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Journal of Information Systems Applied Research

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Governance of Outsourcing: Building a Better Relationship

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Abstract

Outsourcing of IT and related services is an unstoppable business trend. This paper explores key requirements for successful outsourcing: governance and relationships. The research examines the distinction between contractual governance and relational governance through a series of structured interviews with large outsource buyers. Using an outsourcing maturity model, the key question this research seeks to answer is this: what effect does outsourcing maturity have on the outsourcing relationship between a buyer and a provider?

Keywords: Outsourcing, governance, relationships, contractual governance.

1. INTRODUCTION

Global outsourcing refers to third party management of assets and services delivered across multiple international locations. Outsourcing is an accepted practice in many business organizations and a significant body of knowledge has developed over the last two decades that has improved our understanding of the management of outsourcing relationships (Lacity et al., 2009, Hirschheim and Lacity, 2000, Oshri et al., 2009, Dibbern et al., 2004, Lacity and Hirschheim, 1993).

The global outsourcing market, "estimated to be worth nearly half a trillion dollars" (Lacity and Willcocks, 2012) continues to grow in both size and complexity. There can be little doubt that IT outsourcing (ITO) and business process outsourcing (BPO) have become standard business practice. International Data Corporation, a market research firm, estimates that 90% of Fortune 500 organizations have embraced outsourcing as a standard management practice; for many, the management of outsourcing has become a core competency. With this growth, the topic of governance becomes increasingly important to organizations who find that they no longer managing internal teams and projects, but instead managing multiple outsourcing providers.

The research presented in this paper investigate the influence of contractual and relational approaches to outsourcing governance, (Lacity and Willcocks, 2012, Miranda and Kavan, 2005, Poppo and Zenger, 2002, Goo et al., 2009). Lacity and Willcocks have identified both contractual and relational governance as two important categories that determine successful outsourcing outcomes, "Overall, the research found that the best outsourcing relationships are based on sound contractual governance and on strong relational governance."

Yet despite the growing importance of governance, the management and maintenance of outsourcing relationships has continued to be a source of friction, even after 20 years of study(Lacity et al., 2009). Much like individual human relationships, organizational connections seem to suffer the same deterioration and lackluster interaction over time if not properly maintained. A broad study analyzing 20 years of ITO and BPO research from 1988 to 2008 showed that while outsourcing relationships may start with enthusiasm and excitement, by year three, many relationships enter a "mid-contract sag" where staff on both sides have grown exhausted and complacent towards the relationship (Lacity et al., 2008).

The objective of this research is to determine how organizational outsourcing maturity influences the interaction and behaviors of parties in an outsourcing agreement. Ultimately, the goal is to answer the question: what effect does outsourcing maturity have on the outsourcing relationship between a buyer and a provider? While prior literature has highlighted the importance of both maturity and the relationship, there is little research to investigate the interaction between the two concepts. This research will fill the gap in literature regarding outsourcing maturity and relationship.

The structure of the paper is as follows. First, the literature is examined to understand the background perspectives on contractual and relational governance of outsourcing arrangements. We then explain the research approach. Third, the findings are presented and we then offer an interpretation of the findings. Finally, we draw key implications for outsourcing buyers.

2. CONTRACTUAL AND RELATIONAL GOVERNANCE

Many authors have recognized the distinction between contractual governance and relational governance in outsourcing. (Poppo and Zenger, 2002, Vitasek et al., 2011, Goo et al., 2009, Lacity and Willcocks, 2012). Contractual governance deals with formal elements such as contract details, payment and penalties, contract type, duration and size (Lacity et al., 2009). Conversely, relational governance considers the informal, "softer issues of managing buyer-supplier relationships, including trust, norms, open communication, open sharing of information, mutual dependency and cooperation"(Lacity et al., 2009). While the argument has been made that formal contracts can lead to distrust and opportunism between organizations (Ghoshal and Moran, 1996), more recent work in outsourcing has found that contractual and relational governance are actually complementary (Poppo and Zenger, 2002).

