

Profitability of Outsourcing Information Technology

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Abstract

Outsourcing has become big business and a practice that is part of the standard operating procedures of most organizations. How does a firm decide to outsource and what to outsource? This paper reviews the benefits of outsourcing which include not only cost savings but more time for managers to devote to Customer Resource Management among other areas. Disadvantages of outsourcing include loss of control and several other factors. Profitable outsourcing includes 17 essential factors pertinent to reducing the risk of outsourcing: Identify the Objectives, Assess the Reasons for Outsourcing, Address Key Issues, Use a Systematic Method to Analyze Decisions, Consider All Stakeholders, Perform a Benchmark, Create a Sound Request for Proposal (RFP), Identify Responsible Parties, Understand the Outsourcer and Its Service, Recognize That Outsourcing Is Not All Or Nothing, Establish an Adaptable Relationship with the Vendor, Negotiate a Sound Contract, Implement Performance Incentives and Penalties, Establish a Process and Relationship Management Structure, Establish Objective and Measurable Performance Criteria, Train Responsible Parties, and Manage the People Issues. A sample outsourcing decision is illustrated. The bottom line: (1) Will the proposed outsourcing project make things better? (2) Is the agency currently responsible for the function or process performing as well and as cheaply as possible?

Keywords: outsourcing, customer resource management, outsourcer, adaptable relationships, performance incentives, outsourcing project management, cost and benefit analysis.

1. INTRODUCTION

At the beginning of the computer age, organizations turned to third-party technology firms to obtain contracted data processing support. The third parties, referred to as service bureaus, linked organizations into their giant and expensive computers. The

employees of the linked-in organizations timeshared their application through "dumb" terminals; the linked-in organization lacked control and did not get operational and management information in a timely manner. Additionally, the service bureau dictated use, technology, and the pace of change. The service bureau typically

charged per transaction and as an organization grew so did the cost of data processing (Barnes, 2004).

When computer hardware costs began to steadily spiral downward, mainframe, mid-range, and microcomputers became more affordable. Simultaneously, the need for immediate and onsite information management forced computer ownership for most organizations. The service bureaus became obsolete and were replaced with a commercial product market that has expanded to support highly flexible and industry specific affordable software that utilizes less expensive computer hardware (Barnes, 2004).

The advent of network and data communications technology, improved application integration, and increased speed and capacity of computer chips catapulting the executive into a very complex and fast changing environment. Words and acronyms like 4GL, concentrators, multiplexers, token ring topology, T1 lines, all part of the data processing lexicon, seemed like a foreign language to non-Information Technology (IT) executives. Many non-IT associate managers deem it too costly, frustrating, and impossible to stay abreast of all of the new data processing developments (Barnes, 2004). Is it any wonder that these highly capable executives sought relief from outsourcers whose core competency is technology management?

For most businesses, IT is not a core business function; therefore, by transferring information management and data processing to a third party, it permits the outsourcer to concentrate and promote their own core competencies. This allows the company to devote more time and resources to strategic and tactical activities.

Techies were astounded when Microsoft – the Colossal of the IT (Information Technology) world – awarded a three year contract to little known Entrex Information Systems. Entrix now oversees and maintains Microsoft's 16,000 computers and computer networks; so if a Microsoft employee has a problem with a personal computer, laptop or network, an Entrex employee responds to provide technical support (Jones, 2004). Microsoft, the giant of giants in IT innovation, "outsourced" its hardware support and

maintenance to a third party. Why? What advantages and disadvantages were considered in the decision to outsource? What were the quantitative and qualitative aspects of the decision? What are the cost benefits of outsourcing? What additional issues must be addressed? All questions to be answered.

"Outsourcing" is one of those fashionable buzzwords that evolved from the 20th century; it can be described as the strategic use of outside resources to perform tasks traditionally done within the organization or "in-house". Changing technology and a need to constantly implement new IT solutions has made the outsourcing investment the single biggest cost variable in many organizations (Shah, 2004). Results are crucial in today's highly digitized world; IT is a key ingredient in the recipe for corporate success.

In 2000, according to research conducted at Gartner Dataquest, businesses spent \$373 billion dollars in outsourcing. Three years ago, it was estimated that \$833 billion would be spent in the year 2005 on IT outsourcing (Computel, 2001). According to a study published by CIO.com, over 60% of the private sector companies outsource one or more IT functions (Moss, 2002). Outsourcing is a continuing trend and on its way to becoming a multibillion dollar business. How does a company assess whether outsourcing would be beneficial? The assessment must be performed on a case-by-case analysis and requires consideration of minuscule details. Knowing the history of outsourcing may offer some insight.

