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Identifying Appropriate Governance Principles for Different Types of Sourcing Arrangement

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ABSTRACT

Three shortcomings in existing information technology (IT) governance research are identified: an overemphasis on implementation rather than principles, a focus on the individual organisation rather than the relationships between organisations and a tendency to divorce the technology from the activities that rely on it. A governance framework comprised of the overarching principles of *direction* and *control* is proposed and it is suggested that these principles can be delivered through a focus on *performance*, *conformance*, *openness and transparency*, *responsibility and accountability*, and *evaluation and monitoring*. The importance of outsourcing as a form of inter-organisational relationship is highlighted and three case studies of different types of outsourcing arrangement conducted to test the usefulness of the framework. The results suggest that organisations recognise the importance of effective governance to the success of their relationships, that designing appropriate governance for relationships is complicated by factors such as the need to accommodate the disparate requirements of the parties involved and that the framework proposed appears to capture the essential areas.

Keywords

Governance, outsourcing, direction, control

INTRODUCTION

IT has long been accepted as playing a strategic role in the operations of organisations (Brown, 1997) and represents a significant proportion of their investment expenditure (Gu et al, 2008). Yet historically IT has often been poorly managed – both from the perspective of initiatives failing or being abandoned and operational problems. According to the Standish Group (2006), for example, only 35 percent of software projects started in 2006 could be categorized as successful – defined in the broadest sense as being completed on time, on budget and meeting user requirements. The IT Governance Institute [ITGI] (2005) provide numerous examples of the impact of shortcomings in the design and use of IT, including IBM suffering a 16% decline in its share prices due to component shortages caused by problems in the exchange of information with trading partners.

Given the significance of IT, and the problems associated with it, academics and practitioners alike have been arguing for a number of years that performance could be improved by implementing a dedicated governance structure for IT (Watson and Brancheau, 1991; Weill and Ross, 2004; Gu et al 2008). Weill and Woodham (2002) suggested that *effective* IT governance was fundamental in helping State Street maximise the business value from its IT investments and average annual net income growth in excess of 19%.

This paper suggests though that much of the academic work to date on IT governance has been limited through being focused on:

- the technology divorced from the activities that rely on it
- how to implement governance structures rather than the principles they should embody
- governance within an organisation rather than also considering governance between organisations

As such it is suggested that there may be much to gain from an *extension of emphasis*. To assist in this process the paper will seek to identify a set of appropriate principles for the effective governance of IT enabled activities in an inter-organisational context.

The remainder of the paper consists of four main sections. First is a discussion of governance and a suggestion that previous research has overly focused on how IT governance should be implemented rather than seeking to better understand the underlying principles of direction and control. Second is an attempt to define the components of direction and control. Third it is argued that it is necessary to extend considerations of IT governance beyond the boundaries of a single organisation and include the activities that make use of the technology – and that this makes an examination of IT governance in an outsourcing context pertinent. Fourth are the results of a series of case studies designed to test whether the principles and components identified can provide guidance for the effective governance of different types of outsourcing arrangement.

IT GOVERNANCE

IT governance is commonly seen as being derived from corporate governance (Webb et al, 2006). A useful overarching view of corporate governance is provided by Keasey and Wright (1993) who consider it to be a framework for the effective regulation, monitoring and control of companies which allows for alternative internal and external mechanisms for achieving the underlying objectives. The Cadbury Committtee (1992) similarly considers corporate governance to be "the system by which companies are directed and controlled" (p15). There appears to be a broad consensus that IT governance is similarly concerned with *direction* and *control*. Weill and Ross (2004), for example, define IT governance as "specifying the decision rights and accountability framework to encourage desirable behaviour in the use of IT" (p2). AS8015, the Australian Standard for the corporate governance of ICT, defines it as "the system by which the current and future use of ICT is directed and controlled" (Standards Australia, 2005, p6).

