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Theophanis Stratopoulos
University of New Hampshire, theos@unh.edu

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Electronic Alliances: Outsourcing for Competitive Advantage

Theophanis Stratopoulos
University of New Hampshire
theos@unh.edu

ABSTRACT

While several studies have examined the role of strategic alliances in outsourcing, as a way to manage the client-vendor relationship, no systematic attempt has been made to integrate the knowledge from the strategic management literature. The study contributes to this line of research, by developing a framework that weaves the Relational-Theory View with the outsourcing literature. This synthesis leads to the proposition that the more an outsourcing alliance meets the conditions of Relational-Theory, the higher the rent generating potential for the partners. Specific scenarios are generated based on the strategic value of the considered process, as well as the existence and the visibility of the appropriate capability.

Keywords

Outsourcing, relational theory, strategic alliances, resource based view, competitive advantage, IT capability.

INTRODUCTION

Almost twenty years ago, while studying the effects of IT advances on firm and market structure, Malone *et al.* (1987) argued, that IT integration systems (networks) have made the vertical disintegration of value-chain activities in different companies beneficial. Moreover, companies can retain some of the advantages of internal hierarchical relationships in their marker relationships with external suppliers. The authors closed the paper with the following suggestion for business strategists:

“All firms should consider whether more of the activities they currently perform internally could be performed less expensively or more flexibly by outside suppliers...” (Malone et al., 1987; 496)

Although the original suggestion was not specific to IT activities, the subsequent explosion in the IT outsourcing market is a testament to the prophetic nature of this suggestion. In 1989, Kodak opened the floodgate by outsourcing all of its data center operations. Today, it is almost impossible to find a large company that does not engage in some form of IT outsourcing (InformationWeek Research, 2004).

Cathay Pacific Airways, a Hong Kong based airline serving 80 destinations in thirty countries, has significant exposure to IT outsourcing.¹ Over the years the company's IT department grew with the company and it was developing and managing their IT needs. The company's data center was responsible for coordinating fundamental airline IT functions such as reservations, ticketing, cargo handling, etc. These functions are critical for all major airlines and they require a robust IT infrastructure. In 1997, during a period when Cathay was under a lot of pressure to cut costs, the company decided to outsource its data center to IBM Global Services. A few years later, IBM used the former Cathay data center to serve several dozens of clients. Among them are a number of major airlines in Australia, Korea, and Japan. Evidently, IBM Global Services combined its own expertise in terms of offering IT outsourcing services to travel related companies with the 'outsourced' IT capability of Cathay's data center and the talented pool of Cathay employees, in order to gain a successful regional presence for itself. Meanwhile, Cathay was preparing for another round of IT outsourcing.

Is there an alternative? In this paper, I argue that alliances are a reasonable alternative to arm's-length outsourcing. Following the terminology introduced by Malone *et al.* (1987), I call this an electronic alliance, and I see it as a hybrid

1 The information about Cathay Pacific is based on the Harvard Business School case study # 9-303-106. "Cathay Pacific: Doing More with Less" by F. W. McFarlan and F. Young. Boston, MA. 2003. I use the case of Cathay Pacific – IBM outsourcing deal simply as an example that helps me illustrate my argument.

between the market and hierarchy model.² In an electronic alliance the client and the vendor will combine unique and complementary resources. In the context of our example, Cathay provides the unique experience (IT capability) it has developed over the years on how to support the fundamental IT functions of an airline. IBM Global Services provides the experience on how to offer outsourcing services to travel related companies. Combined these capabilities offer the partnership the unique competency necessary to serve the needs of all major airlines in the region.

An electronic alliance is feasible in cases when the client has developed or is developing some unique IT resource or capability. However, the client cannot fully capture the potential rents associated with this resource due to market limitation. Since IT by its very nature is a support activity (Porter and Millar 1985), the market for the resource is limited within the domain of the developing company. Sooner or later the company knows that it will have to yield to competitive pressure and consider outsourcing this particular process. An alliance with a vendor having expertise in the development and selling (outsourcing) of similar IT resources could extend the marketing of this resource to a larger market. If the management of both companies (client-vendor) has the ability to foresee and execute such a scenario it will be a source of competitive advantage for both parties.

I propose the possibility of an electronic alliance as an alternative to the mindset that tends to consider outsourcing primarily during periods of financial pressure. If outsourcing is cost-cut driven the benefits are secure but limited (Quinn, 1999). On the other hand the benefits (as well as the risks) of a strategic alliance are much bigger. The idea of electronic alliance is based on a synthesis of the client-vendor literature on outsourcing with two major theories from strategic management, namely: the Relational Theory View and Resource Based View.

