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CHAPTER 1

Transforming back offices through outsourcing

Approaches and lessons

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Introduction

Senior executives are bombarded with messages to source business services globally. Global outsourcing is prescribed for everything from back office services like information technology development, human resource transactions, and indirect procurement to core services such as innovation, research and development, marketing, and customer care. While the vision of global sourcing networks that are agile, effective, and cost efficient is certainly achievable, it requires an immense amount of detailed management to make it work. That is the message from over 17 years of research.

Since 1989, we and our coauthors represented here (Sara Cullen, David Feeny, Eric van Heck, John Hindle, Thomas Kern, Joseph Rottman, and Peter Seddon) have studied the best, worst, and emerging IT and back office sourcing practices in over 600 large and small organizations worldwide. We have defined outsourcing as the handing over of assets, resources, activities and/or people to third party management to achieve agreed performance outcomes. This can be distinguished from the buying-in of external resources to work under in-house management, and in-house sourcing where internal management and operational resources are used almost exclusively. We have done in-depth case studies based on interviews with now thousands of senior executives, line managers, supplier account managers, business users, and outsourcing advisors in the United States, United Kingdom, Australia, Europe, and Japan. We have surveyed over 400 senior executives in the United States, United Kingdom, and Europe. Our client profile is representative of the overall outsourcing

market. Outsourcing clients are primarily North American companies (60 %) followed by European companies (22 %) and Asian/ Pacific companies (18 %).[1] One key feature of our body of research is that we measured actual outcomes compared to expected outcomes in our case studies and surveys. This enables us to draw conclusions as to the practices associated with success and failure and to analyze results over time. Overall we found:

Outsourcing can deliver on its promises, but it takes a tremendous amount of detailed management on both the client and supplier sides to realize expected benefits. This book provides in-depth insights into the detailed practices that lead to success.

Piecemeal outsourcing frequently yields piecemeal results – slightly lower costs or better service. But transformational outsourcing can lead to transformational results – significantly lower costs, better services, and increased revenues. This book provides in-depth case studies on global companies that have successfully transformed IT, human resources, indirect procurement, and other back office functions through outsourcing. Of course organizations may pursue other approaches to transform their back offices. Let us look at the main options.

Approaches to back office transformations

Back office functions such as human resources, information technology, indirect procurement, finance, and accounting are often perceived as costing too much, providing too little, and responding too slowly. Dysfunctional back offices often occur because large companies grow through mergers and acquisitions, dragging along and neglecting the back office stepchildren. This neglect results in over-staffed, idiosyncratic, duplicate, and incompatible back offices across business units. Brave senior executives are not satisfied with incremental improvements to a few processes. They want organizational reformation and cultural revolution in back office functions.

The goal of a back office transformation is to radically reduce costs, improve service, and even to increase revenues. The practices to achieve these results normally include centralization, standardization, re-orientation of staff, technology enablement, and process redesign. In considering which back office change approach is best suited to an organization, senior executives should consider the resources and skills needed to implement these new practices, such as upfront investment in technology and physical facilities, proven management capability, and effective and strongly

motivated staff. Furthermore, they should consider which approach is politically feasible with the stakeholders, including senior management, business unit directors, process directors, process staff, and of course, the large body of users.

We have identified six approaches to improving dramatically back office functions. Two are fairly typical: do-it-yourself or hire management consultants; four entail various approaches to outsourcing: netsourcing, fee-for-service outsourcing, joint ventures, and enterprise partnerships. Each provides different levels of benefits (see Table 1.1) and some approaches are more suited for certain types of activities (see Table 1.2).[2] The four outsourcing models are fully explored throughout this book, but all the models are briefly introduced below.

Table 1.1 Benefits of back office transformation approaches

Benefits	Do-it-yourself	Hire management consultants	Outsourcing			
			Netsourcing	Fee-for-service	Joint ventures	Enterprise partnerships
Ability to realize all cost benefits internally	X					
Ability to sell approach to internal organization	X	X				
Ability to control in-house	X					
Ability to infuse external energy and capabilities		X		X	X	X
Ability of outsiders to bypass political resistance				X	X	X
Provides clear indication that management is committed to transformation		X	X	X	X	X
Ability to scale solution		X	X	X		
Achieve one-time savings upfront				X	X	X
Guaranteed cost and service improvements for 5 years on baseline services				X	X	X
Guaranteed cost-plus pricing on new services						X
Potential for upfront investment by supplier					X	X
Joint Board of Directors					X	X
Service Review Board and Technology Review Board promote client participation and oversight						X
Revenue generation and sharing					X	X

Table 1.2 Suitability of various outsourcing models

Model	Resource ownership (Infra-structure and people)	Resource management	Client/ supplier relationship	Typical location of supplier staff	Typical client/ supplier contract	Activities most suited for this model
Management Consultants	Supplier	Client	One-to-one	Supplier staff on client site	Time and Materials	Core or non-core capabilities; Customized products and services; Uncertain business or technical requirements
Fee for Service Outsourcing	Supplier	Supplier	One-to-one or One-to-some	Mixed (some supplier staff on client site, some staff centrali-zed at supplier site)	Highly customized contract defining costs and service levels for that particular client	Non-core capabilities; Customized products or services; Stable business and technical requirements
Netsourcing	Supplier	Varies	One-to-many	Supplier staff not on client site	Generic contract specifying rental costs and very minimal service guarantees	Non-core capabilities; Standard products or services; Stable business and technical requirements
Joint ventures	Venture	Supplier investor	One-to-one: Client is both investor and first major customer	Mixed (some supplier staff on client site, some staff centralized at venture)	Highly customized for operations delivery; broadly defined for revenue sharing	client non-core, supplier core capabilities; Significant market for venture's product and services Frequently used to access offshore resources
Enterprise partnerships	Partnership	Client and supplier	One-to-one	Mixed (some supplier staff on client site, some staff centralized at venture)	Broadly defined for revenue sharing, customized after partnership is formed	Client non-core, supplier core capabilities; Significant market for venture's product and services Used for large scale transformation of large back offices

Do-it-yourself. This approach scores high on retaining control and keeping the value of the transformation within the company. But to succeed, it requires both funding and appropriate skills, which may be lacking. It is also the option most likely to encounter internal resistance if senior management does not give a clear signal of its importance. When other internal efforts are more important, management may not provide this signal.

Hire management consultants. This approach has three major benefits over doing it yourself. One, it brings in external energy. Two, management gives a clear signal of commitment to major change by bringing in

outsiders. Three, that commitment reduces political resistance. But this approach does have several major risks. The two most significant ones are potential cost escalation and lack of sustainability because the consultants have no long-term commitments. The result can be a lessened sense of accountability and a lack of alignment between the parties. Furthermore, expertise and knowledge leave when the consultants leave.

Netsourcing. Netsourcing is more about using outsourcing to *build* back offices rather than to *transform* existing ones. In the netsourcing model, the client pays a fee to the supplier in exchange for a product or service delivered over the Internet or other networks. This model may be more familiar to readers under the name "application service provision (ASP)." We ceased to use the term ASP after an extensive study of the space we conducted in 2001. We found a significant amount of complex service offerings beyond the initial one-to-many model, and renamed the space "netsourcing" to capture the complexity (see Chapter 10 for a full discussion of netsourcing).

Netsourcing is primarily used by small organizations to build back office capabilities that would be too expensive to develop in-house, such as accessing supply chain management or enterprise resource planning packages. But we have studied one organization, ABZ Insurance, that used netsourcing to transform both its back and front offices. Their story is explored in detail in Chapter 10. Unlike ABZ Insurance, most large organizations use this approach to seek cost reductions on targeted activities rather than for radical back office transformation. But netsourcing is frequently involved in the following three approaches as a delivery platform.