2. BENEFITS OF OUTSOURCING

Outsourcing is becoming known as a stimulator for higher levels of innovation throughout business practices and technology; it enables companies to utilize their resources to better promote their competitive advantage. An increasing need for IT solutions has made the investment in outsourced--information management based systems the single biggest cost variable in the corporate budget; thereby, the choice of the outsourcing partner is vital (Shah, 2004).

On the average, executives spend only 20% of their time managing customer relations and promoting their business, the remaining

80% is spent managing the details of their business and business processes. Employing an IT service provider enables executives to gain control over their time, promoting opportunities to explore new revenue streams and customer focus (The Network Connection, 2004). "Executives view outsourcing not as an alternative but as a necessity. The ultimate goal of outsourcing is providing superior products and services to customer and/or client" (Bard, 2004).

Staff Scalability and Elimination of Costly Employee Issues

Reducing head count and eliminating costly employee issues such as recruitment, retention, security, and turnover are often cited reasons for outsourcing. IT personnel are highly skilled; the average cost of an IT employee is \$150,000 annually (Salary \$60,000 + benefit and overhead multiplier of 2.5). Their skills are specialized and expensive. Furthermore, recruiting is costly, the Information Technology Association of America claims that at one time over 200,000 information technology jobs are vacant in the United States; companies can't find people with the needed skills (Ohio University, 1999). Recruiting IT specialists is expensive and requires access to unique resources. Eliminating excessive IT staffing costs enhances the existing resources. Eradicating these issues often entices executives to pursue outsourcing, however, downsizing is costly, so additional considerations are a must. Thorough studies must be completed to determine the feasibility of outsourcing with respect to human resources.

A Skilled and High-Quality Resource Pool

IT is a non-core business process for most companies. By outsourcing IT, a company is employing an organization whose core competency is information management. The contracted organization is better qualified to manage infrastructure, processes, equipment, and security. Experience and economies of scale render the contractor best qualified to maximize IT opportunities and minimize the cost resulting in a strategic advantage to those who engage in outsourcing as a provider or user of outsourcing.

Benefit of Shared Resources

Communications, IT hardware, and IT software is expensive, beyond the budget of many businesses, especially small businesses and non-profit organizations. Use of an outsourcer permits organizations to utilize resources economically beyond the company's capacity.

An excellent example: An internet-based business requires a certain amount of Internet capacity to process its average monthly capacity; however, at Christmas time the business requires additional Internet capacity for accepting and processing orders. The equipment to expand the businesses capacity is expensive and seasonal, thus, the business employs an outsourcer to expand its capacity. Sharing infrastructures is extremely beneficial to customers. Customers share data centers, Ethernet and fiber channel switches, disk, tapes and even firewalls. Each of these components is costly, expensive to maintain, and out of the reach of many businesses and nonprofit organizations. Through a third party vendor, businesses and nonprofit organizations have access to sophisticated infrastructure (Rosenthal, 2002). Use of an outsourcer expands the resources available to corporations.

A Broad Range of Technology Skills and Expertise

The proficiency of an IT establishment is to maintain computers and IT systems. An IT establishment that contracts with businesses to be an outsourcer becomes a profit center not a cost center. This difference allows the outsourcer to attract and train high caliber employees (Rosenthal, 2002). Additionally, there are many new innovations in the information management field; changes and developments are frequent and constant. It is difficult to stay current with the frequent advancements in IT, but a necessity if companies are to survive and maintain a competitive advantage (Ohio University, 1999). Outsourcing resolves the problem of an ever-changing technology world and enables the executive to focus on promoting his core competencies.

Process Standardization, Automation, and Risk Reduction

The vendor invests time and money in developing and testing its processes; it becomes an expert regarding the process. The vendor exploits their expertise; thereby, offering stability and continuity in a constantly changing technological environment. The seller has standardized the process throughout the various organizations and across platforms; automating the process and limiting the number of systems to reduce the complexity of the infrastructure. This is beneficial when upgrades or enhancements are required.

Outsourcing reduces risk. Because IT is the focus, contractor is well acquainted with security issues, privacy issues, and regulatory issues and able to implement and execute the necessary requirements with the latest technological innovations.

Because technology is constantly changing and evolving, implementations often become obsolete soon after installation. Outsourcing reduces these risks and transfers this burden to the vendor.

Twenty-Four Hour Support and Monitoring

Outsourcers are flexible with service arrangements. They will take over and occupy a company's data center; relocate the data center to the vendors facility; manage the software and develop new applications; purchase the necessary hardware and or software; obtain the services of employees with the needed skill sets; or variations of these and other options. Any of these options can offer 24-hour support, internal and external monitoring, elimination of unanticipated system problems and system interruptions. It transfers this burden to the vendor.

