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Chapter 4

Outsourcing and the Flexible Firm; The Financial Services Industry

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Additional information is available at the end of the chapter

http://dx.doi.org/10.5772/intechopen.72771

Abstract

This chapter investigates, through a literature review, the increasing use of outsourcing by organisations and why this has become so prevalent in recent years. The use if an effective performance management system for outsourcing projects in the financial services organisation is considered as a means of ensuring success, and how outsourcing can be sustainable through the use of appropriate KPI's. The research results give valuable information on the use of monitoring the performance of suppliers through the use of a clear framework for performance management, and how this will avail the organisation of the many potential pitfalls which may be encountered with outsourcing. Further work is recommended in the area of outsourcing relating to the use of effective performance management and key performance indicators, which are carefully chosen to reflect the markets the organisation operates in, to reduce the risk of failure.

Keywords: outsourcing financial services performance management

1. Introduction

Many European governments have advocated both privatisation and outsourcing to further boost their companies and economies. This has motivated public and private organisations to enhance their core competencies by focussing on these first, whilst giving their other competencies to outside organisations, third-party providers, who in turn can provide focus and use their expertise in these areas. Due to this shift in how these organisations operate, a significant market has developed for companies who focus in the provision of enhanced support activities for other organisations [1].

Since the 1990s, service outsourcing became very popular [2]. Such a move has become prevalent in the service sector, notably in the financial services sector, where, for example, the back

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office operations can be outsourced relatively easily. This in turn allows process efficiencies to be improved [3]. According to the technical committee of the International Organisation of Securities Commissions [4], outsourcing is defined as 'an event in which a regulated outsourcing firm contracts with a service provider for the performance of any aspect of the outsourcing firm's regulated or unregulated functions that could otherwise be undertaken by the entity itself'.

According to the survey published in 2017, the financial sector has been the main driver of UK outsourcing to date. The survey, according to Arvato, suggests that the UK market achieved the strongest half-year performance since 2012. This included outsourcing deals worth £5.2Bn from January to June 2017, up 23%, of which the private sector accounted for the majority, worth £4.5Bn. Of this, the financial services sector was 64%.

As with many new trends, there have been a number of outsourcing projects which have either not met their expectations, or have failed in their entirety. A German management consultancy, Steria Mummert, conducted an exercise in 2008, which confirmed this. Steria Mummert asked 512 managers about their experiences; 30% of the managers said that the implementation of their business process outsourcing has not met their expectations [5]. This raises the question of why some outsourcing projects fail quite spectacularly, whilst some do succeed. Post-outsourcing supplier management has been cited by many researchers regarding poor outcomes in contracting-out [6], especially with regards to ensuring ongoing sustainability of projects in the financial services industry.

This chapter considers different forms of supplier outsourcing, including the notion of the flexible firm. The chapter further considers different forms of managing them to help managers ensure they have a sustainable, successful outsourcing project. This includes the implications of performance management on the outsourcing process and the outsourcing contract. To ensure this, the key success factors are identified, together with alternative frameworks from literature which have been considered and developed by different authors to provide an approach to be adopted to ensure best practise for management of outsourcing.

2. Literature review

2.1. Organisation

Coase [7] defines the concept of an organisation: 'in modern economic theory as an organisation which transforms inputs into outputs'.

Beardwell and Holden (1995) suggest that in order for an organisation to achieve its objectives, there is a need for the completion of a number of tasks. The complexity of the task determines the need for the availability of appropriate technology together with sufficient skills, of the human resources employed, to carry them out. As a result of this Beardwell and Holden (1995) explain 'this division of labour constitutes the lateral dimension of the structure of the organisation', and move on to explain the hierachial relationships of power and authority between the owners and the employees who take on the responsibility for completion of the task(s). As a result of this, Beardwell and Holden (1995) suggest 'some of the basic elements

of an organisation, then, are its ownership and source of authority'. Another basic element of an organisation is to help its employees to succeed.

One of the most important challenges an organisation faces is to make sure that there is a good match between an employee's skills and commitment and the tasks they are being asked to perform. In current rapidly moving work environments, the availability of time for new employees to adapt and develop is lessening. The organisational expectations are for the employees to become productive almost immediately, to perform the task(s) and move on.

