract will be considered successful when the following two conditions are met:

- The customer considers the majority of its objectives have been met, and
- The IT company meets or exceeds its revenue and margin targets.

The research question to be addressed is:

What are the business processes (both technical and support) that an IT company must undertake to successfully deliver an IT outsourcing, exchange based contract; what risks and issues does the IT company face in carrying out these activities; and how might it establish management processes to monitor and review its effectiveness in carrying out these processes?

The research issues in understanding the processes required to successfully deliver an IT infrastructure outsourcing contract are:

- Understanding the *theory* of outsourcing
    - Levina and Ross (1999, 2003) propose that the underlying theory by which IT vendors achieve cost advantages over in-house IT departments is that of the economic theory of complementarities. In essence, this means an IT vendor can develop core competencies in delivering the IT services that are better than the client would be able to develop. The relevance of this theory will be examined in each of the cases studied.
- Identifying and reviewing appropriate frameworks for the provision of IT services in an outsourcing contract
    - For each IT service studied, identifying the activities that must be carried out and understanding the skills and processes required to deliver these activities
    - Identifying activities that span the whole Account or two or more individual services, and understanding the skills and processes required to deliver these activities
- For each case, capturing sufficient information on the outsourcing framework and environment to isolate the impact of these in the analysis of the case
- Establishing a measure of success in the cases to be studied

The research issues in understanding the risks and issues facing the IT company in delivering the services are:

- Understanding the risk context of the typical IT infrastructure outsourcing contract
- Identifying risks and issues for each of the activities the IT company is required to undertake
- Analysing and assessing risks to prioritise risks
- Deciding appropriate treatments for the priority risks and issues
- Determining how these risks and treatments should be monitored and reviewed throughout the life of the contract

The research issues in developing the management processes for monitoring and reviewing the service delivery processes are:

- Identifying suitable Key Performance Indicators (KPIs) for the various activities, drawing on existing KPIs wherever possible
- Identifying suitable processes for measuring and collecting these KPIs
- Establishing appropriate processes for monitoring and reviewing these KPIs on an ongoing basis

RESEARCH METHODOLOGY

The intention of the research will be to develop propositions describing the actions needed within the IT company for IT outsourcing relationships to succeed, given a favourable outsourcing framework and environment. It is qualitative business research since it is addressing a business problem and it will be concerned with concepts rather than variables that can be quantified.

Zikmund (1997, pp. 37-41) describes three types of business research: *exploratory*, *descriptive* and *causal*. He describes exploratory research as "initial research to clarify and define the nature of a problem". Descriptive research is "designed to describe characteristics of a population or a phenomenon". And, causal research is "conducted to identify cause-and-effect relationships among variables where the research problem has been narrowly defined".

This research will be primarily descriptive. It is not exploratory since the problem under analysis is quite specifically defined. As the actions to be identified will be concepts rather than variables, the research cannot be considered as causal. However, there will be an element of causality in the propositions to be developed. These propositions will look something like: "from the cases studied, it would appear that to successfully deliver service 'x', the IT service provider must have good business processes for 'a', 'b' and 'c'."

Case study method (Yin 1994) will be the main research method followed with five cases being examined. These will be based on IT outsourcing contracts currently being delivered by an IT outsourcing company. Data for these cases will be collected by: reviewing the contract, reviewing internal company documents associated with delivery of this contract, and interviews with key staff delivering the contract.

Each case will be analysed to determine:

- the key attributes of the outsourcing framework and environment
- the success or failure of the contract, based on customer satisfaction and the financial performance of the contract for the IT company, and
- in light of the above, the key business processes required for each service delivery area under contract, and the risks and issues associated with these.

Comparisons between cases will also be carried out to identify similarities and differences between the cases. The relevance of the different IT service management process frameworks will be discussed in this analysis.

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