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THE GOVERNANCE OF INTERORGANISATIONAL RELATIONSHIPS: THESIS OUTLINE

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1. INTRODUCTION

This study aims to examine the relation between the intensity of interorganisational relationships and governance patterns used by managers.

Extended enterprises, referring to the firm and its network of strategic alliances, partnerships, and embedded supply chain relationships; emerged from the 1980’s as a hugely popular and rapidly growing form of conducting business (Andersen & Sedatole 2003). Extended enterprises promise to allow firms access to other markets, share risk, fast-track technology development and access to vast sources of capital (Hung 1992). Manifesting itself in many different forms, interorganisational relationships have become a permanent feature of the business environment.

In light of its emergence, researchers have called for a greater examination of the extended enterprise and to investigate the forms of control which govern interfirm relationships. Management and accounting research’s continuing fixation on the traditional hierarchical organisation have largely ignored the information needs of lateral relationships such as networks and alliances (Hopwood 1996).

As such, this study investigates the patterns of control which firms utilise to govern their interfirm relationships. Building upon the seminal work of Williamson (1975), and later contributors namely van der Meer-Kooistra & Vosselman (2000), this study constructs a comprehensive control framework in the context of differing levels of relationship intensity. The interaction of formal and informal controls (e.g. trust) in governing interfirm relationships is built into the control framework.

The potentially moderating effect of organisational culture is also examined. It is hypothesised that an organisation’s ‘way of doing business’ would have a significant bearing on the eventual control pattern implemented by firms. This issue has been largely ignored by research.

Using survey and field data from Australian organisations, this study sheds light on the patterns of formal and informal control adopted by firms to govern relationships of differing intensity.
2. LITERATURE REVIEW

2.1 Intensity of Interfirm Relationships

Interfirm relationships such as joint ventures, alliances and strategic partnerships are characterised by varying degrees of relationship intensity. The intensity of the relationship refers to the tightness of the affiliation that one firm has with other parties in the relationship.

Intensity has been traditionally defined as the extent of interdependence between two or more parties to the relationship (Van de Ven, Walker and Liston 1979, Oliver 1990). More recently, intensity of interfirm relationships have been described as the degree of commitment and infrastructure linkage between parties. (Jarratt 1998). This idea is illustrated in Figure 1.

![Figure 1: Relationship Continuum](image)

The intensity of any interfirm relationship can be pictured as lying on a continuum (Figure 1). At one end of the scale, the relationship can be characterised as a market exchange between buyer and supplier. This is termed a ‘loose’ relationship. As the relationship moves along the continuum, the intensity of the relationship increases as the participants begin to combine their interests, strategies and activities. Firms lock in buyers or suppliers through specialised investments, unique production outputs and/or long term contracts (these dimensions are elaborated below). The tightness of the relationship increases as these dimensions are further amplified. At the extreme point we see a merging together of the participants.

For the purposes of this study, intensity is described by a set of dimensions. These dimensions are drawn from contemporary management, accounting and administrative science studies.


- **Asset Specificity** – The level of specialised capital investments injected into the venture by venture partners that have little or no value outside of the venture.
- **Risk** – The overall level of economic, technological and environmental risk which the parties face as a result of the joint venture.
- **Information-sharing** – The level of information exchange between parties.
- **Length of Transaction Period** – The planned duration of the interfirm relationship.
- **Strategic Importance** – The importance of the venture for the strategic direction and future well-being of each participant.

Generally, each dimension listed above is positively associated with the overall level of intensity of a relationship. For example, intensity increases as asset specificity increases. As these dimensions increase in magnitude, the intensity of the interfirm relationship is predicted to increase. i.e. move along the continuum in Figure 1.

2.1 Management Control Patterns – a Transaction Costs Perspective

Transaction Cost Economics (TCE) is a common theoretical framework used to examine the control and coordination of extended enterprises. Developed largely from the work of
Williamson (1975), it conceptualises the choice of governance structures as one of either market-based, bureaucracy-based or a hybrid.

Under a market-based governance structure, formal short term contracts and the market price mechanism facilitate an effective and efficient transaction (Williamson 1975). Under bureaucratic governance, firms rely on authority, formal controls and asymmetrical command to control and coordinate transactions. Under a hybrid model, a combination of the market and bureaucratic modes of governance is applied.

The choice of governance structure is dependent on the minimisation of transaction costs arising from asset specificity, environmental uncertainty and transaction frequency (Gietzmann 1996). TCE proposes that the governance structure that simultaneously protects the quality of the transaction whilst minimising transaction costs will be chosen to govern the relationship (Seal et al 1999).