Fee-for-service outsourcing. With fee-for-service outsourcing, the client signs a contract that specifies the fees it will pay suppliers to perform services. This is the most common approach, and is primarily used to seek cost reductions on back office services. Service improvements may or may not be specified. Detailed examples are explored in Chapters 3, 5 and 8.

This approach has the benefit of bringing in an outsider. It almost always offers one-time savings and on-going cost and service improvements. However, the long-term relationship can be a difficult one. Once the contract is signed, there is a built-in lack of alignment of incentives and a crucial movement of power to the supplier. This asymmetric power shift can lead to premium pricing of add-ons, lower levels of attention as time goes on, and deterioration of the relationship into an "us-versus-them" mentality.

In our early studies of IT outsourcing, we found that clients often had naive expectations about this model. For example, many clients expected to save 25 percent on IT costs by signing ten-year, fixed-price contracts for a set of baseline services. Many clients subsequently re-negotiated,

terminated, or switched suppliers mid-stream. For example, our survey found that among those respondents who had prematurely terminated an outsourcing contract, 51 percent switched suppliers, 34 percent brought the function back in-house, and the remainder eventually reinstated their initial suppliers due to prohibitively high switching costs.[3]

But the good news is that the lessons for assessing which activities to outsource, evaluating suppliers, and negotiating exchange-based contracts are well proven by over 15 years of research. The model continues to be the dominant form.

Joint venture. As Tables 1.1 and 1.2 suggest, a joint venture solves some of the relationship problems through a shared Board of Directors and sharing of profits. However, power asymmetries still exist and most of the joint ventures we studied do not guarantee sustained improvement. Instead, they rely on nebulous notions of partnership, which can lead to real discomfort between the partners – especially if costs escalate.

In the past, joint ventures between clients and suppliers often failed to attract external clients and the relationships were redefined as exchange-based. Examples include Delta Airlines and AT&T, and (part of) Xerox and EDS (see also Chapters 6 and 7). Problems arose among several such deals because the parties thought they could sell homegrown client assets and capabilities to external clients. But the reality of delivering daily services devoured resources, and client assets and capabilities turned out to be too idiosyncratic for commercial delivery in highly competitive markets like enterprise resource planning (ERP).

In the offshore outsourcing space, joint ventures have been the preferred vehicle for large organizations to create safely a large offshore facility without the risks and hassles of a fully owned captive center. Joint ventures allow US investors access to local expertise for leasing offices, creating infrastructure, and hiring locals. Client investors, such as MasterCard, CSC, Perot Systems, and TRW chose this model over a captive model because they wanted to sacrifice some control in exchange for the supplier bearing some of the risk. For example, MasterCard created a joint venture with Chennai-based Mpower Software Services called MPACT, which had 250 employees performing IT work for MasterCard in 2005.[3] In addition to servicing MasterCard, MPACT has done work for Capital One, Household, Comdata, MagTek, Nedbank, and Alliance Data among others. Offshore models are more fully explored in Chapter 9.

Enterprise partnership. With an enterprise partnership, the client and supplier create a jointly owned enterprise that both services the client investor as well as seeks external customers. However, enterprise

partnerships are different from joint ventures. The first difference is the primary purpose for joining together. With an enterprise partnership model the main focus is delivering cost savings and better services to the client investor. The client's back office is not world-class, so it seeks a supplier to help transform the function through better management, better IT systems, and better processes. External sales are merely a bonus. In a joint venture, on the other hand, the primary purpose is revenue generation through sales to third parties. Essentially, the client views its function as world-class and believes it can gain more revenues by selling to competitors than keeping the advantage to itself. It seeks a supplier to help with commercialization. In our experience, however, the venture often becomes so preoccupied with providing service to the client investor that it has no resources for external sales. In instances where clients truly had a competitive offering, a spin-off has been a more successful vehicle for creating a venture.

The enterprise partnership model has yielded significant back office transformations in organizations such as BAE Systems formerly British Aerospace and Lloyd's of London. Indeed, we have devoted three chapters to the use of this model to transform HR (Chapter 6), procurement (Chapter 7), and insurance policy and claims administration (Chapter 8).

The first enterprise partnership we examine is between BAE and Xchanging for the transformation of BAE's human resource function. The enterprise partnership is called Xchanging HR Services (XHRS). Becoming the venture's first customer, BAE signed a ten-year contract worth £250 million and transferred 430 HR employees to the enterprise. By 2005, BAE had already received the following benefits:

- Cost savings on baseline services
- Service improvement in many service areas
- New web-based technology capabilities rolled out to over 40,000 users in BAE
- A new state-of-the art shared service center was built and occupied
- Retained BAE managers now focus on more strategic activities
- Transferred BAE staff have been retrained to make them more service focused
- Obtained new business, including a £500,000-deal with Spirit Group for HR services in 2005
- Partnership has earned numerous nominations and awards including UK's National Outsourcing Association (2004) and BAE's HR Excellence Award (2005)

The second enterprise partnership we present in Chapter 7 is also with BAE and Xchanging. But this time, Xchanging tackled BAE's indirect procurement. The enterprise partnership is called XPS. Again, BAE was the venture's first customer. BAE initially signed a £800 million, ten-year contract but subsequently added £490 million to the deal during the first three years. Xchanging transformed BAE's indirect procurement and reduced prices for BAE by 12 percent overall. Furthermore, Xchanging improved the procurement service, including user desktop ordering from a newly developed sourcing web portal. By 2005, XPS's business was booming, with XPS controlling US$6 billion worth of procurement spend for BAE and nine other customers.

The third enterprise partnership we present is between Lloyd's of London and Xchanging. This partnership, called XIS, has radically transformed the London insurance market back office (see Chapter 8).

Size of the global business and IT outsourcing market

Despite the challenges with the four back office transformation approaches that entail outsourcing, the global IT and business process outsourcing markets consistently grew during the 17 years we have been studying it.

When we began research in this area in 1989, the IT outsourcing (ITO) market was quite small, only an estimated US$3 billion market. During the 1990s, the global ITO market swelled to what is today a US$200 billion market, as more organizations outsource their hardware, software, and IT staff. The offshore ITO market (primarily India and China) will represent about 25 percent of the global ITO market at US$56 billion by 2008, according to WR Hambrecht. But other research firms such as McKinsey and NASSCOM predict that India alone could grab US$142 billion of the ITO market by 2009. Such figures for ITO (and Business Process Outsourcing – BPO below) are difficult to arrive at accurately, and often turn out to be over-estimates, but do indicate the possibilities.[4]

The BPO market is about three quarters the size of the ITO market but certainly growing rapidly. McKinsey estimates the global BPO market will be US$140 billion by 2008, of which US$17 billion will be outsourced to India. Gartner has even bigger estimates, estimating the size of the global BPO market to be US$173 billion by 2006, of which US$24 billion would be outsourced offshore.[5] It is important to note that BPO deals include a lot of IT. For example, most human resource outsourcing entails the HR IT systems and infrastructure.

Table 1.3 Size of various ITO and BPO markets

Outsourcing market	In-depth coverage Chapter nos.	Global outsourcing size estimates in US$ billion
Information Technology outsourcing	2, 3, 5	$200
Human Resource outsourcing[1]	3, 4, 6	$30 to 50
Indirect Procurement outsourcing[2]	2, 7	$7 to 10
Financial Services outsourcing[3]	2, 8	$15
Offshore IT outsourcing[4]	9	$50
Netsourcing[5]	10	$4

Notes: 1 McIlvaine, A. (2004), "HR's Influential: BPO Pioneer James Madden," *Human Resource Executive Magazine*, April 19.
2 Davies, C. (2004), "The pitfalls of supplier bashing," *Supply Chain Europe*, March, Vol. 13, 12, pp. 46–47.
3 NASSCOM McKinsey Study
4 Op. cit. www.ebstrategy.com
5 John Harney estimates that the ASP market has not only recovered since the dot.com burst, but that it is thriving with 1500 suppliers in a market that will be $20 billion by 2006. See Harney, J. (2005), "The new world of ASPs," *Cutter Consortium*, Vol. 5, 9.