The structure of the paper will be as follows: I will start with a brief review of the outsourcing literature in part II. My emphasis will be on client-vendor relationships. In part III, I will continue with a presentation of the Relational Theory View in the context of outsourcing. In part IV, I will further refine the conditions under which an electronic alliance could lead to creation of relational rents for both client and vendor. I will 'eat humble pie' in part V, by looking at the possible limitations of an electronic alliance as an outsourcing strategy and close the study with a short summary.

RELATIONS IN OUTSOURCING

More than a decade after the ground breaking outsourcing deal between Kodak and its partners, the market for outsourcing of IT services has been growing steadily. Even its harshest critics will have to agree that it has outlived the 'five-year period typical of a management fad' (Lacity and Willcock 2000). During this time the IT outsourcing market has matured not only in terms of volume but also in terms of sophistication. According to International Data Corporation (IDC) the global IT-enabled services market will account for revenues of \$1.2 trillion by 2006. This trend is mirrored by a parallel growth in the spectrum of outsourced products/services, with business process outsourcing, i.e., the outsourcing of IT enabled services being the most recent addition³. At the same time, the supply side of the outsourcing market has undergone a dramatic change that led to the development of several new sourcing models and has made India the new destination of choice for outsourcing of IT enabled services.

The volume of the literature on outsourcing of IT services and IT enabled services is another testimony to the growing importance of this market. Numerous papers have been written in academic as well as professional journals examining such issues as sourcing practices (Lacity and Willcock 1998), forces driving outsourcing (Clark *et al* 1995), determinants of outsourcing (Loh and Venkatraman, 1992), risks and benefits (Lacity and Hirschheim, 1993), hidden costs (Barthelemy, 2001), as well as frameworks for management of outsourcing decisions, and governance structure (McFarlan and Nolan, 1995) among others.⁴

Studies examining the dynamic of a client-vendor relationship and its implications for the success of an outsourcing deal hold a prominent position in this literature. While several of these studies examined the role of strategic alliances, as a way to manage the client-vendor relationship, the quest for the most effective way is still active (McFarlan and Nolan, 1995;

² According to Malone *et al.* (1987) "markets coordinate the flow through supply and demand forces ... Hierarchies, on the other hand, coordinate the flow of material through adjacent steps by controlling and directing it at a higher level in managerial hierarchy." p. 485.

³ Most of the professional sources tend to interchange between the terms business process outsourcing and outsourcing IT enabled services. I will use a similar practice in this study. For a fine distinction between the two of them see Kennedy (2002)

⁴ For a more thorough and in depth literature review, see Lacity and Willcock 2000 (pp. 358-361), Mahnke *et al.* (2003).

Klepper, 1995; McLellan *et al.* 1995; Davis, 1996; Kaiser and Hawk, 2004). In the mid nineties the work of McFarlan and Nolan (1995) and the success of the Xerox-EDS deal (David 1996) provided support to the argument that strategic alliances were the best governance structure. A few years later, Kern (1999) revisited the Xerox-EDS case and found that it had been restructured because of some significant issues and disappointments.⁵ More recently a new crop of studies (Kaiser and Hawk, 2004; Lacity *et al.* 2003) points to the benefits of selective alliance driven outsourcing cases. Quinn (1999) argues that as vendor's capabilities improve, the strategic issue from a client standpoint becomes how can we manage potential outsourcing relationships for greater shareholder value.

The need for additional research in the area of client-vendor relationship comes from several sources (Lacity and Willcock, 2000; Lee and Kim, 1999). Lee and Kim argue that there is need for more research that will lead to the development of a theory base for outsourcing alliances. According to Lacity and Willcock the call for more research in the relational aspect of outsourcing is driven by recent changes in technology. These changes have led to the creation of new emerging practices such as the fact that the market for outsourcing of IT enabled services has become the leading growth market.

Although there has been a steady interest in outsourcing literature in client-vendor relationships, as of to date, no attempt has been made to integrate what we have learned in strategic management literature with outsourcing theory. Such integration can support the development of a framework arguing the rent generating potential of electronic alliances in outsourcing. In the following section, I introduce the relational-theory view as a framework for studying the rent-generating potential of outsourcing alliances.