2.2 The Role of Trust & TCE

The TCE framework has been the subject of criticism in recent literature (see Langfield Smith & Smith 2003, van der Meer-Kooistra & Vosselman 2000). The most pertinent criticism levelled at TCE is that it largely ignores the implications of trust in the design of governance structures.

TCE predicts that the most effective method of dealing with high intensity transactions is to formally contract and monitor them through a bureaucratic type of governance structure (Williamson 1991). TCE proposes that the formal controls and distinct authority of a bureaucracy most effectively mitigate the unexpected contingencies of a high intensity transaction.

A growing body of literature modifies the above view by incorporating informal controls such as trust in the management of interfirm relationships. Trust is defined as the reliance on another party which increases one’s own vulnerability to that other party whose behaviour is not under one’s control (Lorenz 1991). Van der Meer-Kooistra & Vosselman (hereinafter VMK) (2000), recognising TCE’s shortcomings, incorporate trust into the TCE model. Three types of governance structures are described: (1) market-based, (2) bureaucracy (hierarchy) -based and (3) trust-based patterns. VMK argue that the presence of trust between cooperating parties is especially important in ventures of high intensity. Furthermore, they argue that the choice of governance structure is not only contingent on transaction costs as TCE posits, but also other transaction dimensions indicative of relationship intensity. These include the transaction environment and participant characteristics. Figure 2 summarises VMK’s control framework. As intensity increases (characterised by length, risk, and asset specificity of contract), firms are more likely to use a trust-based pattern of controls.

<table>
<thead>
<tr>
<th>Contingency factors</th>
<th>Market based pattern</th>
<th>Bureaucracy based pattern</th>
<th>Trust based pattern</th>
</tr>
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<tbody>
<tr>
<td>Transaction</td>
<td>Low asset specificity; high repetition; measurability of activities and output; short to medium term contract</td>
<td>Medium to high asset specificity which can be protected by contractual rules; low to medium repetition; measurability of activities or output based on contractual rules; medium to long term contract</td>
<td>High asset specificity; low repetition; activities or output cannot be measured well; long term contract</td>
</tr>
</tbody>
</table>
Many potential transaction parties; market price contains all the market information; social embeddedness and institutional factors are not relevant

Future contingencies are more or less known; medium to high market risks; institutional factors influence the contractual rules

Future contingencies are known; high market risks; social embeddedness; institutional factors influence the relation

Not important, because there are many parties with the same characteristics due to which switching costs are low

Competence reputation; medium risk sharing attitude; asymmetry in bargaining power

Competence reputation; experience in networks; experience with contracting parties; risk sharing attitude; no asymmetry in bargaining power

They test the framework through a detailed case study of two firms who have each established their own form of interfirm relationship in the outsourcing of industrial maintenance and renovation activities.

The results of their case studies were inconsistent with their contingency framework: the high intensity contract characterised by high-risk and asset specificity was governed using a bureaucratic system of formal contracts and authority. This was in contrast to the expectation that this contract would follow a trust-based pattern. On the other hand, the contract characterised by lower risk and investment was governed by a trust-based control pattern; which is once again in contradiction to VMK's contingency framework.

Langfield-Smith & Smith (hereinafter LSS) (2003) mobilise a similar framework. Drawing on the VMK contingency model, LSS examine the case of an electricity utility who has outsourced their IT function to an external contractor. The high intensity contract, with its high-risks, long-contract-period and high asset specificity fit the requirements of a trust-based control mechanism. This was confirmed in the operationalisation of the contract where control was achieved by the development of trust, particularly goodwill trust (LSS 2003). In other words, the contingency model was robust to empirical observation. This result is inconsistent with the case study of VMK.

2.3 Reconciling the Results: an underdeveloped framework?
The conflicting results of VMK and LSS are symptomatic of an underdeveloped contingency model. The role of trust in VMK and LSS frameworks is problematic.

In VMK, the case study exhibited characteristics of a high intensity relationship but the actual contractual objective was a simple and predictable ‘problem’ of building maintenance. Given the certainty with which the objectives of the contract could be codified, it is likely that the parties felt that formal controls would be more effective in managing the relationship. Put differently, when the objectives of the relationship can be adequately specified (and thus supervised), participants to the contract will no longer ‘need’ trust as a bonding mechanism. The participants will be more likely to revert to using formal controls in order to codify the contractual outcomes.

VMK’s secondary case study involved a lower intensity contract for building maintenance that included engineering, architecture and instrumentation activities. The objectives of this contract were very ambiguous at the beginning of the contract, thus rendering bureaucratic and market controls ineffective. It was not clear at the outset as to what constituted ‘good’ behaviour from both parties. For this reason, parties relied on a significant degree of trust that the other firm would fulfil their end of the agreement.

