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IT Outsourcing Relationship Management and Performance Measurement System Effectiveness

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Abstract

Managing the relationship between the client and the vendor is of critical importance to the success of the IT outsourcing arrangement. This paper develops and explores a conceptual model based on relational exchange theory that identifies a number of attributes or dimensions that contribute to the overall success of (a) the relationship, (b) performance measurement system effectiveness and (c) the outsourcing contract. This research supports the proposition that successful management of the relationship positively influences the success of public sector IT outsourcing contracts and the effectiveness of the performance measurement system used. An effective relationship complements the performance measurement system effectiveness.

Keywords

IT Outsourcing, Performance Measurement Systems, Relational Exchange Theory, Public sector IT Outsourcing.

INTRODUCTION

Successful management of an IT outsourcing contract depends to a large extent on the relationship built between the agency and the organisation undertaking the outsourced activity. 'Managing the ongoing relationship is the most important part of the outsourcing cycle' and is of critical importance to the success of the outsourcing contract (Hurley & Costa, 2001, p. 57). Poor management of the ongoing relationship between the client and the vendor is often cited as one of the primary reasons for the failure in the contract (Alborz et al., 2003; Earl, 1996; Kern & Willcocks, 2000a, 2000b; Klepper, 1994; Langfield-Smith et al., 2000; McFarlan & Nolan, 1995). A key issue in the successful management of an IT outsourcing contract and relationship is the measurement of the vendor's performance to ensure that all the agreed outcomes specified in the contract are achieved, on time and within budget. An effective or successful performance measurement system is critical to the success of the IT relationship (McFarlan & Nolan, 1995; Willcocks et al., 1995). This paper develops and explores a conceptual model based on relational exchange theory that identifies a number of attributes or dimensions that contribute to the overall success of (a) the relationship, (b) performance measurement system effectiveness and (c) the outsourcing contract. The remainder of this paper is divided into five sections: (1) Theoretical Background, (2) Model and Propositions, (3) Research Method, (4) Results and (5) Conclusion.

THEORETICAL BACKGROUND

This research is based on the theory of Relational Exchange, a social theory that is based on the underlying concept that inter-organisational relationships involve the continuous exchange of goods and services between the vendor and the client for an agreed fee over a specified period of time (Kern & Willcocks, 2000b, 2002; Lee & Kim, 1999). Relational exchange theory focuses on the interactions between the client and vendor and the achievement of their individual objectives. It is assumed that processes 'evolve over time as participants mutually and sequentially demonstrate their trustworthiness' (Lee & Kim, 1999, p. 32). Relational exchange theory recognises the importance of the relationship and takes into account the level of trust, commitment and past experience. IT outsourcing is ideally suited to the concepts of relational exchange theory because it incorporates both the fundamental elements of exchange and relationship. Relational exchange theory helps explain why certain inter-organisational arrangements are more successful than others.

IT outsourcing relationship styles can be classified as either discrete, hybrid or relational (Dwyer et al., 1987; Kim & Chung, 2003; Macneil, 1980). These relationship styles can be arranged on a continuum with 'discrete' and 'relational' styles at either polar extreme, and a hybrid style between the two. Macneil's (1980) work on relationship styles is based on social exchange theory and extends Williamson's Transaction Cost Economic (TCE) theory on market versus hierarchy governance structures beyond the economic viewpoint. The

