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While much research has focused on information technology (IT) outsourcing, little research has concentrated on how a vendor's offerings fit into the strategic vision of its client company. This research identifies the areas in which client companies expect information technology (IT) outsourcing vendors to make contributions to their strategic innovation. Through case studies and a literature review, this research offers insights into each IT outsourcing party's definitions and perceptions of innovation, how client and vendor companies formulate and implement innovation, and each party's expectations in outsourcing for innovation.

Case studies of client and vendor organizations engaged in IT outsourcing arrangements and a review of the service level agreement literature yielded the following findings: (1) client companies present certain challenges to vendors that are trying to innovate in their organizations, (2) vendors must determine how to bridge the gap between the client's current IT organization and the client's desired result, (3) certain traits must be present in client companies in order for them to realize innovation through IT outsourcing arrangements, and (4) certain contractual elements are instrumental in ensuring that the client's innovation requirements are met.

STRATEGIC INNOVATION IN INFORMATION TECHNOLOGY OUTSOURCING:  
IDENTIFYING THE GAPS BETWEEN VENDOR CONTRIBUTION  
AND CLIENT REQUIREMENT

by

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## CHAPTER I

### INTRODUCTION

Since Eastman Kodak's revolutionary decision to outsource a portion of its information technology (IT) function to Ross Perot's Electronic Data Systems (EDS) in 1989, many corporations have followed suit in attempts to improve productivity, performance and customer service (Lee et al. 2000; Dibbern et al. 2004). Firms initially undertook IT outsourcing measures as ways to reduce costs, improve performance, and obtain external technological expertise that was not available in-house (Lacity et al. 2009). Companies now find it important to move past the initial productivity benefits that made IT outsourcing so attractive in its early stages. On the contrary, firms want to focus on gaining strategic advantage by outsourcing their IT services. However, unilateral action by the client company in such a venture would be ineffective. Collaboration and strategic partnership with vendors is necessary for IT outsourcing success (Kern and Blois 2002; St. John et al. 2013).

The IT outsourcing literature is expansive and includes the following topics: the history and evolution of IT outsourcing, the different types of IT outsourcing arrangements, the scope of IT outsourcing, the motivation and reasons for outsourcing IT, the formulation of conceptual IT outsourcing models, the scope of IT outsourcing, suggestions on how to outsource IT, and the risks in IT outsourcing (Gonzalez et al. 2005). Although the IT outsourcing literature has enumerated the determinants of

successful outsourcing relationships between client and vendor, there is a lack of research that considers how vendors can contribute to the strategic innovation of their client companies and participate more actively in optimizing processes and products for their clients. Such consideration is becoming more important as companies attempt to emphasize the value of IT and realize strategic differentiation and establish competitive advantage.

Gaps in the innovation in IT outsourcing literature and practice prompted this study. Previous research on innovation in IT outsourcing has indicated that innovation is highly desired by client companies in IT outsourcing deals, but these clients may not be getting what they ask for from the IT service providers. A Forrester Forrsights Services Survey found that 87% of IT decision-makers state that innovation will affect spending in their companies in 2012 (Benkel 2012). This survey also found that innovation, or continuous service-level improvement, is a key challenge in existing outsourcing relationships.

Furthermore, initial explorations into potential case studies regarding innovation in IT outsourcing yielded perspectives from the Chief Information Officer (CIO) at a large U.S.-based manufacturing company. This manufacturing company experienced less than desirable results with one of its IT outsourcing arrangements. Although the service provider consistently met the stipulations and measurements set forth in the contract, the vendor did not live up the expectations and the strategic vision of its manufacturing client (P. Rasmussen, personal communication, October 22, 2013). Additional informational interviews with professionals in an IT consulting and service provision company found

that very few clients would say that their suppliers are innovating for them or bringing value to their organization through IT outsourcing arrangements (H. Puthli, personal communication, March 3, 2014).

The purpose of this research was to figure out how vendors can assist clients in achieving strategic innovation through IT outsourcing. Thus, this study addressed the following research questions: *What role should vendors play in helping client organizations achieve strategic innovation? What capabilities should client and vendor organizations possess to achieve strategic innovation through IT outsourcing?*

To answer the above research questions, this study conducted a review of the literature in IT outsourcing and innovation theories, developed interview questions to aid a qualitative research approach, and conducted secondary research on service level agreements. Based on case studies of the IT outsourcing experiences of selected client and vendor organizations, this research assessed client and service provider perspectives of the roles that each should play in achieving innovation with IT outsourcing. Additionally, this research also assessed the contractual elements that are required for innovation to occur through IT outsourcing. Specific outcomes of this research include: (a) a better understanding of the roles of IT outsourcing partners in achieving innovation, (b) provision of benchmarks for client companies to assess potential vendors' capabilities for achieving strategic innovation, and (c) contractual guidelines for client companies in attempting to achieve their specific innovation strategies and goals.

This study contributes several important factors to the research and practice of achieving innovation in IT outsourcing. Not only does this research confirm many of the

recommendations that currently exist in the literature, it also provides methods by which client and vendor organizations can collaborate to achieve innovation together more effectively.

This research paper includes the following seven chapters. Chapter I: *Introduction* provides the background and establishes the motivation for this research. Chapter II: *Literature Review* examines various aspects of IT outsourcing and strategic innovation in IT outsourcing, including its history, purposes, phases, decision strategies, governance structures, contract and relationship characteristics, risk management, and best practices. Chapter III: *Methodology and Data Collection* discusses the research design and data collection methods used in this study. Chapter IV: *Case Studies* details the experiences of IT service providers and clients that participated in IT outsourcing arrangements resulting in innovation. Chapter V: *Service Level Agreements in Information Technology Outsourcing Contracts* examines the service level agreement literature and inspects actual service level agreements. Chapter VI *Results, Discussion, and Implications* discusses the findings, contributions, and implications of this research. Chapter VII: *Conclusion and Future Research Directions* summarizes the research, outlines the limitations of this study and recommends future research directions.

## CHAPTER II

### LITERATURE REVIEW

This literature review contains a detailed examination of the research surrounding the various aspects of IT outsourcing and innovation in IT outsourcing. This chapter begins with a brief history and background of IT outsourcing. It continues by examining the scope and motivations for outsourcing IT. This is followed by an overview of the IT outsourcing life cycle, the different components of the outsourcing decision, and organizational readiness for IT outsourcing. Next is a discussion of the contract and relationship characteristics that exist in successful IT outsourcing arrangements. The subsequent section contains an investigation of risk and risk management in the context of IT outsourcing. The penultimate section of this chapter outlines the criteria for successful IT outsourcing arrangements and summarizes best practices in the field. This chapter concludes with an overview of innovation in IT outsourcing, including the types, methods, requirements for, and obstacles to, innovation in IT outsourcing.

#### **Definition of IT Outsourcing**

Leading authorities have defined IT outsourcing as the contracting of part or all of a firm's IT function to one or more external suppliers to achieve a firm's goals (Richmond & Seidmann 1993; Willcocks & Fitzgerald 1993; de Looft 1995; Cheon et al. 1995; Domberger et al. 2000).

## **History of IT Outsourcing**

The first instance of IT outsourcing occurred in 1963 when Ross Perot's company, Electronic Data Systems (EDS), took over all of Blue Cross of Pennsylvania's data processing services (Dibbern et al. 2004). EDS continued to provide IT services to other companies throughout the 1980s, and outsourcing started to gain some attention. In 1989, Kodak contracted out its data center operations in an agreement with IBM, DEC, and Businessland. Kodak's decision changed attitudes toward IT service provision forever. It was the first time that well-known company had outsourced a strategic aspect of its IT function (Dibber et al. 2004).

Hatonen and Eriksson (2009) delineated three different periods in the evolution of IT outsourcing. The Big Bang period occurred between the 1980s and early 1990s. This period began with Kodak's revolutionary decision and focused primarily on cost-cutting measures. The Bandwagon period spanned from the 1990s to the early 2000s, and many companies that utilized IT outsourcing did so in order to cut costs, enhance capabilities, and improve processes. During this period, the focus of IT outsourcing revolved around its determinants, strategies, and the mitigation of risks (Lacity et al. 2009). The period of 'barrierless' organizations began in early 2000 and continues today (Hatonen & Eriksson). This period is one in which organizational transformation has been the focus.

## **Motivations for Outsourcing IT**

In order to analyze how innovation can occur through IT outsourcing, it is necessary to examine the organizational motivations for outsourcing IT functions and processes. The motives for outsourcing IT vary across literature, industry, and practice,

but some common themes are evident. Holcomb et al. (2007) also found the most common goal for strategic outsourcing to be cost efficiency. Hancox and Hackney (2000) found that the main motives for outsourcing IT were to lower costs and improve service (to customers), but that freeing up resources to focus on core competencies was not a significant motive for IT outsourcing. IT outsourcing has traditionally and most often been used in attempts to save client firms money, but its purposes have evolved greatly over the past two decades (Dibbern et al. 2004).

Baldwin et al. (2007) classified the numerous IT outsourcing motives into four different categories: strategic and organizational, political, technical and economic. Table 1 summarizes and classifies the motives found in the literature into the categories delineated by Baldwin et al.

Table 1. IT Outsourcing Motives & Motive Categories

IT Outsourcing Motive Category (Baldwin et al. 2007)	IT Outsourcing Motive	Source
Strategic/Organizational	Focus on non-IT related core competencies	(Baldwin et al. 2007)
	Share in the risks/rewards of new tools/technologies/products/processes	(Baldwin et al. 2007)
	Eliminate a burdensome IT function	(Baldwin et al. 2007)
	Exploit new technology	(Baldwin et al. 2007; Lacity et al. 2009)
	Improve overall business performance	(Baldwin et al. 2007; Lacity et al. 2009)
Political	Comply with new government legislation	(Baldwin et al. 2007)
	Resolve internal conflicts	(Baldwin et al. 2007)
	React to the IT outsourcing bandwagon	(Baldwin et al. 2007; Lacity & Hirschheim 1993)
Technical	Increase access to skills, expertise, and technological benefits and resources that are not readily available within the client company	(Hancox & Hackney 2000; Lacity et al. 2009; Qi & Chau 2012)
	Provide access to better quality services for customers	(Hancox & Hackney 2000; Lacity et al. 2009; Qi & Chau 2012)
Economic	Control costs	(Hancox & Hackney 2000; Lacity et al. 2009)
	Save money	(Hancox & Hackney 2000; Lacity et al. 2009)