Table 1.3 presents the best estimates we found for various outsourcing markets. We study six of these markets in detail in this book: information technology outsourcing (ITO), human resource outsourcing (HRO), indirect procurement outsourcing, financial services outsourcing, offshore outsourcing of IT work, and netsourcing. Our own estimates of trends in client behavior and in the outsourcing marketplace are presented in detail in Chapter 11 of this book.

The outsourcing learning curve

Most of our research participants found they needed to conquer a significant learning curve before they realized expected benefits from outsourcing. It took most organizations a few tries to get outsourcing to work (see also Chapter 2 on this). Thus, we are not surprised that one DiamondCluster study found that 78 percent of executives had terminated at least one outsourcing contract. Our own survey of US and UK CIOs found that 32 percent had cancelled at least one IT outsourcing contract.[6] But clients were quite capable of learning from mistakes, and subsequent outsourcing relationships were frequently successful. Figure 1.1 illustrates the typical client learning curve for outsourcing. During Phase I, senior executives we interviewed became aware of an outsourcing market

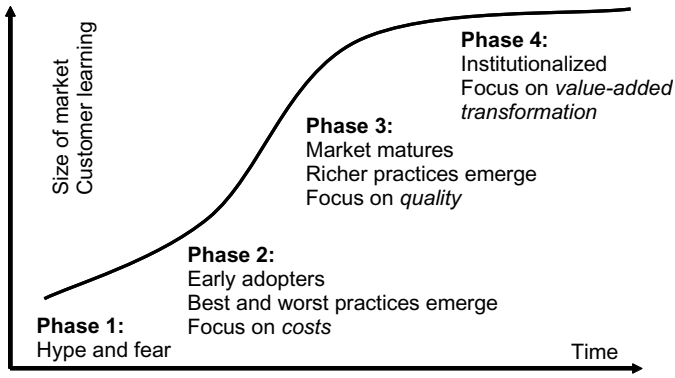

Figure 1.1 Outsourcing learning curve

through marketing hype ("you'll save 60 percent off your costs") or irrational propaganda ("you'll lose all your internal capabilities and intellectual property"). Senior executives quickly learn about potential benefits, costs, and risks by talking to peers, consultants, and reading research. Most senior executives initially engaged in outsourcing (Phase II) to seek lower costs. *During the pilot testing, senior executives learn about the immense amount of in-house management required to effectively work with suppliers and to achieve real cost savings*. As learning accumulated, some senior executives moved to Phase III when they exploited outsourcing for quality as well as cost reasons. One phrase we heard over and over again from participants was, "*we went for the price, we stayed for the quality*."

More mature adopters in Phase IV use outsourcing to strategically enable corporate strategies, such as increasing business agility, bringing products to market faster and cheaper, financing new product development, accessing new markets, or creating new business. From our research, these strategic initiatives often evolved over time. For example, a large US Financial Services firm uses global sourcing of IT and back office functions primarily to enable strategic agility. It has captive centers in Manila and Mumbai, and various joint ventures and fee-for-service relationships with 14 Indian suppliers. During the refinancing boom, the company was able to beat competitors by quickly meeting the immense surge in demand for IT and business process services. As the refinancing boom burst, the company was able to immediately scale back resources. But it took them *15 years* to develop this well-oiled global network.

While at an aggregate level the learning curve suggests a sequential progression and at the micro level, learning is iterative and concurrent.

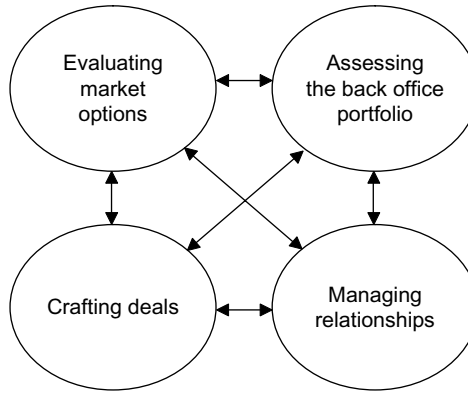

Figure 1.2 Learning and feedback in effective sourcing

Clients continually learn how to assess better their own service portfolio, evaluate suppliers' capabilities, craft contracts, and manage supplier relationships. Even within the same client–supplier relationship, clients frequently revisit the scope of the deal and re-craft contracts several times. This iterative learning process is reflected in Figure 1.2.

In the next sections, the most important client lessons for managing these four processes are described.

Assessing the back office portfolio

Lesson 1: Treat back offices as a portfolio of capabilities. Sound sourcing strategies begin with the assumption that back offices should be treated as a portfolio of activities and capabilities. Some of these activities must be kept in-house to ensure current and future business advantage and flexibility, while others may be safely outsourced. This portfolio perspective is empirically supported by our research findings that selective outsourcing decisions had a higher relative frequency of success than total outsourcing decisions.[7] We defined the scope of sourcing options as:

Total outsourcing:[8] *the decision to transfer the equivalent of more than 80 percent of the function's operating budget for assets, leases, staff, and management responsibility to external providers.*

Total in-house sourcing: *the decision to retain the management and provision of more than 80 percent of the function's operating budget internally after evaluating the services market.*

Selective outsourcing: *the decision to source selected functions from external provider(s) while still providing between 20 and 80 percent of the function's operating budget internally.*

Selective outsourcing decisions have been generally successful with a 77 percent success.[9] This couples with selective outsourcing also being the most common sourcing practice.[10] With selective outsourcing, organizations select the most capable and efficient source – a practice some participants referred to as "best-of-breed" sourcing. The most commonly outsourced functions in IT were mainframe data centers, software development and support services, telecommunications/networks, and support of existing systems. The most commonly outsourced functions in human resources were payroll, benefits administration, and employee training and education.[11] In most cases, suppliers were judged to have an ability to deliver these products and services less expensively than internal managers. The ability to focus in-house resources on higher-value work also justified selective outsourcing.

In general, total-outsourcing decisions achieved their expectations less frequently than selective outsourcing decisions or total in-house decisions. With total outsourcing, only 11 of 19 companies we studied achieved expectations. An example of some total outsourcing success was the South Australian Government's economic development package with EDS. The supplier (EDS) exceeded yearly targets for delivering US$200 million in economic development during the nine-year contract. However, other aspects of the deal were less successful and resulted in moves towards multi-sourcing in 2005.[12]

Participants frequently encountered one or more of the following problems with total outsourcing:

- excess fees for services beyond the contract due to increase in user demand
- excess fees for services participants assumed were in the contract
- hidden costs
- fixed-prices that were mis-matched with market prices two to three years into the contract
- inability to adapt the contract to even minor changes in business or technology without triggering additional costs
- lack of innovation from the supplier
- deteriorating service in the face of patchy supplier staffing of the contract

Exclusive sourcing by an internal department was 76 percent successful.[13] These companies were able to transform their back offices with the

"do- it-yourself" approach. We found, however, that such success stems from a potential threat of outsourcing. *Only through the threat of competition did internal managers have the power to overcome organizational resistance to change, to implement cost reduction tactics used by suppliers, and to temper realistic service level expectations against available resources*. Once empowered through the threat of competition, internal managers often had cost advantages over suppliers (such as no marketing expense, no need to generate a profit). In addition, they often had service advantages, such as idiosyncratic knowledge of business applications.

