

Chapter 11

Sourcing Strategies and Theories

ABSTRACT

This chapter describes the fundamental principles and the underlying theories of sourcing strategies. The authors describe a preliminary service-dominant logic model of outsourcing service using the sourcing theories for successful outsourcing in conjunction with a framework for sourcing innovation. The authors conclude the chapter with a review of some case examples of sourcing strategies.

INTRODUCTION

Building on the basic principles of outsourcing from the previous chapter, this chapter describes the fundamental principles and the underlying theories of sourcing strategies. The authors use the theories to help managers identify, based on their business strategy, what to outsource and how to succeed in outsourcing. To make the chapter useful for practitioners, they also describe the analytical frameworks for identifying and evaluating sourcing options or alternatives, the dimensions and performance measures of sourcing strategies, as well as the sourcing decision process.

Sourcing strategies must be congruent with the firm's strategy and innovation goals. The chapter describes transformational outsourcing and global or offshore outsourcing of IT and business processes and how they are being used by some firms as a vehicle for enabling business and service innovation. To that end, the authors describe a preliminary service-dominant logic model of outsourcing service using the sourcing

theories for successful outsourcing in conjunction with a framework for sourcing innovation developed by Weeks and Feeny (2008).

The authors conclude the chapter with a review of some case examples of sourcing strategies.

DISTINCTIVE NATURE OF IT SOURCING

IT is not just another resource that should be managed like any other resource. Before entering outsourcing strategy, there is a need to stand back and carefully consider the specifics of any IT we put forward as an outsourcing candidate. Lacity and Willcocks (2001) identified the following five characteristics that represent the distinctive nature of IT sourcing decisions:

1. IT is not a homogeneous function, but comprises a wide variety of IT activities. Some IT applications uniquely enable business operations and management processes. Other IT

activities, such as accounting systems, may appear less critical, but closer scrutiny often reveals that the value of such systems lies in the cross-functional integration of business processes. Outsourcing such activities can hinder business performance because suppliers lack an understanding of the implications IT has on other business processes.

2. IT capabilities continue to evolve at a dizzying pace; thus, predicting IT needs past a three-year horizon is wrought with uncertainty. Although companies initially perceive that suppliers will provide access to new technologies, mega-deals are usually contracted around current technologies with only vague reference to future technologies. Most companies find that by the third year into an outsourcing deal, the original contract actually hinders their adoption of new technologies.
3. There is no simple basis for gauging the economics of IT activity. Although price/performance improvements occur in every industry, in few industries do the underlying economics shift as fast as IT. A unit of processing power that costs one million dollars in 1965 costs less than twenty thousand dollars today. Today's computer resources may well cost ten percent less next year. The rapid change in the underlying economics makes it extremely difficult for senior executives to evaluate the long-term costs of outsourcing. While a twenty percent reduction of current IT costs for the next ten years may be appealing to a senior executive today, a few years into the contract he or she may be paying the supplier above-market prices for computer resources. The economics of desktop computing, in particular, change quickly and many managers have been reluctant to lock themselves into a fixed-price outsourcing arrangement. On the other hand, the price of IT skills will continue to be volatile, and in areas of high demand and shortage, escalate, sometimes

quite unpredictably. Staying alive to these switches remains a key skill for client and suppliers alike. Otherwise, profit margins for the supplier can erode quickly; and declining service to the client may be a consequence.

4. Economic efficiency has more to do with IT practices than inherent economies of scale. Although there are indeed economies of scale in some aspects of IT, they occur at a size achievable by many medium-sized and most large-sized companies. Therefore, supplier bids are based more on improvements in management practices than inherent economies of scale. For example, suppliers may cut costs through charge out mechanisms that motivate business users to manage demand, by consolidating datacenters from multiple sites to one site, or by standardizing software.
5. Most distinctively of all, large switching costs are associated with IT sourcing decisions. In most areas of business operations, management can protect itself against poor sourcing decisions in a number of ways—by dual sourcing of component supply or annual contract reviews of an advertising agency. These techniques are often inapplicable or ineffective for IT outsourcing, particularly when a total outsourcing approach is taken.

Thus, there is a need to make these characteristics of IT visible as sourcing decision has many options. They may not change the decision, but they might play a role deciding what to outsource, for how long, to whom, and how to build the relationship with the vendor.

SOURCING ALTERNATIVES

Companies outsource IT for many reasons, ranging from its high profile and current popularity to cost pressures from competition and economic recession. However, industry watchers attribute the growth of the IT outsourcing market to two main phenomena. First, the interest in IT

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