

Writing the Optimal Outsourcing Agreement

This white paper is based on research conducted by Professors Vijay Gurbaxani and David Fitoussi at the Center for Research on Information Technology and Organizations at the Paul Merage School of Business, University of California, Irvine. A copy of the full research report is available at <http://www.crito.uci.edu/projectsMIS04papers.asp>

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Outsourcing has long been used as a way for organizations to focus on their core competency and to benefit from a partner's specialization. In fact, the use of outsourcing to lower cost, improve quality, increase business performance and/or even as a means to restructure continues to be on the rise, particularly in the current tough economic climate. However, the practice remains far from perfect and often looks more like art than science. So while the use of outsourcing for all types of functions continues to grow, the results have sometimes been mixed. Better use of measurements to incentivize suppliers can certainly aid in the process.

Based on recent research by David Fitoussi and Vijay Gurbaxani at the University of California Irvine Paul Merage School of Business, there is a decided lack of guidance on how best to design IT outsourcing contracts that actually encourage and reward good supplier performance. This is particularly true when outsourcing arrangements call for the delivery of multiple objectives, as most do.

In a typical outsourcing contract, we would expect the performance metrics (or SLAs – service level agreements) to tie back to organizational goals. Surprisingly, this isn't always the case. In some instances, goals are poorly defined. In other cases, successful delivery is subject to a large number of variables being outside the supplier's control. Even more troublesome is that many contracts often contain intangible, hard-to-measure goals, for which the individual performance metrics may or may not be linked in any meaningful fashion to overall organizational objectives. And in some cases, individual goals even conflict with one another.

Clearly, most successful outsourcing relationships require multiple measurement criteria. But what are the costs and benefits of imperfect performance metrics? There are few real-world studies of performance incentives in multi-faceted, multidimensional contracts to help us answer this question.

Enter Fitoussi and Gurbaxani. The two professors examined how objectives, performance metrics and performance are related in outsourcing arrangements with multiple goals, using data from 55 IT outsourcing contracts gathered through a survey of 42 firms in 2005. The sample consisted of companies that have outsourced IT services for at least one year, and included data on the contracted work, the objectives, the performance metrics used in the contract and, most importantly, the degree to which the outsourcing relationship was successful.

The survey consisted of companies from a variety of industry sectors including services, manufacturing, pharmaceuticals, biotech, aerospace and energy from the U.S., Europe and Canada. All the respondents were senior IT executives.

They first reviewed previous research into contracts and incentives, and found that often there is a mismatch between the two. Let's look at a few examples.

Mutual fund managers have incentives to maximize the inflow of investments. They want the size of the mutual fund to grow so that they have more assets under management, plain and simple. Clients, on the other hand, want to maximize risk-adjusted returns, which has little to do and may even conflict with how many other investors have chosen a particular mutual fund. Another study found that the use of sales quotas tied to the end of fiscal years pushed salespeople to close deals just before the end of the year, which often resulted in a slump in sales afterward, at the start of the new fiscal year.

In the context of government services, mismatched goals can be seen in job retraining programs which reward suppliers on the basis of the placement of trainees into jobs. The focus on this single measurement can result in cream-skimming and targeted enrollment of higher-ability individuals who are easier to place into new jobs or careers.

However, in other cases, the right incentives can be very effective. A study of a manufacturing firm concluded that incentive pay leads to higher productivity, a higher-qualified workforce and higher profits. Taken together, these studies highlight the critical link between incentives and contractual outcomes, as well as the important costs and distortions that come with setting up the wrong incentives.

In addition, one under-appreciated issue managers face when developing incentives has to do with establishing performance metrics for the more intangible objectives in a deal. In many cases, there are no metrics that have been readily defined, or no mechanisms in place for tracking them. Perhaps not surprisingly, because of these challenging measurement issues, there isn't a lot of real-world research available on the topic.

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For many outsourcing contracts, key goals consist of lowering costs and improving quality. These can be expanded to such specific goals as reducing IT costs, reducing overall business costs, improving business performance or increasing customer satisfaction.