Previous research on IT governance has largely focused not on enhancing *understanding* of those principles of direction and control but on their *implementation*[1]. Tavakolian (1989), Brown (1997) and Sia et al (2008), for example, examined IT decision making and influences on whether it was centralised or decentralised. Sambamurthy and Zmud (1999) identified 3 prevalent modes – centralised, decentralised and federal – while Weill and Ross (2004) proposed six archetypes – business monarchy, IT monarchy, feudal, federal, IT duopoly and anarchy. Weill and Ross (2004) also identified specific areas that IT governance should cover; namely, principles, architecture, infrastructure, business applications and investment priorities. Gerrard (2006) looked at IT governance from the perspective of the IT life cycle – specifically strategy, planning, implementation, management and monitoring. While potentially useful there is a danger that concentrating on implementation not only assumes a common understanding of what effective direction and control mean but also risks being prescriptive by requiring management to view and run the business in a specific way. Indeed Davies (1999), Broadbent (2003) and others, have suggested that the goal of IT governance should be to establish an organisation's objectives and the rules and conventions that should be followed in achieving them rather than to dictate specific actions to be taken – that being the role of management.

DEFINING DIRECTION AND CONTROL

A number of authors have sought to identify the components that contribute to the principles of *direction* and *control*. Davies (1999) and Gray (2004) suggest that *direction* is concerned with guiding the organisation with respect to the particular mission it is established to achieve by establishing appropriate *performance* metrics. From an IT perspective, Webb et al (2006) and Barrett (2000) similarly emphasise the role of alignment and performance management. Pultorak (2006) though has argued that it is necessary to look beyond pure performance to also embrace *conformance* – with financial and legal requirements, health and safety obligations, quality certifications and ratings and professional codes of conduct.

Turning to *control* and drawing upon and synthesising work by the Financial Reporting Council (2008), Cadbury Committee (1992), Davies (1999) and Gray (2004) *responsibility and accountability, openness and transparency, evaluation and monitoring* would appear to be broadly agreed upon foundations. While other literature, especially in the IT domain (IT Governance Institute, 2005; Barrett, 2000; Webb et al, 2006; Weill and Ross, 2004), suggests that *risk management* might represent a useful addition it is proposed here that it can be subsumed within evaluation and monitoring. Figure 1 represents a summary of the essential components of *direction* and *control.* It should of course be remembered that the context of an organisation will influence how these principles and components are translated into practice (Sia et al, 2008; Brown, 1997).

[1] The same is true to a degree with corporate governance also. The Cadbury committee (1992), for example, focused on how company board should be constructed and made more effective rather than its purpose

Governance

Direction:	**Control**:
• Performance • Conformance	• Openness & transparency • Responsibility & accountability • Evaluation & monitoring

Performance	– Agreeing the principal goals of the relationship
Conformance	– Satisfying requirements of regulators and other bodies
Openness & transparency	– Providing quality information and effective reporting
Responsibility & accountability	– Allocating decision rights and the associated liability
Evaluation & monitoring	– Assessing current activities and new opportunities

Figure 1: The principles and components of IT governance

EXTENDING THE GOVERNANCE SCOPE

The ITGI (2005) recognises that governance matters and concerns are not necessarily constrained to the boundaries of a single organisation noting that the "boundaries of today's organizations are more flexible and dynamic .. they [organizations] must start focusing on whole processes, including those that transcend the physical walls of the entity.. such organizational structure is often referred to as the extended enterprise" (p1) . The ITGI (2005) also acknowledges that governance becomes more complex and challenging when one moves beyond those physical walls – "In the extended enterprise environment there is no standard pre-existing governance structure" (p67).

It is also now widely recognised that it is not IT *per se* that is of value to organisations but how it is used and contributes to the achievement of business objectives. Lee (2001), for example, in a discussion of the productivity paradox recognises the impact of the organisational context while Sabherwal et al. (2001) stress the importance of aligning an organisation's IT with its business operations. Mukhopadhyay et al (1995) suggest that to understand the contribution of IT one needs to look at how it changes the way organisations conduct their business. As such it may be necessary to extend the scope of IT governance.

One popular way in which organisations have sought to reshape themselves and change which side of the organisational boundary activities sit on has been through outsourcing. Outsourcing is well recognised as a means through which organisations can work with long-term partners to enhance capabilities or cut costs (Dibbern et al, 2004). According to Willcocks et al (2007) annual global revenues from IT outsourcing alone exceeded US$200 billion in 2005. Furthermore, and of particular interest from the perspective of this paper, is that while initial research on outsourcing focused solely on the technology (Dibbern et al., 2004) it has subsequently recognised the need to embrace the business processes that make use of that technology. Technology Partners (2004), for example, suggested that business process outsourcing and IT outsourcing will be bundled with "the business process ruling the decision making" (p1).