Given that back offices should be treated as a portfolio, the next issue is how to assess the parts of the portfolio to outsource or keep in-house. While common wisdom tells us to keep core capabilities in-house and to outsource non-core capabilities, the distinction is not very useful. More thorough assessment tools are needed to identify exactly what is core and non-core. The following two lessons therefore explore the frameworks used to make core/non-core assessments.

Lesson 2: Identify core capabilities to keep in-house. There are many frameworks based on theories to help managers assess core capabilities to keep in-house. Indeed, we have devoted all of Chapter 3 to this topic. In this section, we introduce three frameworks. *The most important point here is that different frameworks will lead managers to different conclusions, thus as much thought should be put into the selection of the framework as to the actual portfolio assessment*.

The most popular portfolio assessment frameworks are based on theories such as resource dependency theory, agency theory, auction theory, game theory, institutional theory, and, by far the two dominant theories: transaction cost economics (TCE) and the resource-based view (RBV). In many ways, TCE is the ideal theoretical foundation because it specifically addresses make-or-buy decisions based on generic attributes of assets and describes appropriate ways to govern client–supplier relationships. For example, transaction cost economics posits that transactions with high asset specificity (essentially customization), high uncertainty, and/or frequent occurrence are best managed internally, while the rest should be more efficiently outsourced.[14] Indeed, a number of outsourcing empirical studies have found that asset specificity has been a significant factor to consider in make/buy decisions.[15] The RBV has been the second most widely applied theory to the outsourcing context.[16] RBV suggests that managers keep valuable, rare, non-imitable, and non-substitutable strategic assets in-house,[17] while potentially outsourcing the rest. Both TCE and RBV are valuable perspectives because they guide managers to treat the

entire business functions as a portfolio of transactions/capabilities – some of which must be kept in-house while some may be outsourced.

The most direct assessment of IT as a portfolio was the Core Capabilities Model, first developed by Feeny and Willcocks.[18] This is the model we have since updated and generalized beyond IT to include other business functions in Chapter 3. We define four broad categories which clients must keep in-house, even if they intend to outsource nearly all of the business function:

- Governing
- Eliciting and delivering business requirements
- Ensuring technical ability and architecture
- Managing external suppliers

Table 1.4 summarizes the activities to be kept in-house by these different perspectives. To illustrate how these three different assessment perspectives might yield different prescriptions, consider the example of an ERP implementation in a global manufacturing company. Based on the

Table 1.4 Different portfolio assessment perspectives: what core activities should be kept in-house?

Transaction cost economics	Resource-based view	Core capabilities model
High asset specificity: The physical or human assets are non-redeployable for alternative uses or users. The activities are so idiosyncratic and customized that keeping them in-house is less costly than outsourcing.	*Valuable:* the resource can be used to exploit strategic opportunities or ward off threats	*Governance:* strategy, mission, and coordination
High uncertainty: Activities cannot be clearly defined for effective third-party contracting. Threat of supplier opportunism is high unless client incurs excessive transaction costs.	*Rare:* Few competitors have the resource	*Business requirements:* understanding business needs as they relate to the service function (IT, HR, etc), and relationship building among management, users, and the service function
High Frequency: Transactions that occur frequently *and* are highly asset-specific are less costly if kept in-house.	*Non-imitable:* It is difficult or costly for competitors to imitate the resource *Non-substitutable:* The resource has no immediate equivalents	*Ensure technical ability:* The architecture operation may be outsourced, but the client maintains control over architecture design *External supplier management:* Clients must make informed buying decisions, monitor and facilitate contacts, and seek added-value opportunities from suppliers

resource based view, the ERP project would not likely pass any of the core capability tests as ERP systems are widely used by competitors, thus outsourcing would be prescribed. But transaction cost economics suggests doing the implementation in-house if

1. The ERP system had to be highly customized to meet a specific business context (high asset specificity) or
2. The client's unique requirements could not be fully articulated in a sound contract (high uncertainty)

The Core Capabilities Model would suggest a mixed sourcing solution. This model would guide managers to insource parts of the ERP project associated with governing the project, articulating business requirements, and managing the political terrain among users. But their model would suggest outsourcing certain aspects of the project, such as programming, testing, and systems integration to access market scale and expertise.

Lesson 3: Best source non-core capabilities. Once core capabilities are identified, it does not automatically mean that the remaining non-core capabilities should be outsourced. We found that clients who considered additional business, economic, and technical factors of non-core capabilities were most frequently happy with their sourcing decisions.[19]

From a business perspective, some capabilities, which are non-core today, could become core in the future. Outsourcing this non-core function now may impede strategic exploitation in the future. For example, one of our case studies outsourced their web site design and hosting in 1995, which initially served as a marketing tool. As the web became increasingly important to their strategy, including online sales and customer service, the client found their outsourcing relationship impeded the strategic exploitation of the web. It subsequently terminated the supplier at a significant switching cost and brought the function back in-house. From an economic perspective, some non-core activities can be more efficiently kept in-house. For example, several of our case study participants were willing to outsource their large data centers but could not find suppliers who could do it cheaper.

From a technical perspective, some non-core capabilities are highly integrated with other core activities. This makes outsourcing extremely difficult. For example, one case study participant outsourced factory automation but found the supplier could not adapt to the rapid redirections from the sales department, let alone manage the supply chain implications. The system was eventually brought back in-house after paying a significant early termination fee. Assuming non-core capabilities pass these litmus tests, the client must

still evaluate the market options to further validate an outsourcing model and to identify viable suppliers, as discussed in the next section.

Evaluating market options

An important and ongoing sourcing process is to keep abreast of market options, even if the organization is exclusively insourcing at present. The following section introduces three lessons to help executives use the right evaluation process to find the right supplier. These lessons will be fully expanded in Chapters 2 and 4.

Lesson 4: Assess twelve supplier capabilities. Clients have thousands of suppliers from which to choose. Some clients prefer large global suppliers like Accenture, IBM, EDS, and Wipro because of their reputation, scale, and scope. Other clients prefer niche suppliers for specific domain expertise or local suppliers for extra control and attention. In making these choices, *we found that many clients make one major mistake when assessing suppliers: they tend to assess suppliers' resources such as physical facilities, technology, and workforce composition, rather than supplier capabilities to effectively manage and deploy these resources for the client's benefit*. For example, many senior executives ask for evidence of excellent supplier employees. This assessment does not distinguish suppliers because all credible suppliers have excellent people. Instead, senior executives need to ask about the supplier's behavior management capability – how does the supplier motivate and manage people to deliver service through a customer-focused culture?

A better way to assess the myriad of suppliers is to consider the 12 supplier capabilities model created by Feeny, Lacity, and Willcocks (see Figure 1.3). This model will be thoroughly explored in Chapter 4, but is introduced below.

The 12 capabilities establish the basis for three supplier competencies:

- **Relationship Competency:** the ability to create aligned incentives between client and supplier
- **Delivery Competency:** the ability to deliver daily operations while still generating a good supplier margin
- **Transformation Competency:** the ability to meaningfully transform the client's operations to decrease costs and improve service.