The idea of firms using trust as a control mechanism of last resort was confirmed by Lorenz (1991). In his analysis of subcontracting relationships in the French engineering industry, Lorenz found that firms are reluctant to rely on trust to govern relationships. There is an extensive use
of safeguards by firms to minimise exposure to opportunistic behaviour. In other words, firms have a natural tendency for market-based or bureaucratic controls. It is only if market or bureaucratic mechanisms were inadequate did firms resort to using trust. Lorenz summed up the collective sentiment of those firms as thus: “It is good to trust but it is better not to trust”.

This idea was confirmed by LSS’s case study. At the beginning of the outsourcing relationship characterised by high risk and inability to specify objectives, the parties placed a heavy reliance on trust. As the relationship matured, the exact objectives of the relationship became clear to both parties and the use of bureaucratic controls dominated.

The preceding analysis suggests that the ability to specify and codify the objectives of the relationship is the major overriding factor in the choice of governance systems. The effectiveness of bureaucratic and market controls is constrained by the ability to specify the objectives of the interfirm relationship. Where the objectives of the relationship are uncertain to the point of being uncodifiable, firms will resort to trust as a governing mechanism. Where the problem is predictable, as was the case in VMK (and eventually in LSS), the natural preference that firms have for bureaucratic control, will dictate that more formal controls will be implemented to codify the objectives of the relationship.
3. A THEORETICAL FRAMEWORK

The aim of this section is to describe a contingency framework based on the expected relation between the variables of interest (intensity of interfirm relationships and the control patterns used by firms).

The preceding literature review outlined the relationship between the tightness of an interfirm relationship (intensity) and management control patterns. The relationship is illustrated in the framework in Figure 3.

**Figure 3: Contingency Framework – Management Control of Interfirm Relationships**

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3.1 Description of Framework

3.1.A. Intensity of Interfirm Relationship – from section 2.1, the intensity of the interfirm relationship as defined by asset-specificity, risk, information-sharing, length of transaction period and strategic importance. Ceteris Paribus, the higher the intensity of the relationship, the more likely that a firm will rely on trust. Intensity is included in the model as an independent variable.

3.1.B. Organisational Culture - VMK (2000) also identified organisational culture as an important influencing factor which had “wrongly not been incorporated” in their contingency model (VMK 2000). In VMK’s case study, the organisation which had a history of using elaborate rules, procedures and meticulous supervision resorted to formal controls to govern the high intensity transaction which their model had predicted would be governed by trust. On the other hand, the organisation with a tradition of using trust to govern transactions, utilised trust to govern a low risk transaction that the model had predicted would be governed by formal controls. In each case, a potentially influencing factor was identified as the organisational culture which affected the pattern on controls adopted by each organisation. Organisational culture is the embodiment of a firm’s “way of doing things”. It is the firm’s history of conducting business, work practices and established business customs. Thus in implementing governance structures, it is intuitive that firms would adopt practices which largely reflected their own way of ‘doing business’. This is included in the model as an independent variable.

3.2.C. Effectiveness of Market & Bureaucratic Controls – The effectiveness of market and bureaucratic controls is included as a moderator variable. From section 2.3, interfirm relationships of higher intensity will tend to controlled by trust-based systems only if market and bureaucratic controls are ineffective. They are ineffective in situations where the objectives of the relationship are uncertain and cannot be readily codified.
3.2.D. Management Control Pattern - The control patterns are separated into three largely distinct bases of governance: market-based, bureaucratic (formal) controls, trust-based controls. From VMK (2000), these management control patterns are defined as such (Figure 4):

**Figure 4: Management Control Patterns of Interfirm Relationships**
*Source: van der Meer-Kooistra & Vosselman (2000), pp60.*

<table>
<thead>
<tr>
<th></th>
<th>Market based</th>
<th>Bureaucracy</th>
<th>Trust based</th>
</tr>
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<tbody>
<tr>
<td><strong>Contact phase</strong></td>
<td>Competitive bidding</td>
<td>Preselection of potential suppliers; bidding procedures; detailed selection criteria</td>
<td>Trust, stemming from friendship, former contractual relationships or reputation</td>
</tr>
<tr>
<td><strong>Contract phase</strong></td>
<td>No detailed contracting; payment based on standardised activities or output</td>
<td>Detailed and comprehensive contracting; payment based on real activities or output</td>
<td>International contracting; framework contracts; contractual trust; loose links between payment and activities and output</td>
</tr>
<tr>
<td><strong>Execution phase</strong></td>
<td>Periodical, ex-post competitive bidding</td>
<td>Supervision; performance measurement and evaluation; detailed ex-post information processing; direct intervention</td>
<td>Personal consultation and coordination; development of competence trust and goodwill trust; process oriented and culture-based control mechanisms</td>
</tr>
</tbody>
</table>

In the vocabulary of statistics, Figure 4 represents the dependent variable: management control pattern of an interfirm relationship.
4. RESEARCH METHODOLOGY

4.1 Research Instrument
This paper will utilise a combination of field interviews and surveys to gather the necessary data for empirical testing of the contingency framework.