In general, contractual governance reflects the legal agreement between the outsource provider and buyer. Formal contracts, defined by legal processes, reflect an agreement at a point in time and will extend over many years i.e. the contract term. As Goo et al point out, the service level agreements (SLAs) which are defined by the contract provide the basis for executing the provisions of the contract on a formal basis. This execution is referred to as contractual governance. The challenge with outsourcing contracts is the difficulty in predicting the difficulty and complexity of changes that will occur over the many years of the contract term. These "formal controls are the written contractual and management initiated mechanisms designed to guide behavior towards desired objectives" (Macneil 1980 as cited inGoo et al., 2009, Macneil, 1980). Contracts are "designed primarily to address transactions and legal protections such as pricing and price changes, service levels, limitations of liability, indemnification, and liquidated damages" (Vitasek et al., 2011). As such, outsourcing contracts can be inflexible, incomplete or inadequate, established between two legal entities and defined by experts who are unlikely to participate in the ongoing management of the outsourcing arrangement.

Relational governance on the other hand is the ongoing interaction between individuals within the outsourcing buyer and provider organizations who are responsible for the execution and the success of the outsourcing arrangement after the contract is agreed and signed. Relationships are built on cooperation and "high level of trust and commitment" (Goo et al., 2009). In addition to trust, effective knowledge sharing as well as communication regarding expectations, progress, capabilities, strengths, weaknesses and directions for the future have been identified as contributing to "higher levels of outsourcing success" (Lacity and Willcocks, 2012). Indeed, Lacity and Willcock (2012) found in empirical evaluations that higher levels of relational trust and communication were always associated with outsourcing success. Vitasek describes relational governance as a symbiotic relationship where the parties have a vested interest each other's success (Vitasek et al., 2011). Vantage Partners have suggested that relational governance, which requires defined structures, processes and skilled individuals, is a prerequisite to achieving value in outsourcing arrangement (Ertel et al., 2006). Mehta and Mehta refer to relational governance as investments where the "greatest outsourcing benefits accrue to the buyers that actively participate in developing an interactive relationship with the vendors" (Mehta and Mehta, 2010).

Figure 1. below depicts the distinction between contractual and relationship governance.

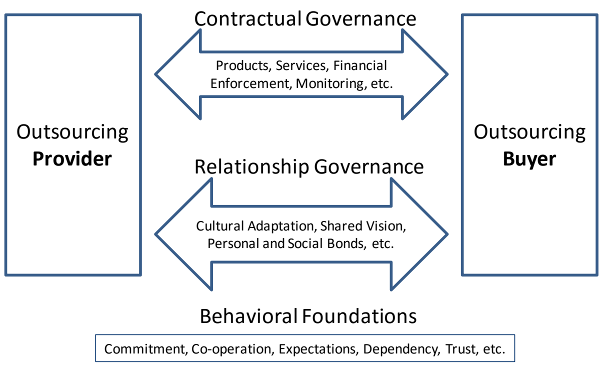

Figure 1. Dimensions of Contractual and Relational Governance (adapted from Kern and Willcocks, 2000).

In this figure, the Contractual Governance components include items described in a contract such as the delivery of products (e.g. hardware) and services (e.g. customer support), that results in financial enforcement (e.g. payments and penalties) and ongoing monitoring (e.g. Service Level Agreements). The Relationship Governance components are less specific and are typically not described in a document, such as cultural adaptation (e.g. how well the provider understands and works within the culture of the buyer), shared vision (e.g. an agreed definition of success), and personal and social bonds (e.g. empathy with and commitment to the individuals on the other side of the relationship).

3. RELATIONAL MANAGEMENT

Not to be confused with relational governance, the relationship defines the interaction between two individuals or organizations. Repeatedly, the management of this relationship is emphasized by authors as being crucial to the success of an outsourcing arrangement (Kern and Willcocks, 2000). Some researchers have identified how "greater outsourcing benefits accrue to buyers that actively participate in developing an interactive relationship with vendors." (Mehta and Mehta, 2010) In the case of outsourcing, this term refers to the connection between the buyer and the provider. From a high level, Kern and Willcocks described this outsourcing relationship as "consisting of context, structure, interactions and behavioural dimensions, which are informed by the antecedent conditions"(Kern and Willcocks, 2000). They go on to state that these antecedent conditions refer to elements of the contractual and relational governance, similar to our understanding of governance formed previously.

