Managing IT Sourcing Relationships Using Service Level Agreements: A Relational Exchange Theory Approach

Jahyun Goo
State University of New York

Rajiv Kishore
State University of New York

Kichan Nam
Sogang University

Raghav Rao
State University of New York, Buffalo

Yong Song
State University of New York, Buffalo

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Jahyun Goo
State University of New York, Buffalo
jgoo@acsu.buffalo.edu

R. Kishore
State University of New York, Buffalo
rkishore@acsu.buffalo.edu

Kichan Nam
Sogang University
knam@ccs.sogang.ac.kr

H. R. Rao
State University of New York, Buffalo
mgmtrao@acsu.buffalo.edu

Yongil Song
State University of New York, Buffalo
yongsong@acsu.buffalo.edu

Abstract

This research-in-progress attempts to investigate how the relational elements in SLAs may potentially boost the success of sourcing relationships. The study provides insight into the development of relational governance through contractual governance over the course of a sourcing engagement, drawing upon relational exchange theory (RET). In particular, we wish to develop a set of possible guidelines that a firm can use to help cultivate an appropriate relationship with a service provider.

Keywords: IT sourcing, service level agreements (SLAs), relational exchange theory

Introduction

As organizations outsource more and more of their IT operations, the relationship between the service recipient (SR) and the external service provider (SP) becomes new strategic asset (DiRomualdo and Gurbaxani 1998). Outsourcing relationships demands the same care and attention to sound management principles and practices as needed for in-house operations. In other words, outsourced processes must be well managed, including provision for continuous improvements and constant innovation. As in marriages or friendships, however, not all sourcing relationships work well. The participants may find themselves wishing they had planned better. If a sourcing relationship is not crafted and managed well from the outset, it will fail to achieve the SR's desired results. As the overall relationship deteriorates the results will be higher costs, operational disruption and lost business opportunities (Goolsby 2002). This leads companies to seek costly alterations in their IT sourcing arrangements. For example, a survey by Input (Input 1999a) shows that several clients switch vendors or take the processes back in-house due to dissatisfaction with reactive services and difficulty in change management. These alterations are proven costly, difficult and time-consuming accompanied by various kinds of costs including termination fees, switching costs, reallocation costs, etc. This often leads to the dilemma that although many sourcing relationships face unacceptable problems, these relationships are not terminated due to the expenses and problems involved (Goolsby 2002). Thus, emphasis should be put on managing the sourcing relationship, nurturing a high level of trust and commitment during the course of the relationship so that the engagement will not end up in litigation or any other significant dissatisfaction. In order to cultivate favorable sourcing relationships, several researchers (Fitzgerald and Willcocks 1994; Saunders et al. 1997; Singleton et al. 1988) point out the importance of working out the details in advance of signing a contract so that both parties understand the goals, the responsibilities of each party, and how to handle difficult challenges together, thus drawing sourcing engagements toward a trusted-based partnerships. Therefore, it is important

for the SR to draw well-suited service level agreements (SLAs) that induce a high level of trust and commitment during the course of relationships, which will lead to the success of IT sourcing.

While the academic and popular press provide conjectures and anecdotal evidence concerning the importance of SLAs in IT sourcing (Fitzgerald and Willcocks 1994; Matlus and Brittain 2002; Singleton et al. 1988; Sturm et al. 2000), empirical studies that investigate the roles the SLAs play in the development of favorable SR-SP relationships through the exchanges over time is atypical. Most studies on IT sourcing have treated the sourcing relationship as a discrete transaction, based using Transaction Cost Economics as a framework (Ang and Straub 1998; Nam et al. 1996).

## Management of IT Sourcing Relationships and SLAs

The importance of interorganizational relationships (IORs) has been recognized by a number of disciplines, including economics (Lerner and Merges 1998), strategy (Das and Teng 1998), marketing (Achrol 1997), sociology (Uzzi 1996) and information systems (Clemons et al. 1993; Kauffman and Walden 2001). In IORs, contracts serve as more than simply a list of rules; they define the tone and the nature of the relationship (Hui and Beath 2002). Thus, the contract is an artifact designed to solve interorganizational relationship problems. In particular, as IT sourcing gained its popularity and acceptance, the contract that shaped the relationship between SR and SP arose as a centerpiece in the IT sourcing research and practices.