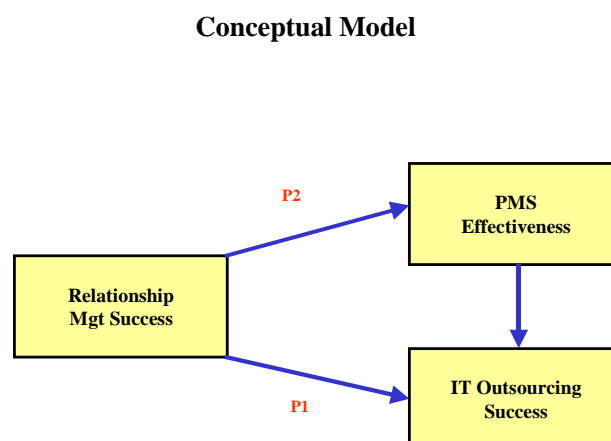
relationship style selected in an IT outsourcing contract is dependent upon the size and complexity of the contract, level of risk, and life maturity of the IT activity outsourced (ANAO, 2001; Hurley & Costa, 2001). Discrete contracts are also classified as ‘transactional’ or ‘classical’ contracts that are formal arms-length relationships that precisely specify the terms and conditions of the contract. They are generally short-term, and the relationship between highly autonomous buyers and sellers are designed to facilitate economically efficient transfer of goods and services (Kim & Chung, 2003). Communication between the parties is very limited. A good example of a discrete transaction would be the ‘one-time purchase of unbranded gasoline out-of-town at an independent station paid for with cash’ (Dwyer et al., 1987, p. 12). Relational, partnering or alliance contracts are softer forms of contracts characterized by an agreement between the parties to cooperate in the achievement of mutually agreed goals (Dwyer et al., 1987; Macneil, 1980; Mulgan, 1997). The major advantage over transactional contracts is that such cooperation creates an environment where trust can be built up and information shared. Relational contracts are more flexible, length is generally greater, and control is achieved through a high level of cooperation. A performance measurement system for a relational exchange versus a discrete transaction is quite different. For example, in a discrete transaction little attention is paid to a performance measurement system because of the short-term nature of the transaction, the quantity is easily ascertained and there is no ongoing relationship. Whereas, in the relational exchange situation, more attention is paid to the design of the performance measurement system because of the complexity of the product or services provided over an extended period of time (Dwyer et al., 1987). A lot more attention is paid to managing the relationship and the achievement of service levels, communication and the resolution of problems.

Research on IT outsourcing relationships and the dimensions or attributes that contributes to a successful outsourcing arrangement is limited (Kern & Willcocks, 2000b). It has been argued that IT research on inter-organisational relationship approaches has been too niche focused and has provided little conclusive insight into the dimensions that lead to a successful relationship (Kern & Willcocks, 2000b). IT outsourcing research has focused mainly on the discrete transaction and largely ignored the importance of the ongoing relationship (Kim & Chung, 2003). In an effort to overcome these weaknesses and fill the gaps identified in the IT literature, researchers have recently turned to social exchange theory approaches detailed in the organisational, management and marketing research areas (Alborz et al., 2003; Kern & Willcocks, 2000b, 2002; Kim & Chung, 2003; Klepper, 1994, 1999).

THE MODEL AND PROPOSITIONS

Research on the success of inter-firm relationships has identified a number of attributes or dimensions that contribute to the overall success of the working relationship. These attributes include: trust, commitment, conflict, communication, co-operation, satisfaction, and dependency (Anderson & Narus, 1990; Grover et al., 1996; Kern & Willcocks, 2000b; Lee & Kim, 1999; Mohr & Spekman, 1994), and high levels of these attributes will indicate a successful relationship. This relationship is shown in the following conceptual model figure 1.1

Figure 1.1



A brief description of the important dimensions identified that contribute to the overall success of the working relationship is detailed in the following paragraphs.

Communication

Effective communication between the client and the vendor is of critical importance to the success of the outsourcing relationship (Mohr & Spekman, 1994). Communication 'can be defined broadly as the formal as well as informal sharing of meaningful and timely information between firms' (Anderson & Narus, 1990, p.44). The exchange of information between the parties needs to be open, honest, timely and accurate. It also needs to be meaningful and useful to ensure the objectives of the contract are achieved, to avoid conflicts and take corrective action when required. Effective communication between the parties leads to cooperation and can enhance trust in the relationship (Anderson & Narus, 1990). Communication between the parties can be both formal and informal (Mohr and Spekman, 1994). Formal communication and reporting requirements specified in the contract can vary, depending on the type of activity outsourced, its size and complexity. For example, formal reporting requirements may include regular weekly, monthly, quarterly and annual review meetings. Informal communication may include day-to-day ad hoc operational meetings to address problems. Communication as a dimension that contributes to the success of the relationship is important (Grover et al., 1996; Lee & Kim, 1999).

