

Association for Information Systems AIS Electronic Library (AISeL)

MCIS 2009 Proceedings

Mediterranean Conference on Information Systems
(MCIS)

2009

IT Outsourcing Governance: Contracts, Relationships And Modes Of Control

Eleni Lioliou

London School of Economics, e.lioliou@lse.ac.uk

Leslie Willcocks

London School of Economics, L.PWillcocks@lse.ac.uk

Follow this and additional works at: <http://aisel.aisnet.org/mcis2009>

Recommended Citation

Lioliou, Eleni and Willcocks, Leslie, "IT Outsourcing Governance: Contracts, Relationships And Modes Of Control" (2009). *MCIS 2009 Proceedings*. 79.

<http://aisel.aisnet.org/mcis2009/79>

This material is brought to you by the Mediterranean Conference on Information Systems (MCIS) at AIS Electronic Library (AISeL). It has been accepted for inclusion in MCIS 2009 Proceedings by an authorized administrator of AIS Electronic Library (AISeL). For more information, please contact elibrary@aisnet.org.

IT OUTSOURCING GOVERNANCE: CONTRACTS, RELATIONSHIPS AND MODES OF CONTROL

Lioliou, Eleni, London School of Economics, Houghton Street ,London WC2A 2AE,
e.lioliou@lse.ac.uk

Willcocks, Leslie, London School of Economics,Houghton Street, London WC2A 2AE,
l.p.willcocks@lse.ac.uk

Abstract

The aim of this research is to provide insights into the interplay between contractual and relational governance in IT outsourcing arrangements. Current IT outsourcing literature has predominantly viewed the contract as a governance mechanism that establishes a framework for the supplier-client relationship, monitors behaviours and measures performance. Our study departs from this high level view and using the Foucauldian notion of governmentality, sheds light upon the conjunction of formal and social control that the contract manifests. Along these lines, our analysis will provide insights into the role of the contract in the creation of “reflexive self-control” and its potential to contribute to the establishment of shared norms, values and goals.

Keywords : *Outsourcing Governance, Outsourcing contract, Control Foucault*

1 INTRODUCTION

With the advent of globalization and enhanced levels of competition, many organizations have acknowledged the difficulties of developing and maintaining the range of expertise and skills necessary to compete successfully. In such an era of turbulent marketplaces and volatile technology, firms are relying more and more on information technology (IT) to remain competitive. One consequence of this pervasive dependence on IT has been a noticeable upsurge of IT outsourcing, now with annual global revenues exceeding \$US 260 billion in 2009 (Willcocks & Lacity, 2009). Additionally Business Process outsourcing (BPO), usually highly IT-enabled, registered over \$US 145 billion (Willcocks & Lacity, 2009).

Interestingly while the multi-billion dollar industry of IT outsourcing is flourishing, a number of IT outsourcing agreements have been terminated or have been under-performing. Earls (2004) reported that a fifth of contracts end prematurely, while Deloitte (2005) found that one in four organizations had brought functions back in-house. To make matters worse, according to Gartner, in 2003 fifty percent of outsourcing projects were considered unsuccessful by senior executives because they have not managed to deliver the anticipated value (Gartner, 2003).

Both academic and commercial publications cited the poor governance and management of the on-going relationship between the outsourcing partners as either the primary, or a major, reason for the failure of the venture (Deloitte, 2005; Kern and Willcocks, 2000; McFarlan & Nolan, 1995; Willcocks and Lacity, 2009). Nevertheless the on-going IT outsourcing relationship remains a relatively under-researched area (Goles & Chin, 2005). According to Kern and Willcocks (2002) it is a paradox that while the emerging outsourcing relationship has been widely acknowledged to be the most important determinant of the outcome of the venture only a limited number of studies have been concerned with it. The authors characterized our understanding of the operations of IT outsourcing relationships as “limited at best” and called for more research in this area. Along the same lines Dibbern et al (2004) in their review of the IT outsourcing literature identified the IT outsourcing relationship as a relatively neglected, yet critical area for future research.

