REDUCING INFORMATION SYSTEMS COSTS THROUGH INSOURCING:
EXPERIENCES FROM THE FIELD

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ABSTRACT

Information Systems (IS) sourcing continues to be a topic of great concern to both IS professionals and senior management. While a number of articles and books discuss the pros and cons of outsourcing, little has been written about companies that evaluate outsourcing but choose insourcing. Do companies actually achieve the cost savings proposed in the insourcing bid? This question prompted the study reported on in this paper. Fourteen in-depth case studies of companies choosing insourcing over outsourcing were studied to assess the implications of this choice. The results paint an interesting pattern of cost reductions but mixed reactions to these savings. Insourcing ‘success’ turns out to be a more complex notion than the literature suggests. Two conclusions emerge: the first is that the perception of success is related not solely to financial outcomes, but rather to the values and beliefs of different stakeholder groups, including senior management, business unit managers and users, and IS managers. The second is that senior management’s perception of success is primarily based on IS’ cost-competitiveness relative to the market, rather than service excellence. We suggest future avenues of research pertaining to the identification of meaningful practices for shaping senior management’s perception of IS.

1. INTRODUCTION

Senior executives and IS managers are questioning whether information services can be delivered more efficiently, and in particular, at lower cost (Kambil, et al., 1993; Feeny, et al., 1992; Applegate and Elam, 1992; Jarvenpaa and Ives, 1991; Earl and Feeny, 1994). No doubt the Kodak outsourcing “success” story has triggered this growth of interest (Applegate and Montealegre, 1991; Loh and Venkatraman, 1992b, Ang, 1993). In 1989, Kodak turned over the bulk of its IS operations to three outsourcing “partners”. This event signalled an important change had occurred in the "sourcing" of IS activity and led to numerous other Fortune 500 companies jumping on the outsourcing bandwagon (Lacity and Hirschheim, 1993a).

IS outsourcing is of interest today because of the dramatic change in the decision domain. Although outsourcing has been an option since the dawn of data processing, the IS services market during the 1950s through the mid 1980s primarily offered single-function contracts comprising a small portion of the customer’s IS budget. Thus, most Fortune 500 companies built large internal IS departments, using the IS services market only for select IS activities, such as time-sharing, payroll, contract programmers, management consultants, or development of a particular system.

Today, sourcing options are much more varied and involve larger portions of the IS budget. While some companies still follow the traditional model of exclusive use of internal IT functions, other companies have opted to sign ten-year, multi-million—even multi-billion-dollar outsourcing contracts with external providers, such as JP Morgan, British Aerospace, British Petroleum, Continental Airlines, Continental Bank, Enron, General Dynamics, McDonnell Douglas, and Xerox. In addition, a host of control mechanisms has evolved to govern these sourcing options; companies establish IS departments as separate companies, sign joint ventures with outsourcing vendors, contract-out entire IS functions for a fixed monthly fee, and engage strategic partners to share IS risks and rewards.

Reflecting practice, academic research in the area of IS outsourcing is also flourishing. A conclusion consistent across much of the research stream is that organizations can cut IS
costs by outsourcing. This message comes through very clearly in the research of Willcocks and Fitzgerald (1994), Loh and Venkatraman (1992a), and Peak (1994). Among the academic research however, some dissension toward outsourcing can be seen. Lacity and Hirschheim (1993b), for example, criticize the position that outsourcing is the preferred vehicle for reducing IS costs. The authors suggest there is often little that an outside vendor can provide (regarding cost savings) that can not be provided internally. If this is accurate, practitioners should question the value of outsourcing, considering instead whether cost savings can be obtained through insourcing. This unexplored “insourcing” option provided the motivation behind our research: to investigate organizations that chose insourcing over outsourcing.