Trust

Klepper (1994, p.230) defines trust as, 'a firm's belief that the partner firm will behave in ways that will benefit the firm and its faith that the partner will not act opportunistically or otherwise take advantage of the relationship'. Detailed contracts reduce the level of risk and actually promote a more trusting and long term relationship (Poppo & Zenger, 2002). An alternative argument to this proposition is that high levels of trust and cooperation between the organisation and the vendor, act as substitute for the need to have complete and formal contracts (Chiles & McMackin, 1996; Poppo & Zenger, 2002). High levels of trust in a relationship is positively associated with the success of the relationship (Kern, 1997; Lee & Kim, 1999).

Cooperation

Cooperation in a relationship refers to the parties working together to the same end. Klepper (1994, p.231) states that, 'cooperation is the undertaking of complementary activities by a firm in a partnership for the mutual benefit of both firms'. Further Klepper (1994) claims that higher levels of trust in a relationship will result in cooperative behaviour because the parties to the relationship know how each party will react. A relationship based on cooperation will avoid conflict the parties will work together to solve problems jointly (State Supply Commission, 2002). Cooperation in a relationship provides a win-win situation for both parties and creates an environment where trust can be built up and information shared. It also provides some measure of flexibility to deal with uncertainty and issues not covered in the contract in a non-adversarial manner (Kern & Willcocks, 2002).

Commitment

Commitment in a relationship refers to the willingness of both the client and vendor to work together to achieve their individual objectives and to make the relationship a success. High levels of commitment from both parties will achieve a win-win relationship (Lee & Kim, 1999; Mohr & Spekman, 1994). 'Commitment refers to an implicit or explicit pledge of relational continuity between exchange partners' (Dwyer et al., 1987, p. 19). High levels of commitment indicate to each party that the relationship is going to continue for the full duration of the contract.

Conflict and Conflict Resolution

Conflict refers to the day-to-day exchange of problems or disagreements that occur between the parties in an IT outsourcing relationship that need to be resolved immediately or referred to a higher level or third party for arbitration and resolution. In an IT outsourcing arrangement, conflict often exists due to the inherent interdependencies between the parties (Mohr & Spekman, 1994). Conflict between the client and the vendor can vary in size and importance and can include disagreements over the objectives, responsibilities and execution of the contract (Dwyer et al., 1987; Goles, 2001). Conflicts can also be caused by a mismatch in the expectations of the parties to the relationship. For example, the client's objective of cost minimisation may not agree with the profit motive objective of the vendor which can ultimately lead to a reduction in quality (Lacity & Hirschheim, 1995). 'The impact of conflict resolution on the relationship can be productive or destructive' (Mohr & Spekman, 1994, p. 139). Therefore it is important to recognise that conflicts should be resolved jointly and all parties mutually agree to the solution. Joint problem solving is critical to the long-term success of the

working relationship (McFarlan and Nolan, 1995). The use of confrontation or domination in a conflict situation can be counter productive and ultimately undermine the success of the relationship (Mohr & Spekman, 1994). Details on how the conflict is resolved and the procedures that should be followed are generally included in the contract or the service level agreement that is prepared prior to the commencement of the outsourcing arrangement. Finally, the level of conflict in a relationship negatively influences the overall success of the IT outsourcing arrangement (Anderson & Narus, 1990; Mohr & Spekman, 1994).

Satisfaction

Satisfaction refers to the organisation's overall satisfaction with the effectiveness of the relationship and the achievement of its outsourcing objectives. Satisfaction has been defined as 'a positive affective state resulting from the appraisal of all aspects of a firm's working relationship with another firm' (Anderson & Narus, 1990, p.45) and is also a close proxy for perceived effectiveness and may lead to extended continuation of the relationship (Anderson and Narus, 1990).

Based on the extant literature and the above discussion it is proposed in this research that successful relationships that exhibit high levels of communication, co-operation, trust and satisfaction directly influence the level of the performance measurement system effectiveness and the overall success of the IT outsourcing arrangement. This is summarised in the following propositions:

Proposition 1 (P1):

Successful management of the relationship positively influences the success of public sector IT outsourcing contracts.

Proposition 2 (P2):

Successful management of the relationship positively influences the effectiveness of the PMS used in public sector IT outsourcing contracts.

