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**www.emeraldinsight.com/0025-1747.htm**



Received January 2007
Revised May 2007
Accepted May 2007

CURRENT RESEARCH DEVELOPMENT

# Defining the most desirable outsourcing contract between customer and vendor

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## Abstract

**Purpose** – The purpose of this work is to identify commonalities that exist within the contracts between customer and vendor companies, the nature of the problems commonly associated with these contracts, and to provide a theoretical model that exists between customer and vendor companies.

**Design/methodology/approach** – This research uses multiple sources of previous research to isolate the key elements and form a theoretical model for the ideal outsourcing contract. The common problems identified were also derived from previous research.

**Findings** – The paper finds that there is a common set of key contractual elements that exist between most outsourcing contracts. The nature of the particular industry the companies exist within and the specific needs within each customer-vendor relationship can be accommodated within the contract by tailoring these key elements to fit each scenario. A set of common problems may arise when any of the key elements are not sufficiently addressed. These problems can greatly devalue the customer-vendor relationship and supply chain as a whole.

**Research limitations/implications** – Future research should examine the theoretical model presented within the context of various industries. Each of the key elements presented and its implications for the customer-vendor relationship should also be further examined.

**Practical implications** – This research may provide a better understanding of the importance of the outsourcing contract to the customer-vendor relationship and/or the contract itself for management.

**Originality/value** – Previous research has not fully addressed the nature of the outsourcing contract and its associated problems. Where this research attempts to identify all key elements of the contract, previous research usually addresses a single contractual element at a time. There has also been little research that discusses the problems that commonly arise within the contractual relationship. The theoretical model within this research may be useful.

**Keywords** Supply chain management, Outsourcing, Contracts, Performance management

**Paper type** Literature review

## Introduction

Outsourcing is a widely covered topic within management research, as are various topics relating relationship management and the legal environment for business. Despite the impact of such issues on today's companies, research on the interconnection between these topics and outsourcing is scant. Consequently, it is important for "companies [to plan the creation of the contract] effectively if they are to maximize the benefits and minimize the risks of outsourcing" (*International Journal of Productivity and Performance Management*, 2004). Zhu *et al.* (2001) indicated

Management Decision
Vol. 45 No. 10, 2007
pp. 1656-1666
© Emerald Group Publishing Limited
0025-1747
DOI 10.1108/00251740710838013

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outsourcing "[to be] contract intensive in nature" and that a "successful outsourcing process [relies upon] a good contract". This implies a need to further investigate the role of the contract and contractual requirements. Filling this void in the literature is one of the main goals for this paper.

Research suggests that most problems within the supply chain can be attributed to a poorly designed or weak contract. Therefore, "the key thing up front is to make sure the [customer] company's goals and objectives are clear" (*Community Banker*, 2003) for the working relationship, and are discussed during the negotiation process. This paper focuses on the resulting contract and is the first part of a comprehensive research program aimed at developing an open frame model for the analysis of outsourcing contracts. Current literature suggests that a tight contract can protect a customer company from a conflict of interests, provide structure for the relationship at hand, and ultimately minimize the risk of failure for both partners Unfortunately, due to the complexities of the involvement of multiple legal bodies, conflicting motivational factors, and time, contracts are not foolproof and can be very risky in the long run. The breakdown of a customer-vendor contract is often detrimental to the customer-vendor relationship.

To address complexities of an outsourcing contract and develop a successful contract for all parties involved, several topics should be investigated to generate an open frame model. Some of these topics include literature on:

- procurement practices and procurement contracts;
- make versus buy decisions;
- outsourcing as a form of collaboration;
- shared services as a form of outsourcing; and
- relationship management as it pertains to the customer and vendor.

These topics are all interrelated to the contract in that they pertain to the initial decision making a company goes through prior to outsourcing and determining the nature of the customer-vendor relationship. Procurement practices address why and how a company will enter into customer-vendor relationships, and the procurement practices are driven by value-based decision making. Likewise, decisions based on company's need and industry's need will drive what type of procurement companies use (direct or indirect), and ultimately the nature of the contract. Make versus buy decisions are typically made regarding manufacturing and direct procurement decisions, but also make versus buy decisions entail analysis as to whether or not to outsource.