As the quality and quantity of output is becoming more demanding, coupled with the unstable nature of work in recent years, more and more organisations are shifting to outsourcing. To this end, outsourcing can be seen as both a strategic and a pragmatic response to the demands and constraints of an organisation.

The selection of strategically relevant resources and capabilities is critical in determining an organisation's core competencies in order to promote ownership and employee success. A core competence is what an organisation prides itself in, what it is especially proficient at, and it is often invisible to the external customer.

This core competence has become more valuable over time and through continued use because, as is mostly the case, core competencies are primarily knowledge based and they become embedded into the culture of the organisation through the passage of time. As a result of this, organisations must continuously invest in their strategically chosen core competence to be able to adapt to the rapid changes in the global economy, if this is not the case, the organisation is clearly at a competitive disadvantage. According to Hitt et al. [8]) 'a sustainable competitive advantage is achieved when organisations implement a value-creating strategy that is grounded in their own resources, capabilities and core competencies'. This viewpoint is based on the assumption that resources and capabilities are of primary importance to profitability and the emphasis is placed upon adapting the external environment to the organisation. The rationale for the resource-based approach to strategy states that the external environment in which an organisation operates is constantly subjected to uncertainty and rapid change. However, an internal focus upon resources and capabilities offer a more secure basis for strategy than a market focus. Thus, it is how the organisation, and not where the organisation, competes. The task of organisational management, therefore, is to decide which resources and capabilities are strategically relevant, and how best to improve them in order for the organisation to exploit all the opportunities in the external environment.

As stated by Hitt et al. [8] organisational resources can be defined as: 'inputs into an organisation's production process, such as capital equipment, the skills of individual employees, patents, finance, and talented managers'. Resources can be divided into tangible and intangible assets and their integration and combination is crucial to ensure an organisation's long-term competitiveness. Tangible resources can not only be easily identified and evaluated, but also imitated by an organisation's competitors. Perhaps the most important and strategically relevant intangible resource is the organisations knowledge, together with the organisations reputation for its products and service quality in being able to create value for its targeted customer.

Day [9] suggests that capabilities are: 'complex bundles of skills and collective learning, exercised through organisational processes, which ensure superior co-ordination of functional

activities'. The strategic integration of an organisation's tangible and intangible resources are its capabilities which must be developed and built upon over time for an organisation to compete in today's global economy.

However, organisations must be aware that core competencies should never be so rigid, so as not to allow the organisation to grow and develop in accordance with the demands both from the internal and external environment.

An organisation's resources, capabilities and core competencies provide the foundation for success; nevertheless they represent one piece of the organisational jigsaw. Resources alone are relatively unimportant; it is the ability of the organisation to use those resources effectively to create opportunities in the external environment which ensures an organisational success.

In addition to our earlier definition of outsourcing, the concept is often quoted in literature is that of Elfing and Baven [10], where the outsourcing concept is seen as, 'a contractual agreement between the customer and one or more suppliers to provide services or processes that the customer is currently producing internally'. Prior to starting the process of outsourcing its paramount to consider the key determining success factors and also the limitations of such direction. As suggested by the Technical Committee of the International Organisation of Securities Commissions [11], there is a need to be mindful of 'the potential that the inappropriate consequences for the outsourcing firm's customers and in certain instances, the potential for systemic risk to the market as a whole'.

Resource-based theory [12] identifies processes and services to be outsourced. Wernerfelt found that when analysing a firm for a future strategy, resources are more important rather than the products it sells or services it performs. He defined resources as tangible and intangible assets, which are tied semi-permanently to the firm. Research by Prahalad and Hamel in [13] found out that organisations' resources are the key in building competitive advantage; these in turn are noted as their core competencies. Core competencies are a starting point when deciding which parts of an organisation can potentially be outsourced. Outsourcing can be carried out both internally in the organisation and, more commonly, carried out externally. Internal outsourcing is noted as 'quasi-outsourcing' ([14], p. 533), where an organisation outsources a process to an entity which acts like an external vendor, but is still owned by the organisation. When an organisation uses external outsourcing, the business process is operated entirely independently by a third-party provider [15]. Further, there are other categories relating to where the outsourcing is located; service performance onsite, onshore-outsourcing, offshoring and nearshoring [16]. Why such alternatives are considered in the majority of cases, is due to costs of undertaking the process in-house against those to be incurred if the process is undertaken by a third-party. Lower costs by a third-party will give reason to consider outsourcing, although other significant issues need to be taken into account [17], including the use of clear performance metrics if the approach is to be used.