RESEARCH METHOD

The research method used to test, refine and validate the conceptual model detailed in this paper was the case study approach. The selection process of cases used in this research was based on theoretical sampling as recommended by Eisenhardt (1989) and Yin (1994). According to Eisenhardt (1989, p. 537), the goal of theoretical sampling is to choose cases which are likely to replicate or extend the emergent theory and "it makes sense to choose cases such as extreme situations and polar types in which the process of interest is transparently observable". To allow for both "within case" and "cross case" analysis, a sample of large, medium and small organisations were specifically selected from both state and large local government organisations in Western Australia. Selection of these organisations was based on a number of factors, including: size of organisation, level of operating expenditure, complexity of IT environment and, finally, recommendations made by the Department of Treasury and Finance (DTF).

The unit of analysis in this study is the IT outsourcing contract between a public sector client and the vendor. The contract was selected as the unit of analysis because it specifically addresses the propositions proposed and the research model outlined in figure 1.1. In total, eight (8) public sector organisations and one (1) university agreed to participate in this case study research. Tables 1.1 and 1.2 below provide a summary of the size of each case and the number of contracts examined.

Agency Examined	Size	Case	Number of Contracts
State Government Agencies	Large	B and H	3
	Medium	A and C	7
	Small	D and E	3
Local Government	Large only	F and G	2
University		I	2
TOTAL		9 Cases	17 Contracts

Table 1.1: Size of Agencies and Number of contracts examined

Contract / Agency	Number of Contacts	Minimum Initial Term (Years)	Maximum Initial Term (Years)	Average Total Value (\$m)	Average Initial Term (Years)	Average Full Term (Years)
State Government	13	½	5	\$26.5m	3.35	5.27
Local Government	2	1	1	\$0.21m	1	1
University	2	2 ½	3	\$14.0m	2.75	5.25
Total	17	½	5	\$21.95m	3.0	4.76

Table 1.2: Case and contract summary details

As can be seen from the above table, the average full term and value of the contract examined was 4.7 years and \$21.9 million.

Semi-structured interviews were conducted with staff responsible or involved in the formulation of the contract documents and the performance measurement system that was implemented. To ensure reliability of the case study data collected, all interviews conducted were based on an “Interview Protocol” that was given to all participants prior to the interview. The case study protocol developed in this research was based on the model developed by Yin (1994). Each interview conducted was taped and transcribed to text. Following each interview these transcriptions were returned to the person interviewed for their verification and checking as to the accuracy of the transcription and answers provided in the interview. Feedback information received from the agency was incorporated in the final transcript. Where possible, agencies also provided archival data that was used to help clarify the IT outsourcing contract and the interviews that were conducted. The forms of archival data that was made available included contract documents, specifications, service level agreements, performance reports and procedure manuals.

The data analysis method used to analyse the qualitative data collected in this research was based on a structured data display approach developed by Miles and Huberman (1994). This method of analysis was selected because it increases the reliability and validity of the qualitative analysis and results by providing the researcher with a uniform and consistent approach to follow in the analysis of each case. It also limits intrusive interviewer bias in the analysis of transcripts and provides an audit trail from transcript to the results of the analysis. Analysis of the interview transcripts and other documents collected in this research focused primarily on the research propositions identified and the variables outlined in the initial conceptual model developed from the literature. This analysis included both ‘within case’ and ‘cross case’ analysis. Each case study was written up and summarised in a case study report.

RESULTS

Each of the managers interviewed was asked a number of questions that specifically referred to relationship management in the outsourcing arrangement. They were asked to describe their relationship with the vendor, its importance, any operational difficulties that were encountered and whether there was link or connection with contract completeness and the effectiveness of performance measurement systems. The following is a summary of the case study interviews findings that specifically relate to the attributes and propositions described above.

Communication

It was found that in a majority of the contracts, communication between the parties was achieved via series of formal meetings that were conducted fortnightly, monthly, quarterly and annually. In only two of the seventeen contracts were no formal meetings held on a regular basis. Details of the meeting and reporting requirements were clearly specified in the contract and the service level agreements. In a majority of the contracts, the meetings were very formally structured, and a number of various reports were tabled for discussion and review.

These reports included budget / actual financial statements, service level targets and results, incidents reports, problem reports, customer satisfaction reports, project reports and action reports.

