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The role of governance effectiveness in explaining IT outsourcing performance

Yong Jin Kim[a,*], Jong Man Lee[b,1], Chulmo Koo[c,2], Kichan Nam[d,3]

[a] Department of Global Service Management, Business School, Sogang University, Seoul 121-742, Republic of Korea
[b] Department of e-Business, Dongyang Mirae University, Seoul 152-714, Republic of Korea
[c] College of Hotel & Tourism Management, Kyung Hee University, Seoul 130-701, Republic of Korea
[d] Management Information Systems, Republic of Korea

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ABSTRACT

Recent studies on IT outsourcing have examined the effect of contract specification and relationship strength on IT outsourcing performance in a separate manner. Previous studies, however, ignored the importance of the governance effectiveness that bonds contractual control and relationship strength together to deliver expected outcomes in IT outsourcing exchange. In this paper, we propose a model of IT outsourcing management where governance effectiveness mediates the effect of both contractual control and relationship strength on IT outsourcing performance. We collected data from 143 client companies of IT outsourcing and analyzed it using the PLS method. Our findings show that both contract specification and relationship strength significantly influence governance effectiveness, although contract specification carries the more effect on governance effectiveness than relationship strength does. The governance effectiveness in turn mediates the effect of contract specification and relationship strength on three sub-dimensions of outsourcing performance: cost efficiency, performance improvement, and overall satisfaction. The results and implications are further discussed.

1. Introduction

As IT outsourcing phenomenon has been expanding during the last decade, securing the effectiveness of IT outsourcing becomes important due to its low success rate of 56% (Koh, Ang, & Straub, 2004). There are two fundamental ways to manage the outsourcing exchanges: contract specification (Brown & Magill, 1994; Sambamurthy & Zmud, 1999) and relationship strength (Ang & Beath, 1993; Grover, Cheon, & Teng, 1996; Kishore, Rao, Nam, Rajagopalan, & Chaudhury, 2003; Koh et al., 2004; Lacity & Hirschheim, 1993; Lacity & Willcocks, 1998; Lacity, Willcocks, & Feeny, 1995; Lee & Kim, 1999; Willcocks & Kern, 1998). Recent studies on IT governance emphasize the importance of employing both contract-based control (explicit control) and relationship strength (implicit control) to manage IT outsourcing relationships (Beulen et al., 2006) and examine the role of IT governance in the decision making processes of IT investment (Xue, Liang, & Boulton, 2008).

Although the previous literature provides some insight into the effect of contract-based control and relationship strength on IT outsourcing performance, it is silent about how the two ways are intertwined to generate the expected outcomes, i.e., performance. Moreover, most of the studies that encompass contract-based control and relationship strength have not been empirically tested (Goo, Kishore, Rao, & Nam, 2009). Previous studies also have regarded outsourcing performance as one dimensional construct that is supposed to consist of multiple dimensions including outsourcing satisfaction, cost efficiency, performance improvement (Grover et al., 1996; Koh et al., 2004; Lee, Miranda, & Kim, 2004).

To fill the gap, in this study, we propose the concept of 'governance effectiveness' in IT outsourcing as a variable mediating the effect of contract specification and relationship strength onto IT outsourcing performance. Governance effectiveness in this paper refers to the effectiveness of the practice institutionalized to reduce uncertainty and achieve better performance in the outsourcing exchange between IT service providers and customers (Oliver, 1991). We argue in this paper that successful IT outsourcing requires effective governance that facilitates IT decision making including priority setting for IT resources (Luftman, 1996; Sambamurthy & Zmud, 1999) and IT management and control (Heckman, 1999; Van Grembergen, 2002). This argument is in line with Goo et al.'s suggestion (2009) that a management mechanism including both contract and relationship is necessary for successful

* Corresponding author. Tel.: +82 2 705 8858; fax: +82 2 705 8519.
E-mail addresses: yongjkim@sogang.ac.kr (Y.J. Kim), jmlee@dongyang.ac.kr (J.M. Lee), helmetgu@khu.ac.kr (C. Koo), knam@ccs.sogang.ac.kr (K. Nam).
[1] Tel.: +82 2 2610 1951; fax: +82 2 2610 1701.
[2] Tel.: +82 2 961 2349; fax: +82 2 964 2537.
[3] Tel.: +82 2 795 9903/10 4600 8710.

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IT outsourcing by providing control and flexibility in managing the exchange.

2. Literature review

2.1. Governance in IT outsourcing context

In the information technology area, many studies have investigated the effect of governance on the performance of IT organizations from the perspective of control and coordination (Mani, Barua, & Whinston, 2010), structure and process (Korac-Kakabadse & Kakabadse, 2001), governance mode (Brown, 1997; Sambamurthy & Zmud, 2000), alignment with corporate policy (Cox, 2005; Pollalis, 2003), behavioral perspectives including culture (Van der Heijden, 2001), and strategic selection of control mechanisms (Van Grembergen, 2002). These studies focus on the governance as the patterns of authority for IT related management activities within an organization (Sambamurthy & Zmud, 1999; Weill & Ross, 2004). They emphasize that to be effective, governance needs to be structured in ways of allowing unique value delivery, optimal resource allocation, risk management, and performance measurement (Ali & Green, 2007; Peterson, 2004; Rau, 2004; Sambamurthy & Zmud, 1999).