Capital Cost Savings and IT Budget Stabilization

Twenty-one percent of firms' outsourcing decisions are aimed at solely cost reduction (IT Convergence, 2003). Outsourcing reduces upfront cost of ownership, hardware and software warranty and maintenance expenses, direct labor cost of IT staff, and training expenses of IT staff and system users (Business Management Applications, 2003). In-house information management can be taxing on a data processing budget

due to unanticipated personnel expenses or technology demands. Moving the computer operations to a third party could eliminate the frequent trips to finance committees, boards, and others that expend funds. Savings realized from successful outsourcing may then be invested in new products and services.

Refocusing the Company's Resources on Its Core Competencies

Companies want to spotlight their core competency; they do not want to become entangled and waste time performing task disadvantageous to those competencies. Outsourcing does not automatically replace the client's capabilities with the vendor's superior capabilities; however, it allows the client the opportunity to exploit the vendor's proficiencies (Singh and Walden, 2003).

IT outsourcing has become one of the most significant management practices to develop from the previous century. Firms now consider outsourcing a strategic activity. Although the benefits are substantial, disadvantages to subcontracting do exist.

3. DISADVANTAGES OF OUTSOURCING

Displaced Employees

Outsourcing sometimes results in job losses, especially in cases where reducing head count is the objective. Plans for redistribution of jobs should be implemented whenever possible, training and relocation of employees may be needed. Extreme caution must be exercised regarding displaced workers, company morale and public opinion. Contracts should include, whenever possible, the absorption of displaced workers by the vendor. The cost of displaced workers both quantitatively and qualitatively must be figured into the cost analysis performed when outsourcing is considered as an option. Poor morale and stress are consequences of outsourcing. Organizations outsourcing IT often must deal with unexpected cost such as lower productivity, added sick leave, and poor quality work. The cost of displaced workers and the effect on company morale may exceed the benefit of the outsourcing project.

“Married for Money” Syndrome

A company that outsources because of price is most susceptible to this syndrome. Similar to the person who marries for money, hence the name, a vendor-client relationship can end badly if cost savings is the sole driver in the relationship. The reason often is that the parties involved failed to build a strong professional relationship. The outsourcer selected the vendor considering price only and failed to establish a good business rapport. Outsourcing strictly to reduce internal costs structure very likely will lead to this syndrome. Establishing a sense of partnership with mutual trust and open communication is the best way to avoid the “marrying for money” syndrome (Jones, 2004).

Loss of Business Wisdom

When knowledgeable staff people are eliminated or absorbed by the vendor, the accumulated know how and business knowledge goes with that staff member. Attempts in the future to return the process in-house will not have the benefit of key personnel with the needed knowledge on staff. Because knowledge is non-quantifiable, organizations fail to value this asset. The retention of corporate wisdom should be taken into account when considering the issue of outsourcing (Gorman, 2003).

Loss of Control

An outside vendor cannot match the responsiveness and service level provided in-house. The vendor is not subject to the same management direction as the outsourcing business. The contract is the key to loss of control. It must be flexible enough to support contingencies, yet solid enough to insure that the outsourcer’s interests are protected. To maintain control, the contract should include clear guidelines and address the following issues in the service level agreement: successful job completion rate, 24-hour response time, help from field help desk, and timely project completion. Most control issues are the result of lack of information.

Dealing with these measures lessens the burden of control. Control problems are reduced if the vendor and client communicate

and establish a mutually beneficial partnership promoting each other’s success. Outsourcing exposes a company to possible abuses, related to errors and irregularities – issues that must be addressed in the contract (Moss, 2002).

Escalating Costs Due to Poor Choices

Performing a successful benchmark to have a comparable facet for measuring helps to determine the baseline cost. Realistic and true costing without distortion is a requirement. Developing multiple scenarios and comparing internal cost to contract specified cost for a variety of situations would clarify the choices and the cost of each choice. Careful consideration of each scenario would offer a better feel for the contract’s needed flexibility. The flexibility of the vendor and the client is reflected in the flexibility of the contract. On the other hand the contract must be specific and sound in regards to the agreement details. There is a fine line between beneficial flexibility and required expectations; thus, enlisting professional counsel with previous experience negotiating outsourcing contracts is suggested.

Vendor Unable to Deliver

Delivery expectations must be explicitly detailed in the contract. A timeline agreed upon by both parties should be tackled within the contract. In addition, day-to-day deliveries and expectations should also be spelled out in the contract. Penalties should be imposed according to guidelines established in the contract.