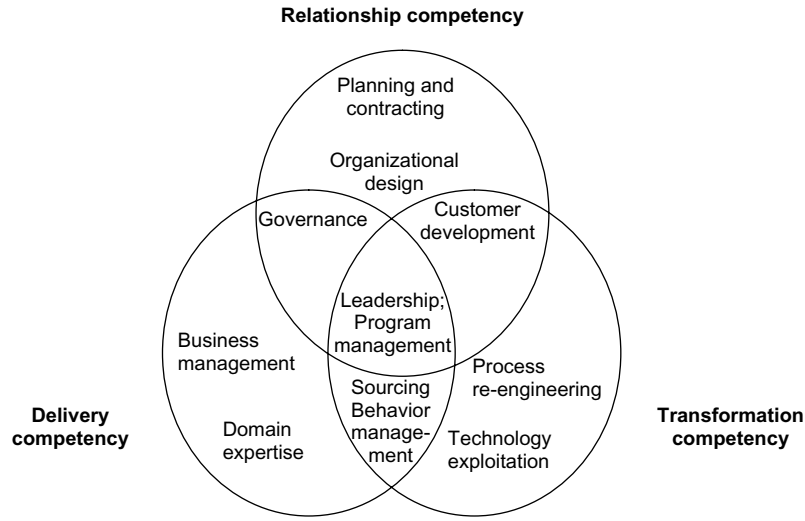

Figure 1.3 12 Supplier capabilities

High-level definitions of the 12 capabilities are found in Table 1.5. Although a detailed explanation of the capabilities is found in Chapter 4, an example will illustrate how the model can be used to compare suppliers. Consider the *leadership capability, defined as the capability to identify, communicate, and deliver the balance of delivery, transformation, and relationship activities to achieve present and future success for both client and provider*. After completing 76 case studies of client–supplier relationships in IT outsourcing, we found that the main differentiator between success and failure was the individuals who were leaders of the supplier (and client) account teams.[20] Leaders must operate more as the CEOs of the relationships, rather than as traditional account managers. Supplier leaders must also have significant clout within their parent organization to mobilize resources on behalf of their clients. For example, one US client was initially thrilled when the supplier hired a high-powered managing director specifically to serve as account leader. However, this outside hire was ineffective in gaining resources and attention at supplier headquarters because no one knew him. The point is that the supplier leader must not only be an excellent "CEO" of the relationship, but must have significant clout within his/her own organization.

To summarize, senior executives cannot merely assess supplier resources and hope to achieve high performance. Instead, senior executives must assess suppliers based on 12 specific capabilities (see Table 1.5).

Table 1.5 12 Supplier capabilities defined

Supplier capability	Definition
1. Leadership	The capability to identify, communicate, and deliver the balance of delivery, transformation, and relationship activities to achieve present and future success for both client and provider
2. Planning and contracting	The capability to develop and contract for business plans which deliver "win/win" results for client and supplier over time
3. Organizational design	The capability to design and implement organizational arrangements to realize plans and contracts
4. Governance	The capability to define, track, assess, and fix performance
5. Customer development	The capability to transition users of an internally provided service to customers who make informed decisions about service levels, functionality, and costs
6. Process improvement	The capability to design and implement changes to service processes to meet improvement targets
7. Technology exploitation	The capability to swiftly and effectively deploy technology in support of critical service improvement targets
8. Program management	The capability to prioritize, coordinate, ready the organization, and deliver across a series of inter-related projects
9. Sourcing	The capability to access whatever resources are required to deliver service targets
10. Behavior management	The capability to motivate and manage people to deliver service with a "front office" mindset
11. Domain expertise	The capability to apply and retain sufficient professional knowledge of the process domain to meet user requirements
12. Business management	The capability to consistently deliver against both client service level agreements and suppliers' own required business plans

Lesson 5: To be sure that outsourcing would be a better approach than do-it-yourself, compare request-for-proposals to internal bids. During the last 15 years, organizations that invited both internal and external bids had a higher relative frequency of success than organizations that merely compared a few external bids to current performance.[21] We believe that this was because formal external supplier bids were often based on efficient managerial practices that could be replicated by internal managers.[22] The question was, "If my managers could transform the back office, why haven't they done so?"

In some cases, internal managers could not implement cost reduction tactics because the internal politics often resisted cost reduction tactics such as consolidating departments, reducing headcount, and standardizing processes and technology. This, we saw, was the major impediment to the do-it-yourself transformational approach.

In the IT space, for example, business unit managers in two divisions at a US food manufacturer did not want to consolidate their data centers into the corporate data center. One data center Director stated, "[The two divisions] didn't want to come to corporate IS in the first place. They didn't want to close their data centers, a control thing, 'my car is faster than your car' thing." Senior executives at this company felt that IT costs had become too expensive and decided to outsource its data centers. The data center Director lobbied to submit an internal bid. Once granted permission, he prepared an internal bid that beat an external bid on cost. Within three years, he cut costs by 45 percent by consolidating and standardizing. But the legitimate threat of outsourcing was the catalyst for change.

In other cases, internal managers were not motivated to improve costs, particularly if the legacy of insourcing had created an environment of complacency. For example, the unionized employees at a US telecommunications company maintained inefficient work practices to protect their jobs. It was not until the union was threatened with losing the job site through outsourcing that union representatives acquiesced and improved efficiency. One of the union representatives expressed the following view: "When you are in the frying pan, you get creative."

Internal bids, however, might be infeasible in some circumstances. For example, rather than use its own capital to invest in much needed IT renewal, DuPont wanted a supplier(s) to make the investment upfront in exchange for variable fees based on usage. Clearly an internal bid team could not compete with the US$4 billion deal DuPont subsequently signed with CSC and Accenture.

Lesson 6: Involve multiple stakeholders in sourcing decisions. Concerning *who* should be making these assessments, our case study and survey data both suggest that multiple stakeholders need to be involved. In our survey data, 68 percent of respondents had at least two stakeholders driving the decision, most frequently the back office manager and lawyers or the back office manager and senior executives.

Successful sourcing decisions require a mix of political power and domain knowledge.[23] Political power helps to enforce the larger business perspective – such as the need for organization-wide cost cuts – as well as the "muscle" to implement such business initiatives. Domain knowledge

on back office services, service levels, measures of performance, rates of service growth, and price/performance improvements are needed to develop requests-for-proposals, evaluate supplier bids, and negotiate and manage sound contracts.

Crafting deals

Assuming an appropriate sourcing model and viable supplier has been identified, the parties must still negotiate a contract. The two most important proven practices for crafting contracts are discussed below:

Lesson 7: Detail fee-for-service contracts, including responsibilities of both parties and mechanisms of change. Of the outsourcing models found in Table 1.2, the fee-for-service model is still the most common model. But our data reveals there are several types of fee-for-service contracts:

***Standard contracts*:** the client signed the supplier's standard, off-the-shelf contract. This is primarily restricted to the netsourcing space.

***Detailed contracts*:** the contract included special contractual clauses for service scope, service levels, measures of performance, and penalties for non-performance.

***Loose contracts*:** the contract did not provide comprehensive performance measures or contingencies but specified that the suppliers perform "whatever the client was doing in the baseline year" for the duration of the contract at 10 to 30 percent less than the client's baseline budget.

***Mixed contracts*:** For the first few years of the contract, requirements were fully specified, connoting a "detailed" contract. However, participants could not define requirements in the long run, and subsequent requirements were only loosely defined, connoting a "loose" contract.

Detailed contracts achieved expectations with greater relative frequency than other types of contracts (75% of detailed contracts were successful). These organizations understood their own functions very well, and could therefore define their precise requirements in a contract. They also spent significant time negotiating the details of contracts (up to 18 months in some cases), often with the help of outside experts. For example, the Financial Manager at a US bank spent three months negotiating the data

center contract, assisted by the VP of IS, internal attorneys, and two hired experts:

> And that's when [the VP of IS] and I and the attorneys sat down everyday for three solid months of drafting up the agreement, negotiating the terms, conditions, and services. (Financial Manager, US Bank)

From our survey, clients included the following clauses in their detailed contracts:

- costs (100%),
- confidentiality (95%),
- service level agreements (88%),
- early termination (84%),
- liability and indemnity (82%),
- change contingency (65%), and
- supplier non-performance penalty (62%).

