

# Chapter 1.3

## IT Outsourcing: Impacts and Challenges

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### ABSTRACT

This chapter provides both practitioner and academic insights into outsourcing. It begins with a review of the literature and practice of outsourcing, followed by a retrospect of its developments since the 1960s, up to present-day emergent trends such as best/smart-sourcing, rural-sourcing and business application grids. Recent legal developments are highlighted, along with their corresponding impacts. Outsourcing decisions tend to focus solely on the short-term benefits of cost reduction and service level improvement and, hence, often lack strategic direction, thus indicating the need for strategic management frameworks in the decision process. This chapter introduces a generic framework for such decision-making and highlights other strategic frameworks developed by researchers. The chapter then concludes by summarizing suggested action points that enable both clients and service providers to best

exploit the recent developments in outsourcing, in order to maintain the strategic edge in an increasingly complex and competitive business environment.

### INTRODUCTION

The term outsourcing was coined in the 1970s to describe an agreement where an external organization provides services for a client that were previously carried out internally (Cap Gemini Ernst & Young, 2003). Initially, an arrangement of necessity, and later, a major cost-cutting move, it has evolved to become a mainstream strategy in a myriad of industries.

The increasingly competitive markets have introduced further pressures to cut costs, and companies are now more inclined than ever to utilize outsourcing, which has spurred its continued growth over the past years. Reports of

outsourcing mega-deals (i.e., deals with total contract value of \$1 billion or more) are increasingly commonplace, indicating the large scale of the outsourcing market. In 2003 alone, a record number of 15 mega-deals were awarded out of the 78 mega-deals publicly announced since that of Kodak Eastman back in 1989. One of the most high-profile of these is the United Kingdom (UK) Inland Revenue organization's mega-deal with the Cap Gemini Ernst & Young consortium, involving what was reported to be the world's largest transfer of 3,500 staff in a 10-year deal worth \$7-9 billion (Cullen, 2003).

Recent statistics indicate that outsourcing is now a \$180 billion industry (Anderson, 2004), and Information Technology Outsourcing (ITO) now accounts for one-third of global IT spending (Cap Gemini Ernst & Young, 2003). The promise of massive cost savings in the region of millions is driving the trend towards more outsourcing mega-deals. However, there have been a number of failed high-profile cases, which raises questions about the potential risks involved, particularly the lack of flexibility of long-term contracts. This was highlighted by the collapse of the Bank of Scotland's (BoS) 10-year \$1.2 billion mega-deal with IBM, which was indicated to have failed because of its inflexibility to accommodate the business change following the merger of BoS with Halifax ("Bank bins £700m IBM deal," 2002).

Another trend that has been in the media spotlight is that of Offshore Outsourcing, which has gained considerable negative publicity because of the controversial connotation of job losses to the client country and the potential of long-term adverse effects to its economy. Currently, 50% of all phone calls to the U.K. National Rail Enquiries are handled by operators in India (Nash, 2003); also, IBM plans to move up to 4,700 programming jobs overseas to save costs, and HSBC will transfer 4,000 customer service jobs to Asia by the end of 2005. These statistics illustrate the extent of the trend towards Offshore Outsourcing, which is becoming increasingly prevalent in various

industries; however, there are risks associated with loss of control and confidentiality issues. In 2003, this was highlighted in a case involving medical transcription, a commonly outsourced process for the medical industry, which the University of California San Francisco (UCSF) Medical Centre had been outsourcing for the past 20 years. Unknown to them, part of the outsourced work was subcontracted to a service provider in Texas, which, without the knowledge of anyone, further subcontracted the work to a physician in Pakistan (Bagby, 2003). The arrangement went without a hitch for 18 months, until the company in Texas refused to pay the physician in Pakistan, who threatened to post the patient medical histories on the Internet if not given the back pay, thereby infringing privacy and confidentiality laws. Although short of total failure in the sense that the outsourcing arrangement was salvaged following private financial settlement with the Pakistani physician, the incident illustrates the potential risks of outsourcing.

The decision by businesses to outsource raises a number of critical issues for corporate management (Currie, 1995). To achieve success in outsourcing, companies will need to be aware of the emergent trends, understand their potential impact and utilize framework techniques for strategic management.

## **BACKGROUND**

Outsourcing is defined by Griffiths (2001) as the strategic use of outside resources to perform activities traditionally handled by internal staff and resources. Laudon and Laudon (2000) define it as the process of turning over an organization's computer operations center, telecommunications networks or application development to external vendors. Incorporating the common theme between these and other slightly different definitions, the authors define outsourcing as the third-party management of assets and resources

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