

## Chapter 12

# Dynamics of Outsourcing Relationships

Given the potential headaches of managing IT, it is tempting to hand the job over to someone else. Indeed, outsourcing once appeared to be a simple solution to management frustrations, and senior management teams at many companies negotiated contracts with large service providers to run their entire IT functions (Gottschalk & Solli-Sæther, 2006). At a minimum, these providers were often able to provide IT capabilities for a lower cost and with fewer hassles than the companies had been able to themselves. But many of these outsourcing arrangements resulted in dissatisfaction, particularly as a company's business needs changed.

Service providers, with their standard offerings and detailed contracts, provided IT capabilities that were not flexible enough to meet changing requirements, and they often seemed slow to respond to problems. Furthermore, a relationship with a supplier often required substantial investments of money and time, which entrenched that supplier in the company's strategic planning and business processes. The company then became particularly vulnerable if the supplier failed to meet its contractual obligations (Ross & Weill, 2002).

In our dynamic perspective of knowledge resources, outsourcing relationships are not just about transactions between a vendor and a supplier. The resource-based theory argues that the firm's ability to mobilize and utilize both internal and externally available resources determines its ability to succeed in the market place. If the firm is short of important resources such as IT resources, an outsourcing arrangement might help overcome the problem as the vendor makes IT resources available to the firm for a price.

The quality of an outsourcing relationship will vary over time. For example, when the client's behavior in the relationship changes, then a reaction from the vendor should be expected. The vendor's reaction

will have to be responded to by the client. In this manner, the relationship might dynamically improve or deteriorate over time. We apply system dynamics to understand such developments over time.

Often, the vendor will have a different value configuration than the client. The vendor being a solutions provider makes it a value shop, while the client might be a value chain, value shop, or value network. Understanding how different value configurations interact will improve the relationship. For example, if the client is a value chain, then information systems operated by the vendor have the main purpose of making production more efficient and effective at the client site. If the client is also a value shop, the information systems operated by the vendor have the main purpose of adding value to the problem solution work done by the client for its customers.

## **AGENCY THEORY**

Agency theory has broadened the risk-sharing literature to include the agency problem that occurs when cooperating parties have different goals and division of labor. The cooperating parties are engaged in an agency relationship defined as a contract under which one or more persons (the principal/s) engage another person (agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent (Jensen & Meckling, 1976). Agency theory describes the relationship between the two parties using the metaphor of a contract. In an IT outsourcing relationship this is a client-vendor relationship and an outsourcing contract.

According to Eisenhardt (1985), agency theory is concerned with resolving two problems that can occur in agency relationships. The first is the agency problem that arises when the desires or goals of the principal and agent conflict and it is difficult or expensive for the principal to verify what the agent is actually doing. The second is the problem of risk sharing that arises when the principal and agent have different risk preferences. These problems are well known in IT outsourcing. An example might be that the client organization wants to reduce its IT costs, while the vendor organization wants to maximize profits. The agency problem arises when the two parties do not share productivity gains. The risk-sharing problem might be the result of different attitudes toward the use of new technologies. Because the unit of analysis is the contract governing the relationship between the two parties, the focus of the theory is on determining the most efficient contract governing the principal-agent relationship given assumptions about people (e.g., self-interest, bounded rationality, risk aversion), organizations (e.g., goal conflict of members), and information (e.g., information is a commodity which can be purchased). Thus the question becomes: Is a behavior-oriented contract more efficient than an outcome-oriented contract? Outsourcing contracts are to a great extent tied up to service-level agreements, where the outcome of the service is the focal point.

The agency theory is applicable when describing client-vendor relationships in IT outsourcing arrangements. Typically, the client organization (principal) transfers property rights to the vendor organization (agent). In the context of IT, assets transferred might be infrastructure, systems and documentation, and employees. For a certain amount of money, the vendor organization provides services to the client organization. This implies a change in legal relationships, and IT services are carried out using a more formal transaction process. The status of personal relationships also changes, from that of a manager and a subordinate, to that of a client-manager and a vendor. According to agency theory, control mechanisms also change, from that of behavioral control, to that of outcome-based control. If both parties to the relationship are trying to maximize their utility, there is good reason to believe that

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