2.3.8. **CONTROL VIS-A-VIS PARTNERSHIP QUALITY**

Knights et al. (2001: 314) note, 'a long tradition of management thought conceptualizes trust and control as opposing alternatives' in which high trust allows for limited formal control and vice versa. Social scientists have also often envisaged contract as detrimental to trust development since contracts can be interpreted as a sign of distrust (Bradach and Eccles 1989; Neu 1991; Lyons and Mehta 1997). Also, active use of the contract (e.g. by monitoring activities, threat or litigation) may evoke conflict (Gaski 1984; Hunt and Nevin 1974; Lusch 1976), opportunism (Goshal and Moran 1996) and defensive behavior (Zand 1972; Hirschman 1984). Bradach and Eccles (1989) further argue that personal relationships can prevent opportunism and can thus be seen as control mechanisms. In this view, trust precedes contracts, and contracts can as a result become unnecessary. Empirical studies have found evidence that trust was reducing the need for contracting and monitoring and hence trust can be conceptualized as substituting for formal control (Lyons and Mehta 1997; Das and Teng 1998).

A differing view is however provided by Marcolin and McLellan (1998) whose research indicated that relationships achieved greater satisfaction through more control and certainty in their relationships, and were better in avoiding conflict, achieving cost reductions, and developing trust.
2.3.9. CONTROL IN THE OUTSOURCING CONTEXT

Choudhury and Sabherwal (2003) stated that the portfolio of control modes used by client personnel in an outsourced project are dominated by outcome controls, supplemented primarily by client efforts to enhance vendor self-controls. This was because they found clan and behaviour control unsuitable to the outsourcing context. Socialization, shared experiences, rituals promoting shared beliefs, and common goals are more difficult to achieve between the members of a client firm and a vendor firm, particularly if the vendor is remotely located (Lacity and Willcocks 2001). Carmel (1999) has also suggested that global software teams often suffer from a lack of “teamness.”

Further, Choudhury and Sabherwal (2003) expected limited use of behaviour controls based on the fact that in an outsourced project, the vendor is often selected after careful screening, which might make the client feel confident about the vendor’s abilities and knowledge and reduce the incentive to implement behavior control. Second, effective behavior control entails the use of mechanisms to monitor the controllee’s behaviors, either directly or through the use of information systems. In an outsourced project, direct observation of the actions of a vendor is harder than in internal projects, especially if the vendor is remotely located (Heeks et al., 2001). It may require the client to position one or more individuals at the vendor (Heeks et al. 2001, Lacity and
Willcocks 2001). While feasible, this may be perceived by the client as expensive and obviating some of the economic benefits of outsourcing. Similarly, the design and use of effective, cross-organizational information systems that reliably inform the client about vendor behaviour are likely to require greater investment of managers’ time and/or technological resources in an outsourced context than in internal projects (Choudhury and Sabherwal 2003). Celly and Frazier (1996) have made similar comments in the context of channel relationships, noting that “Between independent channel organizations, formal authority relationships are not nearly as strong, making monitoring and evaluating distributor behaviors relatively difficult” (p. 200). This view is supported by Kirsch (1997) that formal controls dominate and by Feeny and Willcocks (1998), who concluded that the formal contract is sometimes followed so rigorously that the implicit, a priori understanding regarding the expected outcomes are ignored.

Sabherwal (1999) investigated the complementary nature of trust and structural controls in outsourcing. He conducted case studies of 18 outsourced information systems development (ISD) projects in four different countries from both the client and the vendor's perspective. The data revealed four different types of trust; calculus-based, knowledge based, identification-based, and performance-based. His interpretation of the interview data suggests that a balance between trust and structure improves performance in an outsourced IS development (OISD) context. Performance was loosely defined as project
success. Excessive focus on either trust or structural controls has an adverse effect on performance. Sabherwal states that outsourced IS development projects proceed through cycles that involve trust, structure, and performance. When a balance is struck between trust and structure, good performance results. Similarly, when trust is lacking (distrust), or when an inappropriate structure is coupled with a specific type of trust (over or under control), poor performance results. Sabherwal also suggests that a ‘psychological contract’ exists in outsourcing relationships. This contract, which consists of unwritten and often unspoken expectations, is supported by the level of trust between the parties, and plays a role in resolving unanticipated problems or changes in the accomplishment of outsourced activities.

