Outsourcing IT

by

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In this technology age, businesses opt to hire third party entities to perform or manage a business function on their behalf. This enables executives to focus on the core of the business. These outsourced functions can be done in-house too, but often at a higher opportunity cost.

Economists define the true cost of doing something as the opportunity cost. Opportunity cost is the forgone benefit associated with the next best alternative. On the other hand, most people are trained to think of cost as the cash expense. However, opportunity cost deals with other important factors as well, such as time and usage of resources. These in turn, are highly effective for achieving efficiency in the desired output.

Opportunity cost lies at the heart of outsourcing. The opportunity costs of outsourced business functions are lower as compare to the in-house business operations.

The idea of IT outsourcing is similar to that for accounting or legal practice when it comes to delivering efficient results and cost savings. Moreover, free market ensures that companies to which services are outsourced are dedicated to providing excellent services in that area.

Motivation Issue

An IT organization in a bricks-and-mortar firm is always a cost center, not a profit center. In other words it is considered a support organization whose sole purpose of existence is to support key functions of the business. Therefore, an IT worker's reward is not tied directly to the company's revenues and/or profits. Even in cases where there are profit-sharing plans, an IT employee finds it difficult, if not impossible, to influence the profits of the firm. This results in misalignment of incentives between the two parties.

Employee Turnover

Additionally, it often is the case that the whole IT department is dependent on a single resource, a maverick that runs the show. This is even more important in small and medium sized organizations which cannot afford resources with overlapping and backup roles. Most small business owners do not realize this vulnerability, until one of their IT employees (and sometimes the only one) quits, and the owner is left scrambling at the expense of taking care of business. Again a huge opportunity cost.

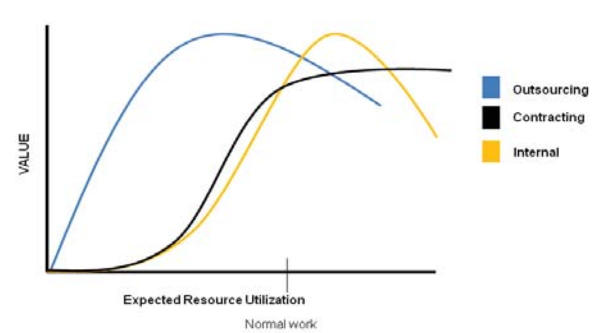
Outsourcing releases the firms so they can pay attention to more important areas of their business. Thus, improving the overall quality and increasing the speed with which their product reaches the market. Apart from that, when a company outsources its IT operations to another firm, its contract is with the firm, not any particular employee. Hence, the client becomes immune to employee turnover. Consider the following example:

What happens when John Doe, an IT employee, quits? Scenario 1: John Doe is employed by the customer firm. John walks away with information and expertise only known to John, leaving customer in chaos. Scenario 2: John Doe is employed by an IT outsourcing organization. Customer feels little or no effect as all the information stays with the outsourcing firm and the outsourcing firm sends someone else in place of John who is equally qualified.

Furthermore, the amount of time spent on managing IT employees creates another huge opportunity cost for the owner of the firm, a factor not present with outsourcing.

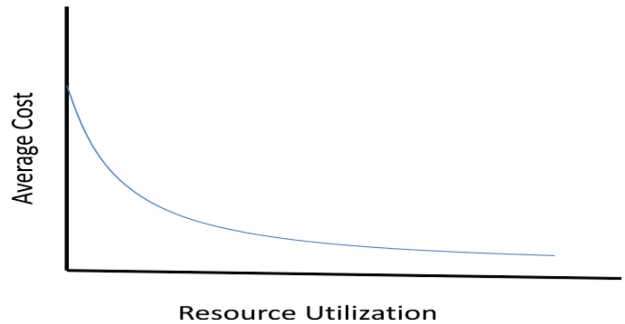
Resource Utilization

In a small business, there may not be enough work for an IT resource. Employing a resource that is only partially utilized, results in waste. Allocating this IT resource to non-technical tasks for achieving 100% utilization only tends to exacerbate the motivation problem. Employing ***jack-of-all-trades,*** as an IT resource, only costs organization more in the long run. However, if outsourced, better value could be provided without wasting resources and time. This is also visible from the graph below, where 3 options are compared, in-house using an internal resource, in-house using a contracted resource, and outsourcing.