Risk and Reversibility

Contracts usually require a company to commit to services for an extended time period, if the outsourcer is not satisfied with the service it could be difficult to break the contract. It will be costly to reverse the situation and return the service in-house. The contract should include contingencies for dissatisfaction. In most cases, the company has no choice but to locate another vendor, which could be a costly venture. Thus the company may find it less expensive to stay with the service it is dissatisfied with. Clear expectations and specifications within the contract will reduce this risk.

Communication Problems

Expectations of service quality must be very explicit. Establishing a partnership between vendor and client is the best possible means to achieve this objective. An open flow of information between companies with a commitment to share knowledge capital and a definition of measurement criteria for the objectives are absolute necessities to insure the outsourcing project is a success. Communication failures are the biggest contributor to outsourcing project failures (IT Convergence, 2003).

Language barriers are often present in the case of outsourcing, especially offshore outsourcing. The authors' personal experience contacting support personnel with outsourcers in partnership with various companies has resulted in difficulty understanding instructions due to language barriers. In the case of offshore outsourcing, the language and culture obstacles must be dealt with; failure to do so will increase the risk of misinterpretation of commitments (Bard, 2004).

Timeliness

The outsourcing process is a challenge regarding timeliness. Anytime additional levels are added to the infrastructure time becomes an issue, a third party vendor adds an additional layer. Reports must be delivered in a manner to be available to the client in a timely manner. Many delivery problems are resolved as a result of the Internet or capacity to transfer files electronically. This may be problematic in that it requires additional security, reliability, and liability. Precise timelines must be procured during the contractual phase and contingencies for delivery failures must be broached.

Reduced Competitive Advantage

The core competency of the vendor is in contrast to the core competency of the client. The strategic objective of each organization is to promote the business. Failure to agree on the big picture and alignment of strategic objectives between client and vendor predestines the project for failure. Additionally, the company that uses the third party vendor increases the possibility over the long run of losing its basic understanding of its data processing needs and what im-

pact that understanding has on its competitive edge. A company's IT should evolve, improve, and add value to the company. A company considering outsourcing should ask itself, will this be better for my customer.

Public Relations

Vendors should be evaluated on their professional competence and compliance to the provisions of the Code of Professional Conduct. Unethical practices by contracted vendors reflect on the clients who contract them (Miller and Anderson, 2004). Downsizing as a result of outsourcing can also be a public relations (PR) nightmare. Outsourcing has become symbolic of unemployment; thereby a sensitive subject for companies seeking to reap the cost benefits and avoid the political and consumer fallout. Journalist, Erika Morphy of CIO Today quoted from a study done by Forrester Research that by 2005, 240,000 IT jobs will leave the United States. This geopolitical matter has not reflected favorably on outsourcing. In fact, this issue has become a political lightning rod and potential for bad public relations. "Bad PR will force companies underground into an offshore witness protection program," quotes Morphy (Morphy, 2004).

Outsourcing is a long-term commitment and not a quick fix to solve an internal management predicament. The investment is not strictly a monetary issue. Successful outsourcing requires a significant amount of time. The average contract takes 1518 months to negotiate and the industry has experienced a 45% failure rate (Bard, 2004). Companies considering employing a third party vendor for information management must recognize that additional consideration beyond economics must be measured. They must quantify the advantages and disadvantages based on the computing environment and company culture.

4. ESSENTIAL FACTORS FOR PROFITABLE OUTSOURCING

A deep--rooted fear of entrusting corporate assets to outsiders is valid. The outsourcing project success rate is only 55% (Bard, 2004). The majority of outsourcing arrangements have to be renegotiated -- 1 in every 8 contracts is prematurely terminated

as an expensive failure (Singh and Walden, 2003). The use of vendors to perform data processing activities is growing rapidly. It is viewed as a way to achieve strategic goals, reduce costs, provide efficiency, and improve effectiveness. It is not free of risk and requires meticulous management. Reducing the risk is central to the success of the project. Addressing the following factors is pertinent to reducing the risk.

Identify the Objectives

Outsourcing should be considered cautiously, methodically and with definitive goals. Companies must determine what they intend to gain from outsourcing, both tactically and strategically, from a department level to an organization level. Outsourcing must be justifiable, never an excuse to wash management's hands of a poorly managed, costly, or misunderstood function. Determining if a function should be outsourced requires that management know the costs of the function throughout the entire organization and how the function is managed. Failure to be well acquainted with the function will give the vendor an unfair negotiating advantage. The outsourcing question requires well-defined goals with precise objectives; failure to thoroughly research the options may result in a contractual battle, or worsen rather than improve the situation – both very costly (Jones, 2004).