RELATIONS IN STRATEGY

To understand the need for a model such as Relational-theory view (RTV), one must consider the following: First, it is a well-accepted fact that simply framing the outsourcing process, as a make-or-buy decision is inappropriate. Outsourcing clients have the option to enter into a partnership or long-term relation with their vendors (McFarlan and Nolan, 1995; Gulati *et al.* 2000). Second, while there are numerous studies on the client-vendor relationship, most of them are based on ad-hoc frameworks, i.e., frameworks that were developed to address the needs of the empirical analysis. In the backdrop of these observations, we have the RTV (Dyer-Singh 1998), which suggests that a firm's capabilities may straddle the firm boundaries and may be embedded in inter-firm routines and processes.

RTV has been offered as an alternative to Industry Structure View and Resource Based View. The industry structure view looks at industry level characteristics that define the overall attractiveness of the industry, and argues that firms operating in attractive industries are likely to be more successful. On the other hand, the Resource Based View concentrates within the firm and attributes success to resource heterogeneity. Successful companies are those in possession of unique resources. The view introduced by RTV is that companies may be able to combine resources in unique ways. Using the network between firms as the unit of analysis, the theory looks at various aspects of partnerships that have the potential to lead to rent creation (competitive advantage). Dyer and Singh argue that competitive advantage is possible when alliance partners combine, exchange, or invest in idiosyncratic assets, knowledge and resources, and employ effective governance mechanisms that lower transaction costs or permit the realization of rents through the synergistic combination of assets, knowledge and capabilities.

The first of the RTV propositions examines the role of investments in relation specific assets. According to Dyer and Singh there are two key sub processes – related to investments in relation specific assets - that influence the ability of partners to generate relational rents: (1) length of the governance arrangement designed to safeguard against opportunism, and (2) volume of transactions between partners.

What is the role of length and volume in the context of outsourcing and outsourcing alliances in particular? The optimum length of outsourcing contracts has been an often-visited research topic. Lacity and Wilcock (2000), among several others, argue that long-term deals tend to be less successful. Difference in incentives between clients and vendors, as well as lack of flexibility have been the main reasons why clients should avoid long-term contracts (Harrigan and Newman, 1990; McFarlan and Nolan, 1995). However, while these limitations are valid in the case of an arms-length type of outsourcing, it is clear that they are less binding in the case of an electronic alliance primarily due to better alignment of incentives between the partners (Lacity *et al.* 2003).

Concerns regarding the maturity of the outsourcing market and its effect on the ability to support a large volume of transactions, and the small number of major players on the supply side has been raised by several authors (Harrigan and

⁵ As described in Lacity and Willcock (2000), pp. 381-382.

Newman, 1990; McFarlan and Nolan, 1995). In at least two studies we find arguments that the outsourcing market has matured. More specifically, Carmel and Agarwal (2002) argue in favor of the maturity for the demand side of the market, while in Rottman and Lacity (2004) we find evidence regarding the maturity of the supply side.

The current state and growth of the outsourcing market is the result of a series of geopolitical, economic, and technological changes that took place since the late eighties and early nineties. The role of these changes was pivotal for the evolution of the outsourcing market. However, the future is more likely to be determined by market forces (competition). The effect of competition as the major driver of the future outsourcing market is very clear in the supply side of the market. In the past, outsourcing service providers gained expertise in administering business activities and slowly institutionalized change while continuously improving the processes over time. Currently, outsourcing vendors not only take on the responsibility to manage the function or business process, but they also re-engineer the way the process has been traditionally done. In addition to this, more companies and countries are entering the supply side of the outsourcing market. The increased competition will force suppliers to become more efficient and more creative in terms of the spectrum of products and services that they offer.

The effect of the previously mentioned changes in the supply side of the outsourcing market is dual. First, in the past the outsourcing market was mostly demand driven. Gradually this is changing and the market becomes more and more supply driven. Second, as the supply side is evolving and providers are more creative in the services that they offer, we are going to see more companies on the demand side lured to the outsourcing market in order to take advantage of these offers. Companies will also re-evaluate what processes are to be outsourced and what are not to be outsourced. This will bring us closer to the creation of the virtual company envisioned in the early days of the IT revolution. Hence, we conclude that the market has matured both in terms of scale and scope.

The second of the RTV propositions, states that the greater the alliance partners' investments are in inter-firm knowledge sharing routines, the greater the potential will be for relational rents. Such rents are conditional upon the partners' absorptive capacity and the alignment of incentives between partners. While the importance of the alignment of incentives has a long history in the IS research literature (Harrigan and Newman, 1990; McFarlan and Nolan, 1995; Lee, 2001; and Lacity *et al.* 2003), the interest in absorptive capacity and knowledge management is more recent (Sambamurthy and Subramani, 2005; Malhotra *et al.*, 2005). As we have already seen, researchers have already argued that alliances are more likely to attain better alignment of incentives between the partners than arms length outsourcing deals (Lacity *et al.* 2003). Lee (2001) has found some empirical evidence validating the effect of the ability of partners to absorb shared knowledge on outsourcing success.