The paper proceeds as follows. First, we describe the two phased research project which looked at IS sourcing. Phase one focused on the outsourcing evaluation process. Phase two, looked at organizations who implemented their insourcing choices. Second, we present the findings of those companies who adopted insourcing. Third, we discuss the issue of ‘success’, noting that financial outcome is not necessarily a good descriptor of success. Success is dependent upon particular stakeholder perspectives.

2. RESEARCH DESIGN

The purpose of the research was to develop an in-depth understanding of the organizational IS sourcing decision making process. This includes the nature of the evaluation process -- what lies behind how an organization makes an IS sourcing decision; the reasons why the decision was made; who was involved in the process; how the decision was actually made and implemented; and what the effects of the decision(s) were. The issues associated with the choice of an IS sourcing strategy are often murky, hidden behind euphemisms, perceived differently by different stakeholder groups, and generally not easily analyzed nor understood.

Because of the difficulty in developing an in-depth understanding, we felt it necessary to adopt a multiple case study approach (Yin, 1984). This approach was deemed appropriate given the fact that: (1) it was not possible to tightly control the research variables nor for the interactions between them; (2) events were often currently unfolding that shaped the overall outcome of the sourcing decision; (3) different stakeholders likely had different agendas which were played out during the course of the sourcing evaluation process; (4) historical antecedents needed to be taken into account to appreciate the decision context; and (5) key actors were available to be interviewed. Case studies also allowed us to explore different stakeholder perspectives on how their organizations made IS sourcing decisions as well as what they thought the resulting consequences were. The choice of the individual case studies was based on the notion of “theoretical sampling” (Glaser and Strauss, 1967; Applegate, 1994). This is where the researchers select a number of cases representing polar extremes that enable comparison across important aspects of the decision domain. The two domains we focused on were: (1) apparent financial outcome of the sourcing decision (cost savings achieved vs. no cost savings achieved); and (2) IS size in terms of hardware environment (greater than 150 MIPs vs. less than 150 MIPs). While the reason for choosing the first domain is obvious, the second needs some elaboration. It was chosen because the outsourcing literature suggests that due to economies of scale, vendors can provide less expensive IS services. Hence we chose large and small data center sites in our case studies.

The research project commenced in January 1991 initially as an in-depth study on outsourcing evaluations. In the first phase of the project, which ended in December 1992, thirty-six senior executives, IS managers, and IS staff from fourteen companies were interviewed about the process and consequences of their outsourcing decisions (see Lacity and Hirschheim, 1993b for details). One lesson learned from the first phase was that outsourcing appeared to be a symptom of the IS managers' failure to demonstrate the value of IS within their respective organizations. Outsourcing was felt by senior management as the best way to overcome poor IS performance: it would lead to cost savings. Although vendors could (and did) reduce costs in a number of organizations studied, most of the policies that were used to
drive down costs were simply that: strategies not technology advantages. Vendors were able to offer lower bids based on efficient management tactics rather than on economies of scale. This was inconsistent with the outsourcing literature which portrayed the vendor as possessing an intrinsic cost advantage, viz. economies of scale. Intrigued by these first cases, thirty additional participants were interviewed in 1993 and 1994—one site was revisited and seven new case studies were conducted—to analyze companies who decided to insource instead of outsource their IS. The second phase of the project focused on the following four research questions:

- Can an internal IS department replicate a vendor’s strategy for reducing IS costs?
- If so, why has it not done so in the past?
- Does an IS department actually reduce costs after winning an insourcing bid?
- If so, how did IS achieve cost savings?

As implied above, the choice of the organizations asked to participate in the research project was not done randomly. The choice was typically made on the basis of pre-established contacts with targeted companies who had recently gone through an IS sourcing evaluation, and where this evaluation exercise was thought to be “interesting”, i.e. where useful lessons could be learned. Thus, the case participants for the research were opportunistically selected. The fact that the cases were not randomly chosen was felt to be a strength rather than a weakness. Pettigrew (1989), for example, suggests that cases should be treated as unique contexts; organizational decisions are assumed to be embedded in the history and social processes of the organization. Such a view stresses the importance of the temporal interconnections of the past, present, and future.