Much like governance, the relationship in an outsourcing arrangement can take on different forms. Commonly, literature has divided relationship types into two extremes: a "transactional style of relationship" and a "partnership style of relationship"(Gardner and Cooper, 1988). A transactional relationship is described as an "arm's length relationship which the rules of the game are well specified and the failure to deliver on commitments by either party can be resolved through litigation." Partnerships are characterized by "a long-term commitment, sense of mutual cooperation, shared risk and benefits, and other qualities consistent with concepts and theories of participatory decision making" (Henderson, 1990). It is important to note that these two styles are seen as bounds to the relationship type and many buyer-provider relationships will exist somewhere between the two.

Researchers have constantly identified a healthy relationship as a cornerstone for any outsourcing relationship (Lacity et al., 2009). However, despite 20 years of research, no clear solution has been defined to resolve the issue of how to best govern the buyer-provider relationship. While a multitude of other difficulties can lead to the worsening of an outsourcing arrangement, this paper will focus primarily on the relationship, as it has been indicated to stifle outsourcing year after year.

4. HOW THE RESEARCH WAS CONDUCTED

This qualitative study was performed in conjunction with the Centre for Outsourcing Research and Education (CORE) and Deloitte Consulting. The research team collected data from 15 outsourcing buyer teams across

Canada, representing approximately 10% of the Canadian outsourcing market. Using a Deloitte outsourcing maturity assessment model, questions were asked about governance and the buyer-provider relationship. The interviews were conducted as semi-structured, which allowed the interviewer to have “some latitude to ask further questions in response to what are seen as significant replies” (Bryman and Bell, 2007). Respondents, typically individuals responsible for the management of outsourcing contracts, provided insights on their organization’s governance capabilities and the state of their provider relationship. Interviews were conducted in-person at the buyer’s office with some members of the research team on conference call and lasted an average of 94 minutes.

Interviewee responses were noted by the research team and recorded for future reference. Data was analyzed under the inductive, interpretivist position that permitted the flexibility to recognize the differences between interviewees and their responses, while still interpreting meanings on a common understanding (Bryman and Bell, 2007). A coding technique outlined by McCracken (1988) was used to analyze interview data and develop the coding hierarchy which grouped all codes relating to governance and the relationship into common categories, each of which was classified as either contractual or relational. Where specific codes were repeated, instances of the code were also counted to give a sense of weighted emphasis to different topics and their importance to the buyer. A sample of the contractual and relational categories is provided in Appendix 1.

In addition to structured interviews, one buyer organization provided the opportunity for multiple interviews that created a small case study. As suggested by Yin (2009), this one case study allowed the research team to “expand and generalize theories, not to enumerate frequencies”.

Industry sector	Number of outsourcing deals
Financial services	7
Aerospace and aviation	4
Agriculture	2
Manufacturing / Energy	2

Table 1: Research participants

Table 1 provides a summary of the industry sectors represented in the data collection.

We prepared the interview guide from the Deloitte Outsourcing Maturity Model. The model looks at ten dimensions of outsourcing. Table 2 below summarizes the ten dimensions with key questions for each dimension. In the semi-structured interviews, the researchers asked the key questions in an identical manner and the discussion would then focus on evidence of the maturity indicators for the outsourcing deal. The responses to the questions allowed the researchers to provide a score to each organization, with 1 being the lowest and 5 the highest. Figure 2 (in appendix B) provides a view of the scores across the 10 dimensions, and Figure 3 (in appendix B) provides a view of outsourcing maturity scores for the 15 projects examined.

Assessment Dimension	Key Questions
Outsourcing Model	Is there a formally defined outsourcing strategy in place, that enables collaborative and mutually beneficial relationships with key service providers?
Outsourcing Objectives and Business Alignment	Are the outsourcing objectives aligned to the needs of the business and the overall business strategy?
Outsourcing preparation	Are there capabilities in place to define scope, structure target state, understand current state impacts and coordinate transition plan?
Relationship	Are there formal processes to proactively manage relationships or interactions between service provider and internal stakeholders?
Performance Management	Are there capabilities to focus on the identification, reporting and benchmarking of performance attributes to assess the effectiveness of in-flight outsourcing contracts?
Service Management	Are best practice service delivery and support processes (e.g. ITIL) leveraged to ensure

	consistent provisioning and management of outsourcing activities?
Financial Management	Are there formal mechanisms to manage invoicing and payments? Are financial audits and benchmarking activities conducted to ensure costs are reflective of fair market prices?
Contract Management	Do key capabilities exist to proactively manage the contract life cycle (e.g. creation, mobilization, change and renewal, termination, dispute management, etc.)?
Outsourcing Organization Structure and Capabilities	Is there a well-defined and structured internal organization to oversee the outsourcing relationship? Are roles, responsibilities and accountabilities clearly established to maintain vendor oversight?
People and Change	Is there a capability to oversee buyer and provider organizational change activities throughout the contract lifecycle?