The critical importance of effective communication between the agency and the vendor to the success of the outsourcing relationship is shown in the following comments from the managers:

Manager, Infrastructure and Contracted Services (B1):

'It is essential that you keep the lines of communication open. You also need to understand both points of view. They are in business to make money and our objective is to minimise costs. Being straight with people is also important and you need to be honest and express yourself without insulting people. Having that open communication formal and informal catch-ups helps build that relationship which in turns helps the effective running of the contract. If you have that relationship it's much easier for them to handle dispute issues, or issues where you're not happy with the performance of an individual being supplied by the vendor'.

Director of Corporate Services (F1)

'The service level agreement is an important component of it and I think you need to meet with on a regular basis and go through and see how whether the key performance indicators (KPIs) have been met. You also need to identify the reasons why the service levels have not been met so that you can fix the problem in the future. The key to it is to have regular meetings and feedback, there's no point in just having a service level agreement unless you're going to put in place a system that monitors and gives feedback. A process or an agreed method of communicating'.

Trust

In a number of the contracts reviewed, managers supported the claim that trust is an essential element in the success of a relationship. High levels of trust allowed the parties to work well together in solving problems. Also, trust was not there at the beginning of the contract and it developed over time. The following comment made by the Manager Information Systems (E1), highlights the importance of trust:

'In this contract because of the faith and trust we had in each other, I believe we worked better in solving problems. Because of the level of trust we didn't have to spend six hours a week going through every nth degree'.

Cooperation

The concept of cooperation and its importance to the success of the relationship was specifically identified by a number of the respondents. The assertion that cooperation in a relationship provides a measure of flexibility to deal with uncertainty and issues in a non-adversarial manner was supported by a number of managers. A sample of comments made by managers in reference to cooperation includes:

Manager, Technology Contract & Procurement (A1):

'You need to be in a position where you have a comfortable relationship with the vendor where you can go to them and say look, with this particular event we were not particularly happy with your approach to the service. What we would have preferred would have been x y z. What you want then from your vendor is a response that they understand what you are saying and can sit down and work out a way that they can do it better next time. Rather than a response from the vendor, which is very defensive and states you are only paying us x dollars and therefore that's all you get'.

Deputy Chief Executive Officer (G1):

'A good working relationship, we've had difficulties about integration but we have been able to work very cooperatively to resolve those and probably improved their product in the process'.

Proactive Management

In a number of cases, managers identified the concept of proactive management as a dimension that contributes to the overall success of the working relationship. For example, in Case A, they wanted the vendor to focus on effective good management, be able to understand their business environment and anticipate changes and problems that they would face in the future. In essence, they wanted the vendor to take management ownership of issues and problems, being proactive rather than reactive. Specific comments made by the Manager, Technology, Contracts and Procurement (A1) that referred to the concept of proactive management included:

'We want them to have an understanding of our business strategies, objectives and culture. So we don't want them to be at arms length from us. We want them to be sitting alongside of us understanding where we are going as an organisation and to tune their service delivery to accommodate that and maximise the benefit that they

can give to us. We like to see some value add through the life of the contract. So if they have some benefits over and above the direct contractual relationship that they can deliver to us, we would like to see them deliver them to us, whatever they might be'.

'We need the vendor to take ownership of problems and issues. They deliver the service, not us, therefore it is up to them to come up with solutions to problems. We don't want to be managing the service for them. So we don't want a culture of blame and excuse'.

In Case A, they also included a specific item in their service level agreement that referred to proactive management. The Manager, Infrastructure and Contracted Services (Case B) also identified the concept of proactive management and highlighted its importance:

'Work in a flexible co-operative manner, provide a service which is customer focused, display a 'can do' attitude, be honest and accountable in dealing with us. Provide the service in a proactive manner, don't wait to be told. Come to us when you think things need to improve. Value add without the need for prompting. Come to us with ideas'.

Proactive management of the IT outsourcing contract is not a new concept and is related to other dimensions previously highlighted. For example, commitment, information sharing and mutual dependency (Lee et al., 2000; Lee & Kim, 1999).

Satisfaction

The majority of the managers interviewed were satisfied that they had at least partly or completely achieved their objectives. None of the cases stated that the contracts were a total failure. In only one case (D1), was the manager critical of the objectives identified in the interview. For example, the following comments demonstrate his dissatisfaction:

Manager Contracts and Research (D1)

'The cost savings were not met. It wasn't a fixed contract so they could increase the budget each year, which is what they did. The staff efficiencies weren't there. New staff had to be trained up and they were flitting between other departments as well, so there wasn't continuity. Further down the track, our division saw the contract as a hindrance'.