2 LITERATURE REVIEW: STUDIES ON THE IT OUTSOURCING RELATIONSHIP

Current research on the IT outsourcing relationship has been mostly concerned with the key factors that influence the outcome of the venture. From an economic perspective a number of researchers concentrated on the contractual agreement as a key determinant of the IT outsourcing relationship. For example, Parkhe (1993) concentrated on the completeness of the contract and argued that the more complete the contract, the smaller the exposure to the potential opportunism of the vendor and the smaller the probability that costly renegotiations will be needed. Aubert et al (2003) on the other hand, argued that in cases of activities that are not easy to predict or difficult to measure, more incomplete forms of contracts are required. Gietzmann (1996) as well as Beulen and Ribbers (2003) appeared to be more concerned with the importance of flexibility at the contractual level, and argued that adjustments and changes may be needed at any point of the outsourcing relationship, especially in its early stages. Andersen and Christensen (2002) further underlined the value of flexibility by pointing out that “when making adjustments is costless the problem is trivial, but if adjustment entails costs in an uncertain environment, then the problem becomes much bigger”. Saunders et al (1997) on the other hand, highlighted precision as an important attribute of a good contract. The authors explained that ill-defined contracts generally result in high IT costs and poor IT service levels. Allery (2004) further asserted that without clarity there is an element of uncertainty that, apart from legal problems, it can also cause operational problems and result in the creation of “hidden costs”. Bennedsen and Schultz (2005) went a step further and indicated that an adaptive, “trial and error” approach when preparing the contract, may be a good way to prevent errors.

Still, a significant number of authors argued that there are no “one-size-fits all” clauses and thus that partnership quality goes to a large extent beyond the contents in the contracts to rely on more social factors. Researchers from this social stream of enquiry moved beyond the contractual arrangement to investigate upon other, “soft” and “more human” aspects of the relationship (i.e. Kern & Willcocks, 2002; Barthelemy, 2003; Lee & Kim, 2003; Tompkins et al, 2006). Trust was widely acknowledged as a key indicator of the quality of the outsourcing relationship (i.e. Sabherwal, 1999; Barthelemy, 2001; Barthelemy, 2003). For example, Pruitt (1981) emphasized that trust is highly related to firms’ desire to collaborate while Zand (1972) highlighted the fact that its absence diminishes the effectiveness of problem solving. Anderson and Narus (1990) went a step further and noted that once trust is established “firms learn that joint efforts will lead to outcomes that exceed what the firm would achieve if it acted solely in its own best interests”. Mohr and Spekman (1996) on the other hand underlined the importance of commitment and supported that either party’s commitment to the outsourcing relationship is a clear indication that the party is willing to exert effort on behalf of the relationship and is motivated to make it a success. Other authors highlighted the importance of communication in breeding relationships based on trust and commitment (Kern & Willcocks, 2002). For example, Kern and Willcocks (2002) recognized communication as key factor for the settlement of conflicts and misconceptions, facilitation of solutions, reduction of uncertainty and generation of flexibility.

Another stream of researchers within the social paradigm considered the power-play between the client and the vendor to be more important in determining the outsourcing relationship. On this issue Fitzgerald and Willcocks (1994) emphasized that it is difficult to maintain partnerships in the field of outsourcing due to an asymmetry of resources and in the power relationship that favours the service provider. Kern & Willcocks (2002) also pointed out that in total outsourcing deals, the supplier will dominate the relationship from the start, as the client is totally dependent on the vendor’s services, whereas in selective outsourcing the situation may be more balanced. Other authors on the other hand, stressed the pursuit of mutual benefits as a factor that can generate mutual dependency and argued that the closeness and achievement of mutual goals, the allocation of risks and the shared responsibility, generate a strong feeling of “chemistry” that strengthens the relationship between the client and the vendor (Mohr & Spekman, 1994; Kumar & Van Dissel, 1996).

Drawing from the inter-organizational relationship literature, most research on the IT outsourcing relationship has treated the contractual and the relational dimension of the venture as two distinct aspects of governance (Sabherwal, 1999; Lee & Kim, 1999; Kern & Willcocks, 2002; Goles & Chin, 2005). On this basis, it was argued that, while the contract as a formal control mechanism is a very important element in the governance of the venture, there are relational norms such as trust and commitment that may become substitutes of the contract. The argument was that these relational norms manifest a form of social control that was equally important in directing individual behaviors.

Interestingly, a number of authors argued that the combined use of formal and relational governance is fundamentally problematic (Ghoshal & Moran, 1996; Bernheim & Whinston, 1998). Their reasoning was that formal contracts signal distrust while relational governance is based on trust. Contrary to this substitution position, Poppo and Zenger (2002) demonstrated in their empirical study that contractual and relational governance functioned as complements. The authors suggested that there is a need to explore further the interplay between contractual and relational forms of governance; this is going to be the departure point of our research.

In our study we will be considering contracts not as mechanistic transactional devices, but as social artifacts. Suchman (2003) suggested that contracts carry both technical and symbolic features. As technical artifacts, contracts establish the overall framework of procedures, rights and obligations in order to achieve desirable objectives. As symbolic artifacts, contracts evoke norms which are generated by the interpretation and understanding of rules they establish.