## **IT Outsourcing Life Cycle, Decision Process Components, and Governance**

### **IT Outsourcing Life Cycle**

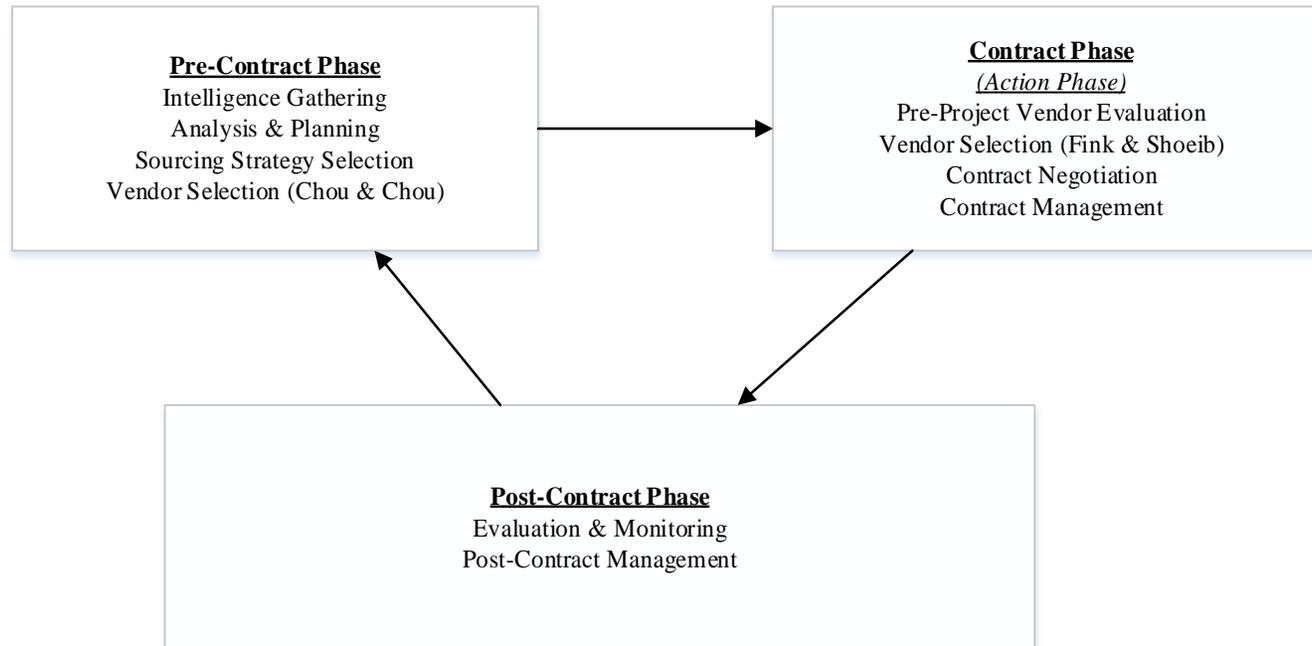
Chou and Chou (2009) identified three different phases of the IT outsourcing life cycle: the pre-contract phase, the contract phase, and the post-contract phase. The pre-contract phase includes the identification of the outsourcing needs, strategic planning, and the selection of the service provider. The contract phase includes the contracting process, the transitioning process, and the implementation of the outsourcing project. The post-contract phase encompasses the assessment of the outsourcing project. During this phase, client organizations focus evaluating and monitoring the outcomes of the outsourcing arrangement. Outcomes in successful IT outsourcing arrangements might include service level or quality improvements, cost reductions, and whether or not the outsourced IT meets the client's management objectives. This final phase also serves as the basis from which the next outsourcing contract is determined. The post-contract phase also helps the client determine whether to continue its relationship with its current vendor or whether to select a different vendor for future outsourcing arrangements.

Chou and Chou's (2009) pre-contract phase can be broken down further into Fink and Shoeib's (2003) three sub-phases: intelligence gathering, analysis and planning, and sourcing strategy selection. During the first pre-contract sub-phase, firms build a solid informational basis, upon which subsequent IT outsourcing decisions can be made. This intelligence-gathering phase focuses on the organization's needs and circumstances, the existing IT function, and the general IT outsourcing phenomena. During the analysis and planning phase, the organization studies the current IT function and analyzes the

feasibility of outsourcing for the organization. This feasibility analysis is based on two different things: the IT department's efficiency and effectiveness and the potential advantages and disadvantages of outsourcing portions of the IT functions. Strategy selection takes place in the pre-contract phase's third sub-phase. Determinants of the eventual organizational sourcing strategy include the selection of the type of sourcing to be used, the number and type of contractors, and the assessment of whether IT is a core competency or not.

Chou and Chou's (2009) contract phase aligns closely with Fink and Shoeib's fourth phase in the IT outsourcing lifecycle (2003). During this action, or implementation, phase, the client selects the service provider, develops the outsourcing contract, and manages the outsourcing relationship. Chou and Chou's post-contract phase aligns closely with Fink and Shoeib's fifth phase in the IT outsourcing life cycle. In these final phases and sub-phases, evaluation and monitoring and post-contract management of the outsourcing arrangement occurs. Figure 1 shows the combined phases and sub-phase of the IT outsourcing life cycle. Note that vendor selection falls under pre-contract phase and the contract phase, depending on which author's framework one uses.

Figure 1. IT Outsourcing Life Cycle



Adapted from Chou & Chou 2009 and Fink & Shoeib 2003

## **IT Outsourcing Decision Process & Governance Structures**

The IT outsourcing decision process is intertwined with the first three sub-phases of the IT outsourcing project. Hancox and Hackney (2000) assert that sourcing decisions are “complex, multi-faceted, and partly dependent on organizational type.” Thus, the outsourcing decision process should include the following components: analysis of the current IT situation (de Looff 1995), evaluation of all internal and external options that could address the organizational problem (Currie & Willcocks 1998), top management support (Lacity et al. 2009), financial management support (de Looff), a formal sourcing selection method, specific contractor selection criteria and process (Willcocks & Lacity 1999), risk assessment of both the client and the potential supplier (Cheon et al. 1995), and evaluation of the potential contractor’s reputation (Wang 2002). Overall, the IT outsourcing decision should be based on the organization’s long term IT strategy (de Looff).

Aubert et al.’s (2012) study of organizational IT outsourcing decisions revealed certain patterns among outsourcing clients in different industries and organizational types. Outsourced activities tended to be simpler than the activities that firms continued to perform internally. Companies were also more likely to outsource IS maintenance activities than IS management and IS operations activities. The more knowledge-intensive an activity was, the less likely a firm was to outsource it. Organizations in industries that experienced stable trends were not as likely to outsource their IT services as firms in less stable industries. Government-owned firms outsourced their IT services significantly less than non-governmental firms. Although the different companies in

Aubert's study maintained conflicting stances and boundaries regarding outsourcing, they all appeared to consider the same variables in making the decision to outsource IT activities.

Additionally, Han and Mithas (2013) uncovered two approaches for making successful IT outsourcing decisions that involve a combination of IT outsourcing activities and in-house IT enhancements. First, rather than substituting IT outsourcing solely for all internal IT investments, the authors suggested that companies invest in more internal IT in addition to and in conjunction with the outsourcing of selected IT activities. Second, in addition to investing in IT outsourcing, organizations should invest in IT human capital from within their firms; this increase in spending on internal IT labor ensures that companies attract and retain a smaller set of higher skilled IT workers rather than a larger set of low-level IT workers (that could eventually be outsourced).

### **Organizational Readiness for IT Outsourcing**

The assessment of an organization's readiness for IT outsourcing spans Fink and Shoeib's first two sub-phases of the IT outsourcing life cycle: intelligence-gathering and planning and analysis. Before an organization decides to undertake IT outsourcing, it should assess its readiness for the task (Martin et al. 2008). The extent of an organization's readiness can thus affect its success in its outsourcing ventures. Assessing organizational readiness involves the evaluation of several different factors, including process readiness, IT readiness, business management readiness, and the degree of alignment between IT and the business (Martin et al.). An assessment of process readiness determines the degree of process formalization that currently exists. Process

formalization includes process documentation, rules, procedures, and clear management practices (Martin et al.). Furthermore, the firm should assess how outsourcing the desired process will affect other business processes (Martin et al.). IT readiness assesses the level of flexibility of an organization's IT infrastructure and the IT manager's degree of organizational business knowledge (Martin et al.). Business management readiness encompasses the level of the business managers' IT knowledge, the project leader's experience, and the support of top management (Martin et al.; Lacity et al. 2009).

### **Other Factors to Consider When Contemplating IT Outsourcing**

Planning and implementing a successful IT outsourcing project demands a broader focus than that which involves IT, process, and business management readiness. In addition to organizational readiness, a firm must assess additional internal and external factors. An organization should evaluate its own internal political climate with regard to outsourcing, appraise its outsourcing culture and history, and ensure that its desired service requirements are specific and measurable (Willcocks & Fitzgerald 1993; de Looff 1995; Cheon et al. 1995). Organizational type and the industry in which the organization competes should also be considered, as some organizational types and industries may be more or less conducive to IT outsourcing (Hancox & Hackney 2000). Finally, the client organization should ensure that there are sufficient IT service providers in the market from which to choose a satisfactory partner (de Looff).

Larabee and Michaels-Barr (1994) discussed the steps that company leaders should take when determining, crafting, and implementing an IT outsourcing plan. During the planning stage of IT outsourcing, the decision to outsource IT should match

organizational and departmental goals. Company decision-makers should reach out to three different sources to gather information and insight before moving forward with the outsourcing plan: (1) outsourcing vendors and consulting firms, (2) the company's human resources department, and (3) IT managers in other companies that have outsourced their IT functions (Laribee & Michaels-Bar). Company decision-makers should also pay special attention to three different types of employees that the outsourcing decision affects: (1) employees who will be retained by the company, (2) employees who are or will be transferred to the outsourcing company, and (3) employees who may be laid off. These steps should not only begin in the planning (or pre-contract) stage, but should continue in the subsequent IT outsourcing stages: announcement and implementation (contract) and follow-up (post-contract) (Laribee & Michaels-Bar).

### **Contract & Relationship Characteristics**

An important component in IT outsourcing arrangements is the agreement between clients and service providers that details the arrangements of the agreed-upon service or product. A contract cannot facilitate a successful IT outsourcing arrangement by itself though. It necessitates a mutual trust and dependence on which a solid client-vendor relationship can be built. This section discusses the contract and relationship components that firms should consider when venturing into IT outsourcing.

### **IT Outsourcing Contracts**

Formulation of the IT outsourcing contract should take place during the action, or contract, phase of the project (Fink & Shoeib 2003). The more successful contracts contain higher levels of detail (Kern & Willcocks 2000; Lacity et al. 2009). In addition

to the issues of price, length (Cheon et al. 1995; Domberger et al. 2000; Cullen et al. 2005; Lacity et al.), and performance expectations, client organizations should also consider the nature of the service they want to outsource, the type of equipment that will need to be maintained, and the escape options desired during and toward the end of the contract period. Ranganathan and Balaji (2007) assert that outsourcing contracts should also contain the following elements: definitions of work schedules, distribution of onsite and offsite resources at the various project stages, skill requirements of offsite staff and methods to address vendor staff attrition, payment terms, penalties and rewards, specifications for conflict resolution procedures, security and confidentiality of client data, documentation standards, and intellectual property rights.