McFarlan and Nolan (1995), drawing on case research encompassing more than fourteen organizations over a four-year period, suggest that vital factors to successfully structuring an alliance are contract flexibility, and standards and control. In terms of the ‘contract’, McFarlan and Nolan stress the need for ‘building’ in the flexibility to respond to evolving technology, shifting economic conditions, and changing competitive circumstances. Performance standards and control mechanisms should be clearly defined, as should plans, processes, and responsibilities for the transition from an in-house to an outsourced environment. When it comes to ‘managing the relationship’, McFarlan and Nolan argue that it is critical for the customer to maintain capabilities that enable it to deal with contractual issues in a constantly evolving
technical and competitive environment. This includes not only monitoring emerging technologies, but establishing and interpreting meaningful benchmarks, and structuring and coordinating tasks and activities between the parties. Finally, while McFarlan and Nolan acknowledge the importance of the contract, they point out that contracts cannot anticipate every contingency. Thus the customer/vendor relationship becomes critical. It is a complex and sensitive interface between the parties at many levels, from senior management down through operational areas, which must be continuously and effectively managed.
2.4 **Transaction Cost Economics and Control**

TCE has its roots in the work of Coase, who held that the firm and the market were alternatives for organizing the same set of transactions (Coase, 1937). Coase's work established that transactions costs—the costs associated with arranging to have work done rather than the cost of doing the work itself—offered the best explanation for the existence of separate firms rather than the universal reliance upon market transactions. Transactions-cost economics (TCE) was developed to justify the firm as economizing on transaction cost—that is, to identify the most economically efficient governance structure and to show the conditions under which the firm and not the market provided the ideal governance structure.

TCE has since become a "common framework for viewing the choice of governance structures in inter-firm relationships" (Langfield-Smith and Smith, 2003). From the intra-organizational perspective, TCE has been used to explain make or buy decisions, transfer pricing, outsourcing and the observed variety of management control systems.

The theory of transaction cost economics rests on two fundamental behavioural assumptions. These are (a) bounded rationality and (b) opportunism. Bounded rationality refers to man's limited cognitive and computational ability (Simon, 1945). The significance of this limitation is that it results in incomplete
contracts for complex transactions. All possible contingencies cannot be foreseen and incorporated into the agreement (Williamson, 1973). Opportunism is “self-interest seeking with guile” (Williamson, 1985: 47) and refers to the possibility that one, or both, parties to a transaction may selectively (or strategically) disclose information or otherwise act in a manner so as to promote their self-interest at the expense of the other party.

Hammermeister (2005) states that while incomplete contracts (due to bounded rationality) in and of themselves, do not necessarily preclude a market transaction, the “depravity of mankind” creates situation in which individuals may elect to disguise, distort, or otherwise manipulate issues and events for their own benefit. Efficient contracting requires one to distinguish between the depraved and the virtuous. Under certain conditions it can be prohibitively costly to do so. These conditions are the transaction attributes of high (1) uncertainty, or the extent to which the activities and desired contributions are amenable to ex ante programming; (2) the degree of asset specificity, or the extent to which alternative uses of investments made to support the activity involve opportunity losses; and (3) the intensity of ex post information asymmetry, or the ability to assess the true quality of actually delivered performance (Spekle 2002).
2.4.1. The Effects of Uncertainty

Spekle (2002) states that uncertainty is a condition that can arise from many sources, including market dynamics, disturbances in the external environment, environmental complexity, task uncertainty, task complexity, and unfamiliarity. However, whatever the source, the effects are similar: desired contributions are not amenable to up front programming, and maintaining flexibility to allow adaptation to events as they unfold and to information as it accrues becomes imperative. This insight allows organizational activity to be grouped in two broad categories: (1) programmable activities, i.e. activities for which the organization possesses sufficient knowledge and information to decide in advance on the way in which they are to be executed in order to achieve success, or activities for which the outcomes that may realistically be expected to result from them can be defined ex ante; and (2) non-programmable activities, i.e. activities for which the organization lacks the a priori ability and experience to relate actions to outcomes.