Once the decision to outsource is made, the form of outsourcing tends to be defined by the industry type – service or manufacturing. Nonetheless, regardless of the industry type, deciding to outsource as a form of collaboration typically involves companies within the service industry and provides a mutual benefit to the customer and vendor. Additionally, shared services with regards to the secondary functions of a business, such as human resources (HR) or accounting, can also be outsourced. The types of decisions within each of these variations of outsourcing have an effect on the method of procurement the respective company uses and the resulting contract. The methods of relationship management will also vary based on a company's need and resulting procurement practices. The amount of control a company is willing to

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relinquish, the level of trust between customer and vendor, and the level of mutuality within the relationship will also dictate the nature of the contract. By further researching these topics, a better framework can be developed to address contractual components more specifically and to include a variety of industries.

Research thus far has resulted in a much broader framework as it applies to contracts. In this paper, the objective is to show that the contract is central to the customer-vendor relationship and to identify the key, also standard, elements of the outsourcing contract that are necessary for the success of the customer-vendor relationship. These key elements are presented in this research as a theoretical model with four major functions: performance, financial, human resource, and legal. Some preliminary research identified that as a minimum the contract should include "outsourcing functional requirements and terms dictating vendor evaluation requirements" with clear objectives for quality and effectiveness (Power *et al.*, 2004). The customer company must examine if a transfer of assets is necessary, this includes licenses, equipment, subcontracts, and hidden costs before these terms can be decided upon. The ownership of intellectual property rights is also commonly transferred and is usually attached to the transfer of technologies between the parties. Pricing and payment terms are also necessary in the contract. "Life-cycle-costing" or "activity-based costing" techniques will enable the companies to build a comprehensive and accurate picture of what services cost under the proposed model (Flynn, 1999) while profit-based pricing helps to ensure quality, with profit as a function of both parties. Also in discussing costs, the contract should clarify "how much and what kind of staff is required, the resulting training, outplacement and hiring implications, and how the transition will occur from old to new" (Flynn, 1999), or simply terms for the transfer of staff. Aside from terms for expectations and costs, the contract should also define the legalities of the relationship such as method of dispute resolution, rules for confidentiality, and intellectual property (IP) rights.

The remainder of the paper will be organized into four sections, each discussing the key elements of the outsourcing contract in terms of the performance, financial, HR, and legal functions of the customer-vendor relationship. A proposed theoretical model further addresses the key elements of the outsourcing contract and expands upon them by providing the associated problems that may arise if any of the key elements are overlooked. Conclusions and future research are outlined.

## Key elements of the customer-vendor outsourcing contract

Having an established contractual framework before entering the customer-vendor relationship is essential. It is not acceptable to formulate any contractual agreements after entering this relationship or in retrospect. The contract governing the outsourcing relationship can be the most important hedge against misunderstandings and disappointments; therefore the more specific the outsourcing contract is between customer and vendor companies, the more likely the relationship will be beneficial to both parties (*The Journal of Business Strategy*, 1997). When formulating the outsourcing contract, the companies involved must decide on the best form of contract that can ensure performance, value, and return on the prospective investment. Regardless of what type of contract developed between customer and vendor companies, outsourcing contracts should always address the standard terms with respect to creating value from immediate and ongoing operations. The challenge in

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creating the contract is to pick the approach that will achieve optimum contract value over the long run (Davis, 2004). The key elements for the outsourcing contract are classified as performance elements, financial elements, human resource elements, and legal elements. These key elements are all indicators of a successful customer-vendor relationship. The proposed theoretical model is summarized in Table I, and addresses these key elements by highlighting their importance and implications of each key element if missteps in the construction of the outsourcing contract take place.

## Key elements for performance

### *Service levels and quality*

It is essential that the customer company fully disclose its expectations for quality and service levels, and means for measuring performance within the outsourcing contract. The outsourcing contract must contain a detailed description of all expectations of vendor performance since service levels for in-house functions are commonly used as the benchmark for outsourced functions. Contracts that encourage vendor performance and discourage underperformance are therefore clearly of interest to managers (Kweku-Muata and Sullivan, 2003). It is not enough for the vendor company to simply perform the functions it has been contracted to do; it must perform them up to appropriate predetermined standards. Although technical mastery is an important prerequisite, it is not useful, if it does not translate into business advantage (Kweku-Muata and Sullivan, 2003). Predetermined performance standards should focus on achievement of minimum standards with an emphasis on maximizing profits while defining details of quality, quantity, timing, and method of delivery of the corresponding inputs and outputs required from both parties to support the outsourced process (Sadler, 2002). Components of information quality, such as response time, accuracy of data, reliability, and quality of support services should all be defined according to the function being outsourced.