There is however only limited research on the governance of outsourcing relationships – and that which does exist has typically focused on the appropriateness of the *contract* negotiated between the participants (see for example Fitzgerald and Willcocks, 1994). Willcocks et al (2007) identify various types of contracts – classifying them as standard, detailed, loose and mixed – and consider them in terms of the time to negotiate, the clauses included – for example relating to costs, confidentiality, service level agreements and early termination – and the success of the ensuing outsourcing relationship. Kern and Willcocks (2000) go so far as presenting a list of contract inclusions. It is suggested here that the focus on contracts puts "the cart before the horse". Williamson (2005) argued that the object of contract is not to be legalistic but to get the job done – and it is therefore necessary to identify what is required for that. Hart (1995) also suggested that where there are problems of agency[2] contracts may not always be sufficient to address them thus requiring the establishment of effective

[2] Agency problems arise where there are potential conflicts of interest between contracting parties that can impact on achieving a stated goal

corporate governance. Maher and Andersson (2000) have argued that effective corporate governance encourages the pursuit of *group* rather than *individual* interests – which is critical to outsourcing where both partners need to benefit for the relationship to succeed (Willcocks et al, 2002). Brennan and Buchanan (1985) state that rules influence outcomes and that it therefore follows that the study of rules and their construction – as embodied for example in governance structures – is critical to understanding success. Taken together it would appear that the current focus on contracts may be inadequate. It is proposed here that the focus should be pushed back to examine the principles of governance which inform and support any contract. In practical terms the importance of the effective governance of outsourcing relationships is illustrated by the case of Satyam, the Indian outsourcing organisation, which provided mission critical applications to many major organisations – such as Qantas, Telstra, Caterpillar and Coca-Cola – and allegedly engaged in undetected fraudulent activity over a number of years. Satyam's customers now find themselves in the unenviable position of potentially having to change suppliers – with all the associated costs – while more broadly re-evaluating their fundamental approach to the construction and governance of outsourcing arrangements (Sharma and Foo, 2009).

METHODOLOGY

Given that little research has been conducted on the principles of governance, especially within an inter-organisational context, a case study based approach was determined to be appropriate (Benbasat et al, 1987). A multi-case approach was taken for the study. While the cases do not, by any means cover all possible sourcing arrangements, they do capture a range which will provide some insight regarding whether the principles, and associated components, of good governance are consistent across contexts. The cases were drawn from the private and public sectors (with one cutting across both) – details are provided in Figure 2. In all cases the relationship was *perceived* as successful by both the supplier and the client. Interviews were conducted with both the service provider and client and were between one and two hours in duration. A semi-structured interview protocol was followed to introduce a degree of commonality while minimising the potential for overlooking the unique aspects of each context (Firestone and Herriott, 1982). While the underlying rationale of the empirical research was purposeful it was deliberately non-directive so as not to preclude the emergence of factors or components not previously considered (Eisenharrdt, 1989). With regard to analysis, data was first reviewed and coded in terms of its relationship to the principles of governance and their components – an approach in accord with the recommendations of Miles and Huberman (1994) and Yin (1981) who suggest organising data "around the substantial topics of the case study" (Yin, 1981, p60). At the same time a case comparison approach underlay the analysis (Yin, 1981). The resultant data display tables represent a crucial link in the chain of evidence between the raw data and the subsequent analysis and development of conclusions.

Case	Type	Supplier	Interviewees	Client	Interviewees
CASE ONE	Traditional outsourcing – where an organisation outsources one or more activities to an external provider	SUPPLIER1 - Local subsidiary of a multinational provider	Senior VP Business Development & Marketing (BDM) Regional Account Manager (RAM)	CLIENT1 - A major provider of telecommunications with operations in Australia & overseas	National Manager Customer Services (MCS) Outsourced Services Relationship Manager (SRM)
CASE TWO	Where an organisation enters into a joint venture with a provider to supply one or more services to itself and to others	SUPPLIER2 – Australian listed provider of business services	Partnership director (PD) Project Manager (PM)	CLIENT2 – A local council	General Manager (GM) Finance Director (FD)
CASE THREE	Where several organisations together establish a separate vehicle to provide services to all of them	SUPPLIER 3 – captive provider wholly owned by its clients	General Manager (GM) Chief Information Officer (CIO)	CLIENT3 – A state based financial services provider	General Manager (GM)

Figure 2: Case and interviewee details

RESULTS

All of the interviewees recognised the importance of IT governance – and the time and effort required to agree the principles and elements at the commencement of a relationship.