Table 2: Outsourcing maturity model (Deloitte)

5. RESEARCH FINDINGS

The following sections describe the three key findings and interpretations from the interviews.

Finding 1 - 'What gets measured, gets managed'

Contractual capabilities are typically those that can be documented, tracked and enforced. These are some of the more easily transferable capability areas since templates can often be applied across different contracts, business units, organizations or even industries. Across nearly all interviews, basic contractual elements were found to be relatively common. However, some of the most mature organizations interviewed were those who leveraged their contracts to the fullest by having the best understanding of their needs. That said, across both contractually mature and immature organizations, the contract was at times viewed as more a source of frustration than of usefulness.

Less experienced organizations showed their lack of maturity in outsourcing through a misunderstanding of their own needs. A medium sized agricultural organization found themselves in a contract which was not appropriate to their needs. They began adjusting service provision, became overwhelmed by change orders, and had their relationship deteriorate with a feeling of helplessness.

"When we feel we're seeing too many change orders, it's really sad the answer that you get… 'get used to it'… this is a sore point and we were not going to go through that again."(Int2)

Eventually, managers begin to understand the things that are important to their organization: what works and what does not. A manufacturing company with over 10 years of outsourcing experience displayed very high procedural maturity and were able to identify the contractual elements that were important, such as delivery standards, and those that were useless to them, such as innovation clauses. However, one manager within this same organization suggested that his ideal scenario would be never to have to use the contract. He showed discontent when speaking about his provider who would overemphasize the use of the contract.

"Ideally, once every contract is done, put it in the drawer and never look at it again, but unfortunately, [provider] would clearly train people on what the contract is: where every comma and period is" (Int12)

He went on to state the potential shortcomings of this approach.

"There is a positive and negative. Sometimes, they don't necessarily understand the contract fully, every participant, so sometimes you have to catch a couple of things that are not ill-intended, but because of a lack of knowledge, they try to get in the contract which are not part of it" (Int12)

Interestingly, on the opposite end of the spectrum, one of the more contractually immature organizations had found a huge discrepancy in satisfaction between two service areas of the contract. One service area (customer care) was considered a huge success and looked at for best practices, yet it was indicated that their relationship had minimal foundation on contractual governance.

Conversely, the organization's most troubled service area (IT) had all but given up on relational governance and fallen back to the contract, creating animosity between the buyer and the provider.

"Customer Care is probably the least aware of the terms of their contract, whereas IT could quote you sections of the contract… but they are almost adversarial [with provider]" (Int4)

Contractual governance can be a very useful way of automating processes to reduce managerial overhead. A financial institution heralded a tremendous contractual success because they,

"were able to structure [the contract] and because it had end to end accountability, [they] could define what the end state was" (Int14).

However, crucial to successful leveraging of procedure is the understanding of exactly what the organization needs. For organizations that are unclear about their current or future requirements, locking into a contractual obligation can be a risky endeavor and a potential source of animosity.

Finding 2 - 'The most important things cannot be measured'

Relational governance is viewed as the intangible half of governance. In contrast to contractual governance, relational characteristics are much more difficult to describe, document and track. As such, they appear to be less understood than contractual ones, however, are shown to be of equal, if not greater importance. Based on interviewee responses, informal communication, flexibility, trust, and openness are highlighted as influencers on the relationship. However, above all others, interviewees continually spoke to the importance of people in developing strong relational governance.

Immature outsourcing buyer organizations often found themselves in states of high provider turnover. During interviews with a crown corporation, struggles were mentioned with the provider relationship due to changing people. The discontent even grew internally in their organization and caused a rift with some of the end users.

"We had some real pain points when people were let go that were critical to a project and progress almost ended." (Int2)

Some of the less mature organizations stated a very hands-off approach to their provider's employee retention. Many took the 'black box' approach of not wanting to concern themselves with the details of the provider. However, maturing organizations began to understand their role in provider turnover. They saw that an employee did not simply work for the provider. Due to the intertwined nature of many outsourcing arrangements, employees will often identify as much or more with the buyer organization.