Practitioners often proclaimed that a key to managing sourcing relationships is the SLAs (Mingay and Govekar 2002). An SLA is defined as a formal written agreement developed jointly between SR and SP that specifies a specific product or service to be provided at a certain level required to meet business objectives (Singleton et al. 1988; Sturm et al. 2000). The SLAs help to establish common goals and provide better visibility of trends and performance through enhanced communication, which enable the SP to become proactive rather than reactive in helping SR solve its business problems (Singleton et al. 1988). Fitzgerald and Willcocks (Fitzgerald and Willcocks 1994) reveal that the SLAs should be well designed in order to reduce unexpected contingencies, possible cost increases, and opportunistic behavior of the service provider. However, the conventional use of SLAs for the sole purpose of measuring results will not pass muster in today's ever-changing and ever-competitive business environment (Maurer et al. 2000). The SLA process must go beyond mere measurement to include a methodology for the ongoing management of service levels, and for the continuous improvement of service activities, functions and processes (Sturm et al. 2000). For example, most of SLAs initiatives in the early 1990s failed because SLAs did not put much emphasis on the ongoing management of service level that was required to secure current, consistent, and reliable delivery of service as it progresses. For instance, Fitzgerald and Willcocks (Fitzgerald and Willcocks 1994) identified through a survey that while 82% of organizations operate SLAs, a rather surprising 78% do not include clauses in their SLAs for adapting to changing circumstances in the future. Thus, defining, implementing, monitoring and managing the levels of service, with the targets being documented in SLAs are a key driver of continuous improvement of the service being delivered. They are also a channel for continuous communication with the SP.

As is true of any other legal documents, however, it is not possible to spell out every rules and agreements in the SLAs. Incomplete contract (IC) theory (Grossman and Hart 1986), modeling firm behavior in the absence of contracts, gave rise to some forms of relationship that extended beyond the contractual binding. As information technology increases the importance of noncontractible investments by suppliers, such as quality, responsiveness, and innovation and when such investments are particularly important, commitment and trust will be a more credible governance mechanism (Bakos and Brynjolfsson 1993b). As a result, the most noticeable practice in IT sourcing is the emergence of partnerships, which can be characterized as a series of exchanges among entities without a definite endpoint (Lee and Kim 1999). However, according to Marcolin (Marcolin 2002), while many firms state that they are involved in a strategic partnership, they act like cozy working partners, not strategic business partners, which will only work when times are good. They are unlikely to survive when the SP's service declines in the later stage of the duration of the contract or when problems are encountered. Furthermore, Fitzgerald and Willcocks (Fitzgerald and Willcocks 1994) contended that the notion of partnership cannot be divorced from that of elements of the contract. This research observed the IT sourcing practices in the United Kingdom and found that for some organizations, partnership was indeed something more akin to the business definition of relationship, when elements of shared risk and reward were well-defined from the outset of the relationship (an incentive based contract).

A review of previous literatures hints at a way of building a partner relationship through contractual means. We argue that the basis for the higher level of business partner relationships in IT sourcing arrangements can be effectively developed through SLAs for the variety of reasons. i) With the growing trend towards virtual, net-liberated e-business sourcing, where both time-to-market and due diligence in a value chain are critical, organizations are sourcing their IT portfolios with the expectation of prompt

development of the partner relationship (Quinn 1999). This is particularly true when the exchange parties in the interfirm relationships, as is the case of IT sourcing, are forced to accelerate the evolutionary process of relationship development because they have limited time together (Lambe et al. 2000). With this in mind, the SR and SP seek a tool to guide and expedite the development of the relational attributes such as norm, trust, and commitment (Klepper 1995), and ii) Outsourcing relationships are not static relationships; they are rather likely to change and evolve over time due to changes in the external environment and in a clients' internal requirements (DiRomualdo and Gurbaxani 1998). While it is expected to be difficult to define expectations when writing SLAs due to the variety of circumstances in IT sourcing, it is particularly true that the upfront structuring of an sourcing relationship results in "seeds" from which flexibility and exchange relations can grow and value can be created (Bendor-Samuel 1999). When a challenge arises, it prompts the need for a deeper level of cooperation or collaboration through the parties' communication and involvement. Thus, the relationship can be restructured, and realigned with interests and trust (Goolsby 2002). Thus, the SLAs should be drawn in a way that addresses uncertainty by including some built-in flexibility in order to manage exchange relations over time. Therefore, we believe that drawing relational-based SLAs will help the partners not only expedite the development of relationship attributes but also offer enrichments, thus leading to high level of functional exchange in IT sourcing in particular.