2.2. Flexible firm

The concept provides the organisation with the facility to be flexible enough to focus on the core business and sub-contract or alternatively outsource the remaining parts of the

http://dx.doi.org/10.5772/intechopen.72771

organisation. For an organisation to be able to respond to such a business model it must be dynamic, flexible and efficient enough to cope with the demands of such an organisational form.

The first objective is to establish what is meant by the term flexible firm and how the concept can be applied to traditional organisations today.

Atkinson's model of flexibility which was developed during the 1980s, identifies four different forms of flexibility within an organisation and defines the ways they can be achieved. As a result of this Atkinson (1986) developed the model of 'The flexible firm', based on numerical, functional, distancing and pay flexibility.

Numerical Flexibility: According to Atkinson (1986), numerical flexibility can be achieved to meet the demands of human resources inputs by increasing or decreasing the number of working hours, or alternatively increasing or decreasing the number of human resources employed by the organisation.

Functional Flexibility: Functional flexibility can be achieved through multiskilling of employees, and the organisation's ability to alternate and utilise the skills of employees to meet the requirements of different tasks at various levels by changing the methods of production and workload.

Distancing: An organisation's numerical flexibility can be improved by replacing the organisation's employees by subcontractors, consultants, self-employed and agency temporaries. These services can be utilised as and when required by the organisation.

Pay Flexibility: Pay flexibility focuses on providing financial support for various functional and numerical flexibilities.

Atkinson's (1986) flexible firm's workers are divided into *core* and *peripheral* working groups, where the core group, i.e., 'the primary labour markets' is focused on running the organisation and securing contracts, whilst the remaining groups', i.e., 'secondary labour markets, stay flexible through quantitative adjustment' according to the organisational needs, followed by self-employed contract workers, subcontractors, outsourcing and agency temporaries all pooled together to complete the task (Atkinson and Gregory 1986) **Figure 1**.

2.3. Outsourcing in the financial services industry

In the financial services sector, Tas and Sunder [3] identified major drivers for outsourcing as well as offshoring, where improvements in communications have made it possible for financial institutions to outsource processes with little loss of control. Globally accredited ISO systems have made it possible to outsource business processes utilising skilled labour.

2.4. Performance management of suppliers when outsourcing

According to Neely et al. [18], performance measurement is defined as 'the process of quantifying the efficiency and effectiveness of action'. In other words, it helps an organisation assess the performance of its processes regarding effectiveness and efficiency.

