

# Contracting Mechanisms in the IS/IT Outsourcing Phenomenon

**Abdulwahed Mohammed Khalfan**

*College of Business Studies, Kuwait*

**Majed Z. Al-Hajery**

*College of Business Studies, Kuwait*

**Khamis Al-Gharbi**

*Sultan Qaboos University, Oman*

## INTRODUCTION

As organisations need diverse and high quality IS/IT services to survive and excel in the rapidly changing business environment (Lacity & Willcocks, 2001), regular attempts have been made by organisations to sustain competitiveness through increasing their investments in IS/IT operations and resources. However, this has pushed for pursuing different options and alternatives as organisations strive to maximise their flexibility and control (Lacity, Willcocks, & Feeny, 1996). To accomplish this objective, more and more organisations are constantly looking to IS/IT outsourcing by external vendors as a viable option rather than pursuing in-house IT developments (Lacity & Willcocks).

As the central key issue in the successful IS/IT outsourcing operation is the right contract (Lacity & Hirschheim, 1995), the purpose of this chapter is to gain a deeper understanding of the contracting mechanisms that surround IS/IT outsourcing operations.

## IS/IT OUTSOURCING DEFINITION AND BACKGROUND

Precise definitions of IS/IT outsourcing differ in the literature, but there is a general agreement that it is the carrying out of IS/IT functions by a third party (Ketler & Walstrom, 1993). In the context of this chapter, however, IS/IT outsourcing refers to information systems/information technology functions only.

Cheon, Grover, and Teng (1995, p. 209) define IS/IT outsourcing as “the organisational decision to turn over part or all of an organisation’s IS functions to external services provider(s) in order for an organisation to be able to achieve its goals. This definition includes the following external services: applications development and maintenance, systems operations, network/communications

management, end-user computing support, systems planning and management, and purchase of application software, but excludes business consulting services, after-sale vendors services, and the lease of telephones lines. An organisation can obtain these services through complete outsourcing, facilities management, systems integration, time-sharing, and other contracts (including rental, installation and procurement, and maintenance and programming).”

## GLOBAL BUSINESS SCOPE OF THE IS/IT OUTSOURCING MARKET

International Data Corporation (IDC, July 24, 2001) indicated that global spending on IT services would reach US\$700.3 billion by 2005, up from US\$439.9 billion in 2001. IDC found that the United States would remain the biggest spender on IT services at US\$335 billion in 2005, up from US\$206.9 billion this year. The Outsourcing Institute (2000) expects a growth in small business outsourcing contracts exceeding 25%. IDC (July 24, 2001) found that spending in Western Europe will grow from US\$127.5 billion to US\$192.4 billion in the same period, and spending in Japan will increase from US\$53.2 billion to US\$75.2 billion. Spending on IT services in the rest of the world will amount to US\$52.5 billion to US\$97.7 billion.

Even though the above-mentioned forecasts implicitly point to increasing size and scope of contracts, Currie (2000, p. 177) observes, “most companies tend to prefer to enter outsourcing contracts which are smaller (in money), shorter (in duration) and more narrow in scope (range of IT services).” However, the megadeals which involve total outsourcing continue to gain media attention due to the dollar value of such deals (Lacity & Willcocks, 2001).

IDC (July 12, 2001) indicated that spending on IT services in Asia-Pacific (excluding Japan) is predicted to rise from US\$18 billion by the end of 2001 to US\$42 billion

by 2005. China will have the biggest growth in IT services spending, up to US\$9 billion in 2005 from US\$900 million in 2000.

IDC (2003) reveals the fastest growth for IT outsourcing services will be in government, financial markets, services, and discrete manufacturing. At the same time, the market opportunity for IT outsourcing services can differ significantly depending on the vertical industry. The report (IDC, 2003), which presents the 5-year forecast for the U.S. IT outsourcing market within 16 vertical markets, indicates a range in the compound annual growth rate (CAGR) from 3.5% in communications/media and education to 7.4% in government.

### **IS/IT OUTSOURCING IN PRACTICE**

There are different types of IS/IT outsourcing. For example, Grover, Cheon, and Teng (1994) have proposed the following taxonomy: (1) complete outsourcing, (2) facilities management outsourcing, (3) systems integration outsourcing, (4) time-sharing outsourcing, and (5) other types of outsourcing. Additionally, Lacity and Hirschheim (1995) provide a taxonomy of IT outsourcing options. They are divided into three categories of IS/IT outsourcing: body shop, project management, and total outsourcing.

### **INSOURCING**

According to Lacity and Willcocks (1998), total insourcing is “the decision to retain the management and provision of more than 80% of the IT budget internally after evaluating the IT services market” (p. 371).

### **SELECTIVE IS/IT OUTSOURCING**

According to Lacity and Willcocks (1998), selective outsourcing is “the decision to source selected IT functions from external provider(s) while still providing between 20% and 80% of the IT budget internally. This strategy may include single or multiple vendors” (p. 371). Currie and Irani (1999) believe that “selective sourcing” is a variant of multiple-supplier sourcing.

### **TOTAL IS/IT OUTSOURCING**

According to Lacity and Willcocks (1998), total outsourcing is “the decision to transfer the equivalent of more than 80% of the IT budget for IT assets, leases, staff,

and management responsibility to an external IT provider” (p. 371).

## **CONTRACT DEFINITION, APPROACH AND THEORY**

A contract is defined as: “An agreement between two or more people or organisations, ‘parties’ to the contract, which creates rights and obligations for those parties. These obligations can be legally enforced by a party who is entitled to their benefits” (Klinger & Burnett, 1994, p. 58). It is normally “a bargain made between at least two parties with an offer by one party which has been accepted by the other party with some benefits gained” (Klinger & Burnett, p. 59). A contract enables the different parties to achieve their strategic and commercial aims. It regulates the relationship of the different parties, pointing out risk and costs. It also can provide a framework for continuing to work together in the computing environment with consideration given to “certain wrongs” such as negligence, “deceit or defamation are legally known as torts” (Klinger & Burnett, p.59). A good contract is often the central key to a successful IT outsourcing relationship (Lee, 1995). As Lacity and Hirschheim (1995, p. 243) explain, “the contract is the only mechanism that establishes a balance of power in the outsourcing relationship.” The contract usually defines the rights, liability, and expectations of both the outsourcing parties (i.e., the vendor and the organisation) and is often the only solid mechanism for regulating the relationship between them. However, research on IT outsourcing negotiations and contract building tend to be mostly theoretical and very limited in scope (Lee). Currie (1995) points out that one of the most significant problems of any IT outsourcing deal is “defining the legal contract that underpins the client-supplier relationship” (p. 194).

Contracts are an important and critical part of outsourcing decisions and can be very complicated due to the fact that there is often a transfer of assets, including people, equipment, software, and buildings from the client to the vendor. For the terms of the contract to be enforceable, they must be “verifiable.” Based on their empirical research, Diromualdo and Gurbaxani (1998) identified elements “critical” to the success of contractual agreements, including: (1) the contract type, (2) performance measurement and evaluation scheme, (3) the compensation systems, and (4) assignment of decision-making rights to the vendor.

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