Figure 1. A Conceptual Framework of the Development of Exchange Relationship through SLAs Based on Relational Exchange Theory
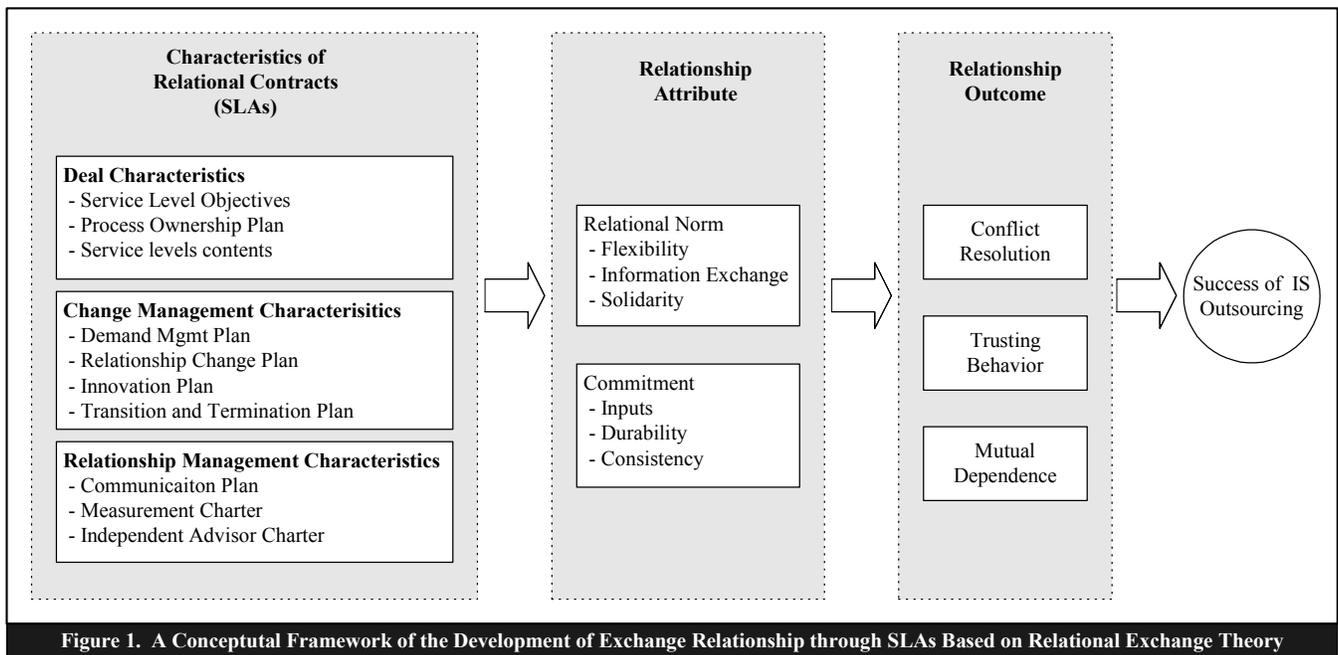
Research Framework

This study attempts to investigate how the relational elements in SLAs may boost the success of sourcing relationships, where the conceptual research framework under study is depicted in Figure 1. The study provides insight into the development of relational governance through contractual governance, drawing upon the relational exchange theory (RET) (Dwyer et al. 1987). We believe that relational contract elements aid in promoting the development of relationship attributes such as the relational norm and the commitment in the course of sourcing relationship. We assert that these psychological protocols should be cultivated as antecedents to engender appropriate behaviors in functional exchanges of a sourcing relationship. These behavior-based practices in turn lead to successful practices of IT sourcing.

In other words, *success of IT sourcing* is determined by relational behaviors including *conflict resolution*, *trusting behavior*, and *mutual dependence*. Those are led by two psychological states of the relationship attributes such as *relational norm*[1] and

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[1]Relational norms "are based on the expectation of mutuality of interest, essentially prescribing *stewardship* behavior, and are designed to enhance the wellbeing of the relationship as a whole" (Heide and John 1992). This will be captured through three sub constructs suggested by the prior literatures such as flexibility, information exchange, and solidarity.

commitment,[2] which can be cultivated through three parts of SLAs: *deal characteristics, change management characteristics, relationship management characteristics*, as described in Figure 1.

Characterization of Relational Elements in SLAs

We first identified 9 contractual elements or seeds that would help in fostering intended exchange relations in a short period of time and incorporate long-term, ongoing changes as well. In light of contractual issues in relational exchanges identified by Macneil (Macneil 1980), Table 1 summarizes the characteristics of those elements to see what different roles they might play within the context of discrete transactions or relational exchanges. These 9 elements are organized into three major parts/factors: deal, change management, and relationship management characteristics. These must become standard parts of SLAs in order to nurture the relational outcomes of SR/SP relationships. While it is impossible to create a robust contract that spells out all future contingencies, our conceptualization with 9 contract elements dramatizes the *multidimensionality* of exchange. In a real situation, more than 9 dimensions may be required. Clearly, the limited focus of our research reflects less than full consideration of the properties of exchange. However, the value of focusing on the these elements will be reflected by relationships that are more efficiently administered, are capable of creating relational norms in a shorter period of time, and are less likely to end in litigation or significant dissatisfaction.