### *Performance incentives and penalties*

Rewarding the vendor company within the terms of the service level agreement can be a difficult task but as a minimum should be linked to measurements that truly test the quality, conformity, responsiveness, and reliability of the vendor company's performance (Sadler, 2002). There are many approaches to establishing incentives and reward levels. It is up to the customer company to determine how quality and service levels will be measured. Turn-around time, buyer satisfaction, number of defective goods can all provide simple measurements for quality and service levels. Regardless of the performance metrics and incentives structure the outsourcing contract dictates, the contract should clearly defined performance objectives and methods for determining rewards that are desirable for both companies involved. While incentives are important to the preservation of quality standards, a company that consistently underperforms must also face penalties. Without penalties for underperformance structured into the outsourcing contract, it is very possible that the vendor company could settle for mediocre performance with little regard for the incentives.

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| Function | Key element | Associated problems |
|---|---|---|
| Performance | Standards for quality and service levels | Company objectives unmet<br>Purpose and nature of relationship may be unclear<br>Increase in costs to implement corrective measures<br>Dissatisfied end-users |
| | Performance incentives and penalties | Companies involved settle for mediocrity in their performance and/or output<br>No real value gained by either company<br>Could foster consistent underperformance |
| | Communication and confidentiality | Misguided management decisions<br>Bullwhip effect<br>Increased costs for corrective measures or legal action<br>Sharing of trade secrets and proprietary information<br>Weakened competitive advantage |
| Financial | Costing and pricing | Over- or under-spending within the budget or cost cycle<br>Costs inaccurately assigned<br>Pricing inaccurately derived from costs<br>Overpayment by customer or end-user for product or service<br>Lower profit margins |
| Human resource | Transfer of staff | Low morale of current employees<br>Underperformance of employees<br>Insufficient number of new hires and amount of hire training<br>Increase in costs for corrective measures |
| Legal | Transfer of assets, includes IP | Access to new technologies or processes not fully utilized<br>Insufficient budgeting to cover costs of transfer<br>Loss of revenue and competitive advantage<br>Increased costs |
| | Warranty and liability | Discrepancies in expected and actual quality of product<br>Fraudulent practices in offering warranty<br>Huge spending in settlement between customer and vendor companies or the companies and the end-users |
| | Terms for disengaging | Loss of profit and increased costs by being "stuck" in contract<br>Missed opportunity for growth<br>Loss of market share<br>Cyclical problem cycle of underperformance and overspending plagues companies<br>Missed opportunity for growth |
| | Method of dispute resolution | Deterioration of business relationship<br>Unnecessary cost of legal fess and settlement<br>Unclear path towards settling dispute |

**Table I.**
Key elements of the outsourcing contract

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*Communication and confidentiality*

The effective communication of information is a great obstacle within the customer-vendor relationship. The outsourcing contract should create a communication infrastructure that creates channels of communications and the direction of communications, lists methods of communications, and details appropriate subjects and information to be communicated between staff, companies, etc. The bullwhip effect commonly plagues many supply chains. It is a breakdown between levels of communication that create discrepancies within the vendors' information and distorts the forecasted level of customer demand, often leading to extra spending and over- or under-production by supply chain functions.

## Key financial elements

*Costing and pricing*

Outsourcing contracts should be designed to handle most cost accounting systems, pending the contracts are performed to completion. The major hurdle in constructing the costing portion of the outsourcing contract is establishing which costs are direct and which are indirect, with direct costs being charged directly to the contract and indirect costs put into cost pools to be allocated in the future (Worthington, 1992). Initial costs such as training, initial rearrangement depending on the outsourcing relationship, production planning, modifications, and new purchases must also be clearly mapped out with sufficient estimated values allotted for each cost. By effectively allocating costs, the customer and vendor companies can more accurately determine the price of the product (especially the case if a manufacturing function has been outsourced).

Pricing should be determined according to the basic costing principles. The outsourcing contract should dictate that payments for product costs will be made by the customer company based upon the assumptions that the actual costs were incurred, the costs were reasonable, and that they were necessary for the function at hand (Steele and Shannon, 2005). Accordingly, pricing is most effectively established when the customer and vendor companies acknowledge profit as a function of both parties. Profit-based pricing and compensation can be used to help ensure the quality of the product and discourage either the customer or vendor company from fraudulently classifying and allocating costs, or pricing a product.

