Considering knowledge management
in outsourcing decisions
Introduction

Trends toward a decentralized business model have led to the common practice of outsourcing. Outsourcing is defined as purchasing external services or resources to deliver projects and services. It is distinct from other sourcing models that use internal resources, form joint ventures or alliances, or form a service company to deliver projects and services (Da Rold, Jester, & Young, 2005). Although the outsourcing business model is not new, it is becoming more common. Recent trends in outsourcing are seeing the creation of entirely new industries to handle business processes (Malone, 2004). Service providers have developed to support organizational needs at the infrastructure level (e.g. help desks, storage, hosting), application (e.g. legacy applications management, application migration, Y2K), and business process (e.g. contact centers, supply management, transaction processing) layers (Da Rold, et al., 2005).

Part of the increased prevalence in outsourcing comes from service providers specifically targeting the organizational needs of companies. Service providers have evolved capabilities that simply were not available before now. However, the major reason cited by enterprises for making this change to an outsourced model is a desire to decrease operational costs. For example, Gartner Research reports that through 2008, two-thirds of IT outsourcing contracts will be created as a result of cost-focused short-term objectives (Da Rold, et al., 2005). While the cost saving characteristic of outsourcing is widely touted, particularly as it applies to offshore outsourcing, organizations are frequently finding that the savings are less than expected or non-existent. Additionally, an outsourcing strategy that focuses solely on cost reduction may undermine other strategic business goals, such as
product quality, service quality, and knowledge management. Numerous examples of successful outsourcing efforts exist, and equally numerous unsuccessful examples. With the overall effectiveness of outsourcing as a cheaper alternative to other sourcing methods open to debate, making these choices based solely on cost savings is inadequate. This paper seeks to examine the positive and negative impacts of outsourcing other than those related to short-term cost savings or strategic reasons. This raises the problem of identifying what characteristics make outsourcing viable? We will begin by considering how rapidly evolving communication systems and business structures have made this sourcing model possible and the opportunities it provides. That leads to a discussion on the benefits and costs of a decentralized organizational structure and how the practice of outsourcing can affect institutional knowledge, specifically the impact on tacit knowledge that is especially difficult to encode and utilize in knowledge management systems.

One of the main reasons a decentralized model of doing business is possible is due to the decreasing costs of communication (Malone, 2004) and increased efficiency of the employment of standardized systems. Malone explains how these new communication systems have resulted in decreased costs of communication. A decentralized organization necessarily has higher communication requirements than a centralized hierarchy. Rather than all communications traveling through a single point at the top of the hierarchy, decisions requiring information from multiple stakeholders happen on all levels. Relatively expensive communication methods such as telephones, face-to-face meetings, or paper-based communication would make the increase in information transactions too expensive and complicated to manage. Reducing the barrier of communication costs, in terms of
time and actual dollars spent, has made decentralization practical for organizations.

**Benefits of decentralization**

The decentralized structure of outsourcing can offer both economic and non-economic benefits. Economic benefits can be reached because services or tasks are not controlled by a centralized control structure, but are guided by market factors to determine cost and levels of service. Additionally, outsourcing can be extremely flexible, thereby reducing opportunity costs and adding strategic value. In companies working with short product life cycles, critical components, resources or expertise can be obtained faster than could be developed internally. Through outsourcing, a company can adapt quickly by accessing areas of expertise that are not immediately available to the organization internally and that would otherwise be costly and time consuming to develop or purchase. An exceptionally successful example of this can be seen in the Toyota automobile company (Watts, 2003). Toyota consists of approximately two hundred different companies that are integrated to supply all the parts and expertise to create their cars and trucks in an extremely efficient manner. For companies involved in projects with short life spans, specific combinations of skills and people can be utilized only for the duration that they are needed (Malone, 2004). This flexibility also allows organizations to access a higher level of knowledge and expertise and to be more competitive than might normally be affordable on a full time basis.

Decentralization offers benefits to employees as well. Malone (2004) describes decentralized structure as one where "power, ownership, and initiative [are] distributed
throughout a whole market " (p. 74). The freedom and autonomy of working in a
decentralized way, where employees maintain a greater level of control over their own
business, provides a more enjoyable work environment. This increased control and sense of
ownership often creates additional benefits. People are more motivated by the increased
ownership of responsibility. Additionally, employees feel in more direct competition with
other providers of the same service, which leads to increased innovation and levels of
specialization. These benefits are subsequently translated directly to the company that
utilizes this outsourced service.