Increasingly, contracts also include responsibility matrices, which outline the responsibilities for both clients and suppliers. This innovation recognizes that suppliers sometimes missed service levels because of their clients. For example, in one of our cases, the supplier did not connect new client employees to the network within the contractual time limit because the client systematically failed to properly authorize new accounts.

No matter how detailed contracts become, changes in requirements will occur. Many detailed contracts now have mechanisms of change, including:

- planned contract realignment points to adapt the contract every few years,
- contingency prices for fluctuation in volume of demand,
- negotiated price and service level improvements over time,
- external benchmarking of best-of-breed suppliers to reset prices and service levels.

In contrast to the success of the detailed contract, all seven of the loose contracts we studied were disasters in terms of costs and services. Two of these companies, actually terminated their outsourcing contracts early and rebuilt their internal departments. Another company threatened to sue the

supplier. Senior executives in these companies had signed flimsy contracts under the rhetoric of a "strategic alliance." However, the essential elements of a strategic alliance were absent from these deals. There were no shared risks, no shared rewards, and no synergies from complementary competencies nor any other of the critical success factors identified by researchers. Instead, these loose contracts created conflicting goals. Specifically, the clients were motivated to demand as many services as possible for the fixed-fee price by arguing, "You are our partners." Supplier account managers countered that their fixed-fee price only included services outlined in the contract. The additional services triggered supplier costs, which were passed to the client in terms of excess fees. Because the clients failed to fully specify baseline services in the contract, the clients were charged excess fees for items they assumed were included in the fixed-price.

Six of the eleven "mixed" contracts we studied achieved expectations. The contracts contained either shared risks and rewards or significant performance incentives. A Dutch electronics company spun-off of the IT department to a wholly owned subsidiary. Because the newly formed company's only source of revenue was the electronics company, they were highly motivated to satisfy their only client's needs.

Lesson 8: Keep contracts short enough to retain relevancy and control, but long enough for suppliers to generate a profit margin. From the client perspective, there is clear evidence that short-term contracts have higher frequencies of success than long-term contracts. From 85 case studies we studied, 87 percent of outsourcing decisions with contracts of three years or less were successful, compared to a 38 percent success rate for contracts eight years or longer.

Short-term contracts involved less uncertainty, motivated supplier performance, allowed participants to recover from mistakes quicker, and helped to ensure that participants were getting a fair market price. Another reason for the success of short-term contracts is that participants only outsourced for the duration in which requirements were stable, thus participants could articulate adequately their cost and service needs. Some participants noted that short-term contracts motivated supplier performance because suppliers realized clients could opt to switch suppliers when the contract expired. As the IS director of a UK aviation authority commented, "It's no surprise to me that the closer we get towards contract renewal, it's amazing what service we can get."

In contrast, long-term contracts have remained troublesome, with failure to achieve cost savings as the primary reason. Few total outsourcing

mega-deals reach maturity without a major stumbling block. Conflicts are increasingly being resolved through contract re-negotiations.

The suppliers, however, have a clear preference for long-term relationships to recoup excessive transition and investment costs. Returning to DuPont's ten-year deal, the transition activities lasted over 18 months as the contract was operationalized in 22 countries to a population of nearly 100,000 users. The transition also included massive investments by one supplier in IT infrastructure, which the supplier could only recoup in a long-term deal. Clearly, the client's incentives for short-term deals must be balanced with the supplier's incentives for long-term deals.

Managing external suppliers

For all the sourcing models, there is an inherent adversarial nature in the contracts in that a dollar out of the client's pocket is a dollar in the supplier's pocket. (This is even typically true for joint ventures because the client investor is also the venture's primary or even sole paying customer.) If the client followed best practices up to the point of signing the contract, they should be sufficiently protected from the devastatingly negative consequences experienced in the early days. If the supplier negotiated a favorable deal, they should be able to deliver on the contract and still earn a profit margin. But even under the most favorable circumstances, relationship management is difficult:

> Really our challenge is relationship management … I know I certainly haven't found the answer yet, but not too many other people have found the answer either. (Client of a Au$600 million contract)

Lesson 9: Put core client capabilities in place to protect the client interests as well as to foster supplier success. In addition to informed buying, these capabilities, which are more fully explored in Chapter 3, include contract facilitation, contract monitoring, and supplier development.

Contract facilitation is the capability to provide a vital liaison role between the supplier and the client's user and business communities to ensure supplier success. In our experience, both users and suppliers place high value on effective contract facilitators. The role arises for a variety of reasons:

- business users want one-stop shopping
- the suppliers need the buffer to foster realistic user expectations
- multiple suppliers need coordinating

- it enables easier monitoring of usage and service
- user demand must be managed to prevent excess charges

Contract monitoring is the capability to ensure that the supplier delivers on the contract. As organizations exploit the burgeoning external market for outsourced services, contract monitoring becomes a core capability. While the contract facilitator is working to "make things happen" on a day-to-day basis, the contract monitor is ensuring that the business position is protected at all times. Effective contract monitoring involves holding suppliers to account against both existing service contracts and the developing performance standards of the services market. It enables the production of a "report card" for each supplier that highlights their achievement against external benchmarks and the standards in the contract.

Supplier development is the capability beyond the legal requirements of a contract to explore increasing ways the clients and suppliers can engage in win-win activities. The single most threatening aspect of outsourcing is the substantial switching costs. Changing suppliers is expensive and difficult. Hence it is in the client's interest to maximize the contribution of existing suppliers, and also, when outsourcing, to guard against what we call the "mid-contract sag." A supplier may be meeting the contract after two or more years, but none of the much talked-about added value of outsourcing materializes. As the contract manager in a major US bank commented after his firm consolidated and outsourced its data centers,

> Sure, the suppliers deliver the contract, but to the letter. They've incurred only one penalty in more than two years. But trying to get them to identify the added value we both talked about at the beginning, let alone deliver it, is very difficult. They've had changes in management staff, so they are driven by what is written down rather than by some of our initial understandings.

In supplier development, clients look beyond existing contractual arrangements to explore the long-term potential for suppliers to create the "win-win" situations in which the supplier increases their revenues by providing services that increase business benefits. A major retail multinational has many ways to achieve this, including an annual formal meeting. An executive from the multinational stated:

> It's in both our interests to keep these things going and we formally, with our biggest suppliers, have a meeting once a year and these are done at very senior levels in both organizations. There are certain

things we force on our suppliers, like understanding our business and growing the business together … and that works very well.

Lesson 10: Embrace the dynamics of the relationship. Even with these capabilities in place, client and supplier relationships will sometimes be troublesome, but the parties still have a good relationship overall. Rather than seek to extinguish such troubles, the best relationships embrace the dynamics of these quite complex interactions.[24]

We identified four common types of client–supplier interactions: adversarial, tentative, cooperative, and collaborative. These are based on the extent of goal alignment for the task at hand:

- **Tentative interactions** occur when goal alignments are unknown, such as during the bidding process. At such times, each side tends to exaggerate their strengths and hide their weaknesses.
- **Adversarial interactions** occur when goals are conflicting, such as interpreting which party should pay for something ambiguously stated in the contract.
- **Cooperative interactions** occur when goals are complementary, such as the client wants the service and the supplier wants the payment.
- **Collaborative interactions** occur when both sides have shared goals, such as educating the user community on what they can expect from the contract.

By attending to the expectations and goals of many outsourcing stakeholders, apparent anomalies in relationships are understood. Why, for example, do client contract managers and supplier account managers *collaborate* to mediate user expectations and then feel perfectly comfortable *fighting* over a monthly bill? Quite simply, the dynamics of stakeholder relationships vary with the task.

We do, however, note one caveat about stereotyping interactions. While generalizations are an effective tool for summarizing common experiences, they ignore the role of individual personalities in the success of client–supplier relationships. In several instances, stakeholder relationships improved when the person was replaced. Client and supplier account managers, in particular, had a high turnover rate in several of the mega deals studied.