Pettigrew (1989) notes that multiple case studies are best characterized as "planned opportunism". For organizational researchers, he offers the following advice: (1) go for polar types; (2) go for high experience levels of the phenomena under study; and (3) increase the probabilities of negotiating access.

The first point—go for polar types—allows researchers to determine if processes are similar (or different) over a variety of situations. For this reason, companies that decided to maintain an internal IS department, as well as companies that decided to outsource were targeted for participation. Of the 21 case studies, 14 involved an insourcing choice to an outsourcing evaluation. Additionally, we chose financial outcomes and size of IS shop as the polar types by which to target specific insourcing cases. Of the fourteen insourcing cases, eight achieved significant cost savings, six achieved no cost savings. Seven of the cases possessed theoretical economies of scale in their IS shops (i.e. more than 150 MIPS), seven did not.

The second point—experience levels—reflects the desire to undertake research in those companies who have considerable knowledge of the phenomena under study. We chose companies who had valuable knowledge of and experience with evaluating outsourcing and insourcing, and were willing to share their experiences. The organizations studied had made their IS sourcing decisions at least one year prior to their participation in our study, with most having 4 to 5 years experience, and some in excess of 10 years.

His last point—pick companies where access is likely—is particularly applicable to research that requires interviews with senior management. Since senior executives often receive research requests each month, pre-established contacts were used to gain access. A number of highly visible outsourcing cases were excluded from consideration because we felt they had been 'over-studied'. We generally used word-of-mouth and personal contact to find appropriate cases, and then used all means at our disposal to convince them to participate in our study. We also assured them of anonymity. This was particularly necessary in gaining access to those cases which could be considered 'failures', i.e. when the benefits hoped for were not achieved. In all, 21 organizations participated in the study. Taken as a whole, the participating companies represented a variety of industries, venues, and sizes.

1 As will be noted in our findings, it turned out that size of the IS shop did not matter.
In addition to gaining access to the research sites, there was a need to obtain multiple stakeholder perceptions. We therefore interviewed people who approached the issue from the viewpoint of senior management, and people from an IS management perspective. While end users were not specifically interviewed, their perspectives were hopefully brought out during interviews with the other two stakeholder groups. There was a high level of consistency between these two groups. Overall, those participating in our study included: 9 senior executives (CFOs, Controllers, Treasurers); 18 CIOs (or equivalent); 30 IS staff members involved in the evaluation; 4 vendor account managers; and 5 consultants.

These interviews provided the basis of the findings presented below. In addition to the interviews, the following supporting documentation was gathered: outsourcing request for proposals, internal bids, external bids, bid evaluation criteria, annual reports, and organization charts.

3. FINDINGS

We now discuss the results of our project in terms of the four questions which motivated the research. In an attempt to make our results more intelligible and believable, we have used actual quotes from the participants to highlight the salient details of their experiences.

3.1 Can an internal IS department replicate a vendor’s strategy for reducing IS costs?

Based on the results of our outsourcing study we felt that in principle, it should be possible for an internal IS department to reduce costs by replicating outsourcing vendors’ IS management strategies. Such strategies include: data center consolidation, resource optimization, chargeback implementation, and other sundry methods. Each of these strategies allow costs to be cut. The case of Continental Bank (Huber, 1993) provides a good example. The company outsourced to reduce the amount of overuse of its IS services. Outsourcing acted as a controlling mechanism. But could the same not have been done without an outside vendor? Huber states:

"Perhaps half of Continental's problems with in-house services stemmed from overuse. For instance, the most routine documents were always sent to the legal department for review. 'Better safe than sorry' people would say, while thinking, 'and besides, it's just an internal cost, not real dollars'" (pp.122-123).