There are also strategic benefits from being geographically distributed. Overseas
outsourcing in multiple time zones for example, offers the potential for a 24-hour workday
without having to pay for overtime. And even a less global distribution can provide
reduced impact from regionally specific problems such as a natural disaster or a local
system outage.

Even with all the optimistic possibilities, a decentralized organization is not always
desirable. Some organizations that require the ability to coordinate large-scale systems with
relatively little communication may be better suited to a hierarchical structure. The classic
example of this is military organizations where a clear chain of command and rapid
response times are critical (Malone, 2004). Also, companies that have long product life
cycles, long life spans, or working on difficult or complex problems may not be well suited
to decentralization.
Costs of decentralization

While entire business processes can be integrated through outsourcing quickly in comparison to establishing new departments internally from scratch, there are often substantial costs associated with outsourcing. For example, establishing efficient processes, implementing infrastructure, and creating the initial service contracts can be time consuming. The time commitment also extends to developing and monitoring performance criteria that measures service levels provided, as well as the additional amount
of time required managing the involved tasks that the outsourcing partner provides. Even though communication costs have been reduced drastically, some costs will be incurred for travel and related communication activities that cannot be handled by inexpensive systems.

It is also worth mentioning that some individuals may not always find working in a decentralized environment desirable. Some people may prefer stability to flexibility and autonomy. Outsourcing and contract work typically does not provide benefits such as insurance programs or incentives such as stock options, stock purchase plans, or vacation packages. Outsourcing and contract work also may blur one's distinction between work and home life. Flexibility and autonomy require clear values and self-discipline (Malone, 2004).

**Effects of outsourcing on organizational knowledge**

Although acquiring access to additional services and expertise is a significant benefit of outsourcing, companies that require organizational knowledge as a valuable corporate asset will encounter challenges with outsourcing. Moving to an outsource model brings with it the need for new management skills, behaviors, and processes. Many characteristics inherent in outsourcing have direct implications on a company's institutional knowledge.

Outsourcing, by its definition of being an externally purchased service or resource, has two particular characteristics that can have a significant impact on a business. A primary characteristic is distance, which can vary from as far away as across the world to as close as across the street. The other main characteristic of outsourcing is which is similar to but distinct from distance is externality. This simply means that the service provider is not officially employed by the hiring organization and is therefore on at least some level an
outsider. These characteristics are related in that externality implies some physical distance, but it is not technically a requirement. A service provider could be in the same building or even in the office next door, although that would be an unusual arrangement. The distinction can be thought of as geographic distance (physical) and relational distance (externality). Neither of these characteristics is unique to outsourcing, but both of these characteristics have impacts on managing knowledge.

One obstacle introduced by externality and physical distance is the ability to maintain consistent standards and goals across groups. This is essential in achieving high organizational performance, improving productivity, and ensuring output quality for many strategic business reasons (Hersey, Blanchard, & Johnson, 2001), but is also vital in creating a knowledge-oriented culture which Davenport & Prusak (2000) describe as "... one of the most important conditions leading to the success of a project ..." (p. 153). The components of creating a knowledge-oriented culture are closely tied to the overall corporate culture in terms of orientation towards knowledge, knowledge inhibitors, attitudes towards the company, and knowledge management project type. When a service provider is external to the company, it becomes very difficult to control these aspects of corporate and knowledge culture because the external company's goals will not necessarily be the same as the company who is contracting them, but there is no direct hierarchy with which to enforce similar goals.

Network theory (and intuition) suggests that physical proximity facilitates face-to-face contact and that proximity's influence on knowledge and other factors, such as distribution channels and access to resources, results in industry clusters (Watts, 2003; Ganesan,
Malter, & Rindfleisch, 2005). Face-to-face contact is considered an important means of transferring information. "Studies have shown that managers get two-thirds of their information and knowledge from face-to-face meetings or phone conversations" (Davenport & Prusak, 2000, p. 12, citing Davenport). Certain dimensions of knowledge are more conducive to face-to-face interactions, such as complex tasks that require visual clues from the person receiving the information to verify their level of understanding and provide the opportunity to ask clarifying questions (Davenport & Prusak, 2000). But a trade off exists between the richness of face-to-face interactions when compared to the low cost and convenience of e-mail or other electronic means of communication (Ganesan et al., 2005).