The following participant quotes testify to the effectiveness of new faces:

> At the beginning of this contract, we actually had to change both of the contract managers three months into the contract to get a more reasonable basis for the relationship because the two of them over the opening three months had continued the negotiations. They were locking horns day-in-day-out. We had to take both of those individuals out and try to recover that relationship. I think that's been successful. Account Manager, public sector organization.
>
> I think it's unhealthy in any case to perpetuate the same relationships for too long, because you then know each other so well that you very rarely bring a new perspective onto things, a fresh pair of eyes with a new set of ideas. General Contract Manager, British Aerospace

Thus, relationship management not only requires an understanding of goal alignment, but also a human resource sensitivity as to the individuals who fill these roles.

Another important lesson here is that each side must have similar power so that they can achieve equitable outcomes. The aims of each party should be fairness, not domination or exploitation. Again, this common playing field can only occur if the client has successfully executed the assessment, supplier evaluation, and contracting processes.

Other sources for client learning

This chapter has demonstrated that clients have learned many lessons about evaluating their back office portfolios, evaluating market options, crafting contracts, and managing suppliers. The learning has served to significantly improve outsourcing transactions since 1989. While this book intends to disseminate these lessons, we recognize that novice clients may need richer learning experiences, thus we offer the following lessons.

Lesson 11: Consider incremental outsourcing to develop experience with outsourcing. Just as you cannot learn to drive from reading a manual, you cannot learn to successfully outsource merely by reading a book.

We found that the best way to accumulate learning is through incremental outsourcing, in which clients adopt this outsourcing strategy precisely to develop an in-house knowledge about outsourcing. With incremental outsourcing, organizations outsourced a small and discrete part of their activities, such as third-party maintenance or shared processing services. The experience gained from this first incremental approach was then fed back into further outsourcing. In two cases, a petrochemical company and an electric utility, organizations found themselves ultimately engaging in total outsourcing.

One US Fortune 500 biotechnology company took a very systematic approach when entering the offshore outsourcing market for the first time. It chose 17 pilot projects that were mostly small in size, required frequent delivery of milestones, and gave pieces of the same project to two suppliers. For example, the company decided that before they would commit to one supplier for a Peoplesoft to SAP conversion, they would have two of the large Indian suppliers do small pieces of the conversion. The company experienced much better project leadership from one of the suppliers in terms of onsite coordination, project status reporting, technical fit, and superior daily communications. The company selected this supplier to complete the entire conversion. When the company went live with SAP, the Indian supplier was granted an ongoing maintenance contract for seven FTEs.

Lesson 12: Hire help. Another very important factor in client learning is the widespread use of key outsourcing consultants and outsourcing legal firms. We are witnessing an institutional isomorphic effect[25] where outside experts seed client organizations with similar standards and methods.

In the ever-expanding BPO market for human resources, Equaterra is the consulting company frequently hired to help clients create RFPs (request for proposals), assess suppliers, and negotiate contracts. In the more established IT outsourcing space, Technology Partners International[26] and the Everest Group have been the prime consulting companies, and Shaw Pittman has been a major legal council. These are just examples. The overall effect of such external constituents is the dissemination of best practices. In particular, mega-deal contracts are now templated, with all the client costs, service levels, performance measures, mechanisms of change, and other clauses nearly identical. Although each organization participating in the research regards these practices as "competitive secrets," practices are nearly identical across mega-contracts. One can usefully debate the impact of such "best practices" of course – for example does their spread reduce competitive advantage from outsourcing, are best practices suitable for every situation and deal? Are they applied in the right spirit or mechanically?

Post-contract management practices are also becoming increasingly standardized, such as external benchmarking of services, color-coded problem resolution systems, joint supplier/client teams to resolve disputes, and responsibility matrices to clearly define client responsibilities and supplier responsibilities. For example BP, BAE, DuPont, UK Inland Revenue, Government of South Australia use some or all of these practices.

In addition to hiring external experts, clients may also access external expertise through outsourcing interest groups, such as the Sourcing Interest Group. Groups provide an opportunity for both clients and suppliers to share and disseminate data. For example, the Outsourcing World Summit draws over 500 outsourcing clients and suppliers each year and features prominent speakers, panels, Q&A sessions and many opportunities for informal exchanges.

Lessons for suppliers[27]

The suppliers in most of our large ITO case studies (where the deals were worth in excess of US$500 million) were EDS, IBM, CSC, Accenture, or Infosys. These suppliers are among the few organizations that have a significant global presence to service such large deals. We found significant variability in the success of such deals. Given the suppliers are the same, it is logical to assume the differentiating factor is the client. Put simply from the supplier perspective: *good clients make for good relationships*. The ideal client has significant experience with outsourcing the right activities, crafting the right types of contracts, and ensuring supplier success through the previously discussed roles and practices. The following lessons stand out as viable ways to educate, inform, and attract good clients, primarily through superior supplier integrity.

Lesson 13: Educate your client during the earliest possible phase. Increasingly, we advise suppliers to help educate naive clients on the issues discussed in this book. For example, after presenting the core IT capabilities framework to one supplier bidding on a significant US government contract, the supplier went back to the US government agency and told them to reduce the scope of their RFP and to retain more supplier management capability. The agency was quite taken aback with this approach, revised its RFP, and subsequently selected the aforementioned supplier because they trusted them.

Lesson 14: Bridle your public relations staff, unbridle your account managers. Increasingly, we talk to outsourcing shoppers who are shying

away from some suppliers because they simply don't believe them. The potential clients complain that the supplier oversells with polished PR and salespeople. Legitimate concerns about possible escalating costs and service lapses are readily dismissed with appeals to their "world class expertise." Client reference lists often include only new clients, where expectations are still high and supplier delivery is still unproven. Clients are not naive; they know that outsourcing relationships will encounter roadblocks and problems. They want to hear stories of past disasters and how the supplier responded to them, what the supplier learned from them. Consider one from our case study of multi-billion dollar company. Senior managers rejected bids from big suppliers and instead signed a ten-year, US$1 billion dollar contract with a small start-up company. The big players sent their slickest salespeople to present. The start-up sent the unpolished, but enthusiastic team of people who would actually be doing the work:

> The early presentations were really quite crap, but they had lots of feeling, lots of passion, lots of drive, lots of enthusiasm. There is a certain pleasure in the naivety … it's like looking at a Lowry painting, it's still beautiful but is naïve, rather than a Gauguin or something like that. I would hate to lose the touch that's in here for the sake of being slick. (Outsourcing client from large UK Company)

Lesson 15: Submit realistic, open bids. Some suppliers underbid in order to secure the contract. This practice is so common, we have devoted Chapter 5 to its consequences, called "The Winner's Curse." Such a strategy was often fruitful in the past because suppliers knew that the client's needs would change, and opportunties for upsell would more than compensate for the loss on the baseline contract. But clients are increasingly aware of such strategies and intentionally select other suppliers for add-ons to keep a competitive playing field. It serves the supplier far better to offer a realistic bid and to disclose how they can deliver on the bid and still earn a profit. Such disclosure might entail their non-imitiable costs in infrastructure and capabilities due to econonomies of scope and scale.

Lesson 16: Propose and price value-added options. Once transition periods are complete, clients generally find that suppliers can deliver on operational objectives of IT contracts. But clients increasingly expect more innovations and opportunties for generating revenues, even if the deals are essentially fee-for-service. Clients express continued dissapointment

on this front:

> Yes, the supplier can achieve all the things that were proposed – but where is this famous added-value service? We are not getting anything over and above what any old outsourcer could provide. (IT Services Director, Aerospace Company)

The value-added supplier proposes and prices options which significantly benefit the client. Examples from our case studies include significant cost savings and service improvement by web-enabling human resource management, creating wireless connections for sales force support, and helping clients use online auctions to reduce procurement costs.