Some of these concepts of governance can be applied to the IT outsourcing context. However, in the IT outsourcing situation, the focus of the governance is on managing the relationship between outsourcers and outsourcees, not the internal relationship. Hence, necessary is to understand governance as a structure or mechanism for managing exchange relationship between participating parties in ways of keeping the integrity of transactions (Williamson, 1979). This concept of governance has been addressed by many studies ranging from business strategy (Barney, 1997; Pfeffer & Salancik, 1978; Porter, 1980; Thompson, 1967) to economics and finance (Fama & Jensen, 1983; Williamson, 1985) to organizational governance (DiMaggio & Powell, 1983; Zucker, 1987).

These studies relying on transaction cost theory, resource dependence theory or institutional theories indicate in common that governance is a multidimensional phenomenon to manage exchange relationships between a set of parties. Transaction cost theory proposes three structural forms of governance of market, hierarchy, and hybrid to manage the risks involved in exchange (Nooteboom, Berger, & Noorderhaven, 1997; Williamson, 1979). Although it provides useful information about the government structure, transaction theory does not explain how the structure forms. Resource dependence theory posits that to reduce uncertainty and dependence on other organizations in securing necessary resources, organizations often build and try to control alliances with other organizations which provide the resources (Hillman, Withers, & Collins, 2009; Oliver, 1991; Pfeffer & Salancik, 1978). Institutional theories explain that under the institutional pressure, organizations build and institutionalize governance structure as a pattern of activities to cope with it and survive by obtaining legitimacy (DiMaggio & Powell, 1983; Zucker, 1987). Although the foci of resource dependence theory and Institutional theories are slightly different in the motives of organizational behavior (a reproduction of routines in institutional theories vs. the achievement of resources and reduction of environmental uncertainty in resource dependence theory (Oliver, 1991)), both theories imply that organizations try to attain stability and legitimacy (DiMaggio & Powell, 1983; Pfeffer & Salancik, 1978; Zucker, 1987). Applying these concepts to the IT outsourcing context gives rise to the concept of governance as a practice or a set of activities institutionalized to reduce uncertainty and achieve better performance in the outsourcing relationship between IT service providers and outsourcers. This practice can improve the performance of the participating organizations (Grover & Ramanlal, 1999; Oliver, 1991) and over time evolve to cope with changes in the environment (Nooteboom et al., 1997; Zucker, 1987).

IT outsourcing is referred to as "the use of external agencies to process, manage, or maintain internal data and to provide information-related services including significant transfer of assets, leases, and staff to a vendor" (Smith, Mitra, & Narasimhan, 1998, p.62). To make IT outsourcing exchange productive, companies basically need to establish effective governance for the interorganizational transactions (Sambamurthy & Zmud, 1999). In this paper, we define governance effectiveness as the extent to which companies participating in IT outsourcing exchange set up patterns of activities in an effective manner to deliver the value of IT outsourcing (LaBelle & Nyce, 1987) and improve performance (Rau, 2004). The structured patterns of activities for dealing with interorganizational transactions, i.e., governance, are negotiated under and shaped by pressure exerted through social relations and contracts (Zucker, 1987). The effectively structured governance allows firms to deal with the issues arising during IT outsourcing transactions (Lacity et al., 1995).

2.2. Contract specification

In IT outsourcing practices, contracts as formal control specify processes, procedures, service level, and performance measurement for achieving foreseeable outcomes (Ang & Beath, 1993; Koh et al., 2004; Lacity & Hirschheim, 1993). In general, the complexity of contract may increase when the contract size is large and asset specificity is high. As a contract becomes more complex, it needs to include more detail specification of promises, obligations, and processes for dispute resolution (Poppo & Zenger, 2002).

The contract in this sense works as a precursor for shaping a control mechanism through which one party influences the behavior of the others in the form of mutual obligations between clients and service providers to achieve the goals of outsourcing exchange (Das & Teng, 1998; Koh et al., 2004; Lacity et al., 1995). The contract in IT outsourcing is frequently specified in the form of Service Level Agreement (Kern & Willcocks, 2002). A Service Level Agreement is a formal written agreement, often developed jointly by a service recipient and a service provider, which specifies in detail the exchanges of services and/or products, financial matters, service enforcement and monitoring methods, communication and information exchanges, and key personnel and dispute resolution procedures (Halvey & Murphy, 1995; Kern & Willcocks, 2002). Even though it is important for contracts to be specified, every single piece of exchange terms cannot be identified to be included in the contract. Hence, to solve the problem of misaligned incentives due to imperfect information, organizations need to establish governance mechanisms based on the contracts (Busco, Elena, Angelo, Mark, & Robert, 2006).

2.3. Relationship strength

Relationship strength refers to the quality of partnership where the parties involving exchanges share mutual beliefs and expectations regarding their responsibilities and obligations in outsourcing relationships (Ang & Beath, 1993; Grover et al., 1996; Koh et al., 2004; Lee et al., 2004). Previous studies on relationship strength focus on trust of four types: calculus-based, knowledge-based, identification-based, and performance-based trust and insist that relationship strength affects outsourcing performance (Lacity, Khana, & Willcocks, 2009). Trust and trusting behavior acting on trust to solve problems in reciprocal exchanges facilitate the fulfillment of obligations when contract alone is unable to resolve complex problems (Jeffries & Reed, 2000).