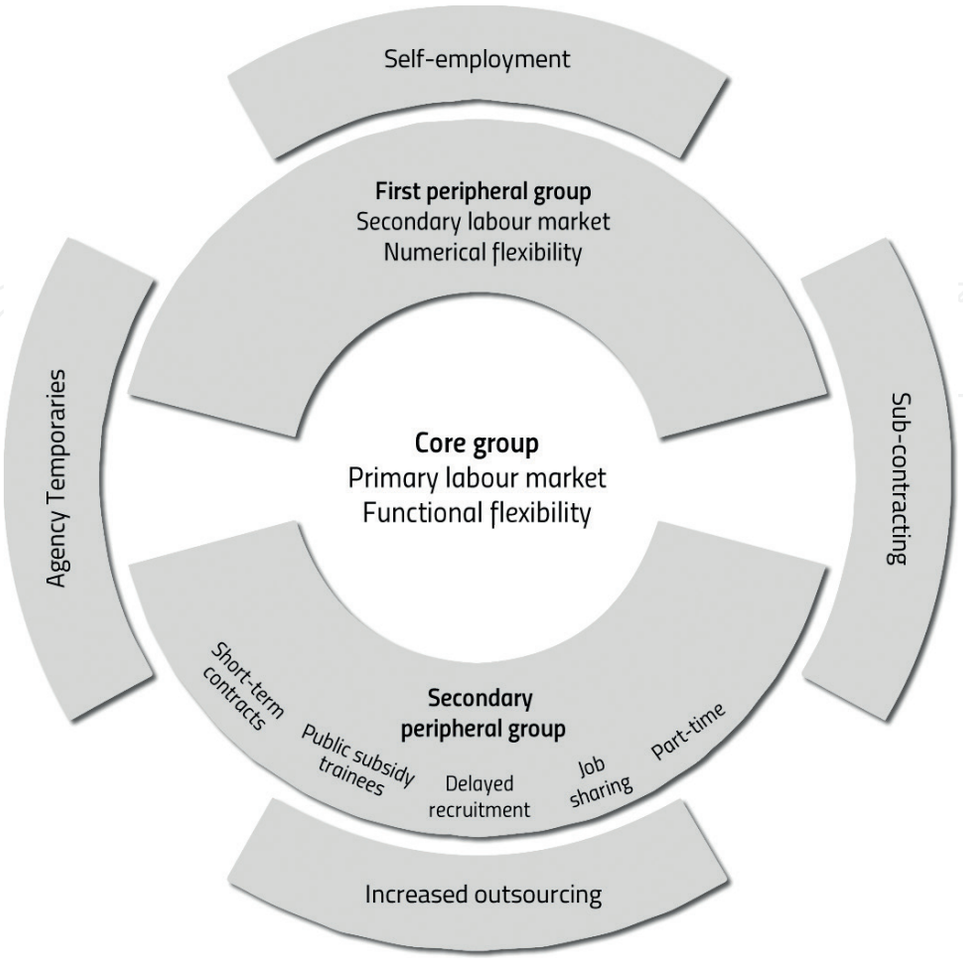


Figure 1. Atkinson's flexible firm.

Performance management has developed from performance measurement [19] in recent years. Literature on measurement has mostly focused on producing data, whereas performance management converts such information into means to improve performance. Folan and Browne [20] saw performance management as using information relating to performance measurement information provide enhanced organisational culture, systems and processes. This is done by using performance goals and prioritising resources, whilst ensuring managers effect and control policy bring about change and meet pre-defined goals by using performance management [20]. Performance management itself has been developed in the field of human resources with a special focus on human performance [19] as well as for managing corporate performance as well.

Notably, the literature exclusively reviews intra-organisational performance. However, performance management of suppliers requires an external view of performance to be adopted. This area has not been extensively investigated, and some authors [20] have suggested further research on performance management systems outside the organisation, including how to effectively assess the supplier. Little work has been done of developing frameworks, which include factors relating to the industry, economy, etc., which can affect the operation of the supplier significantly.

Weimer [17] outlined three major steps in the performance management process; engaging with objective setting, incorporating a performance measurement system able to assess the status of objectives and converting the gathered data into action to ensure performance improvement. To do this, account needs taken of the outsourcing lifecycle. During the different stages of the outsourcing process, account needs taken of the outsourcing lifecycle, which can in turn be sub-divided into phases. The number of the phases depends on what is being outsourced and its complexity, but usually noted as between two and four [17, 21, 22]. Usually, this includes an assessment phase, including a transition plan for when the process moves to the supplier organisation, to ensure the correct outsourcing strategy, the setting of clear objectives to the eventual signing of an outsourcing contract [23]. After selecting the most appropriate outsourcing organisations, a document outlining the service level agreements (SLA) will be required, from which a clear business case for the finally selected supplier organisation will emerge. The final document will be an outsourcing contract for the selected organisation. Outsourcing, for the majority of processes, is not always quick to bring to effect and needs careful planning, requiring a transition plan as processes are transferred to the selected outsourcing organisation. A prime objective at this stage is to move processes with no detrimental effect on the service previously provided by the organisation There will be a transition phase, where processes or services are moved from the organisation to the supplier; according to the transition plan established in the assessment phase [23], the aim being to shift the outsourced operations efficiently to the service provider so that the agreed service levels are met after a short period of time [17].

Once service levels are met, through to when the contract terminates, it is expected that both parties work together to continually enhance the process in order to both reduce costs and to further the benefit of having the process outsourced, using measurement tools [24] as appropriate.