Conclusion

Back offices have clearly been neglected in most organizations. There are many ways to transform back offices, including IT functions, and increasingly organizations are looking to various outsourcing suppliers to help reduce costs, streamline processes, and improve services. From the client perspective, the increasing numbers of global suppliers affords them more power to transform back offices. But to harness this market opportunity, clients need to learn how to continually monitor market options, assess the contribution of their service portfolio for current and future business value, decide what type of relationships suit their needs, craft optimal contracts, and successfully manage supplier relationships. The overall message for clients is clear: *all outsourcing requires continual and significant in-house management*.

For suppliers, they must be able to select educated clients with clear goals, and have the ability to execute such deals while still generating a profit. At the end of the day, success is measured by the operational delivery of the contract, ability to fairly adapt to change, and the ability to identify added-value services.

Notes

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Strategies: Universalistic, Contingency, and Configurational Explanations of Success," *Information Systems Research*, Vol. 15, 2, pp. 110–131.

3. See http://www.mpowerss.com/mpact.shtml
4. "Offshore Statistics: Dollar Size, Job Loss, and Market Potential," on www.ebstrategy.com
5. "Global Size of BPO" on http://www.indobase.com/bpo/global-market-of-bpo.html
6. The DiamondCluster 2005 study has some weaknesses in research methodology. Our earlier survey is represented in Lacity, M. and Willcocks, L. (2001), *Global IT Outsourcing: Search For Business Advantage*, Wiley, Chichester.
7. A detailed description of the research methodology was published in Lacity, M. and Willcocks, L. (1998), "Practices in Information Technology Outsourcing: Lessons From Experience," *MIS Quarterly*, September, Vol. 22, 3, pp. 363–408.
8. There is a recent study that suggests that large scale IT outsourcing is motivated by managerial self-interest. See Hall, J. and Liedtka, S. (2005), "Financial Performance, CEO Compensation, and Large-Scale Information Technology Outsourcing Decisions," *Journal of Management Information Systems*, Summer, Vol. 22, 1, p. 193.
9. Lacity and Willcocks (2001), op.cit.
10. Other sample surveys on selective IT outsourcing can be found in Apte, U., Sobol, M., Hanaoka, S., Shimada, T., Saarinen, T., Salmela, T., and Vepsalainen, A. (1997), "IS Outsourcing Practices in the USA, Japan, and Finland: A Comparative Study," *Journal of Information Technology*, Vol. 12, 4, December, pp. 289–304; Grover, V., Cheon, M., and Teng, J. (1996), "The Effect of Service Quality and Partnership on the Outsourcing of Information Systems Functions," *Journal of Management Information Systems*, Spring, Vol. 12, 4, pp. 89–116.
11. Lawler, E., Ulrich, D., Fitz-enz, J. and Madden, J. (2004), *Human Resources Business Process Outsourcing*, Jossey-Bass, San Francisco.
12. See Chapter 3 in Lacity and Willcocks (2001) for the full case study of South Australia government. For another successful case of large-scale outsourcing at British Petroleum see Cross, J., Earl, M., and Sampler, J. (1997), "Transformation of the IT Function at British Petroleum," *MIS Quarterly*, December, pp. 401–420. For an overall analysis of success factors, see Hu, Q., Gebelt, M., and Saunders, C. (1997), "Achieving Success in Information Systems Outsourcing," *California Management Review*, Vol. 39, 2, pp. 63–79.

13. Lacity and Willcocks (2001), op. cit. The updated case appears in Lacity, M., Willcocks, L., and Cullen, S. (2007) *Global IT Outsourcing*. Wiley, Chichester.
14. For a more thorough explanation of TCE, please see: Williamson, O. (1991), "Strategizing, Economizing, and Economic Organization," *Strategic Management Journal*, Vol. 12, pp. 75–94; Williamson, O. (1991) "Comparative Economic Organization: The Analysis of Discrete Structural Alternatives," *Administrative Science Quarterly*, Vol. 36, pp. 269–296.
15. Examples of empirical testing of Transaction Cost Theory (TCT) in IT context see Ang, S. and Straub, D. (1998), "Production and Transaction Economies and Information Systems Outsourcing – A Study of the US Banking Industry," *MIS Quarterly*, Vol. 22, 4, 535–552; Lacity, M. and Willcocks, L. (1996), "Interpreting Information Technology Sourcing Decisions From A Transaction Cost Perspective: Findings and Critique," *Accounting, Management and Information Technology*, Vol. 5, 3/4, pp. 203–244; Nam, K., Rajagopalan, S., Rao, H., and Chaudhury, A. (1996), "A Two-level Investigation of Information Systems Outsourcing," *Communications of the ACM*, Vol. 39, 7, July, pp. 36–44; Poppo, L. and Zenger, T. (1998), "Testing Alternative Theories of the Firm: Transaction Cost, Knoweldge-Based, and Measurement Explanations for Make-or-Buy decisions in Information Services," *Strategic Management Journal*, Vol. 19, pp. 853–877.
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20. Lacity and Willcocks (2001), op.cit.
21. Lacity and Willcocks (2001), op.cit.
22. For a list of practices clients implemented themselves, see Hirschheim, R. and Lacity, M.(2000), "Information Technology Insourcing: Myths and Realities," *Communications of the ACM*, February, pp. 99–107.
23. For for the role of business executives as IT project champions, please see Beath, C. (1996), "The Project Champion," in M. Earl (ed.), *Information Management: The Organizational Dimension*, Oxford University Press, Oxford, pp. 347–358.
24. For another study that examines four types of outsourcing relationships, see Kishore, R., Rao, H., Nam, K., Rajagopalan, S., and Chaudhury, A. (2003), "A Relationship Perspective on IT Outsourcing," *Communications of the ACM*, Vol. 46, 12, pp. 86–92. To better understand the role of trust in IT outsourcing relationships, see Sabherwal, R. (1999), "The Role of Trust in Outsourced IS Development Projects," *Communications of the ACM*, Vol. 42, 2, pp. 80–87.
25. For more information on institutional isomorphism, see DiMaggio, P. and Powell, W. (1991), "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields," in W. Powell and P. DiMaggio (eds), *The New Institutionalism in Organizational Analysis*, The University of Chicago Press, pp. 63–82; Mizruchi, M. and Fein, L. (1999), "The Social Construction of Organizational Knowledge: A Study of Coercive, Mimetic, and Normative Isomorphism," *Administrative Science Quarterly*, December, Vol. 44, 4, pp. 653–683; Ang, S. and Cummings, L. (1997), "Strategic Response to Institutional Influences on IS Outsourcing," *Organization Science*, Vol. 8, 3, pp. 235–256; Jayatilaka, B. (2002), "IT Sourcing: A Dynamic Phenomenon: Forming an Institutional Theory Perspective," in R. Hirschheim, A. Heinzl, and J. Dibbern (eds), *Information Systems Outsourcing in the New Economy*, Springer-Verlag, Berlin, Heidelberg, New York.
26. On November 14, 2005 EquaTerra and TPI announced they signed an agreement to merge the two companies.
27. Surprisingly little research has studied the supplier's perspective in outsourcing. Some excellent exceptions include Levina, N. and Ross,

J. (2003), "From the Vendor's Perspective: Exploring the Value Proposition in IT Outsourcing," *MIS Quarterly*, Vol. 27, 3, pp. 331; Koh, C., Ang, S., and Straub, D. (2004), "IT Outsourcing Success: A Psychological Contract Perspective," *Information Systems Research*, Vol. 15, 4, pp. 356–374.

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