Similarly, the implementation of a chargeback scheme can also dramatically reduce IS costs. A message which came through loud and clear in our study is that implementing cost savings measures requires IS to adopt policies which may not be readily agreed to by the business units in the organization. Internal politics often drives what can and cannot be implemented. For example, in a number of cases, there was a recognition that consolidating data centers would yield cost savings, however corporate politics precluded it from happening. Each business unit felt that 'their' data center provided special services which could not be provided..."
from a single, consolidated center. Their data centers understood the idiosyncrasies of their particular business requirements, were responsive to their needs, and were, fundamentally, more controllable by the business units. The data centers owed their allegiance to the business units they supported rather than to the corporation as a whole. Not surprisingly, many of these multiple data center environments came from corporate mergers and acquisitions. When one company acquired another, it concomitantly acquired its data center and IS staff. In such an situation, it is not surprising where the allegiance of the data center’s staff lay, nor the ‘ownership’ feeling by the business units. Hence the business units vehemently resisted any form of consolidation. In such an environment, it was often impossible for IS to push through consolidation, the business units had too much power. It was only when senior management empowered the IS department -- in the form of formal outsourcing evaluation -- did IS actually have the authority, i.e. the political muscle, to implement consolidation.

The same occurs when IS wants to implement a standard platform of hardware and software. This often leads to user departments feeling that their particular needs are not being catered for. In FIRM20, for example, IS decided upon providing a standardized suite of applications. This made the regular upgrading of software easy - they simply downloaded the new versions from the server to all users' desktops via the network. This standardization was only possible after FIRM20 created a new CIO position and gave him the appropriate support from senior management. The point is made by the Director of IS Planning at FIRM20 who notes:

"...he [the CIO] is very seriously talking about owning the software on the desktop and telling people what they can run and what they can't run ... he's talking and nobody's greatly exercising; I'm sure a lot of people aren't very happy, but nobody's voicing any concern."

Apparently, the reason why the users aren't "voicing [their] concerns" is because the CIO has been empowered by senior management to embark on strategies which will reduce IS costs, and the standard software platform is one key vehicle.

There are other examples in our case studies where IS knew of ways to reduce costs but simply could not convince the business units to agree to implement them. For example as noted above, the implementing of a full-cost chargeback scheme is one of the best mechanisms for getting the user departments to recognize the true costs of providing various services to them. Many organizations have chargeback schemes, but they are simply allocation schemes agreed to by some IS steering committee to apportion costs. And the way these costs are apportioned are often very unfair. The director of IS planning at FIRM20 cites the following example:

"The engineering folks burned lots of cycles, didn't store much on disks, maybe kept some things on tape. Didn't necessarily print a whole lot, at least not proportioned to the cycles they burned. They ... got one consolidated number and were getting hit with disproportionate bills. The customer folks were getting a free ride in a lot of cases, although they didn't think so."

Unfortunately, it is not an easy task to change the allocation scheme. Business units tend to resist because they feel with full-cost chargeback they will be charged for services that previously were absorbed by someone else (often another department or the corporation as a whole). With allocation schemes rather than true chargeback scheme organizations run into the 'restaurant check' syndrome. It refers to the behavior exhibited by groups of people who go together to a restaurant for a meal. Because it is common for groups to just "split the bill equally" among the people, it is in a person's best (perhaps 'selfish' is a more appropriate word) interest to order the most expensive dish on the menu because its cost will be subsidized by those ordering less expensive dishes. Similarly in IS, it is in the interest of user departments to order the most expensive service possible because in an allocation scheme, these costs will be shared with the other business units. In such a world, everyone will order what could be thought of as a 'Rolls Royce' service when a 'Chevy' might just as easily do. IS costs rise because the business units can demand whatever they want knowing (or even not know-
ing) that the costs will be shared with others. Of course one can just imagine how such a scenario might play out. Business unit A requests a particular expensive type of service (e.g. reports produced in color), so business unit B - not wanting to be outdone - requests something equally exotic (e.g. multi-media interface to some corporate data base). One can imagine how this might escalate. The implementation of a true chargeback scheme would stop such potentially frivolous requests as the user department requesting such services would have to pay the full amount of IS providing that service. But implementing such a chargeback scheme is problematic, and will only be possible if senior management empowers and supports IS to do so. To put it differently, IS needs a ‘big stick’ to hammer resistance with in order to implement cost saving policies. This big stick can only come from senior management.