### **Client-Vendor Relationship Characteristics**

Sometimes organizations complete the IT outsourcing contract and then leave everything in the hands of the contractor with little follow-up attempts to build a relationship. The relationship between the client and the contractor must be actively managed in order to achieve the agreed-upon objectives (Willcocks & Fitzgerald 1993; Willcocks & Lacity 1999; Kern & Willcocks 2000). Such relationships depend, in part, on the quality and frequency of the formal and informal interactions between the parties (Willcocks & Lacity; Kern & Willcocks; Lacity et al. 2009). Moreover, a successful relationship is predicated on behavioral dimensions such as commitment and eventual trust between the outsourcing parties (Kern & Willcocks; Lacity et al. 2009; Han et al. 2008). Furthermore, the sharing of information, the quality of participation, and

collaborative participation between outsourcing parties affect the success of outsourcing relationships.

St. John et al. (2013) asserted that the level of trust between a client and a vendor has a direct bearing on the quality of partnerships, which in turn, determines a successful outsourcing venture. Further, communication is a significant factor in establishing that trust in offshoring relationships. Additionally, “in higher commitment client-vendor relationships, trust rather than incentives and penalties, becomes an important mechanism to ensure that the vendor’s interests coincide with the client’s interests” (St. John et al.).

Yoon and Im (2005) developed a framework for evaluating client company satisfaction that comprised three broad IT areas: consulting services, customer supporting services, and performance. The authors revealed patterns and provided suggestions for client and vendor companies embarking on IT outsourcing relationships. First, vendors should focus on improving the quality of their service level agreements (SLAs) as well as on their education level to improve customer satisfaction. Second, customer satisfaction in services pertaining to application development and maintenance ranked higher for some outsourcing relationships due to the relatively stable market and IT trends in those areas. Third, IT outsourcing clients expect greater support in SLAs than they do in consulting services. “Large enterprises provide more stable information systems and continuity service to customers than subject matter experts, because large vendors have more systematic IT outsourcing departments and experienced service knowledge” (Yoon & Im 2005).

Goles (2003) found that vendor capabilities play a key role in the eventual success of outsourcing arrangements. Vendor capabilities included technical capability, understanding of the customer's business, and the ability to manage the client-vendor relationship.

Liker and Choi (2004) found that Honda and Toyota built superior relationships with their suppliers through six key practices that helped to actively manage IT outsourcing relationships. These practices include (1) developing an understanding of how their suppliers work, (2) turning supplier rivalry into opportunity, (3) supervising their vendors, (4) developing their suppliers' technical capabilities, (5) sharing information intensively but selectively, and (6) jointly conducting improvement activities.

### **Risk Management in IT Outsourcing**

#### **Risk Management**

IT outsourcing can involve risks for all participants. When entrusting personnel, services, and processes to contracting organizations, there is a possibility that the quality of products and services will suffer and that costs will actually increase, as was the case in Bahli and Rivard's 2003 study. Various methods exist to combat and prevent specific risk scenarios, but the optimal risk mitigation technique involves experiential learning (Lacity et al. 2009). By engaging in IT outsourcing firsthand, organizations can begin to understand more about how their IT functions and the whole business can best function in an outsourcing environment, which can be a learning experience on which to base future outsourcing decisions.

Chou and Chou (2009) developed a theoretical framework to analyze the success and risk factors associated with IT outsourcing. This framework correlates with their IT outsourcing life cycle discussion above. During the pre-contract phase, organizational decision-makers should identify outsourcing success factors as well as potential outsourcing risks are identified. Throughout the contract phase, decision-maker should identify additional risk factors; furthermore, firms must manage the outsourcing project and all risks effectively.

### **Best Practices in IT Outsourcing**

#### **Criteria for Successful IT Outsourcing**

Certain criteria must exist in client organizations for IT outsourcing arrangements to be successful. First, organizations that are successful tend to have high technological maturity (Willcocks & Fitzgerald 1993; Willcocks & Lacity 1999). Second, organizations that engage in successful IT outsourcing arrangements retain some IT skills and capabilities in-house, especially with respect to the outsourced technologies (Willcocks & Fitzgerald; Currie & Willcocks). Finally, organizations in successful IT outsourcing ventures strive to create arrangements that minimize dependency on any single supplier or contractor (de Looft 1995).

Qi and Chau (2012) studied how the contract and the client-vendor relationship affected IT outsourcing success. The authors found that both the contractual and relationship aspects of IT outsourcing are necessary for success in IT outsourcing. The contract lays the foundation for the relationship between the client and the vendor, and the contract's complexity and management are major success factors. Additionally,

important factors in the relationship aspect of IT outsourcing include trust, commitment, quality of communication, and the sharing of knowledge between client and vendor. Lee (2001) also found that the quality of the partnership between clients and vendors plays a major role in the success of IT outsourcing projects. A critical element of a quality partnership is the sharing of knowledge between the IT outsourcing parties.

Rai et al. (2009) found that organizational and interpersonal cultural differences are critical success factors in IT outsourcing relationships. Their study suggested that the regular exchange of information, joint problem solving and trust increases the likelihood of project success. Gorla and Lau's 2010 assessment of IT outsourcing confirmed that clients and vendors should have compatible organizational cultures in order to propagate success. Furthermore, vendors should be selected according to their alignment with the client company's industry standards (Gorla & Lau). Additionally, their study suggested employing appropriate governance mechanisms in outsourcing contacts that include both positive and negative reinforcements.

After studying a consortium-based outsourcing arrangement, Kern and Blois (2002) concluded that, to be successful, partners in IT outsourcing relationships should be flexible with one another, promote and facilitate the exchange of information, and exhibit a sense of unity or fellowship.

Palvia (1995) established that both positive and negative consequences of IT outsourcing ventures are possible. While outsourcing IT achieves some benefits, such as an increased level of strategic focus and accessibility to new technology, these arrangements can also have certain drawbacks. Not only does the complexity of

management and politics increase, but so do the costs of coordination, the lack of flexibility and control, and the loss of personnel.

### **Why Do Some IT Outsourcing Projects Fail?**

The list that follows is not exhaustive, but it provides a starting point from which to assess why an IT outsourcing project may not have produced the intended objectives and desired outcomes. First, some organizations choose to outsource IT, because it is not a core competency (Lacity et al. 2009). This practice may perpetuate the misconception that IT cannot be a strategic tool for the organization, but a commodity that should be outsourced (Willcocks & Lacity 1999). An organization must maintain some in-house expertise with the technology that is to be outsourced. This ensures that the internal IT and business managers can effectively delineate their strategic objectives to the contractor as well as reasonably assess the outsourcing outcomes.

Second, incomplete or inadequate contracting may impair the contracting relationship and venture (Willcocks & Lacity; Kern & Willcocks 2000). Consider the scenario in which dispute resolution methods are not outlined in the contract. The lack of techniques with which to deal with inevitable conflict could lead to stalled progress, expensive litigation, and bitter feelings toward IT outsourcing as a whole.

Third, even when following all the prescribed steps for a successful IT outsourcing project, this still does not guarantee that the contractor will understand the client's business at the level needed to be successful (Hancox & Hackney 2000). Only through time, experiential learning, and trust building will the client and contractor arrive at a state of synergy that is acceptable and mutually beneficial to both parties.

Finally, focusing solely on short-term solutions, such as cutting costs or making money, rather than focusing on long-term assessments of dealing with supplier organizations, can be detrimental to current and future IT outsourcing outcomes (Currie & Willcocks 1998; Willcocks & Lacity). If organizations enter contracting relationships with only cost cutting on their minds, then other aspects of the business will suffer, potentially harming both current and future outsourcing ventures.

### **Strategic Innovation in IT Outsourcing**

Following the discussion above regarding IT outsourcing in general, it is necessary to investigate specifically the aspects of innovation within IT outsourcing arrangements and projects.

### **Definitions of Innovation in IT Outsourcing**

A review of innovation in the IT outsourcing literature yielded the following definitions:

“...any activity that improves the client’s performance...” (Lacity & Willcocks 2013)

“...the introduction of something new that creates value for the organization that adopts it...” (Whitley & Willcocks 2011)

“...improved business outcomes for the client firm in which the client expects the vendor to be the principal actor in the innovative changes...” (Weeks & Feeny 2008)

“...something that improves the customer’s performance,” but something that does not need to be completely novel (Lacity & Rottman 2012)

“...the development of new products and technologies...new service offerings, business models, pricing plans, routes to market, and new management practices...” (Birkinshaw et al. 2011)

“...the implementation of new ideas that create value...” (Linder et al. 2003)

Although the definitions vary slightly, three descriptive terms are consistent, either explicitly or implicitly, in the innovation in IT outsourcing literature: new, value, and improvement.

### **Types of Innovation**

The literature has defined several different types of innovation in IT outsourcing, which can be classified into four different categories: product innovation, process innovation, strategic innovation, and other types of innovation.

Product innovation, alternatively referred to as IT operational innovation by Weeks and Feeny (2008), are advancements that involve changes in technology that do not affect primary, or core, business processes. These innovations include the execution of new tools and technologies and the implementation and creation of new products and services (Lacity & Willcocks 2013; Lacity & Rottman 2012; Whitley & Willcocks 2011). Examples of product innovations include new operating systems, new email platforms and new software.

Process innovation, or business process innovation, is defined as a new way of doing things (Whitley & Willcocks 2011) or the development of new and improved processes (Lacity & Willcocks 2013; Lacity & Rottman 2012). Process innovations are achieved by implementing new technologies, but they are different from product

innovations in that they change the way the firm operates in some important way (Weeks & Feeny 2008). Examples of process innovation include the implementation of RFID devices and ERP software.

Strategic innovation is defined as a significant enhancement of a business' product or service for existing customers or enabling the business to reach new markets (Weeks & Feeny 2008).

Other types of innovation in the IT outsourcing literature that do not fit neatly into one of the categories above include organizational innovation (Whitley & Willcocks 2011), automation, and outcome innovation (Lacity & Rottman 2012).

### **Methods of Innovation in IT Outsourcing**

In addition to the different types of innovation in IT outsourcing, innovation can also be classified according to how it is implemented within organizations. Whitley and Willcocks (2011) depicted three different methods of innovation that can occur in organizations. Incremental innovation occurs when a series of small changes takes place; radical innovation occurs when a firm undergoes a large, transformative change; and revolutionary change is a “game-changer” for firms, their customers, and the markets they are trying to reach.

### **Requirements for Innovation in IT Outsourcing**

Although the research surrounding the requirements needed to achieve innovation has yielded slightly different results, most of the literature has some practices and attributes in common. Whitley and Willcocks (2011) assert that four different practices precipitate innovation in IT outsourcing: leadership, which creates the environment

necessary to foster innovation; contracting, specifically new forms of it; organizing differently, or creating “co-managed governance structures and greater multifunctional teams;” and performance, which is “determined by the underlying cultures of the client and supplier” organizations. Whitley and Willcocks assert that, together, these four practices create a growth in trust and teamwork between client and supplier, which should eventually lead to performance.

Weeks and Feeny (2008) suggest that while clients and suppliers should each bring certain attributes to the innovation table, they must also develop some skills in collaboration with one another. Client organizations that want to achieve innovation should have exceptional technical knowledge, their IT function should align with the business, and executive-level leadership should support innovating within the organization. Supplier organizations that want to provide innovation should have the “ability to invest in business process design skills beyond its core” as well as “in-depth involvement in potential clients’ industry sector.” Both IT outsourcing partners (client and supplier) should work together to develop “the levels of trust that are more easily achieved within a single organization” (Weeks & Feeny).

