Drivers of IT Backsourcing Decision

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Abstract

This paper examines the decision to backsource IT functions. Even though outsourcing is a popular means of meeting internal IT needs, press reports suggest that backsourcing is becoming increasingly common. When organizations implement a backsourcing strategy, they incur high rebuilding fees and expensive contract termination fees. Reverting back to the once abandoned strategy also reflects negatively on the organizations' previous strategic decision and judgment. Still, many organizations choose to undertake the challenge of internalizing the once-outsourced functions. An interesting question, therefore, is what factors drive organizations towards backsourcing. Based on press reports of actual backsourcing cases, factors that lead to backsourcing decision were identified. Just as outsourcing decision, organizations choose backsourcing to capitalize on strategic opportunities. Organizations also backsource due to internal power and politics interplay and the failure of outsourcing contract in meeting expectation. Changes in vendor organization and vendor strategy may also trigger backsourcing decision.

1. Introduction

Information Technology (IT) backsourcing is the strategy of bringing the once outsourced IT functions back into the organization with the goal of rebuilding internal IT capabilities [13; 18; 29; 30]. This strategy can be implemented following an expired or terminated contract. In both circumstances, organizations incur high expenses in reabsorbing the outsourced functions into the internal organizations. In the case of contract termination, organizations also have to incur costly termination fees. Farmers Group, for example, paid $4 million in cancellation fees and early termination penalties to extricate itself from its contract with Integrated Systems Solutions [24]. Similarly, Chase Manhattan Bank paid Fiserv $15 million to terminate its outsourcing contract [19]. Gartner Group estimated that backsourcing expenses range between 2% and 15% of the annual cost of a contract [29]. IT backsourcing, therefore, is an expensive strategic turnaround.

Despite heavy penalties and potentially large reabsorbing and rebuilding fees, many organizations still choose to incur the expenses and undergo the trouble of internalizing the once-outsourced IT functions [5]. Among high profile backsourcing cases include Bank One that terminated its outsourcing agreements with IBM and AT&T and chose to hire more than 600 IT employees in an effort to shift away from outsourcing and rebuild internal IT capabilities [22], Oxford Health that cancelled a five-year, $270-$330 million outsourcing deal with CSC less than two years into the arrangement [25], and JP Morgan Chase that ended its seven year, $5 billion relationship with IBM only after 21 months [27].

According to Deloitte Consulting, nearly two-thirds of organizations have already brought some forms of outsourced services back in-house [26]. Gartner Group reported that 56% of small-sized business, and 42% of mid-sized business contracts are backsourced following contract discontinuance [4]. Fitzgerald and Willcocks [10] found that 22% of organizations that prematurely cancelled their contracts chose backsourcing while Lacity and Willcocks [18] reported a higher backsourcing rate of 34%. According to a Compass poll of 70 outsourced US companies, only 4% would not consider taking some or all of their IT functions back in-house when their current outsourcing contracts expire [11]. All these reports and statistics reflect that backsourcing may become a trend that deserves further attention [8; 13; 14].

The backsourcing trend is a concern to both parties of an outsourcing relationship – the organizations that buy outsourcing services and the vendors that sell outsourcing services. Organizations considering outsourcing may question the viability of the strategy. They want to understand why those that have experienced outsourcing choose to abandon the strategy and return back to the original internal IT sourcing strategy that they have previously abandoned. If the reasons that swing the outsourcing pendulum back towards internal provision of IT services are applicable to them, these organizations would want to reconsider their enthusiasm for outsourcing. For organizations that have already outsourced, understanding of backsourcing decision helps them to make better and more informed decision when reviewing outsourcing contracts. As for vendors, the trend touches even closer to their hearts as it impacts their livelihood. Vendors want to understand the reasons behind backsourcing so they can better formulate their future marketing and service strategies in an effort to attract new clients as well as retain existing clients. Therefore, an immediate and interesting question to address here would be "what are the factors that drive organizations towards backsourcing".