With the third proposition, RTV turns to the issue of governance and argues that the greater the alliance partners' ability is to employ self-enforcing safeguards rather than formal or third party self-enforcing safeguards, the greater the potential will be for relational rents due to lower costs (contracting, monitoring costs, adaptation costs, and re-contracting cost) and difficulty of imitation. Theoretical and empirical evidence points to the importance of a sound partnership. Poppo and Zenger (2002) argue that both formal and informal mechanisms are necessary for a sound partnership. Jurison, (1995) argues that the form of partnership represents a passive and ongoing organizational approach to reducing the risk of inadequate contractual provisions. In Hancox and Hackney (2000) we find that partnerships may be comforting for clients about to outsource a complex and high cost activity. Klepper (1995), Lee and Kim (1999) argue that partnership quality is critical success factor for outsourcing effectiveness and Lee (2001) offers some empirical validation.

Last but not least, RTV looks at the proportion of synergy sensitive resources owned by alliance partners. According to RTV, the alliance's rent generating potential is proportional to its ability to combine resources, which are valuable, rare, and difficult to imitate. Dyer and Singh recognize that it is often very costly and difficult to place a value on the complementary resources because of such variations as their prior alliance experience and internal evaluation capacity.⁶ As we have seen the outsourcing market has matured and these conditions are more likely to be met now. Carmel and Agarwal (2002) in their study on the maturation of the offshore sourcing they identify four stages of maturation: (1) companies that do not outsource, (2) companies that are experimenting, (3) companies that seek corporate wide leverage of cost efficiencies through outsourcing, and (4) companies that take a proactive approach and see outsourcing as a strategic imperative. The authors estimate that no more than 10% of the companies have moved to stage four (proactive strategic focus) in their offshore

⁶ Market maturity and RBV are the two channels that I use to relate outsourcing with this RTV proposition. While the discussion on maturity is introduced in this paragraph, the discussion on the role of RBV will appear in the following section.

maturity model. However, they expect that the majority of the large US companies will transition towards the third and fourth stage. A parallel movement in the supply side of the market follows the maturity of the demand side of the market. In the early stages, developments in the outsourcing market – especially the offshore market - were demand driven. Companies like GE and American Express developed their own captive centers in India. However, this trend is changing. As the initial adopters move out of their captive centers, Indian vendors play a more active role in this market (Economist, 2004). Obviously, the further the market moves on the maturity curve the easier it will be for partners to meet the conditions of this RTV proposition.

Our synthesis of the outsourcing literature and RTV leads to the following general proposition:

The more an electronic alliance meets the conditions of RTV the higher the rent generating potential for the partners.

In the following section, I further refine the general proposition with reference to the Resource Based View. I will consider firm specific resources and capabilities that are likely to affect the rent generating potential of an outsourcing alliance.

POSSIBLE SCENARIOS FOR OUTSOURCING ALLIANCES

A synthesis drawing on Resource Based View (Barney 1991, 2001; Dierickx and Cool 1989; Peteraf 1993, among others) and the life cycle of a typical outsourcing initiative offers some useful scenarios/propositions under which an alliance might be more likely to generate relational rents. In a typical outsourcing initiative we are likely to observe the following stages: the client will identify the process to outsource, select the appropriate sourcing model, select venue (in-shore vs. off-shore), transfer process, monitor and control the relationship.

A brief review of the literature on determinants of outsourcing decisions (first stage in outsourcing life cycle) generated the following results: According to Venkatraman and Loh (1994), IT competence and IT decision rights are the basic determinants of an outsourcing decision. In Lacity *et al.* (1996) we find that the decision regarding which IT activities to outsource is based on their contribution to business positioning and operations. The concept of organizational capability in the context of sourcing decision was introduced by Nam *et al.* (1996). Insigna and Werle (2000) associate sourcing decisions of an activity to its potential to yield competitive advantage and the capability of the company to perform an activity more efficiently than its competitors. Roy and Aubert (2000) use the resource based theory as a framework to explain sourcing decisions. The authors argue that the choice of the information system-sourcing mode can be explained by the availability of resources within the firm and the strategic value of these resources. According to the authors the outsource client has four choices (Outsourcing, partnership, conservation, and recuperation). Hence, the first scenario/proposition for an outsourcing alliance:

The electronic alliance is most likely to generate relational rent if the strategic value of the outsourcing process is high and the client does not possess the appropriate resources.