Assess the Reasons for Outsourcing

Examine the strategic advantages and disadvantages for hiring a vendor to oversee IT. Especially weigh the disadvantages of losing command of the resource, losing key personnel with specialized knowledge or skill, and unavailability of the resource cross-functionally. Recognize that outsourcing does not mean the abdication of management's responsibility for a burdensome function (Jones, 2004). Deciding whether or not to outsource is a difficult decision; failure to adequately evaluate the reasons augment the possibility of failure.

Address Key Issues

The evaluation process should answer questions such as:

- What are our core competencies?

- Which services or functions are not an integral part of our core competencies?
- Is the decision congruent with our corporate culture?
- What are the cross functional impacts?

The answer to these questions and others will help answer the ultimate question "Is outsourcing the answer? Does it fit into the organization, and will outsourcing make things better?" (Jones, 2004).

Use a Systematic Method to Analyze Decision

The outsourcing decision warrants numerous steps such as: identifying requirements, preparing and distributing request for proposal (RFP), reviewing bids, evaluating vendors, negotiating contracts, and implementing the project. Consider dividing the project into various phases for manageability:

Consider All Stakeholders: Managers should be able to predict the impact of contracting out their IT. Those impacted include stockholders, customers, suppliers and employees.

For example, news of an impending outsource arrangement may affect the stock price in a positive or negative way, based on whether the project is perceived as an indicator of organizational trouble or benefit.

Customers and suppliers interest must be considered, their privacy and the privacy of their customers and employees is monumental and subject to legal action if not protected. Employee impact is enormous; morale, productivity, efficiency, attendance, and effectiveness can be influenced. After anticipating the outsourcing impact on the stake holder's, managers should take into account these issues in the outsourcing plan (Jones, 2004).

Perform a Benchmark: Determine how good or bad the situation really is; put a stake into the ground and understand the state of affairs. A company should weigh the pros and cons by looking at the present and the future five years down the road. Understanding the present cost structure is required in order to assess the profitability

of the outsourcing deal, comprehension of future cost structure is also necessary. It is vital that a company grasp what they are dealing with (Moss, 2002).

Create a Sound Request for Proposal (RFP): The key element to the RFP is establishing the project scope. It should be explicit in establishing resources and expectations, terms and conditions, rules of engagement, bid process, negotiation process, rules and guidelines. The RFP is the first step in the vendor-client relationship; it is the basis for the success of the outsourcing project (Moss, 2002).

Identify Responsible Parties: Who will take leadership responsibility, perform analysis, and make decisions? The persons involved in the decision process depend upon what is being considered for outsourcing. An executive sponsor is advised and, based on the scope of the project, may require input from top management. Smaller projects usually require only middle management support.

The evaluation team should include management talent, technical talent, user representatives and members with previous outsourcing exposure. Previous experience is most beneficial; it can offer insight into unexpected costs and cost realism. Outside consultants may also be necessary. Smaller teams are typically more effective; the size of the team may enlarge as analysis begins.

Once the decision to outsource is confirmed, someone must oversee and manage the arrangement and vendor relationship. It is critical that the interaction between the vendor and the project team maintain continuity throughout the entire process starting at the ground floor. This stability contributes to the projects success.

Understand the Outsourcer and Its Service: Recognize that vendors aggressively pursue corporations to adopt outsourcing. Managers and project analysts should not be misled by pricing schemes casually offered by the vendor. After the field of vendors is narrowed to a handful, more specific pricing and service agreements can be negotiated, those negotiations will limit the number of vendors to two or three

eventually leading to a final deal based on the best offer.

The actual price structure is the result of negotiations based upon the specific requirements. *Close scrutiny is a must.* Most outsourcing project failures are the result of not assessing the scope of the project properly, and failing to recognize the added cost for non-negotiated expectations. Consulting an unbiased advisor with outsourcing expertise may be extremely helpful with the negotiations and may level the playing field (Jones, 2004).

Recognize That Outsourcing Is Not All Or Nothing: Outsourcing comes in many shapes and sizes. It is a continuum from total outsourcing (responsibility is transferred from the client to the vendor) to minimal outsourcing the sum of which is substantially less than total outsourcing. The stakes are high and a considerable amount of money is usually involved. These deals are normally structured to long term. Vendors profit on economies of scale and yield the best margins on long-term arrangements. In the interest of the outsourcer, contracts should be kept short to maintain flexibility and allow for technology, processes, and business advancements. Thus it drives home the point that outsourcing should not be taken lightly and negotiations can be long and tedious (Jones, 2004).