A review of the literature shows the decision to backsource has received little attention [29]. So, the goal of this paper is to examine the factors that motivate backsourcing decision. The reminder of the paper is structured as follows. The next section differentiates different types of IT sourcing decision and discusses IT backsourcing. The third section explains the research approach. The fourth section is the main findings. The last section presents the

implications of the findings as well as future research avenues.

2. IT Sourcing Decision

IT sourcing strategy refers to the internal or external arrangement through which IT products and services are provided. Depending on factors such as the overall business and IT directions, availability of internal resources, profiles of top management, and compatibility and complementarity of vendors and internal organizational capabilities [8], organizations may choose to implement different IT sourcing strategies to meet organizational needs.

Insourcing is where organizations retain the management and provision of more than 80% of the IT budget internally after evaluating the external IT services market [8]. Outsourcing refers to the strategy of having third party vendors provide services to the internal organizations for a fee and for a period of time [8]. In total outsourcing, services provided by vendors represent more than 80% of the IT budget while in selective outsourcing, services provided by vendors lie between 20% and 80% of the IT budget [8].

Backsourcing is the reversal of existing outsourcing strategy and returning to the previously abandoned internal service provisioning strategy. Just as outsourcing, backsourcing may differ in scale and complexity. It can range from bringing a single IT function such as helpdesk back into the organization to a total backsourcing where an organization rebuilds the entire IT department. The latter is much larger in scale and complex in nature [30].

The decision to backsource is one strategy management does not wish to make nor publish as to some extent it may reflect negatively on its previous judgment. Nevertheless, the number of organizations that choose backsourcing seems to be on the rise. Current research suggests different reasons that lead organizations to bring the outsourced IT functions back in-house. Whitten and Leidner [29] found that product quality, service quality, relationship quality, and switching costs are related to the decision to backsource application outsourcing. Falaleeva [9] reported that costs, goal conflict, and opportunism influence backsourcing decision while McLaughin and Peppard [21] identified failure to achieve contractual objectives, changes in strategic IT role, changes in business environment, technology change, and management change as drivers of backsourcing decision.

Figure 1 depicts these different IT sourcing strategies pictorially. Using the timeline, at juncture J1, the decision to outsource or insource is made. This is the initial sourcing decision made early in the sourcing cycle. At juncture J2 (could be in the middle of a contractual agreement or at the expiry of a contract), organizations make another sourcing decision. At this point, they will decide if they want to continue with the same vendor, switch to a new vendor, or to abandon the outsourcing strategy and choose to revert back to internal provisioning of IT services.

3. Research Approach

To identify factors that lead to backsourcing decision, a review of existing press reports on backsourcing cases was conducted. A list of organizations that have backsourced their IT activities was compiled. For each backsourcing case/organization, two sets of information were gathered: (1) its previous outsourcing contract (i.e., vendor, contract duration, contract value, and activities outsourced), (2) its backsourcing activity (i.e., reasons for backsourcing and backsourcing implementation date).

The reported reasons for backsourcing were classified and categorized using Yin's [31] pattern-matching method. In the initial coding phase, a broad list of reasons was identified, organized and classified into categories using different codes. These codes are explanatory or inferential codes that function to pull the data together into a more meaningful form [23]. In cases where newly identified backsourcing reasons could not be matched with any of the existing code, a new factor code was added. This iterative process of going back and forth from the motivating factor codes to the data from press reports continued until all backsourcing reasons cited in press reports have been coded.

Then, the researchers moved to a more focused coding phase. In this phase, the coded list of reasons were further narrowed down by identifying and keeping frequently used codes while winnowing out less productive codes. The process of examining the categories and refining the codes continued until important themes began to solidify. The next step was to interpret the relationships between each factor and backsourcing decision.

It should be clarified that press reviews that were conducted may not be comprehensive enough as many backsourcing cases went unreported because both organizations and vendors are reluctant or refuse to publish "fail" outsourcing ventures. Nonetheless, existing information identified for reported backsourcing cases along with their cited reasons should be sufficient to form an initial understanding of reasons behind backsourcing decision.