> *"We have as a business an overriding set of principles that we apply"*CLIENT1-SRM

> *"So the first 12 months – well there's been two years of negotiations* [to get the governance right]*"*SUPPLIER2-PD

> *"establishing the driving principles .. rather than just going through a straight kind of contractual arrangement"*CLIENT3-GM

It was also recognised that the implementation of governance will vary according to specific circumstances – such as an organisation's overarching purpose and role, the mix of the organisations involved in a relationship (for example whether it cuts across the boundary between the public and private sectors), and whether a *separate company* is established to house the activities.

> *"have to work within council's parameters"*CLIENT2-GM

> *"a lot of work went into the constitution* [of the partnership vehicle] .. *establishing rights and responsibilities"*SUPPLIER3-GM

Recognition of the significance of governance however does not lead to a neglect of the importance of contracts – though it can lead to a change in role. Interviewees recognised the necessity of having an appropriate contract in place – but often more to document the underlying principles to an arrangement or as a backstop than as the defining feature or driver of a relationship.

> *"the contract discussions for that were difficult, prolonged. But it goes to a point and why they were difficult and prolonged because we never wanted the contracts to drive the relationship. But we needed all the protections in there"* CLIENT2-FD

> *"So it took a long time to get a contract that actually did all those things, but allowed us to actually function in a fashion"* SUPPLIER3-GM

The complexity of inter-organisational governance was highlighted, especially the difficulty of managing multiple – perhaps overlapping or conflicting – governance structures.

> *"We've got a couple of governance structures that work and sometimes don't work and sometimes conflict with each other. So it is a bit of an interesting dilemma."*CLIENT2-GM

The importance of clearly making the distinction between governance and management was also recognised

> *"Don't look in the rear vision mirror at us, we know what we're about. So stop micro-managing us, let us get on."*SUPPLIER3-CIO

Governance component	Requirements	Inter-organisational complications
Performance	Clarity	Competing
	Metrics	
Conformance	Capture all requirements	Different jurisdictions and requirements
	Structures and ethos	
	Change management	
Openness & Transparency	Warts and all	
	Multiple level	
Responsibility & accountability	Clear allocation	Hands off
	Remedies	
	Future	
Evaluation & monitoring	Regular	Who to sue
	Detailed	
	Independent	

Figure 3: Requirements for governance and potential inter-organisational complications

Evidence from interviews suggests that the components identified are relevant and together constitute a cohesive framework. As illustrated by Figure 3 the cases also both provide some details regarding the requirements of each governance component and identify some potential obstacles or complications for inter-organisational contexts. The elements of the governance framework are reported on individually below.

Performance

Clearly defining the objectives of the relationship and developing metrics for expected performance were seen as important.

> *"clear agreement on what are the outcomes that you're trying to deliver from the arrangement…getting the metrics on the table"* SUPPLIER2-GM
>
> *"control the strategic sort of direction.. through performance management"*SUPPLIER1-BDM
>
> *"for any partnership to work, there needs to be an impact, so there needs to be something that is measurable"*CLIENT2-GM

The difficulty though of ensuring that the metrics were objective or "real" and not open to manipulation was also acknowledged.

> *"Price is better than cost because it is more real .. costs you can change what you include or how you allocate. Prices are transparent and verifiable and benchmarkable"* SUPPLIER3-GM

Conformance

The importance of conforming with required obligations – such as regulation or legislation – was recognised along with the recognition that it is as much about putting in place an ethos of compliance, the principles for its management and the enabling – or enforcing – structures, as meeting specific, current requirements given that these are continuously changing and evolving.

> *"There's a big compliance burden now. .. need to pick up all the changes in legislation and making sure that we're implementing it through all of our policies and processes"* CLIENT3-GM
>
> *"Complex.. but work from the basis that compliance is critical and you have to put everything necessary in place to achieve it.. can not dictate though because too much variation and change"* CLIENT2-FD
>
> *"Made sure have the necessary compliance structures in place"*CLIENT1-SRM

The complexity was compounded when participants to an arrangement operated under different compliance regimes; with the principal difference remarked upon being between the public and private sectors.

> *"the complexity of these three different creatures coming together in a sort of fashion, with all these different tax requirements and legal reporting requirements and everything like that, really meant that we had to develop this very complex sort of structure"*SUPPLIER2-PD

Openness & transparency

It was recognised that for a relationship to work effectively it was necessary to ensure that information *flowed* around *all* the organisations involved.

