Chapter XIV

A Framework for Evaluating Outsourcing Risk

Merrill Warkentin, Mississippi State University, USA
April M. Adams, Mississippi State University, USA

Abstract

This chapter provides a framework for evaluating and mitigating the risks associated with IT outsourcing projects. Outsourcing projects have been met with successes and many failures. The causes of such failures must be systematically investigated in order to provide managers guidance to avoid future risks from outsourcing projects. This chapter discusses the outsourcing relationship, highlighting the primary causes of project successes and failures, then offers a framework for evaluating vendor relationships to avoid contingencies that may lead to failure. The authors hope this framework will serve as a guide for managers of firms seeking to outsource various IT functions, as well as managers of vendor firms who seek success in these relationships.
Introduction

Outsourcing is the process of transferring or reassigning the operation and management of certain functions or activities from an internal group to an outside entity. Typically, the organization will delegate noncore operations to the external subcontractor or vendor, yet it often involves transferring a significant amount of management control to that vendor. Outsourcing goes beyond simple supply chain transactions in which a firm purchases products or services from an external vendor. It is a more closely coupled interaction in which the parties engage in extensive communication and coordination and which relies on an enormous amount of trust.

Any business function or activity can be outsourced, but most outsourcing experiences involve the transfer of design, production, and various services. It is unusual that a business will outsource all of its IT support, but it is not unheard of. Generally, businesses outsource IT projects that cannot be handled in-house. Most outsourcing relationships are between only two parties; in this chapter, we will call the company which outsources its work the client, and the one that does the work, the vendor.

Outsourcing has commanded extensive attention in the academic literature and the popular press over the last decade as many firms seek to benefit from hiring partner firms to provide certain nonmission critical products and services. Within the information technology (IT) arena, outsourcing has been particularly prominent as an issue for management consideration. IT managers have outsourced a variety of IT-related functions and activities, including development, maintenance, helpdesk activities, storage, database servers, data entry, and even strategic IT planning.

In the U.S., domestic outsourcing of IT related activities, which began as early as the 1960s, has focused on services and facility management and progressed to total solution in the 1990s (Lee, Huynh, Kwok, & Pi, 2003). The issue rose to prominence with the Kodak outsourcing deal with IBM, signed October 2, 1989, which permanently changed the rules of IT strategic management (Loh & Venkatraman, 1992). Before the Kodak project, large companies maintained their own IT support functions. It was unheard of to entrust IT to a vendor. Kodak changed all that to help legitimize outsourcing, and CIOs’ attitudes changed as well. Miraculously, outsourcing became about core competencies, cost savings and strategic partnerships with IT service vendors. The precedence was set and within a decade, outsourcing has exploded into a global industry.

Was it all smooth sailing? Actually Kodak made some mistakes — its arrangement with DEC, for example, proved highly unsatisfactory. Kodak had to transfer to IBM as soon as contractual terms allowed. However, Kodak also did several things right. For one, it established at the start a relationship management
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