4. Findings

This section presents the results of press reviews on factors that lead to backsourcing decision. Table 1 shows the cited reasons in each backsourcing organization while Table 2 groups the cited reasons into three main factors. The following discusses each of the factors.

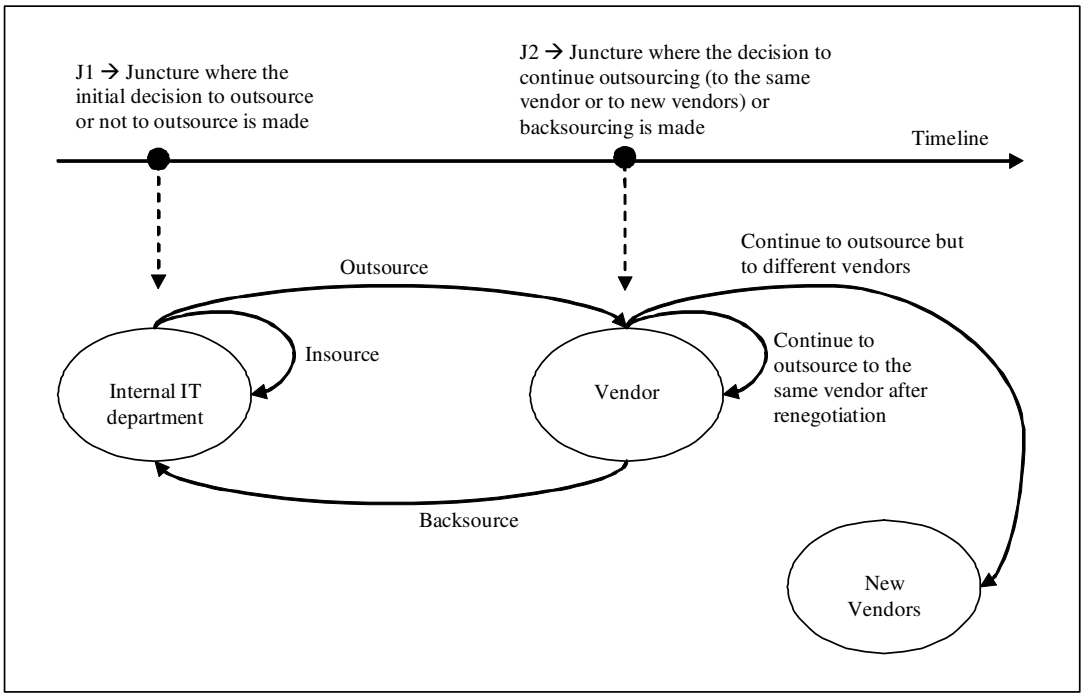

Figure 1. Types of IT Sourcing Strategy

4.1 Strategic

Changes in strategic direction in organizations have impacts on IT sourcing strategy [15]. This link between business direction and IT sourcing strategy is established in the outsourcing literature where organizations outsource their IT to 'return to core competencies' [19; 20]. Under this circumstance, IT is considered a commodity. However, as strategic direction changes, organizations may reposition IT from a commodity to a strategic resource. For example, an organization that plans to expand its business to the global market using e-commerce may now see IT as strategic in helping it to achieve the new direction. Thus, following the logic of "outsource commodity, insource strategic activities", organizations will now choose to internalize the once outsourced IT functions. Furthermore, with new strategic changes, organizations may find that the previously signed outsourcing contracts could no longer accommodate the expansion needs in a cost effective and efficient way. This will again motivate them to shift to backsourcing.

Even in circumstance where organizations downsize such as reducing existing number of products and services, consolidation, etc, there is possibility of them backsourcing IT functions. This is because outsourcing contracts often tie organizations down to certain terms that cause them to lose the flexibility of scaling-up or scaling-down depending on their needs. Thus, organizations may begin to feel the needs to readjust their sourcing arrangements. Since the best way of gaining flexibility is to have internal and full control of IT, backsourcing becomes the natural decision.