Along these lines, in studying the IT outsourcing relationship our principal aim will be to investigate the role of the contract in generating formal and social control over the outsourcing arrangement. More specifically, we will concentrate on the examination of how the contract exercises formal control by monitoring behaviors and measuring performance and also how it manifests a complementary form of social control with the potential of developing shared norms, goals and values.

3 THEORETICAL UNDERPINNINGS

Our study will introduce in the research field of IT outsourcing governance the Foucauldian notion of “governmentality” (Foucault, 1980). In Foucault’s words, “governmentality” refers to the “conduct of our conduct” (Foucault, 1980). Foucault used this term to emphasize that governance is not only about directing, regulating and leading others, but also about leading oneself. Discussing the relevance of this concept to the study of organizations, Clegg et al (2002) suggested that “for Foucault, governmentality meant both strategies of organizational governance in a broad sense as well as self-governance by those who are made subjects of organizational governance”.

Miller and Rose (1990) distinguished between two elements in governmentality: “rationalities” or “programs” of government and “technologies”. Rationalities or programs of government are ways of thinking, ways of rendering reality thinkable in such a way that it becomes open to calculation and programming. Bulkeley et al (2007) suggested that programs of government identify:

1. the objectives of government
2. the objects of government (what should be governed)
3. and the nature (how governing should take place)

Technologies of government are assemblages of persons, techniques, institutions, instruments for the conducting of conduct; they refer to all those devices, tools, techniques, personnel, materials and apparatuses that enable authorities to act upon the conduct of persons individually and collectively, and in different settings (Miller & Rose, 1990).

Miller and Rose (1990) supported that “knowing” an object in a certain way defines certain forms of visibility that in effect make the object of government amenable to intervention, calculation and regulation. More analytically, they argued that “Knowing an object in such a way that it can be

governed is more than a purely speculative activity: it requires the invention of procedures of notation, ways of collecting and presenting statistics, the transportation of these to centers where calculations and judgments can be made and so forth. It is through such procedures of inscription that the diverse domains of "governmentality" are made up, that "objects" such as the economy, the enterprise..... are rendered in a particular conceptual form and made amenable to intervention and regulation" (Miller & Rose, 1990).

These ideas are particularly useful for a more in-depth investigation of the role of the contract as a technology of government in the outsourcing relationship. However, our study will extend the concept of governmentality and will try to examine the extent to which the contract sets the space for the creation of what Clegg et al (2002) call "reflexive self-control", meaning "situations where external sources of surveillance become unnecessary".

4 RESEARCH METHODOLOGY

The chosen research strategy for our study is the case study method. The case study research method is considered suitable because it enables the researcher to study contemporary phenomena over which he/she has little or no control and examine the context within which these phenomena take place (Yin, 2003). Benbasat et al (1987) suggested that the case study is a particularly useful research strategy primarily for two reasons: First of all, the researcher is enabled to study information systems in a natural setting and achieve a better grasp of reality. Secondly, through the case study method, the researcher is given the ability to answer "how" and "why" questions and understand the nature and complexity of the processes taking place (Benbasat, 1987). Along these lines, the case study research method is expected to enable us to get into a more profound investigation of the role of the contract in the outsourcing venture as well as the influence it exercises on individual activity and the development of norms, values and goals within the context of the venture.

The participant organization is a global investment bank. The case is anonymised for the purposes of publication at the request of the bank in question. At this stage the research is very much work-in-progress but reveals interesting provisional results. The main data collection methods we have used consist of procuring documents and conducting interviews. The documents we have gathered so far include the company's outsourcing policy, a draft of its master services agreement and a description of the project under investigation. Documents were considered particularly important in order to understand the legal rights and obligations of each outsourcing partner, as well as the formal processes that the contract establishes in order to control the venture, protect the rights of each party and impose their obligations.

On the other hand, interviews will allow us to gain the reflections of people on how control takes place in action, how they think of it and how it influences norms, values and goals. Key themes that have been raised during the interviews include: the rationality behind the IT outsourcing project under investigation; the development of the supplier-client relationship; the role of the contract in controlling the venture (with a special focus on SLAs and KPIs as ultimate tools of on-going formal control); and the development of psychological contracts. At this point, we have obtained numerous informal discussions with one of the client's senior business managers and 21 interviews both from the client and supplier organization. Each of the interviews has lasted approximately one hour. More specifically, we have interviewed:

- 4 client senior business managers
- 3 client senior IT manager
- 3 client lawyers
- 5 supplier senior business managers
- 2 supplier senior IT managers

- 4 supplier IT staff

5 PRELIMINARY FINDINGS

Governmentality scholars have long recognized that in order to govern a specific domain it is necessary to make it visible. Only when a domain is visible, can it become governed and thus rendered open to calculation, regulation and intervention (Miller & Rose, 1990). Furthermore, governmentality “seeks to constitute each self-interested actor, both individually and organizationally, in such a way that they have something to gain from greater collaboration within the project. It does so by tying individual and organizational bonuses to performance on transparent indicators, in such a way as to seek to ensure that no trade-off between them will take place” (Clegg et al, 2002).