3.3 Does it reduce costs after winning the bid?

Based on the seven in-depth cases analyzed in our insourcing study, it is apparent that each was able to achieve significant IS cost savings (see figure 1).

### FIGURE 1: SUMMARY OF INSOURCING DECISIONS

<table>
<thead>
<tr>
<th>CASE SITE</th>
<th>INDUSTRY CLASSIFICATION</th>
<th>FUNCTIONS INSOURCED and SIZE</th>
<th>SAVINGS ACHIEVED</th>
<th>YEAR INSOURCE BEGAN</th>
<th>INITIATOR OF THE DECISION</th>
</tr>
</thead>
<tbody>
<tr>
<td>FIRM15</td>
<td>Apparel Manufacturer and Retailer</td>
<td>2 Data Centers; 56 MIPS</td>
<td>Reduced Costs by 54%; Reduced Headcount by 37%</td>
<td>1988</td>
<td>IS Manager</td>
</tr>
<tr>
<td>FIRM16</td>
<td>Public University</td>
<td>3 Data Centers; 106 MIPS</td>
<td>Reduced Costs by 20%; Reduced Headcount by 23%</td>
<td>1992</td>
<td>Senior Manager</td>
</tr>
<tr>
<td>FIRM17</td>
<td>Food Manufacturer</td>
<td>Data Center; 180 MIPS</td>
<td>Reduced Costs by 45%</td>
<td>1988</td>
<td>Senior Manager</td>
</tr>
<tr>
<td>FIRM18</td>
<td>Petroleum Refining</td>
<td>3 Data Centers; 200 MIPS</td>
<td>Reduced Costs by 43%; Reduced Headcount by 51%</td>
<td>1991</td>
<td>Senior Manager</td>
</tr>
<tr>
<td>FIRM19</td>
<td>Telecommunications</td>
<td>Data Center; 32 MIPS</td>
<td>Reduced Headcount by 46%</td>
<td>1991</td>
<td>Senior Manager</td>
</tr>
<tr>
<td>FIRM20</td>
<td>Energy</td>
<td>Data Center; 150 MIPS</td>
<td>Reduced headcount by 25%; Increased workload by 25-30%</td>
<td>1989</td>
<td>Senior Manager</td>
</tr>
</tbody>
</table>

3.4 How were the savings achieved?

Participants in our insourcing study identified cost reduction tactics that focus on three major IS cost drivers: people, hardware, and software. Participants noted that insourcing decisions should focus on cost drivers rather than esoteric aspects such as "service quality" and "technical competence". They felt that reducing the cost drivers was the only way to slash IS budgets. In particular, because personnel costs are the greatest proportion of IS costs, participants focused on headcount reduction. For example, most of the savings from data center consolidation can be attributed to reduced personnel. In addition, some participants found innovative ways to reduce hardware and software costs. Overall, participant's tactics to reduce IS cost drivers relate to eleven categories: (1.) Automation, (2.) Chargeback, (3.) Data Center Consolidation, (4.) Departmental Reorganization, (5.) Employee Empowerment, (6.) Hardware Negotiations, (7.) Just in Time Resources, (8.) More Efficient Resource Usage, (9.) Service Elimination, (10.) Software Negotiations, and (11.) Software Standardization (see Lacity and Hirschheim, 1995 for details).

Figure 2 identifies which tactics were used by which participating companies and indicates whether the tactic was successful. In most cases, participants quantified the savings achieved by these tactics either in terms of dollars or headcounts. In some cases, however, participants could not specifically isolate savings to particular tactics, thus savings are described more theoretically.