## Key human resource elements

*Transfer of staff*

The outsourcing contract must address all issues concerning the customer company's in-house staff. It should include all provisions for how active the staff of the customer company will be with the staff of the vendor company or the transfer of any staff from the customer company to the vendor company, in the event that the current staff transition to the vendor company. The contract should discuss which personnel functions will remain under control of the customer company, while the process for recruitment, growth in staff or downsizing, and personnel infrastructure must be addressed with regard to the vendor company (Siegel, 2000). The contract must also include all provisions for the training, hiring, and compensation of vendor company staff to ensure that quality of staff is dictated in a thorough manner. The transfer of

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managerial personnel functions must also be addressed in these manners to avoid a gap in expectations between the customer and vendor company.

## Key legal elements

### *Transfer of assets and intellectual property rights*

Terms of ownership of current assets, usage of new and current assets, and the transfer of ownership for assets should be addressed within the outsourcing contract. The nature of the customer-vendor relationship allows both companies access to new technologies and expanded investment capabilities and the outsourcing contract should address all the companies' assets accordingly. Licensing agreements and protection of intellectual property should also be addressed as assets. IPs have been identified as compromising approximately 85 percent of the overall economic value of a corporation; therefore IP is the most important asset for the customer and vendor companies to consider when disclosing terms of transfer of assets in the outsourcing contract.

IP constitutes a strategic resource that may be represented by patents, trade secrets, copyrights, and trademarks that can assist organizations in the development of core competencies and sustainable competitive advantage (Fitzpatrick and DiLullo, 2005). Addressing terms of IP rights and ownership is complex but a necessity for the appropriate companies to protect its assets. The outsourcing contract should provide an infrastructure for adequate corporate security that protects IP exchanges among customer and vendor companies (Fitzpatrick and DiLullo, 2005), how IPs will be utilized by the customer and vendor companies, and the degree to which IP can be accessed at all levels of the customer and vendor companies. In the event that the customer company enters into contract with the vendor company with the purpose to jointly develop IP, the outsourcing contract must address all ownership and control issues during the partnering activities (*US Copyright Law*, 1976). Regardless of whether IP is single or jointly owned as dictated by the outsourcing contract, the restrictive covenants must be compatible with antitrust laws (Saunders, 2003).

### *Warranty and liability*

A warranty is a promise that the resulting product or service from an outsourced function will be of certain quality, does not infringe upon any ownership rights within the outsourcing contract, and that the product or services will be sold free of any pretenses (Brennan, 2003). The outsourcing contract should provide the terms of warranty the vendor company must uphold with regards to providing the outsourced function to the customer company and should also detail the necessary steps of proper disclosure of warranty agreements to end users. Proper documentation and proof of warranty should be required by the outsourcing contract to protect the customer company and ultimately the end users from any issues concerning quality of the product or services.

Liability clauses govern the amount and type of legal liability that either party may incur as a result of the transaction. Liability issues often result from problems with warranties on provided products and services, stemming from quality and technicalities of the transaction between customer and vendor companies. With both companies involved in the outsourcing contract attempting to limit their total liability; it is important for the contract to set a reasonable and fair liability cap as to not favor

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one company over the other. With regards to the liability cap, it is important for the outsourcing contract to not put a cap on liabilities that do not involve issues of quality and warranty because the customer or vendor company could severely handicap themselves in the recoup monies lost due to more sever breach of contract, such as intellectual property infringement (Brennan, 2003).

## Terms for disengaging

"Being locked into a long-term contract may complicate future mergers and acquisitions" (*International Journal of Productivity and Performance Management*, 2004) for the customer company therefore it must allow for "termination for convenience" in the event the relationship between a customer and vendor becomes unprofitable. The business relationship between a customer and vendor company may not always remain profitable in the long run, therefore it is essential that the outsourcing contract provide a framework for terminating the outsourcing relationship. The termination settlement should allow for the companies involved recovering the price of the functions being terminated and decide settlement expenses while protecting the companies from either one gaining an unjust economic advantage over the other (Worthington, 1992).

Nondisclosure and no compete agreements are also recommended for regulating the post-contract environment. Nondisclosure agreements are necessary to protect the customer and vendor companies from a loss of proprietary knowledge and prevent either company's personnel from using any proprietary knowledge in future endeavors (Fitzpatrick and DiLullo, 2005). The transfer of assets and staff must also be readdressed in the event of this type of relationship termination. These terms should be addressed within this key element of the outsourcing contract to avoid any legal battles that arise due to disputes over property, rights, and payments.