"I think that the organization realized that we have a lot to do with attrition. If you're too hard on the supplier, if you treat them too much like a supplier and not enough like part of the family, you drive them away" (Int13)

The most mature outsourcing organizations treat providers not like suppliers, but like partners. By engaging in constant, informal communication that is open and upfront, issues were often seen ahead of time and confronted before they became serious. This type of frank communication also helped build trust and encourage partnership between the buyer and provider.

"There are a couple of issues have escalated, but it is very open and upfront, so things get dealt with quickly" (Int13)

"Have been some contractual misinterpretations, but at the end of the day, no one want to look bad in front of the other. We try to create a spirit of partnership so it's very rare that things go very wrong." (Int12)

This type of informal trust and understanding was raised as crucial by many respondents for allowing the flexibility needed in the service delivery. However, organizations such as the manufacturing company quoted below were undermining trust by being too contractually focused, and not being flexible enough themselves.

"I don't think we're there from a trust perspective, I think we still are putting our suppliers on notice when they are not following a process the way it should be followed." (Int10)

Juxtapose this with organizations who openly admitted to being very immature on contractual capabilities, however, maintained successful outsourcing arrangements due to their relational trust and flexibility. The first is a financial institution who trusted their provider enough that for a full year, they were effectively operating without any metrics. The second is a quote from a manufacturing company who stated that they had given up on their contract, but were still able to adjust through the recession because of the flexibility offered by the provider.

"We had to go on faith for the first year of our [billing drivers] because we were restructuring, but luckily the trust level was so high that we could do that." –Int9

"In 2008 when the market crashed, we had to tighten up, I took [35%] out of our deal because I said 'I can't afford it'… I was under contract with these guys, they did not have to cooperate to the extent that they did, but they were very, very flexible."-Int11

This kind of trust and flexibility goes a long way towards developing the relationship. The interviewee from the second quote (Int11) also stated that because of this collaborative, understanding approach during the recession, he was now planning to expand the scope of outsourcing at the upcoming renewal.

Finding 3 – A poor relationship can result in reduced contract value

A single case study from one of the buyer organizations allowed the research team to dive deeper into the issues surrounding relational governance. This case is summarized in an IDC article describing multi-sourcing and the outsourcing centre of excellence. (Babin, 2013)
In the late 1990s, a North American power utility realized that capital requirements for ongoing infrastructure upgrades and customer demands for competitive prices required that the utility should focus on its core competencies. As a result of the strategic realignment, the company decided to focus on the generation and distribution of electrical power as its core competency, while other processes within the organization — customer services, finance, HR, office services, and computer services — should be outsourced.

Through a rigorous public request for proposal (RFP), the utility identified one outsourced provider to deliver the non-core services. A key feature of the outsourcing agreement was the need for the provider to retain most, if not all, of the outsourced employees in the same jurisdiction as the hydro utility. This was clearly a first-generation outsourcing arrangement, since very little had been previously outsourced at the utility and there was little experience with outsourcing within the organization. The outsourcing deal was established as a 10-year multi-service deal; it was hailed as a significant strategic change that allowed the utility to focus on important issues. The deal was valued at approximately $1 billion and was projected to save customers just under $200 million. Both parties viewed the outsourcing relationship as strategic and transformational.

Approximately halfway through the deal, it became apparent that the 10-year single provider agreement was not working well. Although several of the services (towers) were operating well, several were not. From our interviews at the buyer we heard of dissatisfaction from internal and external customers, as well as poor or adequate performance, had created an atmosphere of distrust and tension. Several external reviews to seek areas for improvement had been conducted. As the deal reached the final years and the contract needed to be renegotiated, it became apparent that a single-vendor 10-year deal was out of the question. The various services were segmented and taken to market as multiple RFPs. The buyer organization recognized that it would take on the responsibility of integrating and providing oversight to multiple providers. The result was a multi-source arrangement, with the original vendor retaining a smaller set of services compared to the original contract.

The key interpretation of this case is the observation that although a well-defined contract had been established, and formed the basis for the formal governance processes, the relationship between individuals and between the two organizations lacked trust, openness and communication. The poor relationship resulted in a much-reduced scope and contract value for the incumbent outsource provider at renewal.