### FIGURE 2: COST REDUCTION TACTICS USED BY CASE PARTICIPANTS
4. DISCUSSION

Based on the economic findings of reduced IS costs, it is tempting to conceive of insourcing as a success, but a deeper interpretation of the data paints a more perplexing picture. In fact, two primary lessons emerge:

- Stakeholders have varying perceptions of insourcing success.
- Senior management’s perceptions of insourcing success depend upon IS management’s ability to convince them they are cost-competitive relative to the market.

4.1 Stakeholders have varying perceptions of insourcing success

Prior to our data collection, our conception of insourcing “success” and “failure” was equivalent to financial outcomes of the process, i.e., “successes” are companies that achieved dramatic cost savings of at least 20 percent, while “failures” are companies that achieved little or no cost savings. However, after our interpretive analysis, we re-conceptualized our notions of “success” and “failure” along stakeholder lines. In the majority of cases, our original conception of cost-savings as the primary criterion for success only captured the perceptions of senior executives, whom we concluded perceived IS as a cost to be minimized. Illustrative quotes from our participants capture such senior management’s perception of IS:

"They are always telling us our processing for payroll is too damn expensive. Then when you say, 'Well have you looked outside?' 'Oh yes, we beat the heck out of them.' So our costs are too high but they can't get it any cheaper." --Director of IS Administration, FIRM15

"The Board could care less about IS. They treated it like they treated the heat or electricity." --CIO, FRIM16

"There was a feeling that this was a rat hole to pour money down...We don’t like you guys anyway, you cost too much, you want to increase our prices, our profits are down, we want to go outside." --Data Center Manager, FIRM17

When considering other stakeholders, such as users, perceptions of insourcing success were not based on costs, but rather service excellence. Based on our interpretation of the cases, we note that costs are directly related to service levels—the better the service, the higher the cost. Thus, cost efficiency and service excellence represent conflicting agendas for IS performance. The result: in most instances, cost reductions led to perceived service degradation. Consider the following examples.

Users want local data centers, although a consolidated data center is less costly. Users at FIRM8, FIRM21, and FIRM16 perceived that local data centers were an aspect of service
excellence, even though multiple data centers were considerably more costly to operate than one consolidated center. Users in these companies resisted data center consolidation until senior management mandated it.

**Users want customized software, although standard software is less costly.** Users at FIRM8, FIRM17, and FIRM20 perceived customized software as an aspect of service excellence, but idiosyncratic software was significantly more expensive than standardized package solutions. At FIRM17, for example, users in each business unit demanded custom-tailored software— even when standard packages were more cost efficient. Different business units chose different packages for word processing, electronic mail, fourth generation languages, and spreadsheets. From the business unit perspective, it made more business sense to use packages with which users were familiar rather than incur the inconvenience and expense of learning a standard package. Users at FIRM17 perceived that 100% availability was an aspect of service excellence, but the extra capacity and software needed to deliver this service drove up costs.

**Users want excess resources “just in case,” although “just in time” resources are less costly.** Users at FIRM21, FIRM17, and FIRM19 perceived that tactics which led to more efficient resource usage reduced their service levels. For example, users perceived that replacing printed reports with on-line reports, migrating datasets from direct access storage devices (DASD) to tapes, and standardizing forms reduced their service levels. From senior management’s perspective the cost savings are worthwhile—users don’t always review printed reports and may infrequently need a dataset. But from the users’ perspective, they must wait longer to receive printed reports (even if they are needed infrequently), must wait longer to gain access to datasets, and must learn how to fill out the new standardized forms.