4.2 Power and Politics

Power and politics at top level management can have impacts on organizational strategy including IT sourcing strategy. Top management often plays important roles in initiating, formulating and implementing strategic change within organizations [2; 7]. They bring with them different characteristics such as experiences, educational backgrounds, philosophies, beliefs, values, and knowledge that will impact their decision making [1; 2; 12]. Such impact is often reflected in strategic change within organizations [3; 28].

One of the factors that drive the initial outsourcing decision is this power and politics interplay among different departments as well as among different senior executives in organizations [16]. Their negative perception and lack of confidence towards internal IT department push them to pursue IT outsourcing. When this original group of executives is replaced by new business or IT executives who believe in IT and internal provisioning of IT services, sourcing strategy in organization will change once again. This time it is from outsourcing to backsourcing.

4.3 Outsourcing Expectation Gaps

Outsourcing expectation is organizations' beliefs about what vendors will and should provide them should they engaged in an outsourcing relationship [17]. Generally, these expectations are formed as a result of press publications that continue to

Table 1. Examples of Backsourcing Cases

Organization	Vendor	Contract			Cited Reasons for Backsourcing								
		Value	Length	Backsourced after (years)	Cost	Service quality	Loss of control	IT resource accessibility	Changes in strategic directions	Changes in IT role	Changes in organizational structure	Power & politics	Changes in vendor organization / strategy
AA	IBM	£55 m	7	3	x								
Bank One	IBM and AT&T	$1.4 b	6	<3	x		x			x		x	
Farmers Group	IBM	$150 m	10	8	x			x			x	x	
JP Morgan Chase	IBM	$5 b	7	2			x	x			x	x	
McDermott	AT&T	$600 m	10	2		x						x	
Lehman Brothers	Wipro	$100 m	Multi-year	1		x							
MONY	CSC	$210 m	7	3			x						x
MPEA	Redsky Technologies	Unknown	3	3		x		x			x	x	
Oxford Health	CSC	$330 m	5	$1^1/_2$	x		x		x	x			
PacifiCare Health Systems	Keane	$500 m	10	4							x		
Prudential	Capgemini	£55 m	5	5	x					x			
UMass Memorial Health Care	First Consulting Group	$102 m	7	3						x			
Washington Mutual	IBM	$553 m	10	5		x				x		x	

Table 2. Factors motivating backsourcing decision

Factors	Cited Reasons
Strategic	Changes in strategic directions
	Changes in IT role
	Changes in organizational structure (due to acquisition, mergers, etc)
Power & politics	New management
Outsourcing expectation gaps	Cost
	Service quality
	Loss of control
	IT resources accessibility (e.g., human capital, knowledge capital, state-of- the-art technology
Changes in vendor organization	Vendor merges with other organizations

advocate the benefits of IT outsourcing. In many organizations, outsourcing is even considered the 'silver bullet' that solves all problems [14; 16]. Consequently, many organizations leap into outsourcing expecting to save cost, have better service quality, and gain access to latest technology and highly skilled personnel [6; 14].

As organizations venture into their outsourcing relationships, they realize that their outsourcing expectation is more of a myth than a reality [13; 16]. They find that the actual experience failed to measure up to their initial expectation [13; 14]. Not only that, organizations often find that narrow outsourcing contractual terms limit the level of flexibility they used to enjoy prior to outsourcing [8]. All these create an expectation gap that leads organizations to rethink their outsourcing strategy and in many cases to bring the outsourced functions back in-house.

4.4 Changes in Vendor Organization/Strategy

Even though the decision to re-internalize the outsourced functions often originates from the client side, changes in vendor's organization or vendor's strategy may also trigger backsourcing. For example, mergers and acquisitions of one vendor organization with another vendor organization may change the strategic direction of the new entity. This change may influence how the new vendor organization approaches existing outsourcing contracts. This may potentially cause disputes or uneasiness on the clients' side leading them to shift away from outsourcing and move towards backsourcing. Similarly, when vendors move their focus and attention onto higher value contracts, organizations with lower value contracts may feel the impact in terms of service quality. As a result, an expectation gap arises which then leads to the decision to backsource.