### *Method of dispute resolution*

Naturally disputes arise within many customer-vendor relationships, but in theory the proper implementation of the key elements of the outsourcing contract should prevent most disputes. The outsourcing contract should anticipate the fact that disputes will occur and deal with this issue accordingly. The use of attorneys and the litigation process is very costly and can have harsh effects both directly and indirectly on the companies involved. Money and reputations are often squandered in lengthy courtroom disputes. The outsourcing contract needs to take this into consideration and encourage the use of alternative dispute resolution (ADR) as the required approach to resolving issues between the customer and vendor companies. ADR is less risky, less time-consuming, and less costly then the litigation process, but it most notably lets the parties involved preserve their professional relationship while resolving a dispute (unless the dispute is concerning termination of the contract). Depending upon the preferred method of ADR as stated in the outsourcing contract, third-party representatives for each of the companies should be predetermined and named within the contract as well (Long, 1994).

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## Proposed theoretical model: key elements of a successful customer-vendor relationship

The theoretical model for the ideal outsourcing contract between customer and vendor companies is conceptualized with four main functions: performance, financial, human resource, and legal. The model is summarized in Table I. The key elements listed and presented in a previous section are each classified within one of the four main functions. Common problems that may arise when any key element is insufficiently addressed or overlooked within the outsourcing contract are classified according to the key element they are associated with.

## Conclusions and suggestions for future research

The existence of an outsourcing contract is essential but simply developing the contract is not enough to solidify the customer-vendor relationship. Although this is the first step in a comprehensive research program towards an open frame model for outsourcing contracts, the idea that the contract is central to the customer-vendor relationship is constant and can be further validated through future research. As shown in Table I, outsourcing contracts must consist of a specific set of key elements, at a minimum. These key elements should be specific, yet all-encompassing in that they effectively describe all expectations and details for the customer-vendor relationship, yet capture the general nature of outsourcing and the supply chain model as a whole. The proposed model for the ideal contract is also dependent on future research and is currently based upon assumptions that future research should correct. There are multiple problems associated with insufficiently addressing or overlooking any of the key functions of the outsourcing contract; organizations involved must assume the responsibility and address repercussions accordingly.

As organizations are increasingly deciding to outsource functions within the supply chain model and relying upon the outsourcing contract to dictate the nature of the customer-vendor relationship, management should acknowledge and address these issues when building the customer-vendor relationship. The contract is the framework for which a majority of the customer-vendor relationship is based. Developing a desirable contract is essential to ensuring the success and value of customer-vendor relationship. The contract should be a product of extensive research, negotiation, and a sharing of each company's objectives for the relationship. The common problems that arise from insufficiently addressing key elements of the outsourcing contract are difficult and costly to correct, and these problems affect all members along the supply chain.

The contract must also reflect that the needs of the companies involved in the customer-vendor relationship are unique, and dependent upon the companies' goals and needs. While the key elements of an outsourcing contract are applicable to most every organization involved with outsourcing a function of the supply chain, contracts should also be adapted to reflect the specific nature of the organizations involved and their respective industries. Therefore, a single contract cannot be used as a blanket to cover all relationships. The terms within each of the key functions and elements of the contract should be tailored to meet specific demands.

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## Future research

This paper is the first stage of a larger research initiative, the literature reviewed and proposed theoretical model are reliant upon further expansion. The second phase of this initiative would involve a more extensive and inclusive review of archive literature such as: procurement practices and contracts, make versus buy decisions, customer-vendor relationship management, outsourcing as a form of collaboration, and shared services as a form of outsourcing. These topics will reinforce the connection between the contract and outsourcing and allow for an open frame model to capture what the initial model cannot address at this stage of the research initiative. We also suggest that the nature of the outsourcing contract as it pertains to a particular industry be addressed. By segmenting the outsourcing contract by industry type, it seems possible to better understand the nature and problems within the outsourcing contract more specifically and examine how the identified key elements are adopted into the outsourcing contract to meet the industry's unique demands. Phase three of the research initiative will incorporate a validation of the open frame model developed during the current phase and stage two. A formal methodology should investigate, define, and implement satisfactory metrics, so that technical data can be collected and analyzed to support the revised model – an open frame model for successful outsourcing contracts.

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