This is best attempted, where possible, as a partnership, although experience and research has pointed to this actually not being the case and often a reason for failure. This highlights the importance of the outsourcing contract [25], which needs to set out in unambiguous terms the scope of the work within the outsourcing being carried out, together with roles, responsibilities, liabilities and expectations of the parties managed by the contract ([15], p. 134).

Frameworks such as that of Platz and Temponi [26] identify the most important elements of the outsourcing contract, covering performance, financial, HR and legal functions to ensure the contract is fully covered and can be managed to the expectations of both parties. Oher authors see the most important elements being specifications for service levels and quality to encourage vendor performance and discourage underperformance [26], whilst others include guidelines to ensure measures are taken where there are cases of poor performance by the supplier [15] as well as for over-performance [27].

2.5. Performance management systems in outsourcing projects

Aron and Singh [28] stress the importance of using internal measurement before the outsourcing decision as a key factor in contributing to success. This is useful where a comparison is later made to ensure, or otherwise, that the outsourcing service provider is providing

a better service/process than would have been the case if this were still provided in-house better than this own organisation did when the process or service was still performed in-house. Further, noted that benchmarking of the service/process should also be carried out to ensure the appropriate levels of performance and cost expectations are realistic and likely to be met.

After the selection of the service/process to be outsourced, Gottschalk and Solli-Saether [29] describe stakeholder management as significant and a further important factor in ensuring that outsourcing is a success. They see the relationship between buyer and vendor needing effective and defined management to ensure success; these required efficient and effective approaches to ensure success. Weimer [17] contributed to this in pointing out that success of an outsourcing project solely depends on the professionalism in managing the outsourcing supplier's performance.

During the operations phase, performance management is critical to success. Measures used need mutual agreement at the start, but there must be the flexibility in contractual agreements to allow measures to be changed due to enhancements to the process or where factors impinge on the process provided. Amendments to pre-agreed contractual measures need to be considered, as many outsourcing projects fail where there is inflexibility in coping with changes to the changing environment [30]. There is agreement among research that changes to contracts needs careful regulation to cope with changing business conditions [31].

Basu [32] also points to the need for careful selection of the performance measurements to be utilised; too often there is failure in taking time to consider what is appropriate to the process being outsourced; taking time at this stage can save considerable discussion at later stages in the work. Dittrich and Braun [23] stress the need to consider both hard and soft measures at this stage. Later work by Pai and Basu [25] reviewed performance metrics and placed them into four categories; volume of work, quality of work, responsiveness and efficiency.

2.6. Tools for performance management

The most commonly used tool in outsourcing projects is the Balanced Scorecard approach [31]. Devised by Kaplan and Norton [33], the Balanced Scorecard is a tool used by many organisations to provide a tool to translate objectives to performance measures and is appropriate to outsourcing projects.

Performance management of outsourcing is also only of relevance if the reasons for failure to meet measures is given careful consideration and the reasons for this poor performance [30]. Prior to suggesting improvements, the cause needs to be found and reviewed to find if the cause is temporary or a change to the work is required.

It is essential to find out the causes of poor service levels first before designing an improvement programme. It is also important to review what will be done where levels are exceeded; sharing the rewards of enhanced performance can be excellent for both parties and needs careful consideration as well as considerable encouragement. On the contrary, how to deal with poor performance needs careful consideration and managed in a way that ensures the contractor is encouraged and motivated to meet or exceed targets [34]. Pai and Basu [25] introduced the

concept of a service credit system; payments to the outsourcing service buyer, when the supplier does not meet the service levels. The main purpose of this is to provide the organisation providing the service with incentives to meet target performance and has proven to be very effective for supplier performance improvement [25]. Throughout the above approaches, the means of communication needs careful consideration, together with how this is managed, as part of the drive to improve the outsourcing relationship [35]. By building trust through communication, the post-contract transaction costs can be reduced [31]. Authors, such as Dzierzon [30] and Schoeninger, have recommended teams of staff dedicated to this task, where the scale of the project is large.