**Heavy IS users want general allocation chargeback systems, although unit pricing leads to lower costs because it reduces user demand.** Most notably—heavy IS users at FIRM17, FIRM4, and FIRM20 perceived the change in chargeback as a drop in their service levels (as evidenced by their complaints to IS managers). Initially, these companies had general allocation chargeback systems, which motivates excessive user demand. These chargeback systems are analogous to splitting a check at a restaurant; each diner is motivated to order excessively because their companion will pay for half. In turn, the companion is motivated to match the order— if you order a drink, I’ll order a drink or else I’ll pay for half your drink without the pleasure of consumption. Light eaters— or light IS users— complain of the inequities in such systems. When the chargeback systems at these companies were changed to eradicate the inequities, the previous “free riders” naturally complained of a drop in service.

Thus, in virtually every cost-cutting practice, users perceived a reduction in service. And because service degradation accompanies severe cost cuts due to the cost/service trade-off, users were most displeased with the insourcing outcomes in the majority of cases.

IS managers’ perceptions of insourcing success and failure are even more complex than users because they are caught in the middle of the cost/service trade-off. Because senior executives were demanding cost cuts while users were demanding service excellence, IS managers were expected to perform the near-impossible: provide a Cadillac service at a Chevrolet price. Thus, most IS managers in the study were hoping that the insourcing decision would provide support in making cost/service trade-offs. The IS manager at FIRM5 exemplifies the position of many IS managers that the insourcing evaluation would help him gain support in making cost/service trade-offs:

“I said, ‘I cannot get any support from you in how to allocate these resources. And we cannot be the traffic cop in this whole process because it is not right.’ I said, ‘I’m trying to satisfy everybody and it’s not working.'”--VP of IS, FIRM5
The VP of IS at FIRM3 explains how he was always caught in the middle of senior management’s complaints about high IS costs and users’ demands for more service:

“He [the Chairman of the Board] would sit there and pistol whip me to death about my expenses and I had to answer every one of them. I wasn’t making him happy because he wasn’t getting me to agree to reduce my costs. I said I’d be glad to cut expenses...anything that my user organization doesn’t need, just let me know. If the marketing guy doesn’t want me to do invoicing, we’ll shut her down tomorrow.” --VP of IS, FIRM3

Thus, we now assume a stakeholder interpretation of success and failure. We have categorized these stakeholders into three main groups: senior management, business unit managers and users, and IS managers. Each stakeholder group sets a different expectation for IS performance, and as such holds different perceptions of IS performance and the effects of insourcing. For senior management, success is interpreted to be cost savings. For business unit managers and users, success translates into improved service levels. For IS managers, success is related to the reputation of IS in the business, in particular the recognition it receives from senior management. IS managers try hard to have their functions positively perceived by senior management, and this leads to the second lesson.

4.2. Senior management’s perceptions of insourcing success depend upon IS management’s ability to convince them they are cost-competitive relative to the market

We believe that senior management’s perceptions of success are relative to the market. Senior management perceives that insourcing is a success when they perceive their internal IS departments could cost-compete with the external market. Of course, the management of such perceptions becomes a major challenge to IS managers—they must find “objective” evidence of their cost competitiveness. There appear to be several practices IS managers used in our case studies to convince senior management that insourcing is the most efficient alternative.

An internal bid beats an external vendor bid. Senior managers are most likely to believe in the cost-competitiveness of the internal IS department if it successfully competes with external vendor bids for the company’s IS business. In such an environment, an outsourcing evaluation and subsequent bid from an internal IS department offers the chance for IS to adopt cost savings strategies (such as data center consolidation, software standardization, chargeback, etc.). IS is mandated (through the outsourcing evaluation) to reduce costs on its own. Cases such as FIRM4, FIRM16, FIRM17, FIRM19, FIRM20 and FIRM21 provide examples where the internal IS organization competed and won against outsider vendor bids. It should be noted that in all these cases, the insourcing evaluation decision was driven by senior management. It is more likely that senior management will believe in the cost-competitiveness of their internal IS organizations if, and only if, they initiate the evaluation. If IS management initiates the evaluation, there is a greater chance that senior management might perceive the evaluation as “rigged” and discount it, as in the case of FIRM2, FIRM12, FIRM5 and FIRM7.