4.2 Field Interviews
The field interviews will provide a contextually based research instrument for examining management control patterns. It is envisaged that 10-20 in-depth interviews will be conducted with Australian firms identified as having some form of interfirm relationship in the form of buyer-supplier contracts, alliances, strategic partnerships and embedded supply chains.

The target interviewees will be the relevant personnel of the subject firm who is in charge of managing or overseeing the interfirm venture. The purpose of the interview is to gather information about the characteristics of the relationship, organisational culture and the control mechanisms put in place by the firm.

The field interviews provide a comparative advantage relative to other research instruments because of the need for contextual data regarding the transaction environment and organisational culture. These contextual characteristics are almost impossible to gauge by using experimental or archival methods of research.

A secondary purpose of the interviews will be to fine-tune the survey research instrument (outlined below).

4.3 Survey Instrument
The survey is an appropriate research instrument to use in this study because (from Gibbins 2001; and Judd et al 1991):

1. The variables of interest in this study do not have to be manipulated. This study is not interested in cause-and-effect relationships.
2. The values of the variables simply need to measured and compared against a sample population. A survey is the most efficient and effective means of doing so.
3. There is a lack of publicly available, reliable and extensive data concerning individual interfirm relationships and related characteristics.

4.4 Contents of the Survey
Participants will be asked to respond to a series of questions concerning a specific interfirm relationship which they oversee or manage. The survey will request respondents to choose “an inter-organisational relationship such as an alliance, strategic partnership, joint venture or supply chain which you oversee/manage”. Responses will be graded on a seven-point scale.

The survey will contain questions regarding four main areas:

1. Intensity of Relationship (independent variable). To preserve the anonymity of the research question, respondents will not be asked to grade the level of intensity of the relationship. Instead, respondents will be asked to respond to questions regarding the dimensions of intensity outlined in Figure 3. To further preserve the anonymity of the research question, the questions will be randomly distributed throughout the survey (i.e. there will not be a large block of questions regarding the intensity of the relationship). Furthermore, these questions will be re-worded so that in some cases, a high grade on the 7-point scale may indicate decreasing intensity.

2. Organisational Culture (Independent variable). Respondents will be required to answer questions regarding the firm’s work practices and customs regarding the management of the
business. The questions will elicit responses concerning how the firm has traditionally managed its relationships with buyers, suppliers and partners. There will also be a series of open-ended questions to probe deeper on the aspects of the organisation’s culture which may have an influence on the type of controls adopted by firms. The purpose of these questions is to gauge whether the firm has historically used trust or formal controls as the predominant management style.

3. **Control Pattern used to manage relationship (dependent variable).** Respondents will be asked to answer questions regarding their patterns of control used to manage the relationship. These questions will be modelled around the characteristics of each pattern of control outlined in Figure 4. Each question would ask the respondent to grade the extent that the firm uses the subject type of control (e.g. detailed contracting) in the management of their interfim relationship. These questions will also be randomly distributed throughout the survey.

4. **Effectiveness of Bureaucratic and Market Controls (moderating variable).** The effectiveness of market and bureaucratic controls will be largely determined by the characteristics of the interfim relationship.

4.5 **Target Respondents**
The survey will be administered to firms who agree to participate in the study. Firstly, phone contact will be made with firms identified as having some form of interfim relationship. The consent of the relevant personnel overseeing/managing the relationship will be sought and the survey instrument will be mailed or administered in person thereafter.

As mentioned earlier, a series of interviews with managers of various firms will be conducted prior to mass distribution. The purpose of these interviews is to gather feedback about the questionnaire design and the variables which are being measured. In addition, the interviews will gather information about the most appropriate recipients of the survey.

A pilot version of the study will also be administered with interviewees before a final revised version is distributed.
5. CONCLUDING REMARKS

The study aims to answer the pertinent question as to how firms manage and control interfirm relationships of varying strength and intensity. This study builds on prior research by taking an incomplete framework and refining it by (1) the addition of previously omitted variables and (2) the reorganisation of the model along lines of intensity.

The study utilises field research and a survey instrument to test the validity of the model and sheds light on the function of formal control, trust and organisational culture on the management of extended enterprises.
7. REFERENCES


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