Some scholars have lauded incentives as a potentially promising way to achieve innovation, although the research reveals that different types of incentives work in different ways. Mandatory productivity targets, innovation days, and project-level gain-sharing are the most effective innovation incentives according to a 2014 survey administered by Lacity and Willcocks. Threat of competition and special governance arrangements between client and supplier are some of the other successful incentive

agreements that Lacity and Willcocks uncovered. The least successful incentives included innovation funds, relationship-level gain-sharing, pain-sharing and benchmarking.

Overby (2010a) suggests that choosing the right provider, focusing on more than cost savings, setting up innovation metrics in the contract and defining innovation correctly are all necessary for innovation to occur. Birkinshaw et al. (2011) suggest that innovation should be the focus of the entire company, not just the focus of a few engineers and CIOs. Thus, innovation needs to be both bottom-up and top-down.

### **Obstacles to Innovation in IT Outsourcing**

In contrast to the requirements for innovation in IT outsourcing are the obstacles that firms encounter when attempting to achieve said innovation. Birkinshaw et al. (2011) found that many innovation ventures fail due to a lack of attentive and deliberate follow-up, not due to a shortage in brilliant ideas. Overby presents even more concrete obstacles to innovation in other research, including ineffective change management (2010b), inadequate governance (2010b), inadequate skills of suppliers (2007, 2010b), imprecise definition of innovation (2007; 2010a), cultural differences (2007), communication issues (2007), internal resistance (2007), internal budget constraints (2007), and lack of innovation metrics in the contract (2010a).

### **Best Practices for Innovation in IT Outsourcing**

In order to overcome the obstacles that are outlined above, research suggests several different best practices when trying to achieve innovation through IT outsourcing. Carabello et al. (2011) purport that outsourcing partners should consider not only their

organizational culture, but also their geographic and ethnic culture, as all three types of culture affect the way a firm operates and communicates, thus affecting innovation success or failure. Whitley and Willcocks (2011) suggest that “client and supplier develop a goal that is high-level, design contracts that include the sharing of risks and rewards, define co-managed governance structures that support teams collaborating on adaptive work, and ensure the relationship between client and supplier is based on trust.”

Regarding the outsourcing contract, Lacity and Rottman (2012) suggest three practices for designing innovation into it: providing gain-sharing benefits, creating and sustaining innovation funds, and developing special governance (mechanisms) for innovation.

Overby (2010b) outlines a high-level step-by-step process for client companies to ensure that their potential for innovation in IT outsourcing is more successful: (1) delay the request for proposals (RFP) or determine the goals for innovation before beginning the vendor selection process, (2) know and decide what type of innovation it wants without having to ask the vendor, (3) use outsourcers as consultants by meeting and agreeing on the innovation before the contract is signed, (4) getting all key business and IT stakeholders and vendor executives together to “hash out the” governance “meat” and structure of the outsourcing relationship, (5) budget and pay for innovation, and (6) share the rewards through methods like gain-sharing.

In accordance with Overby’s findings, Krishna and George (2011) found that a comprehensive outsourcing governance structure that provides joint incentives for ongoing improvement is vital for successful innovation. Additionally, change

management and an organizational commitment to transformation through outsourcing play key roles in successful innovation (Krishna & George). Over the course of creating transformation (or innovation), client companies should create a plan that includes the following components that are specifically related to their innovation goals: description and objective, scope of plan, investment amount, benefit/savings, user impact, dependencies, and timeframe (Overby 2009).

CHAPTER III  
METHODOLOGY AND DATA COLLECTION

**Data Collection**

This research collected and analyzed primary and secondary data. The primary data in this study consisted of unstructured interviews with selected organizations that were currently or previously engaged in IT outsourcing arrangements, either as clients or as service providers. The secondary data in this study comprised a review of service level agreement (SLA) research and an analysis of actual SLAs.

**Primary Research**

**Criteria for selecting organizations.** Organizations were selected for this study due to their experience with and their attempts to achieve innovation with IT outsourcing. Additionally, some of the organizations were selected due to their IT outsourcing relationships with one another. This approach was taken in order to provide a comprehensive analysis innovation in IT outsourcing. This examination of both sides of outsourcing relationships allowed for a more robust analysis that included both parties' perspectives.

Firms were asked to participate via word of mouth through contacts in academia and practice. The initial intention of this study was to conduct a detailed case study of a large manufacturing company's IT outsourcing experiences. The CIO of this company was dissatisfied with the state of one of its current outsourcing arrangements and desired

more information regarding IT outsourcing. Although the planned research with this company fell through due to the firm's inability to participate at the level needed for this study, this initial conversation helped narrow the scope of this research. Invitations to participate were subsequently extended to two different IT service providers. Further invitations were extended to client companies through contacts at these two service providers. In total, representatives from five different organizations were interviewed. Invitations to participate in this study were extended to additional client companies of the IT service providers, but few of these clients agreed to be interviewed, citing impending projects, limited time and resources, and a general unwillingness to discuss private operations.

**Profile of organizations studied.** Representatives from both client and vendor organizations were interviewed. The final firms included in this study varied in size and specialization. These organizations represented a broad range of industries, comprised both the public and the private sectors, and included medium and large firms. While most of the organizations were based in the U.S., a few of them maintained offices and conducted operations in international locations. The industries in this research included organizations that specialized in healthcare, insurance, manufacturing, higher education, and government. The types of IT outsourcing in which these organizations participated included product, process, and technology services. Key IT outsourcing stakeholders were interviewed in each organization, including CEOs, CIOs, project directors, heads of research, and marketing personnel. Specific company and interviewee information is outlined below.

**Questionnaire formulation & development.** During the preliminary phases of this research, conversations with one of the aforementioned IT service providers yielded valuable advice for developing the interview questions. Executives in this organization suggested developing two different categories of questions: one for the supply (vendor) side and one for the buyer (client) side. After consulting previous research and survey instruments on IT outsourcing and innovation in IT outsourcing, a standard set of open-ended questions was developed for this study's potential subjects. Additionally, Lacity and Rottman's (2012) research provided guidance in developing questions for clients' and vendors' differing perspectives of innovation in IT outsourcing.

After the questionnaire was developed, it was submitted to the aforementioned IT service provider for review. That company suggested including additional questions related to contractual elements of innovation. Due to the open-ended nature of the questions, and the experience gained from prior interviews, the questionnaire evolved even further throughout the data collection process.

Table 2 outlines the questions that were eventually used in the interviews, delineates which organization type was asked which questions, and states the source for each question. Questions that were added during the data collection process are so noted in the *Source of Question* column in Table 2. Otherwise, the sources for the questions in Table 2 are defined as original to this research or adopted from other survey instruments and questionnaires that were found in the literature.

Table 2. Interview Questions & Sources

	<b>Client Questions</b>	<b>Vendor Questions</b>	<b>Source of Question</b>	
<i>Company Background/ Overview</i>	What is your company's industry, size?		Original question	
	Where is your company located?		Original question	
	What service or product do you offer your clients or customers?		Original question	
	Would you classify yourself as a client or a vendor organization?		Original question	
	What is your position in the company?		Original question	
	What is the level of IT outsourcing in your organization?		Original question	
	What is the purpose of IT outsourcing in your organization?		(Qi & Chau 2012)	
<i>Innovation Overview</i>	What is your definition of innovation? How do you define innovation?		(Lacity & Rottman 2012)	
	How do you achieve innovation?		Original question	
	When IT service providers speak to you about innovation, what are they primarily talking about?	When customers speak to you about innovation, what are they talking about?		(Lacity & Rottman 2012)
	Does your company possess the capabilities needed to innovate or aid a vendor in innovating for you?			Adapted from Goles 2003
	How does your company use IT for innovation? What is the purpose of innovation in your company?			Original question
<i>Current IT Outsourcing Relationships</i>	Do you currently involve your IT outsourcing vendor in the innovation idea and strategy formulation process? How?	Has the client company involved you in the formulation of the innovation idea and strategy? How?		Original question
	Does the vendor possess the capabilities needed to deliver your desired innovation?	Do you possess the capabilities needed to deliver the desired innovation to your client?		Adapted from Goles 2003

	What metrics do you have in place to assess how your IT service provider is meeting your innovation needs?	With respect to innovation, to what extent do you understand the client company's desires, expectations, constraints, and behaviors?	Original question
	What efforts are made to help vendors understand your company's operations and processes in preparation for innovation?	What role do you play in understanding the client's desires to innovate?	Adapted from Shi et al. 2005
	Are you satisfied with the level of innovation that your IT outsourcing vendor has provided? Would you consider the innovation that the vendor provided successful?	Is your client satisfied with the level of innovation you have provided?	Adapted from Goles 2003; Shi et al. 2005
	Is the desire for innovation clearly a part of your organizational culture?	Is the desire for innovation clearly a part of the client company's culture?	Original question
	Do you already have or would you consider having an "Innovation" clause factored into the contracts, Service Level Agreements (SLAs), Master Service Agreements (MSAs) or Term Sheets?		Suggested by Neo Group
	If innovation is factored (directly or indirectly) into existing contracts, how is it defined and measured? For example, are there rewards and penalties for clearly defined innovation outcomes? If not, is there a definitive plan to include an Innovation Clause in future contracts and/or renewals?		Suggested by Neo Group
	What's the biggest conflict in your outsourcing arrangements? How do you address conflicts?		Original question. Developed during the data collection process.
<i>Expectations from IT Outsourcing Relationships</i>	Who should be responsible for formulating the innovation idea and strategy - client, vendor, or both?		(Lacity & Rottman 2012)
	What capabilities do you expect from the vendor in support of your organization's innovation?	What capabilities do you need in order to deliver innovation to your clients?	Adapted from Goles 2003

	What capabilities do you need in order to facilitate innovation with your vendor?	What capabilities do you expect your client company to have in facilitating innovation with you?	Adapted from Goles 2003
	What role, if any, should the vendor play in the innovation strategy formulation process?	What role, if any, should you play in the innovation formulation strategy?	Original question
	What kind of innovation do you expect from a vendor?		Original question
	What else should the vendor contribute to the outsourcing relationship in order to achieve innovation?	What else should the client company contribute to the outsourcing relationship in order to help you achieve innovation for them?	Original question
	How do you deal with relationships when working with multiple vendors?		Suggested by Neo Group

The final questionnaire included four different categories of questions: (1) company background, overview, and demographics; (2) perspectives and definitions of innovation; (3) characteristics and components of the company's current IT outsourcing relationships, and (4) company expectations from IT outsourcing relationships. As shown in Table 2, most of the same questions were asked of both the client and vendor companies that were interviewed. Some questions were asked solely of the client companies.

**Interview procedures.** Interviews were conducted with representatives from five different organizations. The first two interviews were informational interviews that helped establish the scope and develop the instrument for this research. The latter three interviews were the cases that were analyzed for this study. With the exception of the first informational interview, which was conducted in person in late 2013, all other interviews were conducted by telephone conference in 2014. Below are the details of each interview that was conducted for this research.

