PITFALLS OF OFFSHORE IT OUTSOURCING

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ABSTRACT

Companies are resorting to offshore IT outsourcing in numbers that have never been seen before. However, organizations that do not thoroughly and objectively evaluate the ramifications of incorporating outsourcing into their business models are unlikely to achieve expected benefits of offshore IT outsourcing. This paper presents a discussion of various risks associated with offshore IT outsourcing including outsourcing contract, scope, security and privacy, loss of knowledge, hidden costs, and post-outsourcing.

INTRODUCTION

Although outsourcing has generally been embraced as an integral component of corporate strategy, particularly during today's recessionary times, it cannot be viewed as some kind of universal panacea. Entrusting the enterprise information systems to a third party overseas involves great consideration and a recognition of the risks associated with this strategy. In every step of the outsourcing process, there are inherent risks that must be mitigated if a firm is to achieve outsourcing success. Although there are numerous risks involved in an IT outsourcing deal, many firms do not carefully evaluate them [26].

Firms expect to reduce their overall IT costs, focus on their core competencies, and gain superior technical resources through outsourcing. However, without careful considerations of various risks associated with global IT outsourcing, any gain in the above areas can be more than offset by significant losses not only in financial terms but also in the areas of individual privacy, data security, and the enterprise knowledge among others. This paper identifies and discusses the main critical risk factors that must be taken into consideration by the organizations engaging in global IT outsourcing contract.

AREAS OF OUTSOURCING PITFALLS

A thorough understanding of various risk factors that must be taken into account in the decisions to outsource overseas would significantly reduce the pitfalls of offshore IT outsourcing. Following presents a detail discussion of various categories of these risks.

The Contract

Without question, the single most important component of any outsourcing deal is the contract. It describes the services that a vendor is being paid to provide, discusses financial and legal issues, and "becomes the blueprint for the life of the agreement" [15, p 54]. Because the contract obligates the firm and the vendor to each other, extensive efforts must be taken to ensure that every detail of the outsourcing arrangement is spelled out in the contract [2]. To avoid pitfalls of IT outsourcing contracts, the following major items must be identified and carefully addressed:

1. ***Service-Level Agreements:*** SLA's prevent service degradation in crucial areas such as response time by obligating the vendor to perform at a specified level while still meeting the firm's lower cost expectations [22].
2. ***Provisions for Non-Performance:*** Outsourcing contracts must establish provisions such as cash penalty, problem detection procedures, and bi-partisan committee for dispute resolutions [18, 22].
3. ***Baseline Measures:*** The baseline represents specific services that are accounted for in the outsourcing contract, and for which the customer and vendor have arrived at a financial agreement. It is important to specify obligations of the firm and the vendor beyond the baseline threshold [2].
4. ***Contract Length:*** The time-span of outsourcing contracts is generally long-term; many multi-million dollar contracts extend beyond 10 years. Research, however, has found that short-term contracts, generally less than four years, reduce uncertainty and achieve a higher level of cost savings [19].
5. ***Flexibility:*** As businesses expand and regress, system requirements such as functionalities, technology, and integration are likely to change. If the vendor's flexibility regarding "change-of-character" and added functionalities are not properly addressed in the contracts the firm may end up paying significantly more than it expects when requiring necessary changes [18].
6. ***Vendor's Standard Contract:*** Vendors often provide a standard contract that they offer as a carrot to expedite the tedious negotiation process. The problem with such contracts is that they favor the vendor and do not include any performance standards or penalty clauses [20].

Data Security and Individual Privacy

There are a variety of privacy and security issues concerning offshore IT outsourcing which may have negative consequences if they are not addressed properly by all parties involved. Literature on privacy and security is abundant and ranges from ethical and legal issues [2, 8, 9] to international arrangements and government regulations [11, 21, 35]. Although the literature has covered these issues throughout the past several decades, the recent surge in IT outsourcing on the one hand, and the ever increasing electronic flow of information on the other hand, have intensified concerns in the area privacy and security.

Without a careful considerations related to safeguarding employees' and customers' privacy, and securing the corporate information assets, any gain in financial terms can be offset by significant losses in individual privacy and data security.

Outsourcing Scope

Once outsourcing is considered an appropriate strategy, the issue turns to the question of what IT functions to outsource. The classical example of Kodak outsourcing deal of 1989 involved an approach whereby a great bulk of its information technology was turned over to three vendors. This approach which generally represents at least 80 percent of the IT budget is termed "*total outsourcing*" [20]. Total outsourcing deals have been burdened with problems that range from failed promises by vendors, to complaints of a loss of alignment between business strategy and IT. To mitigate the risks associated with total outsourcing, *selective sourcing* is often considered. Research has found that firms employing selective sourcing strategies reach their IT outsourcing expectations more frequently than those that use total outsourcing [19].

Loss of Enterprise Knowledge

Outsourcing entails displacement of employees; some take early retirement or are laid off, some are moved to the vendor site and eventually assigned to other assignments, some accept another job elsewhere, and many others who may feel uncomfortable or threatened by the newly signed outsourcing agreement [1]. The result could be a serious blow to the firm's pool of in-house IT talent and overall enterprise knowledge that includes, but not limited to, strategic and process knowledge [29].

Hidden Costs

Firms that fail to properly assess various hidden costs later learn that their expected savings have been eroded or completely wiped out [3, 4]. These hidden costs include: intangible costs of vendor search and deal negotiation [24], cost of services beyond baseline service [20], transition costs [8], and post-outsourcing costs [13].

Post-Outsourcing Transition

In an ideal scenario, once a company makes the decision to outsource to an IT vendor, the ensuing relationship is permanent. However, a firm may finish a contract with one vendor and choose to sign on with a different one. Such a transition involves the same risks and costs that the company faced when it outsourced initially. Alternatively, an organization may decide "in-source" and rebuild its internal IT department. In addition to reacquiring physical resources previously transferred to the vendor, the firm must also obtain IT expertise [13]. Many IT outsourcing arrangements transfer employees from the customer to the vendor. If the firm later chooses to reintegrate IT activities internally, it must be prepared in recruiting and maintaining a proficient IT staff.

SUMMARY AND CONCLUSION

Many organizations are engaged in offshore outsourcing of their IT activities in various degrees and for many reasons including cost, shortage of IT talents, quality, and tax incentives among many others. Without a thorough assessment of various risks involved in offshore outsourcing of IT activities, however, any benefits may be offset by significant losses due to various risk factors and missed opportunities. This paper presented major risk factors that must be taken into consideration when deciding to outsource IT activities offshore. However, further research is needed to gain a better understanding of the significance of these risk factors.

NOTE: Full paper including tables, charts, and references are available from the author upon request.