Implications for control structures:

The availability of norms and standards in the first group permits a fairly comprehensive ex ante articulation of the characteristics of the contribution that is required from the members of the organization, and contracting for that contribution can be reasonably complete. Control, therefore, can be prescriptive
or authoritative in nature, featuring rules of behavior, specific instructions, and relatively rigid performance targets, and focusing on assuring compliance to these pre-imposed norms. In the second group, in contrast, it is not possible to specify required contributions in advance. Due to the absence of ex ante standards, contracts must be of a general thrust nature, emphasizing a general commitment or sketching the broad confines within which performance ought to fit, rather than delineating a precisely specified contribution. (Spekle, 2002)

2.4.2. ASSET SPECIFICITY

As per Spekle (2002) asset specificity refers to the size of the opportunity losses that arise if the (physical or human) investments made to support the activity are to be put to alternative uses or users. The degree of asset specificity is directly linked to the marketability of the investments. It is low in case of general purpose assets for which a large and active market exists. Conversely, it is high in the case of specialized, custom-built assets for which there is no readily accessible alternative source of supply or demand.

Hoetker and Mellewigt (2004) state that commonly, specialized physical assets are required to support the activities of the alliance. The prototypical example is that of specialized machinery but physical assets may also be specific to a relationship by virtue of their location or because they are discrete investments “made at the behest of a particular customer” (Williamson 1991:281). Asset
specificity is not limited to physical property however. Employees of a firm often develop specialized knowledge that would be of limited application outside of the relationship in which it was developed (Williamson, Wachter, and Harris 1975). Asset specificity arises because this knowledge is specific to a given relationship could not be transferred to relationships with another partner.

Implications for control structures:

Relationship specific assets of either type create an obstacle to the formation of an alliance, as neither party wants to expose itself to their inherent risks. Firms must therefore structure their relationship in order to mitigate these risks commonly done by the use of varied type and degree of control mechanisms. (Hoetker and Mellewigt, 2004). Controls play a vital role in enabling transactions that require investments in specific assets. They create a mutually agreed upon range of acceptable behaviors and specify each party’s roles, performance expectations, and dispute resolution mechanisms (Poppo and Zenger 2002). By placing credibly enforceable limits on the actions of each party, controls constrain the subsequent ability of one party to extract additional rents from the other by failing to perform as agreed (Williamson 1985).

When little is at risk in a relationship, simple controls will be sufficient. As asset specificity increases’, placing more at risk, a more complex and costly
control structure, establishing a more sophisticated set of associated activities, becomes worthwhile (Klein, Crawford, and Alchian 1978).

Physical and knowledge assets present different governance problems, which formal and informal control modes address with different degrees of effectiveness. Different modes of control also differ in their ability to support the coordination of efforts across firms, which is as important to the success of an inter-firm relationship as the mitigation of opportunism.

2.4.3. EX POST INFORMATION ASYMMETRY: OUTPUT MEASURABILITY

As per Spekle (2002) the third variable is the level of ex post information asymmetry, i.e. the extent to which the organization is able to observe and to assess perceptively the true quality of actually delivered contributions. A situation of low output measurability may for instance arise when the relevant information is highly specialized in character (e.g. expert information), or when it is not possible to protect the information from opportunistic manipulation by the sender at acceptable cost. Then, the organization is effectively unable to assess the quality of performance, even after it has been delivered.
Implications for control structures:

When one is able to specify what one expects from the activity, one will usually have at least some notion as to the behaviors that may actually result in those expectations. Thus, the aim of control is both the ensuring of desired contributions as well as the prevention of unwanted actions or behaviors indicating the use of behavior control mechanisms (Spekle, 2002).