Relationship Effectiveness and Outsourcing Success (Proposition 1)

From the interviews, it was found there is some support for the proposition that successful management of the relationship positively influences the success of public sector IT outsourcing contracts (Proposition 1). As detailed above, the majority of contracts that were reviewed displayed high levels of communication, cooperation, trust and overall satisfaction. A number of managers stated they were satisfied with the relationship and that it positively contributed to the success of the outsourcing arrangement. For example:

Manager, Technology, Contracts and Procurement (A1):

'The relationship is vital because it goes to some of those things that are hard to measure'.

Manager, Infrastructure and Contracted Services (B1):

'A good relationship with the contractor is critical to the success of the contract'.

Relationship Management and PMS Effectiveness (Proposition 2)

In a number of the contracts reviewed, managers supported the proposition that successful management of the relationship positively influences the effectiveness of the performance measurement system used in public sector IT outsourcing contracts. Comments made by a number of managers that support the proposition that a relationship exists include:

Manager, Infrastructure Contract & Procurement (B1):

'The important factor about performance monitoring is that you have to manage by fact and not fiction. So it makes the relationships sounder because it takes the value judgement out of the equation because you're measuring key essential things and you can't argue with them'.

Alliance Contract Manager (H1):

'If the PMS is very clear and concise in exactly what needs to be provided then it improves the relationship, because there is no argument. It is in the PMS, it means it has been budgeted for, it's been agreed too, there is

no further argument necessary. There is no argument because it is clearly documented as to what will be delivered and what will be measured'.

Both the above quotes clearly demonstrate that effective management of the relationship actually complements or enhances the performance measurement system effectiveness. For example, a high level of communication is also critical to the success of the performance measurement system. At the commencement of the contract there is little or no trust or cooperation and therefore organisations must rely on formal and well-structured performance measurement system. Both trust and cooperation grow during the term of the contract (Kern & Willcocks, 2002). An organisation could not rely solely on high levels of trust and cooperation to manage the relationship between the client and the vendor.

There was no support for the claim made by Poppo and Zenger (2002), that relationships that display a high level of trust and cooperation between the parties, act as a substitute for the need to have detailed performance measurement systems. There was also no support for the argument proposed by Poppo and Zenger (2002) that increased performance measurement signals to the vendor a lack of trust.

CONCLUSION

Managing the relationship in an IT outsourcing arrangement is quite different to managing the relationship internally. Traditional internal sourcing is very much resource oriented, where internal management has total control. When organisations outsource their focus shifts away from managing resources and toward defining results and shaping the outside relationship through which these results are produced. Organisations can increase their level of indirect control and accountability by creating a detailed or complete contract that clearly specifies how the contract and relationship will be managed (Kern & Willcocks, 2000b). The contract outlines the foundation to the relationship and can greatly influence the success of the working relationship between the organisation and the vendor (Kern & Willcocks, 2000b). A comprehensive contract provides details on the scope of work, roles and responsibilities of each party, service levels and how they will be measured and assessed, dispute resolution procedures and communication protocol. To get the most from a contract, managers and vendors need to foster a relationship supporting the objectives of both parties, which focuses on results to be achieved (ANAO, 2001).

In summary, the findings of this research support the claim that high levels of communication, trust, conflict resolution, co-operation and proactive management contribute to the overall success of the working relationship. This research supports the proposition that successful management of the relationship positively influences the success of public sector IT outsourcing contracts and the effectiveness of the performance measurement system used. The results of this research clearly demonstrate the positive contribution that managing relationships successfully makes toward a successful IT contract. The results also indicate that an effective management of the relationship between the client and vendor complements or enhances the performance measurement system effectiveness. An effective relationship that displays high levels of trust and co-operation does not act as a substitute for the need to have a detailed performance measurement system. While there was overall support for the theoretical model and propositions it did not explain all cases. We are therefore going to expand (a) the model, and (b) the data, to consider an integrated approach which incorporates multiple theories. To enhance the richness and validity of this research and its findings it is planned to combine relational exchange, institutional and transaction cost theories. Further research is needed in this important area. Information in this area will allow practitioners to better understand the important factors or dimensions that contribute to the successful management of outsourcing contracts.

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