MANAGING THE OUTSOURCING CONTRACT: A CRITICAL STEP TOWARDS SUCCESSFUL IMPLEMENTATION

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ABSTRACT

Contracting with a vendor for the delivery of information technology (IT) services, called IT outsourcing, require careful considerations and coordinated planning by top management and CIOs. This paper provides an analysis of the critical factors that must be considered in managing outsourcing contracts to assure a successful implementation.

INTRODUCTION

IT outsourcing has been on the rise for many years rise and its popularity has only been stimulated by today's stumbling economy. While the burst of the dot-com bubble and the ensuing economic recession has hit the information technology sector extraordinarily hard, outsourcing is one area of IT that has experienced growth. More and more, companies are looking beyond their own facilities and technical expertise to achieve their business objectives. Before a firm can outsource any part of its IT, it first needs to fully evaluate the outsourcing options, selection of the outsourcing vendor(s), and particularly prepare a carefully drafted contract. There is a host of factors that must be identified and carefully explored to enhance the prospects of drafting confident outsourcing contract.

The purpose of this paper is to identify and present an analysis of the main critical factors that have been considered in the literature to lead to a successful outsourcing contract. To establish the context of the paper, a brief overview of, and reasons for, outsourcing are provided first.

THE OUTSOURCING CONTRACT

One of the most important aspects of any outsourcing deal is the contract. It describes the services that a vendor is being paid to provide, discusses financial and legal issues, and "becomes the blueprint for the life of the agreement" [10]. Because the contract obligates the firm and the vendor to each other, extensive efforts must be taken to ensure that every detail of the outsourcing arrangement is spelled out in the contract. In other words, the contract must be airtight, leaving very little or no room for misinterpretations. In spite of the contract's importance, firms sometimes sign agreements that omit crucial details and leave too much room for individual interpretation [2]. Several important factors must be evaluated and incorporated into the contract in order to protect the firm's vital interests. The following section presents an analysis of these crucial factors, and can serve as a guideline for executing a successful outsourcing contract.

Service Level Agreements

Service level agreements (SLAs) are clauses in a contract that ensure the firm is getting the level of performance that it expects from the vendor. Without SLAs to serve as a measure of the vendor's work, a firm has no concrete basis for determining whether it is getting what it's paying for. While most firms expect to reduce their IT costs through an outsourcing agreement, they do not want to do

so by sacrificing service quality. SLA's prevent service degradation by obligating the vendor to perform at a specified level while still meeting the firm's lower cost expectations [16]. Although it's crucial to include SLAs in an outsourcing contract, defining them can be a tricky proposition. For example, a better alternative to "averages" is to focus on the variability of help desk ticket resolution times [10].

Penalties for Non-Performance

Outsourcing contracts cannot be expected to achieve a firm's desired results unless they specify a course of action to be taken when a vendor is not meeting its service level obligations. Therefore, good contracts must not only specify SLAs, but they must also establish some kind of penalty for non-performance. Cash penalties are a common and effective way to protect an organization against repeated bouts of service falloffs. For this reason, it is important to make provisions in the contract for problem escalation procedures [16]. One suggestion is to create a bi-partisan committee that can act in these instances to deliver a fair and binding resolution to such disputes [12].

Baseline Measures

An integral component of the contract is specifying the baseline. The baseline represents those services that are accounted for in the outsourcing contract, and for which the customer and vendor have arrived at a financial agreement [1]. Several issues can arise with regard to the setting this threshold. The outsourcer, being motivated by profits, may tend to minimize the baseline measures so as to increase the possibility that the customer incurs additional fees. A properly constructed contract, takes these into account by pre-specifying rates that the customer can reasonably manage.

Contract Length

Signing long-term contracts represents another contract risk that needs to be factored in when considering an outsourcing agreement. Research has found that short-term contracts, defined generally as those that are for less than four years, achieve cost savings with a "higher relative frequency than long-term contracts" [13, p.377]. Another issue to consider is vendor complacency [17]. Short-term contracts require a vendor to constantly prove its worth or face the prospect of being denied a renewal.

Strategic Partnerships

Another contract-related risk of IT outsourcing is the false notion that many take of perceiving their contracts as strategic partnerships [15] [18]. Viewing a firm's relationship with a vendor in this light is dangerous because it can lead to signing loosely worded contracts. Executives may erroneously reason that because a vendor is a partner, disputes that arise in the future will be resolved harmoniously and without either side looking to take advantage of the other.

Flexibility

An outsourcing agreement can be risky if the terms of the contract do not provide flexibility and room for growth. As businesses expand and regress, technical demands are likely to change. New technologies may become available, but an organization may find itself unable to take advantage of them because its outsourcing contract doesn't permit such accessibility.

Post-Outsourcing

In spite of how much time and energy is put into negotiating a fair contract, a firm must always make contingency plans after the relationship with the vendor ends. Contracts that neglect to do this may leave a firm without a way to address its IT needs, which could deliver a fatal blow to the firm's prospects for success. Therefore, it is imperative to include reversibility clauses into the contract [3].

Vendor's Standard Contract

Vendors often have a standard contract that they offer as a carrot to expedite the tedious negotiation process. The problem with such contracts is that they favor the vendor and do not adequately include performance standards or penalty clauses [12] [14]. Since every organization is different and has unique technical requirements, an outsourcing contract should be customized to fit only that specific firm.

Management Involvement

Recent research suggests the highest levels of outsourcing success are obtained when the decisions are made jointly by senior executives and IT managers [13]. The reason for this is because IT outsourcing is both a political process and a technical endeavor. Senior executives possess the political muscle that is required to enforce measures that IT managers would not be able to enact on their own, such as software standardization and cost-cutting tactics.

Intangible Costs

Managing an outsourcing agreement represents costs and challenges that some companies may not be fully aware of [18]. It consists of three primary responsibilities: ensuring that the vendor fulfills its contractual obligations, bargaining with the vendor, and negotiating needed contract changes [3].

Post-Outsourcing Transition

Although outsourcing is defined as a purchase [12], it hardly resembles any of the other purchases that organizations typically make. In an ideal scenario, once a company makes the decision to outsource to an IT vendor, the ensuing relationship is permanent. However, just as human relationships don't always last forever, outsourcing relationships expire as well. Prudent business strategy requires that an organization prepare itself for the costs of post-outsourcing.

CONCLUSION

IT outsourcing can be viewed as a double-edged sword. On the one side, it has the potential to be an effective business strategy and, on the other side, there are risks that can easily negate many of these benefits and make outsourcing a perilous business proposition. Which side of the sword a company's fate lies on is partly dictated by the approach that it takes to draft the outsourcing contract. This paper presented a set of crucial factors that should be considered when drafting the outsourcing contract. Table 1 exhibits some of the risks that may be associated to overlooking these factors and preventive measures to be incorporated in the outsourcing contract.

Full paper is available from the author upon request.