*Informational interview 1.* A face-to-face interview was conducted with the CIO of a large U.S.-based manufacturing company. This interview took place on the campus of The University of North Carolina at Greensboro and lasted approximately forty-five minutes.

*Informational interview 2.* A telephone interview was conducted with the following participants from Neo Group, a global services and sourcing company located in the U.S.: the Founder, Chairman and CEO; a partner; and the Head of Research. The interview lasted approximately fifteen minutes. The participants in the Neo Group

interview were located in New York City while the researchers were in Greensboro, North Carolina.

*Case study A – Key Management Group interview.* A telephone interview was conducted with Subhash Bhatia, the founder and CEO of Key Management Group (KMG). Ana Chocarro, who serves in a marketing capacity at KMG, also participated in the interview. The participants in the KMG interview were located in New York City while the researchers were in Greensboro, North Carolina. The interview lasted approximately one hour and was recorded. The meeting notes were transcribed from the audio recordings and submitted to Bhatia, who clarified certain aspects of the interview and approved the notes that were taken.

*Case study B – Metropolitan State University interview.* A telephone interview was conducted with the project director for the ERP implementation project at Metropolitan State University. The MSU interview participant was located in New York City while the researchers were in Greensboro, North Carolina. The interview lasted approximately forty-five minutes, and the proceedings were recorded. The meeting notes were transcribed from the audio recording, and submitted to the project director for feedback, who clarified and modified the interview transcript and approved it for use in this study. The MSU interview participant was located in New York City while the researchers were in Greensboro, North Carolina.

*Case study C – City of Metro interview.* A telephone interview was conducted with a consultant who facilitated IT outsourcing arrangements between the City of Metro and its vendor. This IT outsourcing consultant provided the City's perspective of the IT

outsourcing projects on which it embarked. The Metro interview participant was located in New York City while the researchers were located in Greensboro, North Carolina. The interview lasted approximately forty-five minutes, and the proceedings were recorded. The meeting notes were transcribed from the audio recording, and submitted to consultant for feedback, who clarified and modified the interview transcript and approved it for use in this study.

### **Secondary Research**

Feedback obtained throughout the course of this study yielded suggestions to research actual SLAs and SLA templates to determine whether and how innovation is mentioned in IT outsourcing contracts, namely in the SLAs. SLA information was not available from the companies that were included in the case study portion of this research; therefore, it was necessary to conduct a search of the academic and practical literature for SLAs and innovation in IT outsourcing. An initial survey of SLA literature in IT outsourcing primarily revealed sample SLAs, SLA templates, and SLA instructions and best practices. Actual IT outsourcing SLAs were not found for private companies, but some were available for various public institutions. The actual SLAs eventually included in this study consisted of four different public organizations, including a state government, two public universities, and a federal institution.

### **Research Design & Methodology**

The data collected in this study is qualitative in nature. The primary data used a case study approach. Findings from the unstructured interviews of these case studies were analyzed, synthesized, and used to develop common themes and concepts. The

secondary data in this study used a literature review approach. Common themes and concepts on innovation in SLAs were therefore gleaned from the literature.

## CHAPTER IV

### CASE STUDIES

This research collected primary data through case studies. The first case examines an IT service provider's perspective, and the latter two cases examine IT outsourcing clients' perspectives.

#### **Case Study A – Key Management Group**

Key Management Group (KMG) is an IT service provider and consulting company. When it was established in 1990, it initially provided legacy applications and subcontracted property and casualty insurance services. In 2000, the company also started outsourcing mobile applications. Although it is based in New York City, KMG has three offshore development centers in India, and the company currently employs over three hundred developers. KMG continues to provide a variety of IT services to clients around the globe today, primarily serving the property and casualty insurance and healthcare industries.

KMG provides IT services, chiefly at the consulting and implementation levels. KMG's offers multiple services to its clients, including mobile applications, application support and maintenance, software development, data integration services, device integration services, legacy migration and modernization services, web-enabling solutions, software package support services, testing, business analysis and support, business process outsourcing (BPO) and knowledge process outsourcing (KPO).

Although some of the innovations that KMG provides to companies could be considered strategic for their clients, KMG does not offer IT outsourcing explicitly at a strategic level. KMG's CEO describes his company as the architects, the plumbers, the electricians, and the builders, the 'doers' who turn ideas into realities.

Ninety percent of KMG's clientele is based in the United States, but some clients reside internationally. KMG has worked with some of the largest pharmaceutical and insurance companies in the world. KMG places great value on its relationships with its clients. Although the company's goal as a service provider is to meet its clients' requirements, it also recognizes the importance of establishing and maintaining lasting and successful relationships with its clients. Through such relationships that foster commitment and trust, KMG is better able to provide expertise and professional perspective to help clients meet their IT- and process-related business goals and objectives. One of KMG's first clients, as well as one of its longest-lasting relationships, is a prominent U.S. insurance company. KMG has worked with this company for over 20 years, has helped it through bankruptcy and bore witness to its more profitable periods.

### **Innovation**

From KMG's CEO's perspective, innovation occurs when the company is able to convey new ideas or technologies to their clients as well as help execute those ideas. KMG has a long history of providing innovation to the healthcare and insurance industries. According to the CEO, many companies in these industries are not naturally on the cutting edge of technology, because they are still using legacy systems. The client companies' employees know how to use their own legacy applications very well, but they

do not have time to keep up with all the new technologies on the market today. When client companies are eventually forced to adopt new technologies, they must either ensure that current employees are trained on them, or they must outsource the project to IT service providers. KMG “is in the business of keeping up with new technologies.” KMG’s provision of innovation is a two-way street though. Clients initially guide KMG in the direction of their desired outcome(s), but KMG ultimately guides the clients through the execution of the innovation.

In many cases, KMG develops an innovative idea or product for one client and then tries to propagate the idea to other similarly situated clients that may need that technology. For example, one of KMG’s healthcare client companies wanted a solution that eliminated the use of all paper in board meetings, as the encumbrance of paper “made the meetings clumsy.” KMG helped convert all their meeting paperwork over to iPads. After successfully implementing this solution for this client, KMG then attempted to market it to other comparable clients in nearby areas who may have needed such a solution.

Developing mobile applications is another way that KMG has helped companies in the insurance industry innovate. Consider the scenario in which an insurance agent is trying to sell a new policy, but the customer has questions about his or her old policy. In the days before mobile technologies, agents would have to wait until they physically got back to the office to look up the information and answer their customers’ questions. Now all this information can be accessed via the agent’s smartphone or tablet, thus decreasing response times, improving customer service, and increasing efficiency/productivity.

## **Challenges to Innovation**

KMG has faced two principal challenges in its attempts to innovate for clients: training and resistance to change. In the insurance and healthcare industries, the clients' employees are accustomed to using older technology. Since innovation generally involves new technology, training becomes a significant issue. For instance, if an insurance company has one hundred employees writing insurance policy, and they are all using the older legacy system, the implementation of the new technology becomes a large undertaking. Attempts to replace a legacy system with a new system are frequently met with resistance, especially when so many employees are accustomed to the older technology. In KMG's experience, senior level management of the client companies generally wants innovation, while many lower-level employees are resistant to the changes that innovation will bring. One reason is this aforementioned issue of training. Another reason is that the eventual end users of the new technology fear being left behind and losing their jobs. Further, although upper level management is generally in favor of innovation, some clients are still resistant due to elevated project expenses, economic downturns, and lack of a dedicated budget for innovation.

## **Building and Managing Relationships**

When asked about the formulation of the innovation idea and strategy in its IT outsourcing relationships, KMG's CEO highlighted the importance of collaboration between vendor and client for innovative ideas to be successful. He stressed that the innovation idea must be a joint effort and that the client and vendor must share a common interest. Without the client's buy-in, innovation does not work. KMG suggested that, on

the client side, the CEO and the CIO should be involved in this process. In many cases, a CEO gets an idea from an industry-specific magazine or publication and sends the CIO to an industry trade show or conference. On the vendor side, KMG employees who are well versed in these new technologies meet with the CIOs at these trade shows and explain how their solutions can benefit the client company. The CIOs then convince senior management back at their companies to execute these innovative ideas.

As stated above, KMG attempts to establish lasting relationships with potential clients at trade shows and industry conferences. KMG accomplishes this by employing people who are comfortable with mobile technology and familiar with newer technologies, but who may not yet have practical experience with, or understanding of, the legacy systems that potential client companies use. KMG sends these employees to trade shows and conferences to establish a rapport with CIOs of hospitals and insurance companies in attempts to help explain how KMG can benefit their companies. KMG has found that CIOs are “a little more open” to new ideas and suggestions in venues like trade and industry shows as opposed to direct solicitations and other marketing techniques. These KMG employees learn about the client companies’ problems from the CIOs, and KMG tries to help solve their problems.

KMG generally follows the same protocol for securing clients and obtaining IT outsourcing contracts. Once the CIO of a potential client company shows interest in what KMG has to offer, the client gives KMG a small problem to work on. KMG begins by developing a sample, or pilot, project. Once KMG forges a relationship and successfully

completes a pilot project, the relationship is usually solidified and they start working on the real business problem for the client.

### **Expectations of the Client**

In an IT outsourcing relationship, the client more often than not expects the vendor to lead path to innovation. As referenced above, in prior research, vendors cannot achieve innovation for the client alone by working in a silo. Vendors need some level of input from their clients.

KMG employees understand very well the technology that it employs and delivers to client companies, but they may not understand the inner workings of the industry as well. The client company understands the industry knowledge but may not be as familiar with the newest technologies and how these new technologies can benefit the company. In KMG's experiences, this has created a gap between what the client wants and needs and what the new technology can do for the customer. This *knowledge gap* becomes a critical issue when KMG starts the process of innovating for its potential clients. Before a client commits to spending money on a brand new technology, it wants to know how this specific solution will benefit its customers, doctors, patients, etc. An open dialogue is necessary for this to occur. If KMG understands at the outset what the client company wants to ultimately achieve, then it can help minimize this knowledge gap.

In order for KMG to understand exactly what their clients want, and in order to successfully execute an innovative idea, KMG's CEO emphasizes that clients must have four things when outsourcing conversations begin. A client must first have a desire to innovate. This desire to innovate must pervade all aspects of the company, starting with

the CEO and CIO and trickling down to senior management, all other employees, and the organizational culture. Second, a client must maintain a budget for innovation. KMG's CEO asserts that innovation is not cheap. Clients must be willing to spend the necessary money to innovate. Third, an open dialogue must exist between client and vendor. Finally, client companies must have patience. Innovation takes time to accomplish – it does not happen immediately.

KMG wants clients to be open, to share with them the business problems and issues that need resolution. For that to occur, a certain level of trust is required between the players involved. Historically, KMG has worked better with existing clients. “The problem lies with expanding and gaining new clients. Clients receive solicitations from hundreds of vendors a day,” and each vendor claims to be the best at what it does. How, then, do clients know that KMG is more innovative than other IT service providers? They don't. KMG has taken some lessons from IBM when dealing with this issue. It tries to do what is right by the client. The client does not yet know this though, and this is where the miscommunications and misunderstandings may occur.