Establish an Adaptable Relationship with the Vendor: Contracting relationships range from market-like relationships to joint venture relationships. A market-like relationship is defined by a choice of many vendors, short-term contracts, and ease of ending relationship; the project is fairly simple and straightforward. A joint venture relationship is defined as long term, mutually beneficial, performing as a partnership, and involves complex projects. In the middle of this gamut is the intermediate relationship. Choosing the wrong relationship may result in excess costs or project failure (Jones, 2004).

Negotiate a Sound Contract: There are many critical components to a good outsourcing contract. There should be no winners or losers, every aspect should be governed by the contract and agreed on by both the client and the vendor. The negotiators

must cover all contingencies including how to resolve conflict. The agreement should not be open-ended and should delineate who, what, when and where of conflict resolution. The manner in which employees are handled during the outsourcing process and contract loopholes may result in lawsuits. Hence, legal advisers should be involved in the contract negotiations.

The terms and conditions of the contract impact the degree of accountability that can be expected from the vendor, and require proper scoping of the project at the onset (Jones, 2004).

Implement Performance Incentives and Penalties: Provide incentives that encourage the vendor to exceed performance expectations with bonuses and penalize the vendor for failure to perform.

Establish a Process and Relationship Management Structure: Provide in the contract a relationship management structure between the client and vendor, possibly a joint management team responsible for day-to-day and strategic aspects with defined responsibilities, agenda, and frequencies of meetings (Jones, 2004).

Establish Objective and Measurable Performance Criteria: Focus on results--objective, measurable, quantifiable, and comparable to a preset yardstick established during the benchmarking process. These metrics must be quantifiable and collectable at a reasonable cost and benchmarked against other vendor's performance within other organizations (Jones, 2004).

Train Responsible Parties: Applicable to both the client and the vendor alerting all interested parties to the sensitivity needed to fulfill the client's need.

Manage the People Issues: Communication is critical to a successful evaluation. Measures to ensure successful communication include establishing a hotline to control the rumor mill, new releases and newsletters and meetings to insure the right message is distributed. Keeping everyone informed reduces malcontent, which is especially critical if the client's employees are to become the vendor's employees. This is very important because the employees, although employed

by someone else, are still responsible for the process output. Individuals who feel they have been mistreated will have the power to bring systems down.

Additionally, the user community has a right to know, they should be provided with contacts and an issue resolution process. They should not be overlooked.

Consideration for the stockholders is also an aspect; prudence for their interest and need to know is another facet. Keeping people informed every step of the way is important (Jones, 2004).

Outsourcing is a mammoth undertaking, and requires painstaking analysis. A company's failure to do their "homework" will result in failure of the outsourcing venture.

5. PROMOTING OUTSOURCING PROJECT SUCCESS AND AVOIDING THE PITFALLS

No one wants to fail nor sets out to do so. Keeping in mind some guideposts may avoid potential problems when approaching the outsourcing question.

- Be realistic in estimating projected savings.
- Create an explicit Request for Proposal (RFP).
- Analyze all pros and cons.
- Quantify the value of qualitative aspects as much as possible.
- Consider outsourcing on grounds other than cost savings.
- Contemplate the outsourcing decision based upon the strategic advantage it can offer.
- Establish flexibility within the contract.
- Include quantifiable performance measures in the contract.

The outsourcing decision should be approached by looking beyond the cost benefits, at the changes in the nature of service provided. With public and private organizations constantly restructuring and pursuing additional strategic advantages, innovation is becoming the key to survival. Thereby outsourcing is emerging as a strategic issue.

For an example of outsourcing cost-benefit analysis, see the case of the Windmere Neighborhood Association in the Appendix.

The case presented in the appendix exhibits the cost analysis of an outsourcing decision; although very simple, it offers a measurement of the cost considerations in an outsourcing decision. Because of its simplicity it doesn't require the many contemplations of a more complex outsourcing project.

6. CONCLUSION

There are some fundamental principles that should be involved in the Outsourcing decision. IT outsourcing is not inherently good or bad. Those in favor of outsourcing are those that have had positive experiences with outsourcing and those against it have had negative experiences with outsourcing. Outsourcing has advantages and disadvantages. The decision requires that essential factors be considered and certain pitfalls avoided.

The bottom line: (1) Will the proposed outsourcing project make things better? (2) Is the agency currently responsible for the function or process performing as well and as cheaply as possible? Making things better means better service level at same price or same service level at better price. Companies considering outsourcing must do its homework in order to properly answer these questions. That homework entails determining the project scope; identifying the resources; determining the service levels measured in every single category, specifically those that add value; analyzing cost (true costs), creating a sound RFP, and negotiating a rigorous contract. The diligence devoted to that homework will be reflected in the success of the project.