In the Fitoussi and Gurbaxani study, some of the metrics that were used to track organizational objectives were relatively easy to measure, such as reducing IT costs. Others objectives such as improving IT quality were more difficult. The impact of this range on the ability to quantify SLAs was of key interest to the researchers. In particular, their analysis focused on contracts that contained multiple or even potentially conflicting components that could in turn reduce the effectiveness of the outsourcing arrangement. This is a timely question, because these types of complex outsourcing arrangements are not unusual, and in fact have become increasingly common over the years.

So, what causes organizations to get into trouble with regard to their metrics? Problems arise when too many measurements are used, based largely on the relative ease of measurement. In the process, other important, but difficult-to-measure objectives are often left out of contracts. This regularly results in poor outcomes for outsourcing relationships.

A company really has only three fundamental options when some objectives are measurable and others less so. They can measure those that are easy to define and ignore those that aren't; they can choose to measure very little; or they can measure precisely those that are easy to measure and develop multiple imperfect measures for the more intangible goals. In the first scenario, a likely outcome is that the intangible goals will not be met. One sees this a lot in practice. A vendor meets or exceeds all SLAs, but the client is still unsatisfied. In the second, there is an increased likelihood that the vendor may under-perform broadly. In the third scenario, the vendor will divert attention away from the measurable objectives to the less measurable ones, reducing performance on the measurable objectives, but improving performance on the intangible objectives.

It is particularly important to note that whether or not one should use good available metrics for a measurable objective depends on the presence of other less-measurable objectives.

Consequently, it is important for managers to include a well-balanced mix of measures for their objectives. These objectives should span the range of easily measurable things such as IT costs, to more-difficult-to-measure objectives such as IT quality or customer satisfaction. The exact choice depends on the overall set of objectives that the client has.

While such an approach may seem logical or intuitive, the reality for managers and executives is not always appealing. Focusing on a finite number of measures means that there will often be trade-offs in an outsourcing relationship. Many managers operate under the assumption that more measurements are better than fewer. So the temptation is to load up on as many SLAs and other measurements as possible. But if you think about it, organizations can spend a lot of time measuring all sort of things, including many items which are irrelevant. Indeed, the research shows that when too many metrics are tracked, the cost of measurement goes up and, at the same time, performance can actually decrease.

What happens in these cases is that the metrics incentivize the vendor to expend effort to meet or exceed agreed-upon levels. This may mean, and in practice often does, that a vendor focuses excessive attention on what is measured, and insufficient attention on objectives that may be more important but are unmeasured. The result is that it takes both client and vendor effort away from more-important issues.

In a sense, there is a real cost to including tangible and intangible objectives in a contract. Managers either need to deliberately refrain from measuring what they can measure ("less is more") or overload the contract with metrics aimed at improving what they can't measure well. Most will choose the latter but, as the authors show, the results are not necessarily better.

An insurance company once developed 8,000 IT metrics to track service levels – clearly a situation where measurement mania had gotten out of control. In such cases, so many measurements were not only unnecessarily expensive, but they also spread the supplier's efforts to serve the client too thinly. This makes it impossible for the vendor to see the forest for the trees. Simply put, when everything is a priority, then nothing is.

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That the research by Fitoussi and Gurbaxani suggests measurement costs increase with too many metrics, while performance actually goes down is a key finding – yet it is only half the story. Of equal importance is that it's also often difficult and expensive to attach a number or a metric to any particular subjective objective, so care should be taken when doing so. One approach is to use multiple metrics for these hard-to-measure objectives. Counterintuitively, the purpose of including multiple imperfect measures for intangible objectives is not just to direct some attention to these intangible goals; it is also to divert excessive attention and effort away from the measurable objectives when they are in conflict. Focusing a vendor on cost reduction when the real value lies in innovation is counterproductive. So as a client, you should want to reduce the emphasis on cost reduction by balancing it with incentives, imperfect as they may be, for innovation.

It is really, really important to take a holistic approach to the arrangement. Think of all the objectives that are intended to be achieved. Recognize the measurement costs and the incentives that each SLA creates for the vendor. Then take a balanced approach to performance measurement. By doing so, the likelihood of success is increased greatly.

Good managers will want to make sure that the right things are being tracked – things that are systematic and repeatable. For one-off cases or hard-to-forecast events, the quality of the outsourcing relationship is probably more important than trying to identify each and every applicable metric that could be put into a contract. Look for a provider that is flexible and willing to adjust as business conditions invariably change over the life of the contract.

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