**Tacit Knowledge**

Desouza and Evaristo (2004) address two categories of knowledge management approaches that they call "codification" and "personalization" (citing Hansen, et al.). Codification is a process where personal knowledge of individuals is collected in a standardized form, typically a centralized repository, and made available to members of an organization. In contrast, personalization refers to the tacit knowledge that is shared primarily through direct person-to-person contact. Personalization is also closely tied to relationships and trust between individuals sharing knowledge. It is the process of building trust relationships that puts a strong emphasis on personal contact. Even with decreased communication costs and additional communication systems, the level of trust required for effective sharing of tacit knowledge is difficult to achieve. Davenport and Prusak (2000)
describe some of the characteristics of tacit knowledge that make it a challenge to transfer.

• It is difficult to encode in a document or database.

• It is developed and internalized over a long period of time within a specific cultural environment.

• Often the "knower" is not aware they know it or that it is valuable to others.

• Some knowledge can't be represented outside the human mind.

Because of these difficulties, "... the codification process for the richest tacit knowledge in organizations is generally limited to locating someone with the knowledge, pointing the seeker to it, and encouraging them to interact" (p. 71).

In some cases tacit knowledge sharing with the outsourcing agency is not critical to the strategic business goals of a company. In these cases, the expertise of the outsourced company is unique from the knowledge assets of the main business and may allow for a company to benefit from specialized knowledge that they do not contain within their organization. For example, a Human Resources department would not need the specific knowledge that could be provided by members of a company's development department. There is possibly more value brought by the specialization of expertise in their particular area than would be achieved by internal methods. By focusing on a repetitive task in a slowly changing environment, they are able to realize the specialization benefits that come with repetition of a limited range of tasks and the economy of scale that is typically only seen in large corporations with a hierarchical structure (Watts, 2003). Certain businesses or business components are more suitable for outsourcing:

• Businesses that require additional flexibility or responsiveness.
• Businesses where knowledge is not a specific competitive advantage

• Businesses that have well-established standards and systems.

• Businesses where the outsourcer and core business have motivation for mutual success.

• Businesses in which communication takes significant time and effort.

• Businesses with outsource employees that are motivated by common values.

However, this is not as simple as it may seem. A Human Resources department may require specific cultural knowledge for hiring, for example. A comprehensive understanding of what attributes are considered valuable in employees and what values should be sought is important in setting policies within Human Resources for maintaining cohesive work environments.

In some cases sharing knowledge with a service provider may result in a complicated situation. In inter-organizational knowledge sharing, it is usually assumed that both organizations have knowledge that would be useful for the other organization, and by sharing that knowledge, both companies would benefit. However, when one company has knowledge that provides a key competitive advantage or perhaps a monopoly over the other, they must decide if the overall gains would be worth the strategic problems of sharing that knowledge with their competitor. (Loebecke, Van Fenema, & Powell, 1999).

Conclusion
The decision on whether or not an organization should outsource a part of their business is a complicated one, and should not be taken lightly. Searching for short-term cost savings is not a bad idea, but choosing outsourcing based solely on cost reduction or tactical problems is a short-term solution and will undermine a company's potential for long term success. The organization should have sufficient management skills and the ability to adapt new behaviors and processes to successfully manage an external part of their business. These skills should include knowledge management abilities and a willingness to apply them to a new and more challenging situation. Tacit knowledge must specifically be considered when planning an outsourcing strategy, particularly if the component of the business to be outsourced already exists internally and valuable institutional knowledge will be lost. The transfer of tacit knowledge can have a profound effect on quality and overall strategic business value. Cultural and language barriers add challenges to the already difficult process of transferring tacit knowledge and are of particular concern in cases of cross-border outsourcing. Finally, once a decision has been made to outsource aspects of a business, specific knowledge management strategies can be implemented that will maximize the benefits that are available from a decentralized business model.
References