As described above in the trade show scenario, the chance of a vendor forging a successful partnership with a client increases greatly if the client can see a demonstration of the product that is being marketed. In KMG's case, after the client sees a demonstration at the trade show, a KMG employee who is well trained in the potential client's industry and in the technology he or she is promoting engages the CIO in further discussion. Trust begins here, when the conversations occur and the client sees a demonstration. This is typically when IT outsourcing relationships begin to bloom for

KMG. Once a relationship is forged and a pilot project is successfully completed, that client then spreads the word of the good work that KMG has done for them, which generates even more successful business relationships with new clients. KMG subsequently relies on client references and word of mouth to develop new interest in their products and services. Trust is difficult to build, and it blossoms slowly, but when trust and innovative ideas are propagated by client references and word of mouth, it becomes easier for KMG to find new clients and establish new relationships.

### **Measuring and Evaluating Success**

KMG and its clients evaluate success differently when it comes to strategic innovation in IT outsourcing. KMG evaluates success when it signs a contract with a client, when it “gets the job.” Its clients, on the other hand, evaluate success after the innovative solution has been implemented, for instance through their customer satisfaction ratings. If a client specifically requests updates on the progress during the life of a project, then KMG complies by developing incremental assessments at one or more intervals throughout the project’s development and implementation. KMG clients generally want benchmarks immediately at the beginning and then along the course of the project. KMG admits that success is not always easily measured though.

### **Case Study B – Metropolitan State University**

MSU is a large public urban university located in the U.S. It is an integrated university system that comprises 24 different types of college campuses across the metropolitan area in which it resides, and it serves over 500,000 students annually. The University is in its ninth year of a complex enterprise resource planning (ERP) system

implementation. This project currently has a value of nearly \$300 million. Some of this project has involved IT outsourcing. The first two years of the IT outsourcing component of this project involved finding contractors and vendors and negotiating contracts. So far, MSU has outsourced its data center and the hosting for its ERP system. While MSU has collaborated with KMG on components of this ERP project to date, vendors other than KMG were selected for future IT outsourcing projects at the University. The examples provided in this case study are not limited to MSU's experiences in outsourcing with KMG, but also include MSU's interactions with other IT service providers with which the University has collaborated.

### **Innovation**

One of the primary objectives of the ERP system implementation was to improve processes across the university system. Because MSU's ERP project on IT outsourcing was process-based, the organization defined innovation, at least for this project, from the perspective of improving and streamlining processes.

One of the processes that needed improvement dealt with canceling the enrollment of students who had not yet paid their tuition fees after a certain cutoff date. (MSU did not want to keep a seat allocated to a student who had not paid by the deadline or who was not going to pay their bill at all, but instead wanted to ensure that a paying student could enroll and benefit from that seat.) Once the vendor installed and implemented the new software, MSU noticed that the task of canceling enrollments actually became more cumbersome than before the new system was implemented. When MSU approached the vendor about this issue, they responded by analyzing more closely

the method that MSU used to process enrollment cancellations. When the vendor originally designed the system, they studied how other universities completed the enrollment cancellation process. When the vendor compared this research they had done to MSU's current method, they found that MSU's traditional method of enrollment cancellations was much more time-consuming than it needed to be. The vendor suggested that if MSU performed their enrollment cancellations in a different way, the school could reduce the time it took to complete the process for each student. The vendor backed up their suggestions with data they had collected on this process, thus making it more difficult for MSU to reject their idea in the name of status quo. MSU realized that this was a better way to complete this process and implemented the vendor's suggestion.

The ERP project director noted that, traditionally, when a client has revealed a software or system problem to the vendor, the vendor has responded with changing the programming or some other element of the software itself. In this case, the vendor helped the client innovate by streamlining processes and making university operations more efficient, thus bringing value to the client organization.

### **Relationship and Contract Management**

The elements necessary for an IT outsourcing relationship that breeds innovation may vary from earlier research and practice. Some IT outsourcing partners have begun including innovation clauses in their contracts in order to solidify their innovation requirements and increase vendor accountability.

Innovation clauses have played a role in some of the more recent IT outsourcing projects that MSU's ERP project director has seen. In one outsourcing contract

negotiation in which they participated, the client and the vendor agreed on innovation clauses that related to improving productivity and processes for the client. More specifically, the contract included a clause for the vendor to facilitate the client's ascension from Level 0 to Level 1 on the Capability Maturity Model Integration (CMMI) scale, while also improving the robustness of the client's IT processes. The vendor's job was to transfer their expertise in the CMMI area and improve this attribute for the client. In this way, even though the vendor may not have been involved specifically in some of the outsourcing areas, the client still received some of the vendor's innovative benefits.

Both rewards and penalties were included in the innovation clause to motivate the vendor to innovate for the client. Rewards included things like bonuses. Penalties included things like delayed credits or performance credits against SLAs. In the MSU's project manager's experience, rewards have worked better than penalties to incite superior performance from vendors.

When asked about the extent to which both client and vendor need to be involved in the innovation idea and strategy formulation process, the project director stated that it depends largely on the desires of the client and how much they want their vendor involved in those discussions. MSU prefers a more collaborative approach to the innovation idea, so that each partner can learn from one another. In the project director's opinion, the outsourcing relationships in which the vendor has the opportunity to provide input and collaborate with the client are more successful than those relationships in which they do not. He recognized though that this is not the way that every contract is

developed or written. Some contracts are very rigid and dictate exactly what the vendor is to do, without giving them an opportunity to provide much input.

MSU's project director suggested that before a contract is agreed upon, the key people involved in the outsourcing arrangement should gather in the same room, encourage team building, encourage discussions on innovation, and encourage discussions regarding how to bring the different organizational cultures together. He further stated that it is difficult to bring the cultures of two different organizations together, but it is important to understand any cultural differences, so that all employees can work together. Before embarking on a contractual relationship with one another, all outsourcing parties should gather together, talk to one another, share opinions and ideas, and understand one another's opinions and ideas. In the long run, these types of meetings foster more creativity and collaboration, more innovation, and more breakthrough thinking.

### **Challenges to Innovation**

According to MSU, culture is one of the factors that will either facilitate or hinder innovation through IT outsourcing. One of the things that MSU's project director found that either fosters or discourages innovation, or vendors from coming forward and suggesting ideas, has to do with the economic realities of the contractual agreement. Sometimes the contracts are so punitive and onerous that they do not foster the collaborative relationship necessary to bring about innovation. This is where conflicts may arise, when contracts are structured in a way that each outsourcing parties' project objectives differ. For instance, with a more punitive contract, the objective for the

vendor may evolve into maximizing their own profits or minimizing penalties as opposed to providing the best value to the client. This type of conflict can be alleviated if the appropriate discussions are held early on in the deal-signing and contractual conversations.

One of the things that the ERP project director has tried to include in the outsourcing contracts is the element of building and sustaining a relationship between the client and the vendor. He asserts that the relationship aspect of the contract should be high-level, in which key people from each side of the partnership meet on a periodic basis, escape the day-to-day conflicts, financial problems, and other issues they may be running into. Participants in these meetings should look at the outsourcing arrangement more as a relationship and see how they can work with each other to bring about some innovation. Clients should put these meetings in the outsourcing contract as guiding principles, to remind all parties involved that there is a bigger purpose to this outsourcing arrangement than just receiving a product.

### **Measuring and Evaluating Success**

MSU's ERP project director suggested that one of the key characteristics of a potentially successful outsourcing relationship is to ensure that the elements of the innovation clauses are measurable and quantifiable. He asserted that there must be some way to measure the improvements or the streamlining that the vendor contributes. Otherwise, it becomes difficult to attach any kind of reward to the improvement or penalty to the lack of improvement.

### **Case Study C – City of Metro**

Metro is a very large city government located in the U.S. This public institution comprises multiple agencies that provide various services to its citizens. Metro contracted with a prominent IT outsourcing vendor in the U.S. on some fairly large and mission-critical projects. One project involved an e-commerce solution for the city's Finance Department. The objective of this project was to make it possible for citizens to pay property taxes, parking violation fees, and licensing fees online. The vendor essentially created a virtual agency for the city. This project also made it possible for citizens to adjudicate their parking violations online, increasing the city's overall efficiency and improving service to the citizens. This e-commerce project took approximately one year to complete.

Metro also worked with this vendor in the late 1990s on a project surrounding the impending events of Y2K. Much of this Y2K project involved the remediation of computer software, so that the year would be correct when the computers in all of the city agencies switched over from 1999 to 2000. The vendor took an additional step for Metro in this Y2K project by researching and ensuring for the continuity of business. The vendor looked at the city's top business processes and the top services that they offered their citizens. They started by identifying 300 processes that the city completed, ranked these processes, and created a list of the top seventy-five processes. The vendor determined which processes the city could survive without for some time and provided contingency plans for those that were necessary for the continued functioning of the city government.

## **Innovation**

When asked to define innovation, the Metro representative stated that quality is a prime aspect of innovation on which it focuses. Metro desires product and process innovations that are tested and validated by superior quality standards and that will be more acceptable to their customers, the citizens. From Metro's perspective, quality exists not only in technological advances that a vendor offers, but also in the streamlining of processes that have helped it to become more efficient.

The aforementioned e-commerce project was one such project that delivered the quality and innovation that Metro desired. Like most governmental institutions, Metro is organized in different divisions or compartments called agencies. If a citizen wants to pay a water bill or property taxes or obtain a license, the city normally offers these services through the various appropriate agencies. Before e-commerce existed, each agency had their own separate methods and processes for collecting money from citizens as well as their own vendors with which they dealt. Each customer, or citizen, would have to physically travel from one agency to another to pay each bill and acquire each service. Once a virtual agency was created though, it made possible the consolidation of all these different activities, and customers could then make all their payments with a single transaction. This gave a tremendous advantage to the client company's customers, not only in terms of removing the time limitations of making multiple payments to the city, but also in terms of removing the physical inconveniences of doing business with various agencies located in different geographic locations in the city. The technology

that was implemented for Metro now takes care of how the money comes in, where it goes, and which agency receives it.

This example brings to light the technological advances that help the client become more efficient, streamlined, and able to offer better service to their customers. Information technology outsourcing was instrumental in this situation, because Metro was able to find a service provider that possessed the required skills to work around the clock, thus making it possible to provide the desired output in a much shorter timeframe than it would have otherwise taken if Metro had relied on in-house staff and skills to complete the project. If Metro had attempted this project without the vendor, it may have taken a longer time to implement. But by working with a vendor instead that could make it in a more efficient and streamlined manner, Metro was able to deliver these services in twelve months or less. Time to market was much faster due to the better skills, better quality control and better processes.

In both of the IT outsourcing situations in which Metro was a client, the vendor developed and implemented two different innovative ideas and solutions for the city. The e-commerce system was a technological advancement, but the innovation it delivered was more evident in its streamlined processes, its improved productivity, and the enhancement of Metro's customers' experiences. In the Y2K project, the vendor went above and beyond what was normally expected of an IT service provider. The vendor looked past what Metro initially requested and delivered an innovation that would benefit them far into the future.