There is a continuing trend toward more IT outsourcing. Outsourcing offers potential benefits; however it also involves risk. Creating a win-win scenario between the vendor and client will improve the success rate of the outsource project. Outsourcing must be used as a management tool that promotes strategic and tactical activities. Companies look to their systems to manage information to benefit the organization's purpose, and constantly search for ways to enhance that

system. Each company must answer for itself how the systems should be structured to optimize benefit and do so cost effectively. Every venture should offer cost reduction, improved service, better quality management, and superior productivity levels. The cost, quantifiable and non-quantifiable, of acquiring the information should not exceed the value of the information.

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APPENDIX

Cost Benefit Analysis of Windmere Neighborhood Association

The following is a cost benefit analysis (CBA) for an exclusive neighborhood association in Peoria, Illinois. It exhibits some of the cost issues involved in the outsourcing dilemma. Because of the simplicity of the outsourcing in this example, it is not required that every issue in the outsourcing question be addressed.

Windmere Neighborhood Association (not the real name) manages a small recreation facility available to its residents who pay membership dues. The recreation facility includes a pool, picnic area, playground, snack bar, party room, and grille/bar. The association receives its funding from membership dues, snack bar proceeds, party room rental proceeds, grille/bar proceeds and a grant from the local Parks and Recreation Department. The budget for Windmere is \$192,000 annually. The staff of Windmere Neighborhood Association consists of one fulltime manager, 1 fulltime assistant, 1 fulltime groundskeeper, and 2 fulltime cooks; members of the association on a volunteer basis assume additional duties. The following is a demonstration of a cost benefit analysis that has been performed for the Windmere Neighborhood Association and addresses some of the cost issues to be considered in deciding the profitability of outsourcing. The names contained within the cost benefit analysis have been changed at the request of the parties involved.

Executive Summary

The Windmere Neighborhood Association (WNA) manages the recreation facility that is contained within the Windmere community on behalf of the members of the association. Membership in the association is required of all residents in the Windmere community; membership is available at various levels based on access to the different venues. Venues include a park with picnic and playground area, swimming pool, snack bar available during pool hours, grille/bar available evenings only, and party room available on a rental basis to members only.

WNA must perform a software upgrade to its ASI software that is used by WNA to manage its food service; these periodic upgrades are required as established in the service contract signed by the WNA when it purchased the ASI package. In order to upgrade three personal computers and one server, memory must be purchased for the personal computers to accommodate the required memory space for the upgrade. Dreck Associates of Peoria, IL (not the real name) agreed to perform the installation and upgrade at a significantly reduced rate, they also offered to price the memory significantly below retail price. It was determined that the estimated hourly rate was significantly reduced compared to the standard market price of software installation/upgrades.

It is recommended that Windmere Neighborhood Association employ Dreck Associates (Dreck) to perform the upgrade and purchase and install memory at a total cost of \$1,216.50. This ASI system is critical to maintaining the food service at WNA and the upgrade is a requirement of the service contract. Moreover, the upgrade will improve ASI performance and personal computer performance. The use of Dreck to perform the upgrade of software and memory will reduce ASI downtime, provide a warranty for the service, and reduce the cost of the memory purchase and installation.

Introduction

The Manager of Windmere Neighborhood Associates requested the study. The study was conducted by one of the authors, on a volunteer basis. Dreck provided the estimate. The analysis began on June 1, 2004 and was completed on June 16, 2004.

Scope and Purpose

The purpose of the study is to assess the feasibility of employing Dreck versus in-house staff to perform a software upgrade to the ASI Food Service system. The following are the requirements of the upgrade:

1. Purchase three 64MB memory chips
2. Install three 64 MB memory chips
3. Perform personal computer Microsoft updates
4. Perform ASI server upgrade
5. Perform ASI personal computer upgrade

Methodology of the Study

Dreck will estimate the cost of the memory purchase and agree to provide the memory at a significantly reduced rate, below retail, and to perform the upgrade at a reduced rate. Dreck was asked to submit a formal estimate and include warranty data. All staff members were interviewed to assess the possibility of performing the upgrade in-house and ASI personnel were interviewed to gauge time requirements.

Recommendation

This report provides data and cost savings of \$256.85 provided WNA employs Dreck to install memory in 3 personal computers, perform personal computer updates, perform ASI server upgrade, and perform ASI personal computer upgrades. These savings are realized in staff time, ASI software downtime, memory cost savings, and warranty cost. To achieve these savings, WNA should employ Dreck to purchase the memory, perform the personal computer updates, and upgrade the ASI software on the server and personal computers.