Because outsourcing is based on expected resource usage, it delivers the best value for small to medium sized businesses

An outsourcing company, on the other hand, maximizes resource utilization across multiple clients using economies of scale that lowers the cost of operations in the entire supply-chain.



Economies of Scale

Arguments against Outsourcing

Despite the fact that IT outsourcing provides many benefits, there are instances where people have argued against it. For instance, if IT operations are part of your core-competencies and are assets differentiating your firm from your competitors, you may not want to lose your competitive edge through outsourcing, where your confidential information could be utilized by your competitors. An example of this could be IT operations supporting R&D efforts of a company. However, this can be mitigated through proper contracts and subsequent enforcement, and it really is not a problem for small companies.

Another major reason for keeping IT operations in-house is mission-critical data and systems supporting core business processes. While it may be true that company's day-to-day survival depends on this sensitive data or process, properly written SLAs and outsourcing partner's credibility could be used to mitigate such risks. After all IBM powers eBay's portal, which is the main product of eBay and also its only source of revenue.

Some companies avoid outsourcing as they believe it will affect their reputation. Despite knowing the cost benefits of outsourcing, these companies choose to do things on their own, simply because they want to send a strong signal to their customers about their ability to manage processes and data. In other words, it has less to do with the costs and more to do with the branding and ultimately revenues. A large company in the Midwest (company name intentionally not disclosed), a processor of Medicaid Claims, has chosen to build and manage its own state of the art data center. The reason given by the firm is that their clients often visit and tour their data center. When a customer is impressed by their state of the art facility, they are more likely to get business from them.

Some customers may voice concern that too much dependency on an outsourcing organization increases their switching cost, which allows the IT firm to get away with increasing their prices as time goes on. While this may be true, in principle it is no different than having internal IT staff. Again, this risk can be mitigated through a properly written contract, which caps yearly increases in fees and obligates the vendor into facilitating knowledge transfer if the client wishes to switch companies. Keep in mind that a vendor is always an entity that can be held legally accountable for the interest of its client. The same goes for employees, but they do not have deep enough pockets for their employers to hold them legally accountable in most cases.

Conclusion

According to Forrester, IT outsourcing has become the key driver of the business world. The overall IT outsourcing business turnover worldwide is approximately $120 billion per year, estimated by Forrester. It has grown exponentially over the years and continues to grow. **[1]** Apart from that, Gartner, a famous technology research company, had recently stated that worldwide market of IT outsourcing grew by 7.8% in 2011. The total revenue of worldwide IT outsourcing for the year 2011 was $246.6 billion which in 2010 was $228.7 billion. **[2]**

While there will always be some companies that will find comfort in in-house IT operations, it remains generally true that those that capitalize on outsourcing with the right partners, reap tremendous benefits. In conclusion, IT outsourcing, when executed properly, can provide the following benefits:

- Improved focus on strategic objectives
- Reduction in overall cost of operation (including opportunity cost)
- Faster response times
- Access to latest technologies and best practices
- Reduction in personnel risk

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Reference

1. *Ross, Christine F., Bill Martorelli, and Paul Roehrig. "Forrester." Topic Overview: Outsourcing. Forrester, 08 Apr. 2008. Web. <http://www.forrester.com/Topic Overview Outsourcing/fulltext/-/E-RES45576>.*
2. *"Gartner Says Worldwide IT Outsourcing Market Grew 7.8 Per Cent in 2011." Company Press Releases. N.p., 7 June 2012. Web. <http://companies.mybroadband.co.za/blog/2012/06/07/gartner-says-worldwide-it-outsourcing-market-grew-7-8-per-cent-in-2011/>.*

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