Outcome measurability, has also generally been found to have a positive relationship with outcome control (Eisenhardt 1985, Snell 1992, Kirsch 1996). That is, if desired outcomes can be clearly articulated and accurately measured, controllers will be able to exercise outcome control. For instance with respect to outsourced software development projects, Kirsch et al., (2002) note “outcome measurability is also an antecedent of outcome control”

2.4.4. TCE AND GOVERNANCE STRUCTURES

Spekle (2001) showed that given bounded rationality and opportunism, task characteristics are predictably associated with distinctive control problems that need to be dealt with. Organizations try to cope with these problems by adopting appropriate control structures as depicted in Fig. 2.5.
Though there is an overwhelming variety of control structures, but within this variety, a limited number of typical control patterns can be discerned: (1) arm's length control, featuring outcome control based on market-derived standards or predefined contractual provisions; (2) machine control, which is administrative control based on codification of behaviour or predefined performance targets; (3) exploratory control that works from converging insights that accrue and spread during the process; and (4) boundary control that is proscriptive in nature, emphasizing actions to be avoided. These archetypal control structures differ in their problem-solving ability, which make them appropriate for the governance of some activities and contributions, but not for others. Figure 2.6 is a diagrammatic representation of Spekle's control archetypes.
Based on TCE, Van der Meer-Kooistra and Vosselman (2000) developed a model of the management control structure of outsourcing relationships consisting of three control patterns: a market pattern, a bureaucratic pattern and a trust pattern. Their field research further revealed that institutional, strategic, cultural and historical factors were of significant importance.

Langfield-Smith and Smith (2003) extended their model to outsourcing, based on their analysis of the characteristics of the transaction, environment and parties. Control was achieved through outcome controls and social controls
developing over time, and through the development of trust, particularly goodwill trust. Table 2.5 summarizes their findings.

Table 2.5: Summarized model of Langfield-Smith and Smith (2003)

Outsourcing Controls

<table>
<thead>
<tr>
<th>Outsourcing control pattern</th>
<th>Characteristics of the transaction, transaction environment and parties</th>
<th>Control mechanisms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market based Pattern</td>
<td>Transaction</td>
<td>High task programmability</td>
</tr>
<tr>
<td></td>
<td></td>
<td>High output measurability</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Low asset specificity</td>
</tr>
<tr>
<td></td>
<td></td>
<td>High repetition of transactions</td>
</tr>
<tr>
<td>Transaction environment</td>
<td>Many potential parties</td>
<td>Market price contains all the market information</td>
</tr>
<tr>
<td></td>
<td>Market price contains all the market information</td>
<td>Social embeddedness and institutional factors not relevant</td>
</tr>
<tr>
<td>Parties</td>
<td>Not important</td>
<td></td>
</tr>
</tbody>
</table>

80
<table>
<thead>
<tr>
<th>Bureaucratic based pattern</th>
<th>Transaction</th>
<th>Outcome and behaviour controls, focused on direct intervention by outsourcing party</th>
</tr>
</thead>
</table>
|                           | - High task programmability  
                           - High output measurability  
                           - Moderate asset specificity  
                           - Low to medium repetition of transactions |
|                           | Transaction environment  
                           - Future contingencies known  
                           - Medium to high market risks  
                           - Institutional factors influence contractual rules |
|                           | Parties  
                           - Competence reputation  
                           - Medium risk sharing attitude  
                           - Asymmetry in bargaining power |
| Trust based Pattern | Transaction | Outcome and social controls develop over time |
|                       | - Low task programmability  
                       - Low output measurability, that tends to increase over time  
                       - High asset specificity  
                       - Low repetition of transactions |
|                       | Transaction environment  
                       - Future contingencies unknown  
                       - High market risks  
                       - Social embeddedness  
                       - Institutional factors influence the relation |
|                       | Parties  
                       - Competence reputation  
                       - Experience in networks  
                       - Experience with contracting parties  
                       - Risk sharing attitude |
2.5 SUMMARY

The two streams of academic literature that provided the theoretical foundations for this research study were (1) Outsourcing theory especially academic research in the area of IT/IS outsourcing and practitioner studies in business process outsourcing and (2) Control theory, particularly the study of control, its antecedents and its forms as explained by transaction cost economics. Further popularly used theories of the firm were looked at from the perspective of their relevance to outsourcing.