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Risks in offshore IT outsourcing: A service provider perspective

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KEYWORDS

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Client;
Outsourcing;
Relationship maturity

Summary Offshore outsourcing of Information Technology (IT) services is the prevalent practice in global businesses today. Despite the strategic advantages and cost benefits that offshore outsourcing offers, outsourcing relationships also involve risks, for both the client, as well as the service provider – a fact that is evidenced by the reported failures of such engagements. Some of the prior researches in this area have focused on identifying various types of client risks and their sources. However, the study of risks from a service provider's perspective has not received due treatment in literature. This study analyses offshore IT outsourcing risks from the perspective of service providers. A case based approach using the principles of grounded theory was used for studying the risks. Theoretical sampling was used to collect data from 5 mid-tier offshore third party service providers based in Bangalore, India. From our coding and analysis three broad categories of service provider risks emerged, namely, *macroeconomic*, *relationship specific* and *project specific*. Relationship maturity, nature of contract, nature of service or project and nature of client were identified as contextual factors which influence the degree of risk. © 2009 Elsevier Ltd. All rights reserved.

Introduction

Offshore outsourcing, popularly known as *offshoring*, is an important global strategy for most organizations today. Offshoring business functions outside the boundaries of the firm were originally envisaged as a cost based strategy. The economies of scale and scope coupled with labor arbitrage provided a convincing business case, especially for US organizations, to shift business processes to

offshore destinations like India (Ghemawat, 2007; Carmel and Agarwal, 2002). Offshore outsourcing is today growing and maturing from cost strategy perspectives to more value based partnerships. Partnership based contracts that have a network governance structure (Williamson, 1985) focus on the benefits of technology catalysis (Lee and Kim, 1999; Lee et al., 2003), which in turn strengthens resources and allows for flexibility in technology service.

The client side issues in outsourcing have been well researched. Transaction Cost Economics (TCE) (Coase, 1937; Williamson, 1985) provides a basic framework for

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understanding the client side rationale in outsourcing and also the behavioral dimensions of service providers that determine the transaction cost to clients. In addition, a wide array of theories from various perspectives, such as economic (economic efficiency and agency cost theories), strategic (resource-dependency, core competency and coordination theories) and social (political, social contract and exchange theories) have been applied to understand client side issues in outsourcing (Lee et al., 2003). These theories help in building a business case for outsourcing, predominantly from a client perspective. However, efforts in theory building that support service providers in the offshore outsourcing context have been scanty. Since the industry is still nascent and has been growing at a CAGR of 30% during 2001–2006 (NASSCOM, 2006), it is important to develop a clear conceptual understanding of service provider issues for sustaining its successful growth.

The growing opportunities in offshore outsourcing do entail a cost to clients and service providers. Outsourcing partnerships carry risks as evidenced by reported failures of such engagements (Prewitt, 2001; Andersen, 2002). The failure of an outsourcing contract affects both the clients and the service providers. In general, outsourcing contracts are designed on the basis of certain assumptions and hence carry inherent risks owing to a limited understanding about the future. As outsourcing engagements continue to evolve and become increasingly complex, their success will largely depend on understanding the risks involved, and in the deploying of effective mitigation strategies.

Offshore outsourcing in services could be classified into two major categories – IT outsourcing and Business Process Outsourcing (BPO). While the major service lines for IT outsourcing include Infrastructure Management Services (IMS), Application Development (AD) and Application Maintenance (AM); the less prevalent lines of service in outsourcing are consulting, R & D, etc. (Software, 2004; Beulen et al., 2005). BPO services consist of a number of service lines depending on the industry vertical; and can include a wide array of services starting from back end data processing and call centre operations to high valued services involving design and product development. Since offshore outsourcing risks for business processes and for technology services are vastly different, a combined study of offshoring risks would be ineffective. Hence, this study focuses only on the service provider risks aspect in offshore IT outsourcing.

Risks in offshore IT outsourcing engagements

Academic research has paid substantial attention to client side issues in IT outsourcing risks. Some early studies in this area have been anecdotal, providing management insights on IT outsourcing risks (Earl, 1996; Klepper and Jones, 1998 quoted in (Kern and Willcocks, 2001)). Following a case study method, Willcocks and Lacity (1999) analyzed IT outsourcing risks in insurance services. Further, Willcocks et al. (2000) studied the risks of IT outsourcing in the UK Defense Sector. These studies also outlined mitigation strategies for outsourcing firms. There are a few other case based studies in this area which generated insights for classification and

mitigation of IT outsourcing risks (Kern and Willcocks, 2001; Aubert et al., 2005). Kern and Willcocks (2001) developed a framework for IT outsourcing risk analysis with ‘relational due diligence’ in risk mitigation.

Firm level risks in IT outsourcing have also been studied using strategic theories. As per the theory of core competence, the outsourcing of key IT services outside of a firm’s boundaries could lead to depletion of strategic resources leading to loss of competence (Prahalad and Hamel, 1990), in addition to loss of control and flexibility. Therefore, based on the choices made, offshoring decisions on issues like IT service lines, location, partners, number of partners, contract type, etc., result in differing degrees of risks (Graf and Mudambi, 2005; Ge et al., 2004; Pandey and Bansal, 2003).

The economic theories that are most relevant to the study of IT outsourcing risks are Transaction Cost Economics (TCE) and Agency Theory (Williamson, 1985; Eisenhardt, 1989a). Based on the assumptions of bounded rationality and opportunism, prior research has identified shirking, poaching, and renegotiation as opportunistic vendor behavior (Clemons and Hitt, 1997; Aron et al., 2005). Shirking involves deliberate underperformance by the service provider, who still claims the full payment for the task as if the task has been performed according to contractual terms. The possibility of shirking exists because the behavior of the service provider cannot be monitored all the time and also because contracts are signed on the basis of limited available information and as such cannot cover all contingencies and future behaviors. Poaching is the illegitimate effort to make extra revenue by misusing the client’s critical business data. It may involve breach of trust that is detrimental to client’s business. This is a serious challenge in the context of offshore outsourcing where legal frameworks for data security and Intellectual Property Rights (IPR) are not well defined in the service provider’s country. A service provider may also outsmart the client by knowing the client’s IT services better than the client, thereby leading to a dependence asymmetry that is in favor of the service provider. This increases the bargaining power of the service provider which may in turn lead to demand of more money for the same work.

Service provider’s risks in IT outsourcing engagements

Academic research analyzing the issue of IT outsourcing from a service provider perspective has been scarce. We survey some prior work related to service providers here, though not all of them directly relate to risks. The empirical study of Harter et al. (2000) showed that process maturity of service provider firms reduces the cycle time and effort in software product development. This finding provides an additional incentive for the service providers to attain process maturity level certifications such as CMM; which in turn will be a value addition to the firm by increasing its attractiveness for clients seeking prospective offshore vendors (Davenport, 2005). Levina and Ross (2003) closely examined the role and value of a vendor (in this paper, *service provider’s*) in a long application management outsourcing engagement and found that the vendor was enticed to share

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