In the case study, we found the outsourcing contract setting a number of mechanisms and techniques that sought to render the outsourcing venture “visible” and “calculable”. These included measurements, SLAs, KPIs, monitoring and reporting techniques as well as communications. These mechanisms and techniques that the contract entailed were designed to create transparency and also constitute the space of action for mechanisms aimed at regulation and intervention (for example process improvement plans, step-in rights, termination rights or penalty-rewards schemes). In many ways this was precisely the espoused governmentality objective.

From our findings so far, it also appeared that each actor at the organizational level was relatively alert to the importance of contractual mechanisms generating visibility and transparency in protecting their interests. Transparency was identified by many actors to be of great significance to the definition of expectations of each outsourcing partner and the accomplishment of a common understanding. Non-transparent processes on the other hand, were most typically associated with the obstruction of collaborative work together with the generation of misunderstandings and conflicts. On this basis, transparency was being perceived as a facilitator to the alignment of goals at the inter-organizational level.

However, in the case study it appeared that there was a relative neglect of linking individual to organizational goals, thus failing to create motivation for what Clegg et al (2002) call “reflexive self control”. From our findings it turns out that contractual control was directed towards securing organizational interests primarily by establishing appropriate monitoring techniques and organizational incentives. While monitoring techniques constitute a formal type of control, organizational incentives can be regarded as a more social form of control. Nevertheless, in the case study it appeared that this social form of control steaming from the contract did not contribute to the development of norms and values that would benefit the outsourcing venture. The reason was that only a weak link between organizational and individual goals and interests existed. This observation appears to be an indicator of the need for the client organization to contractually ensure that key individuals in the outsourcing project are incentivized appropriately and their goals are linked to the objectives of the outsourcing venture.

References

- Allery, P. (2004), *Effective Outsourcing: Practice and Procedures*, Pagination, UK.
- Andersen, T. and Christensen, M. (2002), “Contract Renewal Under Uncertainty”, *Journal of Economic Dynamics and Control*, 26(4):637-652.
- Anderson, J.C. and Narus, J.A. (1990), “A Model of Distributor Firm and Manufacturer Firm Working Partnerships”, *Journal of Marketing*, 54(1):42-68.
- Aubert, B. Houde, J.F. Patry, M. and Rivard, S. (2003), “Characteristics of IT Outsourcing Contracts”, *Proceedings of the 36th Hawaii International Conference on System Sciences*.
- Barthelemy, J. (2001), “The Hidden Costs of IT Outsourcing”, *Sloan Management Review*, 42(3):60-69.