We can further refine this proposition if we replace the condition on “possession of appropriate resources” with reference to the appropriate IT capability. We define IT capability as the organizational ability that enables a firm to use its IS resources in such a way that they can perform a particular function more efficiently than its competitors. A firm may have already developed an IT capability or it may be in the process of developing such a capability. We will examine each of these scenarios separately. It seems logical to assume that if the firm has already developed the IT capability in a particular function, the firm will have no incentive to enter into an alliance. However, this may be misleading. Two empirical studies found evidence relating the visibility of an IT capability (Dehning and Stratopoulos, 2003) or strategic initiative (Chen and Miller, 1994) to firm performance. In the former of these studies, the higher the visibility of an IT capability the smaller the duration of its competitive advantage. In the latter we have learned that highly visible strategic initiatives potentially have an adverse effect on financial performance. If all competitors know the nature of the IT capability, then it is a matter of time before they try to copy this capability. The company has two choices either ignore the fact that most of the competitors are in hot pursuit of its capability or try to make the most out of it by selling it to its competitors. Perhaps the story of SABRE is the most known example of the parent company (UAL) selling the product to its competitors. Hence, we have the second scenario/proposition for an outsourcing alliance.

The electronic alliance is most likely to generate relational rent if the strategic value of the outsourcing process is high and the client possesses a mature capability, i.e., a capability that has received significant recognition from its peers/competitors.

In our third scenario, we examine the case of a client that is developing an IT capability but the desired economies of scale have not been attained and might not be feasible as long as the market for this capability is limited to the client's domain. This is close to the Cathay data center example that we saw in our introduction. Obviously, the company has developed the capability to cover the IT needs of airlines in the South-East Asia, however the internal Cathay data center will not be able to attain the desired economies of scale (and scope) as long as its market is limited to Cathay. In a case like this an external provider could improve the performance of an IS function by expanding its consumer base and thus obtaining economies of scale. The incentive for the client is even higher if competitive intelligence indicates that competitors are in the process of developing a similar capability. In this case an alliance with a vendor having access to a larger market may serve as a preemptive strike that will force competitors to abandon their plans and consider acquiring the service from the alliance. This leads to our third scenario/proposition.

The electronic alliance is most likely to generate relational rent if the strategic value of the outsourcing process is high and the client's IT capability can attain the desired economies of scale once offered to a wider market.

The last scenario – slightly different from the previous – is based on the experience of BAE Systems and Xchanging (Lacity *et al.* 2003). In this scenario the client is considering outsourcing a critical process in which it does not possess the desired capability. On the other hand, the vendor has the expertise to develop the capability but lacks the market exposure that will allow them to attain the desired economies of scale. This leads to our last scenario/proposition.

The electronic alliance is most likely to generate relational rent if the strategic value of the outsourcing process is high, and the vendor could attain the desired economies of scale by developing the capability to meet the client's needs.

CAVEAT EMPTOR

Obviously, there are several significant weaknesses associated with a client's choice to enter into an outsourcing alliance. On the top of the list is the issue of flexibility, the ease of exiting a current alliance and replacing it with another vendor or even insourcing (Venkatraman and Henderson, 1998; Yong *et al.*, 2003; Ybarra and Wiersema, 2003). The risk of opportunistic behavior is high when the client organization is limited to a long-term alliance with a single vendor. It is likely that the vendor will have little or no incentive to accommodate unanticipated changes. Another issue that has been raised in the literature is with regard to governance inseparability (Argyres and Liebeskind, 1999). The governance of new transactions becomes inseparably linked to governance of transactions that have been previously contracted for with the vendor. Clients are also concerned about losing the skills that they outsource (Quinn, 1999). Last but not least, measuring the vendor's contribution and monitoring vendor's activities to ensure alignment with the client's interests is more difficult in outsourcing alliances (Kishore *et al.* 2003).

SUMMARY

While several studies have examined the role of strategic alliances in outsourcing, as a way to manage the client-vendor relationship, no systematic attempt has been made to integrate the knowledge from the strategic management literature. The study contributes to this line of research by developing a framework that weaves the RTV with the outsourcing literature. This synthesis leads to the proposition that the more an outsourcing alliance meets the conditions of RTV, the higher the rent generating potential for the partners. Specific scenarios were generated based on the strategic value of the considered process, the existence and the visibility of the appropriate capability.

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