An internal IS department attracts external customers. If IS is allowed to solicit business from outside the organization and is successful, senior management is again likely to see IS as cost-competitive. The case of FIRM5 is illustrative. The VP of IS of FIRM5 noted that approximately 15 percent of IS’s income came from services provided from outside the company. He felt this was important beyond convincing senior management of his functions’ cost-competitiveness. It instilled a “service mentality” in the IS staff -- either they satisfied these outside customers or the customers would look elsewhere for IS services next time. This had a knock-on effect in the way internal users were handled. They too were treated as customers who had real choices when it came to choosing their IS service provider.
Internal IS managers implement a unit-price chargeback system. We believe that senior management's perceptions of IS success relative to the market is influenced by the IS chargeback system. Prior to the insourcing decision, IS was accounted for as an overhead in all of our cases except FIRM5, which only served to highlight the costs, and not the value of IS. For example, the VP of IS at FIRM3 noted back in 1985 that his CEO kept asking him why IS budgets were rising when budgets in all the other functional units were falling. The VP of IS responded that marketing costs dropped 10 percent in large part because IS implemented a new credit card system and that transportation costs dropped because IS automated 16 truck refueling systems. By implementing a unit-price chargeback system, users of the services come to understand the real costs of each service activity. Moreover, they then have the ability to modify their behavior to raise or lower their billed costs by increasing/decreasing the level of services they request.

But insourcing does not guarantee that senior management will perceive IS as cost-competitive nor does it always lead to their positive recognition of IS. For example, IS managers at FIRM1, FIRM2, and FIRM7 hoped that the insourcing projects would raise the status of IS in the eyes of senior management, but failed on this front as evidenced by their subsequent firings and company decision to ultimately outsource. Even though the outsourcing evaluation showed insourcing to be the most cost-effective arrangement, IS management failed to change senior management’s negative perception of the internal IS department. They failed in their attempt to have senior management perceive IS as cost-competitive relative to the market. Why? Apparently because they initiated the outsourcing evaluation rather than senior management. In such cases, senior management seems to believe the evaluation is biased, irrespective of whether it is or is not. (See Lacity and Hirschheim, 1993b for examples of cases where IS management did in fact bias the outsourcing evaluation in their favor.) Given that perceptions are everything, perception management (some might choose to call this ‘manipulation’) is critical.

5. CONCLUSIONS

In summary, we believe that outsourcing evaluations often result from the frustrations caused by different stakeholder expectations and perceptions of IS performance. This belief is based on an analysis of what IS managers can realistically achieve versus what senior executives and users expect them to achieve. Different stakeholder perspectives set unrealistic performance expectations for IS managers, leading to frustration, loss of faith in internal IS management, and hopes that outsourcing vendors will provide the solutions. While outsourcing can lead to a reduction in IS costs, this reduction often comes at a price: reduced service. Moreover, since it is known that most of the cost savings come from the implementation of key cost reduction strategies such as data center consolidation, unit-cost chargeback systems, standardized software, etc. rather than economies of scale, internal IS departments should be able to reduce costs on their own. And indeed they did.

However, while IS managers can theoretically implement cost reduction strategies, internal politics often prevent them from doing so. This is why senior executives need to allow IS managers the ability to submit internal bids in competition with external vendors. The outsourcing threat may overcome political obstacles and allow IS managers the freedom and power to propose and implement drastic cost cuts. If senior executives merely compare external bids with current costs, they may allow the vendors to "pick the low lying fruit." That is, vendors may make drastic cost cuts but absorb most of the savings themselves, merely passing some benefit to customers in the form of modest price cuts.

But even if insourcing is chosen over outsourcing, and the expected cost savings are realized, there is no guarantee it will be perceived as “successful” due to the very different expectations held by the various stakeholders. Success is related to who is doing the evaluating.
REFERENCES