5. Discussion and Conclusions

This paper examined the factors that motivate backsourcing decision. The research findings suggest that organizations backsource not only to correct existing problems but also to harvest new business opportunities. Specifically, when outsourcing contracts fail to meet expectations, it is natural that organizations response by changing their existing contracts. It is interesting, however, to see they choose the backsourcing option to return to the initial IT sourcing arrangement they have abandoned. The failure of vendors in meeting outsourcing expectations shows that this strategy may not the "silver bullet" as hoped by senior management. Thus, when outsourcing brings problems, organizations react by backsourcing in an attempt to correct the problems.

Furthermore, when opportunities arise, organizations again choose backsourcing to have internal IT capabilities supporting necessary changes. New strategic directions such as expansion into new markets, mergers and acquisitions, and repositioning of IT role to be more strategic drive organizations to backsource IT functions. Just as in outsourcing strategy, power and politics could also be a factor that motivates backsourcing decision. New management with different beliefs of IT sourcing strategy may alter existing strategy to fit their philosophies. Drivers for backsourcing decision may also originate from the vendor's side. Changes in vendor organization and vendor strategy may have impacts on existing outsourcing contracts which then trigger clients' backsourcing decision.

Note that there is seldom just one factor that motivates organizations to bring the outsourced IT functions back in-house. Rather, several factors usually come together to contribute to backsourcing decision. That was the case in almost all reported backsourcing cases. Nonetheless, there may be one primary factor that is more important than another, and that creates a chain reaction linking the rest of the factors. Also, even though backsourcing decision is made by client organizations, the drivers may originate from within the client organizations, from within the vendor organizations, or as a combination of both. Figure 2 categories the four factors of backsourcing decision based on the source that triggers backsourcing decision. Strategic related factors and power and politics factors come from client organizations. Changes in vendor organization/strategy originate from vendor organizations. The issue of outsourcing expectation gaps comes from both client and vendor organizations.

The research findings here are of value to both organizations and vendors. For organizations that have already outsourced, understanding of backsourcing decision will help them to make better decision when reviewing outsourcing contracts. For

organizations considering outsourcing, understanding of the factors that contribute to backsourcing decision help them to examine even more carefully the suitability of an outsourcing arrangement to their organizations. It also reminds them the need to build clearer clauses into Service Level Agreements should they choose to continue with outsourcing. For vendors, understanding of the factors that lead to backsourcing decision can help them to better formulate their future marketing and service strategies in an effort to attract new clients as well as retain existing clients.

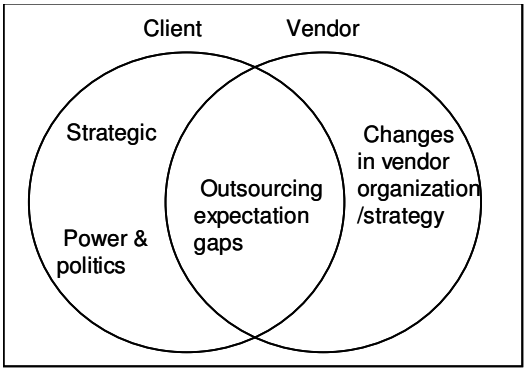

Figure 2 Client and vendor involvement in motivating backsourcing decision

This research forms a good preliminary understanding of the factors that drive backsourcing decision. However, the level of understanding achieved here may be limited by what is accessible in the press. Thus, future research should try gaining access to some backsourcing organizations in an effort to collect first-hand data on backsourcing phenomena. Through this way, in-depth understanding of backsourcing, including drivers of backsourcing, will be achieved. Future research should also examine the interplay among different factors that lead to backsourcing to reach a comprehensive picture of backsourcing drivers. Beyond this, research should explore the strategies organizations could employ to ensure successful implementation of backsourcing. The implementation plan should include both the process of transitioning from vendors to internal IT departments and the capability of internal IT departments to function optimally after the transitioning period.

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