- Barthelemy, J. (2003), "The Hard and Soft Sides of IT Outsourcing Management", *European Management Journal*, 21(5):539-548.
- Benbasat, I. Goldstein, D. and Mead, M. (1987), "The Case Research Strategy in Studies of Information Systems", *MIS Quarterly*, 11(3):368-387.
- Bennedsen, M. & Schultz, C. (2005), "Adaptive Contracting: The Trial and Error Approach to Outsourcing", *Economic Theory*, 25(1):35-50.
- Beulen, E. & Ribbers, P. (2003), "IT Outsourcing Contracts: Practical Implications of the Incomplete Contract Theory", *Proceedings of the 36th Hawaii International Conference on Systems Sciences*.
- Bernheim, B.D. & Whinston, M.D. (1998), "Incomplete Contracts and Strategic Ambiguity", *American Economic Review*, 88:902-932.
- Bulkey, H., Watson, M. and Hudson, R. (2007), "Modes of Governing Municipal Waste", *Environment and Planning*, 39:2733-2753.
- Clegg, S. Pitsis, T. Rura-Polley, T. and Marosszky, M. (2002), "Governmentality Matters: Designing an Alliance Culture of Inter-organizational Collaboration for Managing Projects", *Organization Studies*, 23(3)317-337.
- Dibbern, J., Goles, T., Hirschheim, R. and Jayatilaka, B. (2004), "Information Systems Outsourcing: A Survey and Analysis of the Literature", *The Database for Advances in Information Systems*, 35(4):6-102.
- Earls, A. (2004), "End of the Affair: Bringing Outsourced Operations Back in-house" *Computerworld*.
- Foucault, M. (1980), *Power/Knowledge: Selected Interviews and Other Writings 1972-1977*, Harvester, London.
- Fitzgerald, G. & Willcocks, L. (1994), "Contract and Partnerships in the Outsourcing of IT", *Proceedings of the Fifteenth International Conference on Information Systems*, Vancouver, British Columbia.
- Ghosal, S. and Moran, P. (1996), "Bad for Practice: A Critique of the Transaction Cost Theory", *Academy of Management Review*, 21:13-47.
- Gietzmann, M.B. (1996), "Incomplete Contracts and the Make or Buy Decision: Governance Design and Attainable Flexibility", *Accounting, Organizations and Society*, 21(6):611-626.
- Goles, T. and Chin, W. (2005), "Information Systems Outsourcing Relationship Factors: Detailed Conceptualization and Initial Evidence", *Database for Advances in Information Systems*, 36(4):47-67.
- Kern, T. and Willcocks, L. (2000), "Exploring Information Technology Outsourcing Relationships: Theory and Practice", *Strategic Information Systems*, 9:321-350.
- Kern T. and Willcocks, L. (2002), "Exploring Relationships In Information Technology Outsourcing: The Interaction Approach", *European Journal of Information Systems*, 11(1):3-19.
- Kern, T. and Willcocks, L. (2009), "Contracts, Control and "Presentation" in IT Outsourcing" in Willcocks, L. and Lacity, M. (2009), *The Practice of Outsourcing: From Information Systems to BPO and Offshoring*, Palgrave, London.
- Kumar, K. and Van Dissel, H.G. (1996), "Sustainable Collaboration: Managing Conflict and Cooperation in Interorganizational Systems", *MIS Quarterly*, 20(3):279-300.
- Lee, J.N. and Kim, Y.G. (1999), "Effect of Partnership Quality on IS Outsourcing Success: Conceptual Framework and Empirical Validation", *Journal of Management Information Systems*, 15(4):29-61.
- Lee, J.N. and Kim Y.G. (2003), "Exploring a Causal Model for the Understanding of Outsourcing Partnership", *Proceedings of the 36th Hawaii International Conference on System Sciences*.
- McFarlan, W. and Nolan, R. (1995), "How to Manage an IT Outsourcing Alliance", *Sloan Management Review*, 36(2):9-23.
- Miller, P and Rose, N. (1990), "Governing Economic Life", *Economy and Society*, 19(1):1-31.
- Mohr, J.J. And Spekman, R.E. (1994), "Characteristics of Partnership Success: Partnership Attributes, Communication Behavior, and Conflict Resolution Techniques", *Strategic Management Journal*, 15(2):135-152.
- Mohr, J.J. And Spekman, R.E. (1996), "Perfecting Partnerships", *Marketing Management*, 4(4):34-43.
- Parkhe, A. (1993), "Strategic Alliances Structuring: a Game-theoretic and Transaction Cost Examination of Interfirm Cooperation", *Academy of Management Journal*, 36(4):794-829.

- Poppo, L. and Zenger, T.R. (2002), "Do Formal Contracts and Relational Governance Function as Substitutes or Complements", *Strategic Management Journal*, 23(8).
- Pruitt, D. (1981), *Negotiation Behavior*, Academic Press, New York.
- Sabherwal, R. (1999). "The Role of Trust in Outsourced IS Development Projects," *Communications of the ACM*, 42(2):80-86.
- Saunders, C., Gebelt, M. and Hu, Q. (1997), "Achieving Success in Information Systems Outsourcing" *California Management Review*, 39(2):63-79.
- Suchman, M. (2003), "The Contract as a Social Artifact", *Law & Society Review*, 37(1):91-142.
- Tompkins, J. Simonson, S. Tompkins, W. and Upchurch, B. (2006), "Creating and Outsourcing Relationship", *Supply Chain Management Review*, 10(2):52-58.
- Willcocks, L. and Lacity, M. (2009), *The Practice of Outsourcing: From Information Systems to BPO and Offshoring*, Palgrave, London.
- Yin, R. (2003), *Case Study Research: Design and Methods*, Sage, London.
- Zand, D. (1972), "Trust and Managerial Problem Solving", *Administrative Science Quarterly*, 17(2):229-239.

Internet Sites

- Deloitte (2005), Calling a change in the Outsourcing Market, available at:
http://www.deloitte.com/dtt/cda/doc/content/us_outsourcing_callingachange.pdf
- Gartner (2003), Press Release, available at:
http://www4.gartner.com/5_about/press_releases/pr24mar2003b.jsp