2.7. Financial services outsourcing: key factors for success

The preceding paragraphs provide generic factors to be considered in ensuring success. For the financial Services industry, two further factors have been added. Authors writing about outsourcing in financial services point to the need to consider risk management. This requires [36] a risk analysis of the outsourced process. First, the process requires evaluation with regard to the internal business risk should the outsourcing process fail. Gewald und Dibbern [37] put forward four classifications for this; Performance risk, where the supplier does not deliver according to expectations leading to potential damage to reputation of the financial services institution; Financial risk, where the financial institution will be obliged to pay more for a service than initially planned; Strategic risk, where the organisation may lose resources that could contribute to competitive advantage; and finally, Psychological risk where managers' departments are outsourced. A second issue is where there may be legal restrictions imposed on financial services institutions with regard to them outsourcing distinct areas of their business. Governmental institutions, including the Basel Committee on Banking Supervision, the Committee of European Securities Regulators and in the UK, the Financial Services Authority (FSA), have stressed the necessity of legal regulations relating to the outsourcing of financial organisations. These relate to supplier dependence, legal risks, IT risks, to only name a few [36]. The UK Financial Services Authority' regulations were analysed by Evans [38], who found that the identification of potential risks and necessity of systems for management and control of these risks are a major issue within these regulations. This demands a secure supplier contract, employed within a relationship management system. There is a need for internal and external due diligence and the introduction of a well-managed performance measurement system are claimed by this legal body as well. Outsourcing within the financial sector in general, is seen [39] as increasing risks where outsourcing is used.

A further area of interest that is quoted in literature about performance management in financial services outsourcing is the statement of auditing standards (SAS) 70, originally developed by the American Institute of Certified Public Accountants as a communication tool for auditors to discuss the functionality of audit processes between outsourcing parties. This is an international standard for the evaluation of supplier's performance control systems [36]. This gives the outsourcing organisation an independent view on the processes and performance of the supplier. Reports are prepared by audit companies on a continuous basis to ensure that the outsourcing company can assure the supplier's capability for the delivery of the outsourced services [40]. This provides a valuable supplement for the supplier's performance assessment.