6. INTERPRETATION

Ideally, managers would have enough time to dedicate a focus to both to contractual and relational governance. When trying to govern an outsourcing relationship, "…the balance of not just multi-level, but formal and informal is important" (Int9). However, the reality for most outsourcing managers is a limitation on time and resources and a decision to be made between developing contractual governance or relationship governance capabilities. Interestingly, relational maturity seemed to be independent from maturity in contractual areas. Some organizations were very immature in contractual capabilities, yet quite mature from a relational perspective. Others were exceptionally mature at contractual capabilities, however, found their relationship suffering due to a lack of relational maturity.

Contractual capabilities, while better understood, often take more effort to develop and are difficult to get right. As such, inexperienced outsourcing buyers seemed to find greater success in relational practice.

"It's a lot of the informal things that make things work. So you heard in the last minute the formal things don't often work and there's a reluctance to go to formal." – Int4

Even organizations with well-developed contractual capabilities identified the issue with contractual governance; it can become vastly complex, difficult to understand, and widely interpreted.

"I think we have a very strong contract with the right flexibility but it is this thick and... I don't think it's easily digestible and always transparent" –Int9

Relational governance by comparison is often more straightforward; simply maintain an open, flexible, understanding and collaborative connection with your provider to work towards a mutual vision of each organization's goals. However, the risk identified by the very individuals who had been operating with high relational and low contractual maturity, is that if key individuals leave or problems ever arise, there is little to fall back on. Contractual governance is required at times, particularly when resolving issues between the buyer and provider.

"…it all of a sudden matters when you get a major service failure. So I'm exposed there, I understand that and want to do something about that over time." –Int11

7. IMPLICATIONS FOR OUTSOURCING BUYERS

The implications of the above findings suggest a new way of developing the interactions between buyers and providers. Traditionally, companies just entering the outsourcing market will acknowledge their inexperience and seek third-party aid to develop a well-structured contract to guide them through the learning curve of their outsourcing relationship. This results in a defined set of contractual governance structures. The subtle nuances of the intangible forms of relational governance seem too complex to grasp without the proper experience.

However, the findings of this research suggest that the approach should be the opposite. Given the number of inexperienced organizations who aired grievances about the relationship pains caused by unsuitable contracts, contractual governance may not be the easy starting point. Findings instead suggest that inexperienced outsourcing buyer organizations should look to develop relational governance capabilities in parallel with contractual governance capabilities. By developing a strong relationship, providers will be more willing to adapt and evolve the service provision through the difficult transition phase and towards a steady state. Once the relationship is firmly established, the buyer can then work with the provider to formalize many of the procedures and practices that are in place to ensure continuity of the arrangement even through tumultuous times.

Much like incorporating external legal teams in the development of new contracts, third-party consultants can be used to help expedite the development of the buyer-provider relationship and ensure best practices are adhered to. However, buyers must be wary when using consultants to help build their outsourcing relationships. Interview data indicated that during the preparation, negotiation and transition of the outsourcing arrangement, buyer organizations must thoroughly understand their own strategy and processes or risk misalignment of their provider with the true needs of the organization.

8. CONCLUSION AND FURTHER RESEARCH

Mature outsourcing (buyer) organizations benefit from contractual governance because they understand their goals and can define the contracts and procedures in a way that aligns the relationship with their current and future needs. However, even the most mature organizations need still to focus on relational governance, because no contract is perfect and there will always be relationship disputes that are more easily resolved through relational means. Mature buyers understand that a higher level of openness, trust and collaboration are critical to the success of complex outsourcing arrangements. More mature organizations appreciate the value of a better understanding of, and empathy for, the provider's business model and challenges.

Immature outsourcing organizations appear to suffer in the area of contractual governance because they do not understand their own outsourcing needs and tend to commit to long term contracts with inappropriate metrics, SLAs and terms, which deteriorate the relationship. Relational governance due to its flexibility can act as a substitute for poor contractual governance. As the organization learns more about what it needs, relational governance allows for a more organic evolution of the relationship over time. A proactive commitment to more openness, cohesion, and collaboration between the outsourcing buyer and provider leads to higher levels of trust and better value from outsourcing.

Further research has been discussed with the participating organizations to examine both sides of an outsourcing deal from the perspective of provider and buyer regarding contractual and relationship governance. This would allow the researchers to understand the contractual and relationship perspectives from both sides of the outsourcing deal.

9. ACKNOWLEDGEMENTS

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