> *"So from a communication perspective it's absolutely fundamentally critical that we maintain that communication across all of our stakeholder groups."* SUPPLIER2-PM
>
> *"warts and all and deal with the bullets"*CLIENT1-SRM

The emphasis was as on putting in place principles and structures that facilitated communications (while clearly understanding the role of that communication).

> *"Multiple forums and structures that facilitate communication between at different levels"*SUPPLIER2-PD
>
> *"you've really got to understand what it is that you're trying to achieve and that's got to be able to be articulated by both parties and more importantly, right down to the people who are delivering the service.. we have an open book policy right through the organisations and with clients"* SUPPLIER1-BDM

Responsibility & accountability

Interviewees commented on the need to clearly establish who does what within a service arrangement and ensure that they are held accountable for delivery to the agreed standard.

> *"Needed to establish contracting that makes it very clear who was responsible for what"*CLIENT2-GM

It was also emphasised that *clients* need to understand that they *retain a role* – that they can not simple hand over an activity to another – since there will remain dependencies and the provider will require support – for example the efficient and effective processing of a payroll depends in part upon the quality of the inputs received.

> *"Because to some degree, they might want to be more hands-off, because they don't want to take responsibility. You're the experts. You do it. You take responsibility for it"*SUPPLIER2-PD

Furthermore it was suggested that the arrangements needed to formally address what would be done when problems were identified.

> *"Have to be able to accommodate problems and disagreements without dragging everything to a screaming halt"*CLIENT3-GM

> *"Clear set of SLAs with very clear remedies"*CLIENT1-SRM

Finally interviewees argued that at the outset attention should be paid to how *future* developments would be accommodated to avoid potential problems emerging. For example, one interviewee commented that while issues relating to the *current* technology platform had been addressed – such as agreeing the quality of service to be provided and who was responsible – little attention had been paid to who had the authority to upgrade it.

> *"quite vague .. could in the future create problems.. I think the answer to that is, yes there will have to be discussion"* SUPPLIER2-PD

Evaluation & monitoring

Interviewees had put in place processes and structures that enabled them to monitor and evaluate current activities and *new* initiatives.

> *"We've got a quite stringent reporting system, probably more than most. We get quite in-depth reporting on a monthly basis about anything and everything."* SUPPLIER3-GM

> *"There is regular reporting put in place and there are triggers for review, escalations if there are issues"*SUPPLIER2-PM

> *"we have a process in place for us to look at new opportunities and decide if they can be accommodated within our current relationship"* SUPPLIER2-PD

The value of independent third party evaluation was also noted

> *"We get KPMG to come in and do an independent audit of our systems"* SUPPLIER3-GM

CONCLUSIONS

The results suggest that the current focus in the literature on *how* governance structures should be implemented, for example the degree of centralisation versus decentralisation, should be extended to give greater consideration to identifying the *principles* of governance. From a specifically inter-organisational perspective, the cases highlight both the importance of the governance of those relationships and the need to look beyond the construction of effective contracts. The cases also highlight the complexity of governance in an inter-organisational context – including the difficulty of constructing a governance structure where there are different perspectives and requirements and which may include the creation of a separate legal entity. Furthermore the research – through its inclusion of *activities* as well as technology – calls into question the historical restrictive emphasis on IT governance and suggests that perhaps the focus should be more broadly on *operational* governance – as compared to the financial governance that lies at the core of corporate governance.

Turning to the specific governance framework developed, this would appear to form a useful starting point for research in the area – with all of the interviewees accepting their relevance and significance of the principles and components. The fact that cases were constructed across a variety of sourcing arrangements also suggests that the basics of good governance may be somewhat generic.

The research conducted though clearly has a number of shortcomings that need to be rectified in future studies. All of the cases examined considered themselves to be successful. Only if unsuccessful cases are studied as well will it be possible to determine whether and how effective governance contributes to success. It is not possible from the current analysis to determine if the principles and components identified are necessary and sufficient – are all of them required? Are there others currently missing? The definitions used also need to be refined to remove the potential for overlap – is *openness and transparency* necessary as a separate element or should it be subsumed within *evaluation and monitoring*. Finally, identifying the principles for effective inter-organisational governance is only useful if it is then followed up with a guide as to how to put them into practice ie the research should supplement rather than replace that on implementation..

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