## **Expectations from the Vendor**

Metro expects certain qualities to be present in its vendors and its outsourcing relationships. Once the vendor is familiar with Metro's current situation and business requirements, the vendor is expected to contribute innovation in the form of robust processes as well as the ability to deliver those (technical) requirements. In order to contribute such innovation, the vendor has no choice but to rely on its clients' knowledge of their own problems and desired solutions.

In addition to expecting certain things from its service providers, Metro recognizes that clients should also bring certain things to the IT outsourcing table. Clients should contribute their understanding of their own requirements, the business problem, and the marketplace in which they wish to compete. This information and insight are things that the vendor typically does not have when embarking on a new project partnership.

## CHAPTER V

### SERVICE LEVEL AGREEMENTS IN IT OUTSOURCING CONTRACTS

Academic and industry research on SLAs in IT outsourcing yielded source documents that primarily contained SLA definitions; SLA templates; and instructions, necessary components, and best practices for writing effective SLAs. Although these various industry leaders and scholars defined SLAs differently, the overall concept of the SLA remains consistent throughout IT outsourcing literature. The Cullen Group, a global sourcing consulting company, considered the SLA to be a formal product specification document (2009). Goo et al. (2009) defined the SLA as a formal written contract between the client and vendor that defines the different elements of the contracted service as well as the specific levels at which the service will meet the client's business objectives. Goo (2010) extended this definition to include the specification of "metrics by which the effectiveness of various contracted services and lower-level activities, functions and processes" are measured, examined, changed, and controlled. Additionally, SLAs should exist as vehicles by which IT outsourcing parties can set (Goo 2010) and validate their expectations of one another and set guidelines for measuring project success (Syntel n.d.).

The SLA literature also recommended that specific references to innovation be written into IT outsourcing agreements. Goo (2010) suggested including an innovation plan in contracts that contain "joint efforts at continuous performance improvement and

planning.” Such innovation plans should specify the processes by which innovations are coordinated between IT outsourcing partners, along with incentive plans that benefit each party (Goo et al. 2009). Performance metrics play a key role in attempts to innovate through IT outsourcing. In addition to the types of metrics that are normally included in utility-type outsourcing contracts, Niranjana et al. (2007) suggested that incentive-related metrics should be expressly included in SLAs in order to “motivate and sustain desired behavior,” namely innovation. Although recent literature and SLA instructions have recommended that innovation be explicitly incorporated into the IT outsourcing contract, very little evidence of innovation plans or clauses was discovered in the actual SLAs that were analyzed in this research.

The actual IT outsourcing SLAs that were analyzed for this research came primarily from the public sector and represented state governments, federal institutions, and public universities. No SLAs were publicly available for private companies. The SLAs that were studied consisted of either basic utility-type service contracts, in which the client did not necessitate or desire innovation (DISA 2014; Charles Darwin University n.d.), or they contained implied references to innovation without express innovation clauses or plans (UC Riverside 2012; Oregon State Government n.d.). Each SLA that was analyzed contained specific metrics related to the service requested from the provider, as well as other contract components suggested in SLA best practices literature. For the two SLAs that contained (what could be interpreted as) implied references to innovation, specific SLA terminology included action items such as service level improvements; service delivery improvements to the client’s customers; delivery of

new tools, technologies, and applications; management of IT and business process improvement projects; and facilitation of change management planning (UC Riverside; Oregon State Government).

Table 3 displays descriptions of the institutions that were studied for the SLA component of this research, including the type, sector, the IT service that was outsourced, and whether innovation was implied or mentioned expressly in the SLA. None of the SLAs contained innovation plans or clauses. Also, the types of IT services delineated in the SLAs for the Defense Information Systems Agency (DISA) and Charles Darwin University (CDU) were for more utility-type, or non-core, services that would not have directly affected primary business processes. Interestingly enough, the IT services that were outsourced for The University of California-Riverside (UCR) and Oregon State Government (OSG) were also for non-core, utility-type services, but some of the metrics outlined in their SLAs contained language that implied product and process innovation.

Table 3. Characteristics of Organizations & Service Level Agreements

<b>Institution Name</b>	<b>Institution Type</b>	<b>Institution Sector</b>	<b>IT Services Outsourced</b>	<b>Express Innovation Clause/Plan</b>	<b>Implied Innovation Metrics</b>
<i>Defense Information Systems Agency (DISA)</i>	U.S. federal agency	Public	Network services; Unified Capabilities (voice, video, messaging, wireless, mobile); IP data; satellite communications	None	None
<i>University of California at Riverside (UCR)</i>	U.S. postsecondary educational institutional	Public	Desktop support; server and security administration; application and web development and support; IT management; project management	None	<ul style="list-style-type: none"> <li>- Introduction of new tools and technologies</li> <li>- IT and business process improvement project management</li> <li>- Change management planning</li> </ul>
<i>Oregon State Government (OSG)</i>	U.S. state government	Public	Network services; IT professional services; data	None	<ul style="list-style-type: none"> <li>- Develop new applications/customize new applications</li> <li>- Improve service</li> </ul>

			storage and backup; hosting; collocation; application delivery; e-government services; desktop support; computer lab services		delivery to citizens - Improve efficiency of government management through new collaborative tools
<i>Charles Darwin University (CDU)</i>	Australian postsecondary education institution	Public	IT help desk services	None	None

Though the research outlined above contend that SLAs are important to IT outsourcing success, scholars recognize that these contracts cannot exist in a vacuum. In addition to the formal written agreement is the need for mutual trust, dependence (Goo et al. 2009), and effective governance (The Cullen Group 2009), all of which depend on the quality of the relationship that is established between the client and service provider. Furthermore, although none of the actual SLAs analyzed for this research contained innovation clauses or definitions, aspects of innovation were apparent in the metrics and objectives of some of these contracts.

CHAPTER VI  
RESULTS, DISCUSSION, AND IMPLICATIONS

**Results**

The results of this research indicate that clients and vendors agree on some aspects of innovation in IT outsourcing, but that each party brings differing perspectives and contributes different capabilities to their outsourcing arrangements. Additionally, service level agreement research indicates that the inclusion of certain elements in IT outsourcing contracts is necessary for innovation to occur.

**Key Management Group**

This case provided an overall view of a vendor's perspective of innovation in IT outsourcing relationships. KMG provides an array of services to a variety of organizational types within the healthcare and insurance industries. The examples given in this case exhibit the characteristics of one-to-one client-vendor IT outsourcing arrangements. KMG has historically helped client companies innovate through the adoption of new tools and technologies, but in most of the examples given above, the innovations that KMG brings to clients ultimately change the clients' business processes and work flows for the better.

Specific IT outsourcing contract documents were not available for inspection in this case, but KMG's answers imply that relationship building takes place early on in its

outsourcing arrangements, before the contract is written. Company representatives start building relationships with potential clients even before conversations regarding specific technologies or processes begin, as evident in their marketing techniques at conferences and trade shows. KMG helps establish trust between itself and client companies by providing technology demonstrations at trade shows and by executing pilot projects for potential clients before taking on bigger, more critical projects. The long-term relationships that KMG attempts to forge with clients perpetuate this mutual trust and commitment between both outsourcing parties.

Clients seek innovation from KMG for reasons other than simply cutting costs or saving money. KMG's projects have helped its clients streamline processes and improve the provision of services to their clients' customers, which fall under the strategic/organizational and technical categories of IT outsourcing motives outlined above.

KMG possesses several capabilities that play key roles in achieving innovation for its clients. First, the IT service provider possesses superior technical capabilities. KMG intentionally hires employees who are knowledgeable of and open to using new tools and technologies. Second, KMG caters to a limited number of industries, insurance and healthcare, and it knows these industries well. This allows KMG to create and optimize the same types of innovative solutions for its clients as opposed to providing many non-innovative solutions to many different industries.

## **Metropolitan State University**

This case provided a client's perspective of innovation in IT outsourcing arrangements. MSU has engaged, and is currently engaging, in a multi-sourcing strategy, an arrangement that involves the use of several different vendors to achieve its business goals and objectives. The ERP project, on which MSU is currently working, inherently involves the implementation of new technologies, but the level of IT outsourcing that MSU is employing with this project is process-based. One of MSU's goals for this ERP implementation was to streamline processes and make operations more efficient. Thus, the innovation that MSU received from its service provider was process-based. This case also proved to be one in which improving and streamlining processes were more motivation for innovation in IT outsourcing than saving money and cutting costs.

Specific IT outsourcing contract documents were not available for inspection in this case, but innovation clauses have played a role in effecting innovation in some of MSU's outsourcing arrangements. Some of MSU's contracts have included innovation clauses, and both rewards and penalties have been included in the organization's contracts. Further, some characteristics of these innovation clauses have been quantifiable and measurable, making it easier to assess innovation when it does or does not occur.

The relationship-building aspect of innovation takes place early in MSU's IT outsourcing arrangements and extends throughout all phases of its projects. Key IT outsourcing decision makers from each party come together on a periodic basis,

encouraging collaboration, creativity, and communication in attempts to bridge cultural differences that exist.

The vendor that provided the enrollment cancellation technology and innovation possessed capabilities that MSU itself did not have on board. The vendor's technological expertise and specialized experience in the higher education field helped it facilitate an innovative solution for the University system.

### **City of Metro**

This case provided a client's perspective of innovation in IT outsourcing arrangements. Metro engaged in a one-to-one service provision relationship with the same IT service provider that has completed multiple IT outsourcing projects for it over the course of several years. Although at least one of the IT outsourcing projects that was completed for Metro involved new technological advancements, the innovative benefits that Metro eventually received included the improvement of services to its customers, increasing the efficiency of its operations, and improving processes. The motivations to outsource in this case included improvements in productivity, performance and service quality, not necessarily cutting costs or saving money.

The long-term nature of the relationship between the client and vendor in this case yielded arrangements that were driven by trust and commitment. This mutual trust provided additional relationship benefits, which positively impacted the eventual innovations that were produced.

The vendor that helped Metro achieve its desired innovation possessed the capabilities to deliver the final products, including technical knowledge and process

knowledge. Metro also contributed to the innovation equation. By knowing and understanding their own business requirements and the market in which they wished to compete, the city was able to aid its vendor in achieving innovation.

### **Innovation in IT Outsourcing Contracts**

Both the primary and secondary research conducted for this study indicates that IT outsourcing contracts should contain two different elements: innovation clauses and quantifiable metrics. The SLAs that were analyzed revealed no evidence of innovation clauses or plans, but some of them contained measures that could be interpreted as innovative.

### **Discussion**

This research explored the elements and characteristics necessary to achieve innovation through IT outsourcing arrangements. More specifically, this research sought answers to the following questions: *What role should vendors play in helping client organizations achieve strategic innovation? What capabilities should client and vendor organizations possess to achieve strategic innovation through IT outsourcing?* In addition to answering these questions, this research has answered additional questions concerning the achievement of innovation through IT outsourcing. Case studies revealed similar perspectives from both the client and vendor sides of past and current IT outsourcing partnerships. The discussion that follows includes (1) some of the challenges that vendors encounter when trying to innovate for clients, (2) the contractual elements needed to achieve innovation through IT outsourcing, (3) the contributions that client companies should make to outsourcing arrangements, (4) the capabilities that vendors

should possess when trying to innovate for clients, and (5) the characteristics that both partners should bring to the outsourcing table.