Justification

In-House Install and Upgrade performed by current staff manager		Dreck	
Price of memory + tax (per PC)	\$ 74.55	Price of memory + tax (per PC)	\$ 67.10
Total price of memory	\$223.65	Total price of memory	\$201.30
Estimated number of hours for memory install and updates per personal computer	3.5	Estimated number of hours for memory install and updates per personal computer	2.5
Total hours for 3 personal computer upgrades	10.5	Total hours for 3 personal computer upgrades	7.5
Hourly rate (per In-House Hourly Rate Chart below)	\$ 19.94	Hourly rate (per estimate)	\$ 30.00
Estimated number of hours for ASI server upgrade	4.0	Estimated number of hours for ASI server upgrade	1.5
Estimated number of hours for 1 ASI personal computer upgrade	3.0	Estimated number of hours for 1 ASI personal computer upgrade	2.0
Total hours for 3 personal computer upgrades and 1 server upgrade	13.0	Total hours for 3 personal computer upgrades and 1 server upgrade	7.5
Total hours for memory upgrade and ASI upgrade (Total of hours in bold)	27.5	Total hours for memory upgrade and ASI upgrade (Total of hours in bold)	16.5

In-House Salary Value Rate: Annual Fringe Benefit Rate and Annual Overhead Cost Rate provided by the WNA accountant					
Title	Annual Salary	Annual Fringe Benefits (Rate = .3245)*	Annual Overhead Cost (Overhead Rate = .12)**	Burdened Cost ***	Hourly Cost ++
WNA Manager	\$ 28,055	\$ 9,103.85	\$ 4459.06	\$ 41,617.91	\$ 19.94
WNA Assistant	\$ 25,168	\$ 8,167.02	\$ 4000.20	\$ 37,335.22	\$ 17.89
* Annual Salary * Annual Fringe Benefits Rate ** (Annual Salary * Annual Fringe Benefits Rate) * Annual Overhead Cost *** Annual Salary + Annual Fringe Benefits Rate + Annual Overhead Cost ++ Burdened Cost / 2087					

Additional Charges		
Charge	Cost	
	In-House	Dreck
Cost to perform Managers Duties while manager is performing upgrade. (WNA assistant salary * 4 hours) ++	\$ 71.56	\$ 0.00
Cost to enter Food Service data after upgrade is complete and system restored to production (WNA assistant salary * number of hours required to perform upgrade)**	\$420.42 ^^^	\$295.20 ^^^
Note: The required time is an estimate based on the amount of food service activity during the upgrade. ++ Estimated number of hours for assistant to perform required duties of manager during upgrade. ** During upgrade all food service will be maintained manually with the use of hand written receipts. After the upgrade is complete the receipts will be entered into the system by the WNA assistant ^^^ NOTE: The upgrade down time is reduced when the outsourcing service is used		

Cost Analysis		
	In-House	Dreck
Total price of memory (3 personal computers)	\$ 223.65	\$ 201.30
Total price of memory installation and updates (3 personal computers)	\$ 209.37	\$ 225.00
Total for PC Upgrade	\$ 433.02	\$ 426.30
Direct Labor Cost for ASI upgrade: [Total of Upgrade hours (PC + ASI)] * Hourly Rate]		
Cost to Input Food Service after upgrade Completion	\$ 420.42	\$ 295.20
Indirect Labor Cost (See chart of additional Charges)	\$ 71.56	\$ 0.00
Total for ASI Upgrade	\$1,040.33	\$ 790.20
Total Cost	\$1,473.35	\$1,216.50
Note: Value of User Benefit cost not considered because the costs do not vary regardless of the option selected.		

Cost Variance

The variance in the "Cost to Input Food Service after upgrade completion" is the result of the required ASI downtime of In-house install versus Dreck install.

Additional Points: Dreck will warranty their work; however, they are not liable for the failure of the ASI vendor software.

Implementation: The 3 personal computer upgrades, the ASI server upgrade, and the ASI personal computer upgrades will occur on Monday, June 28, 2004.

Summary

The employment of Dreck to purchase, install and update 3 personal computers, upgrade the ASI server, and upgrade the ASI software on 3 personal computers will result in financial savings of \$256.85. The use of Dreck to perform the install and upgrades will offer a warranty for the service provided and shorten ASI downtime due to upgrade. Dreck will provide the memory for the personal computer upgrades. ASI will provide the software upgrade in the form of a CD.