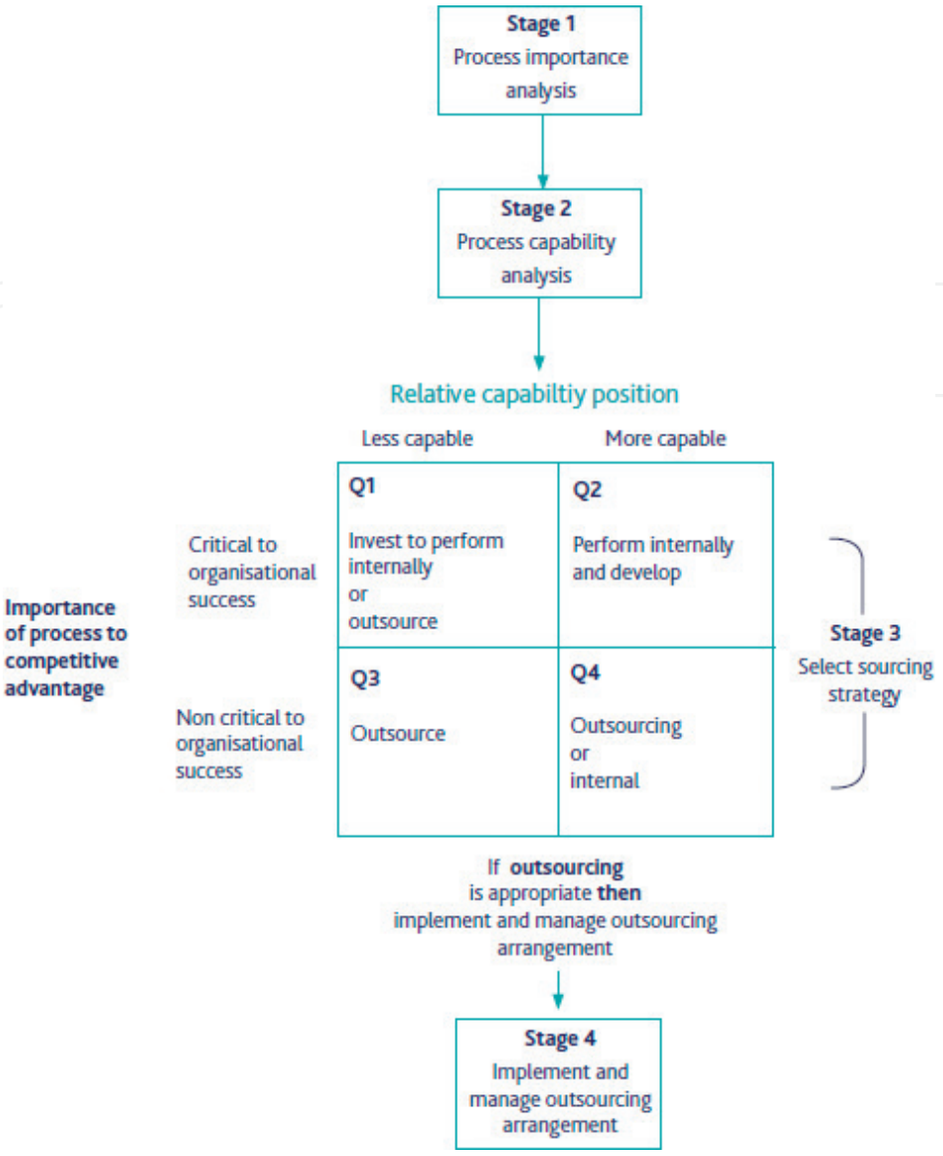


Figure 2. McIvor's performance management framework [41].

2.8. Performance management frameworks for outsourcing projects

Figure 2 is an example of a Framework for managing outsourcing, developed by [41]. This provides an organisation with a guideline of how to implement performance management both prior to, and during an outsourcing project. McIvor split this into four stages:

1. Process importance analysis, identifies the process's contribution to corporate success. Core competencies contributing to competitive advantage should remain in-house. Non-core competencies should be considered for outsourcing. This area of McIvor's study uses the so called critical success factor (CSF)—method to identify critical and non-critical processes.
2. Process capability analysis, is used to determine whether the outsourcing organisation is capable of performing the process to the same or a higher level when it is compared to potential external suppliers. This stage will use both cost analysis and benchmarking.

3. Choosing the sourcing strategy based on the analysis results is then carried out by the organisation. There is then the decision of whether the organisation carries on, or whether it decides to outsource.

4. Finally in McIvor's framework, the further step relates to the implementation and management of the outsourcing arrangement if this is the chosen path, following the third stage. Here, a sub-classification into contract management, managing and evaluating the relationship is made. Although the study gives some indication on how to manage and evaluate the supplier, a clear tool or guideline for design and implementation that could be adapted to the majority of outsourcing projects is not given.

Further to the above, Weimer [17] has put forward an approach to transform the Balanced Scorecard, normally used for internal use, into a performance measurement tool for outsourcing projects. The work of Weimer concentrated on the need to identify the relevant information necessary for an organisation to effectively manage the outsourcing project (Hodel et al. [24]; Basu [32]; Würz and Blankenhorn [31]), are also noted authors relating to using the balanced Scorecard.

In identifying relevant information for performance management in outsourcing, Weimer used the Delphi technique to organise and share opinion through feedback. Service reporting and performance management were the two areas, where he found a distinctive need for good information, together with measurement and reporting tools that produce information regarding service levels, quality and customer satisfaction to ensure success of the outsourcing contract. Weimer found the balanced scorecard to be of benefit in undertaking this task.

3. Conclusion

Limited work has been undertaken in the development and use of effective performance management in outsourcing projects, beyond the work of McIvor and Weimer. However, the frameworks shown, do provide a model for organisations to follow to ensure they consider appropriate stages, which if done in detail and managed appropriately, should lead to success.

In addition to the main areas addressed in this chapter, there is a requirement for further research into the relationship between performance management and the notion of outsourcing, using data from organisations who have undertaken such a move in recent years. There are many real, potential challenges to outsourcing as has been the case in recent, turbulent international markets. There has been a notable amount of literature on successful outsourcing within the financial services sector, but there further research work is required to ensure organisations use carefully selected KPI's relevant to their particular situation, whilst ensuring they are aware of the use of these.

Further recommendations relating to the above [42] are that organisations, in order to reduce the risk of failure when outsourcing, they need to consider a number of key factors prior to embarking such a strategic move. Bateman suggested that they also take account of 'realistic expectations; sufficient in-house expertise to enable effective contract management and have a contingency plan so that you can, if necessary, take the service back in-house'.

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