Client companies present certain challenges to vendors that are trying to innovate on their behalf. The first of these challenges is the resistance to new technologies, innovation, and change in general. As Birkinshaw et al. (2011) set forth, innovation must be both top-down and bottom-up to be successful. Executive leadership, senior management and line employees must all be on board for innovation through IT outsourcing to be successful. If organizational leadership is resistant to change at the outset, then it is unlikely that the decision to outsource for innovation will ever be made. On the other hand, once organizational leadership decides to outsource for innovation, actions of lower-level employees (who may be more affected by the outsourcing arrangement than many other levels of employees within the client company) could affect the outsourcing situation, depending on their acceptance of or disagreement with the outsourcing arrangement. The second of these challenges is the lack of training on the new technologies that are implemented in the client company. However, lack of training on these new technologies may also be the reason that client companies want a service provider to help innovate for them.

Certain contractual elements are highly instrumental in ensuring that the client's innovation requirements are met. First, IT outsourcing contracts should contain innovation clauses. Innovation means different things to different people, different organizations, different industries, and different sectors. Therefore, an innovation clause should contain a definition that is specific to the client's requirements. Innovation

clauses should also provide enough reward to incite innovation, but should not be too punitive as to discourage creativity. Lacity and Rottman (2012) found that gain sharing to be the best mechanism to incent innovation, but they also found that it is utilized in a very small percentage of outsourcing arrangements. IT outsourcing contracts should also contain specifically defined methods of evaluation. These evaluation methods must be quantifiable. Furthermore, some metrics should be geared solely to measure innovation. Both of these contractual elements have been acknowledged in previous literature, and this research has confirmed that they are important factors in innovating through IT outsourcing.

In order to achieve innovation through IT outsourcing, clients need to have certain things on hand before they even consider the outsourcing decision process. Clients first need to have an understanding of their own business problem and requirements, including an understanding of where the company currently stands and where they want innovation to take the company. This includes knowing what capabilities they do or do not already possess within the organization. Second, clients need to have a good understanding of the marketplace with respect to their own customers' desires and needs, as well as with respect to potential clients that they are trying to reach with their desired innovation. Third, clients should ensure that they have employees on hand that are experts in own legacy systems and in-house technology. This helps ensure that the translation to any new system, technology or process takes places more smoothly. Fourth, the client company should have an organizational culture that is open to collaboration, new ideas, and new technologies. Fifth, clients need to dedicate a portion of their budgets to

innovation. Service providers in this analysis suggested that clients are not always prepared to pay for the innovation they desire. A lack of dedicated innovation funding on the client's part makes it difficult for IT outsourcing partners to successfully facilitate innovation. Finally, clients should be patient. Innovation does not happen in a day. Clients should understand that it takes time to build a quality system, product, process, and relationship. Client companies should ensure that they have the aforementioned knowledge and tools before making the decision to outsource. Although it is possible that a service provider would be able to facilitate innovation in a client that does not possess all of the aforementioned characteristics, it is also possible that the process will not flow as smoothly.

Service providers must also bring certain capabilities to arrangements if they desire to achieve successful innovation through IT outsourcing for their client companies. The following characteristics should result in more satisfied client companies. First, vendors should maintain superior in-house technical expertise and capabilities and should stay abreast of the latest technologies on the market. By the same token, vendors should possess the ability to assess a client's specific situation and determine which technology will benefit the client the most. Second, vendors should be competent in their client's industry of specialization. This coincides with previous research that has revealed that selecting the right vendor is a key component in achieving success through IT outsourcing (Overby 2010a). Third, vendors should have the ability to bridge the 'knowledge gap' between the client organization's current state of affairs and the client's understanding of what a new technology can do for the organization. This goes hand in

hand with two of the things that the client needs to bring to the table: their understanding of the business problem and their understanding of the systems that they currently have in place.

Both parties should also bring certain elements to their outsourcing arrangements to improve the likelihood that innovation occurs. First, vendor and client must be willing and able to collaborate. This ability and willingness must come from something deeper within each organization, namely the organizational culture. Second, both parties must establish and maintain a mutual trust with one another. The client's hiring of a service provider does not automatically instill trust between the parties. Trust is must be built and earned between the parties over the course of time. Just as KMG outlined in the case study above, something concrete should be used to help establish this mutual trust, whether it is a successful pilot project, positive feedback from previous clients, or evidence of innovation (new markets, improved service or processes, improved efficiency, etc.) in previous clients' projects. Third, clients and vendors should engage in an open dialogue during all phases of the outsourcing process (pre-contract, contract, and post-contract). Communication and discussions should be deliberate, open, and honest. Furthermore, if someone or something is not performing to standards set forth in the contract, then conversations should occur as soon as possible. Potentially detrimental situations should not be left to stagnate. Ignoring potentially damaging issues could cause further problems at critical points later during the outsourcing process. Fourth, adequate planning should take place before the decision to outsource or innovate occurs. Fifth, each party should possess the ability to understand the cultural differences in the

partner organization. Not only should they understand the differences, they should also understand how to proactively overcome any issues that could arise from these cultural differences. This aligns with the ability to communicate openly and honestly with one another. Finally, both parties should have high-level meetings on a periodic basis to discuss the outsourcing arrangement from a relationship perspective and how the relationship can bring about innovation.

### **Themes in this Research**

In addition to the detailed recommendations set forth for potential IT outsourcing partners that desire innovation, this research also revealed two themes. While some elements of these themes are consistent with previous research, some could be considered new insights in the field of innovation through IT outsourcing.

The first theme is that innovation occurs most often when IT outsourcing engagements are more strategic and when a high level of trust exists between client and vendor. According to the data collected in this research, mutual trust occurs most often after a service provider has proven their ability to deliver an innovative service or product on an innovative platter during previous projects and/or with previous clients. If a vendor company can successfully forge innovation for a potential client through a small pilot project, then the client may be more likely to trust that vendor with bigger innovation projects in the future. Moreover, if a vendor has a successful track record of innovating for past clients, then its reputation should speak for its capability to innovate. Trust does not occur immediately. Rather, it must be earned over time and through multiple interactions between the different parties. One of the most successful relationships in this

research was between a client and a vendor whose alliance has spanned two decades, through both good and bad economic times.

A second theme revealed in this research is that when IT outsourcing innovation projects begin, they typically start out as technological advances or are initially contracted as implementations of new tools and technologies. These types of innovation projects generally result more in process-based innovations. This phenomenon, which was clearly evident in the MSU case above, came about due to the experiences and capabilities that the service provider possessed at that time. The takeaway from this is that the innovation that is initially planned may not always be the innovation for which the project or the service provider becomes known. As the CEO of KMG also stated, an innovation does not have to be groundbreaking for a client to consider it innovative. It need only be new to the client that desires it at that moment. This is why companies like KMG are successful in IT consulting and outsourcing for innovation. They re-use innovative ideas and introduce them to clients that have never seen them before. This depends on the actions and capabilities of dedicated service providers that value their relationships with their current clients.

### **Implications**

The findings from this research answered the study's initial research questions and helped to achieve this study's objectives, which were to (1) determine the role that IT service providers should play in helping client organizations achieve strategic innovation, and (2) determine the capabilities that both client and vendor organizations should possess to achieve strategic innovation through IT outsourcing. In fulfilling these

objectives, this research provided an opportunity to study firsthand the opposing sides of IT outsourcing relationships in the context of achieving innovation.

This research provides both theoretical and practical implications for innovation in IT outsourcing. First, it reinforces many of the recommendations set forth in the IT outsourcing literature, especially with respect to the organizational climate and the capabilities of each outsourcing partner. Based on the review of the literature on IT outsourcing and innovation, the findings in this study can be generalized to the greater body of general outsourcing research and practice, not only those arrangements that pertain to innovation through IT outsourcing. Additionally, this research outlines methods that client and vendor organizations can use in their attempts to achieve innovation through IT outsourcing. For instance, all of the findings here suggested that contracts and SLAs should contain innovation clauses or plans in order to successfully achieve innovation, but none of the SLAs analyzed for this research contained innovation clauses. This implies that clients are not receiving innovation from vendors, because they are not stipulating it in their outsourcing contracts. This also implies that there is a lag between research and practice, possibly due to the difficulty in operationalizing innovation. Finally, though this research suggested specific methods to achieve innovation through IT outsourcing, some of these suggestions represent a more conceptual perspective on the topic. For instance, trust cannot be quantified, and as indicated above, innovation is difficult to define.

## CHAPTER VII

### CONCLUSION AND FUTURE RESEARCH DIRECTIONS

Through case study and literature review, this research explored the elements and characteristics necessary to achieve innovation through IT outsourcing arrangements.

#### **Limitations & Future Research**

Some of the insights from this analysis could also be applied to IT outsourcing arrangements that are not explicitly intended to facilitate innovation. This could be considered a limitation of this study. If so, this may necessitate future research of innovation in IT outsourcing arrangements, specifically in which innovation is expressly indicated in pre-implementation talks and in the IT outsourcing contracts of the organizations that are studied.

Further, this research examined only what may be considered successful IT outsourcing relationships, in which both parties (client and vendor) looked favorably upon the outcomes with respect to innovation. Companies who may have had unfavorable experiences with innovation from IT outsourcing may be less likely to share their experiences with the academic world. To improve the breadth of organizations studied and the value of the data collected, future research might include an anonymous survey of organizations with varied IT outsourcing outcomes, both successful and unsuccessful.

Additionally, the companies studied in this research were solicited through contacts in academia and the IT service provision industry. Eventual interviewees volunteered to participate. Future research might select organizations in a more randomized manner, perhaps focusing on a single industry or organizational type rather than casting such a wide net. It may then be possible to uncover patterns among certain industries or types of client organizations with respect to innovation in IT outsourcing.

Finally, there were definite limitations regarding the SLA portion of this research. SLAs for the companies that participated in the case study portion of this research were not available for analysis, and the SLAs that were eventually analyzed came only from public institutions. The following recommendations may also enrich the literature on innovation in SLAs: study more private companies that are willing to share their SLAs, study more organizations that have explicitly designed innovation into their contracts and SLAs, and conduct in-depth longitudinal case studies of organizations' IT outsourcing arrangements that explicitly contract for innovation.

### **Conclusion**

This study set out to explore the role that IT outsourcing parties play with respect to achieving innovation through outsourcing arrangements. This research achieved its objectives through two different methods: (1) conducting case studies of client and vendor organizations that have engaged in IT outsourcing arrangements, and (2) conducting a literature review of service level agreements in IT outsourcing arrangements. The outcomes of this research ultimately included the following: (a) a better understanding of the roles of IT outsourcing partners in achieving innovation, (b)

suggested methods by which client companies can assess potential vendors' capabilities for achieving strategic innovation, and (c) contractual guidelines for client companies attempting to achieve strategic innovation. This study has confirmed previous research findings with respect to innovation in IT outsourcing as well as provided some new insights and recommendations for future research and practice.

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