Data Collection

Data is being collected through questionnaires using survey method. A list of IT professionals was obtained from the *Directory of Top Computer Executives* published by Applied Computer Research, Inc. After preliminary tests of the questionnaire and interviews with IT faculty to revise and finalize the questionnaire, 3000 questionnaires were sent to top IT managers or CIOs in the U.S and Canada.

Expected Contribution of this Study

This study adds value in two ways. First, we investigate an approach to structuring SLAs for building exchange relationships. We provide managers with a strategy and techniques for dealing with complex sourcing relationship problems. This is particularly relevant in the sense that many net-liberated sourcing practices today are currently strategic and long term, and require close interdependent relationships between the SR and SP. The study objective is to develop a set of guidelines that a firm can use to help cultivate appropriate relationship with a SP over the course of the sourcing engagement.

Second, this paper is among the earliest attempts to employ the lens of RET to examine how firms can build up a relational governance mechanism through SLAs in IT sourcing arrangements. A research model grounded on RET will be tested through hypotheses using the partial least squares (PLS) method. At the conference, we will present the detailed results based on the complete analyses of PLS and their theoretical and practical implications.

References

Available upon request.

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[2]Commitment refers to an implicit or explicit pledge of relational continuity between exchange partners (Bensaou and Venkatraman 1995; Morgan and Hunt 1994). Typically the notion of commitment connotes solidarity and cohesion, but these synonyms are vague (Dwyer et al. 1987). Here, we consider three measurable criteria of commitment: inputs, durability, and consistency proposed by Kumar et al. (1995).

Table 1. Characteristics of Contractual Elements in SLAs Derived from a Relational Exchange Perspective				
Characterisitics of Relational Contract (SLAs)	**Contractual Elements**	**Contractual Issues in RET**	**Relational Exchange**	**Discrete Transactions**
Deal Characteristics	Service Level Objectives	Contractual solidarity (regulation of exchange behavior to ensure performance)	Increased emphasis on legal and self-regulation; psychological satisfactions cause internal adjustments	Governed by social norms, rules, etiquette, and prospects for self-gain
	Process Ownership Plan	Number of parties (entities taking part in some aspect of the exchange process)	Often more than two parties involved in the process and governance of exchange	Two parties
	Service Level Contents	Obligations (three aspects: sources of content. sources of obligation. and specificity)	Content and sources of obligations are promises made in the relation plus customs and laws; obligations are customized. detailed, and administered within the relation	Content comes from offers and simple claims, obligations come from beliefs and customs (external enforcement), standardized obligations
Change Management Characteristics	Demand Mnagement Plan	Expectations for relations (especially concerned with conflicts of interest. the prospects of unity, and potential trouble)	Anticipated conflicts of interest and future trouble are counterbalanced by trust and efforts at unity	Conflicts of interest (goals) and little unity are expected, but no future trouble is anticipated because cash payment upon instantaneous performance precludes future interdependence
	Relationship Change Plan	Planning (the process and mechanisms for coping with change and conflicts)	Significant focus on the process of exchange; detailed planning for the future exchange within new environments and to satisfy changing goals; tacit and explicit assumptions abound	Primary focus on the substance of exchange; no future is anticipated
	Innovation Plan	Cooperation (especially joint efforts at performance and planning)	Joint efforts related to both performance and planning over time; adjustment over time is endemic	No joint efforts
		Division of benefits and burdens (the extent of sharing of benefits and burdens)	Likely to include some sharing of benefits and burdens and adjustments to both shared and parceled benefits and burdens over time	Sharp division of benefits and burdens into parcels; exclusive allocation to parties
Relationship Management Characteristics	Communication Plan	Primary personal relations (social interaction and communication)	Important personal, noneconomic satisfactions derived; both formal and informal communications are used	Minimal personal relationships; ritual-like communications predominate
	Measurement Charter	Measurement and specificity (calculation and reckoning of exchange)	Significant attention to measuring, specifying, and quantifying all aspects of performance, including psychic and future benefits	Little attention to measurement and specifications; performance is obvious
	Independent Advisor Charter	Power (the ability to impose one's on others)	Increased interdependence increases will the importance of judicious application of power in the exchange	Power may be exercised when promises are made until promises are executed

* Adapted from Macneil (1980) and Dwyer et al. (1987)