



Changing the boundaries of the firm

Adopting and designing efficient management control structures

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Abstract

Purpose – To develop a model in which alternative patterns of management control are confronted with situational and institutional features in the context of transactional relationships. The model could be of use to managers in making rational decisions regarding the boundaries of the organization.

Design/methodology/approach – The model is developed by drawing on transaction cost economics extended with systems theoretical notions on trust.

Findings – Three patterns of management control are identified: a market pattern, a bureaucratic pattern and a trust pattern. Furthermore, the transactional and institutional factors that determine the choice of a control pattern or elements therein are identified and confronted with the three management control patterns.

Research limitations/implications – An extended transaction cost economics approach is rather static of nature and, therefore, could be criticized for its lack of attention to processes of gradual development. In practice, adoption and design of management control structures are only part of the story; there also is gradual development or evolution in management control. However, the implications of the model are restricted to rational decision making regarding the adoption/design of management control patterns.

Originality/value – The paper provides a relevant and usable model for the adoption and design of management control patterns.

Keywords Transaction costs, Control, Bureaucracy, Markets, Trust

Paper type Conceptual paper

1. Introduction

The boundaries of firms are continuously subject to changes. Firms hive off existing activities in order to concentrate on core activities, a tendency that already started several years ago. “Make or buy”-decisions prove to be important issues on the agenda of management (Van der Meer-Kooistra and Vosselman, 2000).

In the scientific management discipline the make or buy decision has traditionally received a lot of attention. Whenever the management of a company is considering contracting out an activity that is carried out internally this, in accordance with traditional economic-normative management accounting theory, has to be justified with a relevant cost approach: decision-dependent production costs (in terms of opportunity costs) of the “make” alternative have to be compared with the buying price to be paid to a third party (“buy”).



Gietzmann (1996) has pointed out that the relevant cost approach originating in neo-classical economic theory is based on a rather simple decision-making model and a rather simple model of interaction between organisations, which are viewed as production functions, squeezed in between markets. The assumption is that each organisation is managed by one actor, who without any costs has access to all necessary information. Management problems due to uncertainties in the environment and complexity in the production function are not recognised as such. These latter in practice frequently necessitate decentralising the decision-making, leading to complex and thus costly management control. As this necessity does not fit into the neo-classical assumptions the coordination and motivation costs resulting from decentralisation are ignored in the make or buy decision, leading to a serious underestimation of the cost consequences in the “make”-alternative. The same applies to the “buy”-alternative, which for the same reasons also entails coordination and control costs. In practice the control costs of the “make”-alternative will of course differ from the buy alternative. This is why it is essential to take into account such costs.

For feasibility reasons this paper particularly emphasises the governance part of the “buy”-alternative in the “make or buy”-decision. Particularly, it aims at understanding efficiency in adopting or designing a management control structure in a transactional relationship by an outsourcer. Efficiency being the central issue we will take an economic perspective. As the neo-classical theory of the firm cannot provide us with usable insights we will draw on new institutional economics, particularly transaction cost economics. Our ultimate aim is the development of a model in which, from an efficiency perspective, alternative patterns in management control systems are confronted with situational and institutional features of a transactional relationship.

Before starting our model building, we will introduce and clarify two important concepts in this paper: management control systems and transactional relationships.

Management control systems aim at influencing actors in order to enhance the efficiency in transactional relationships (of which transactions are a part). This gives management control a strongly behavioural focus and a concern with the effect of behaviour on outcomes (Merchant and Simons, 1986). Though management control issues have been especially studied in the context of integrated organisations, there is a comparable set of problems in situations where independent organisations cooperate (Van der Meer-Kooistra and Vosselman, 2000; Speklé 2001). The cooperation as such also forms in some way or another an organisation, but then one in which diverging interests could exist which cannot be managed within a hierarchical context.

The meaning of the concept transactional relationship is wider than that of “transaction”. A transaction is the delivery of goods or services. The concept of transactional relationships is defined as follows: a relatively long-term contact with regard to transactions between two or more actors. A transactional relationship can comprise more than one transaction. In such a relationship three phases are distinguished: an exploratory phase, a contract phase and an execution phase. From the outsourcer’s point of view the exploratory phase is mainly concerned with finding parties and requesting information, for instance, in the form of quotations or information about the competences and reputation of possible parties. In the contract phase deals are made about products or services to be delivered and required mutual obligations, possibly in written detail. In the execution phase the transactions are carried out.

Each phase in a transactional relationship has its specific control problems. In the exploratory phase the control structure will have to support the search for a suitable partner. In the contract phase agreements are made about the control structure and control processes for the execution phase, possibly in detail and in writing. Here the question is important how efforts and outputs can be correctly met and monitored, including payment. In the execution phase the control activities have to be fleshed out. In this phase parties are sometimes faced with the necessity to react to changes in the environment, owing to which activities may have to be adapted and agreements have to be reviewed.

The remainder of our paper is organised as follows. In the next section the essence of transaction cost economics will be outlined. Two control mechanisms will be derived from transaction cost economics and be complemented with a control mechanism resulting from the system-theoretical approach by Luhmann (1979, 1989): a trust mechanism (Adler, 2001). After having examined in some more detail the significance of trust for the control of transactional relationships and establishing a link between trust and information supply, alternative control patterns for a transactional relationship will be derived. These patterns will then be linked up with situational and institutional features. The paper will end up by drawing some conclusions and by raising a discussion on the position transaction cost economics (as a branch of new institutional economics) takes compared to other (institutional) approaches towards interfirm control.

2. Transaction cost theory and the control of transactional relations

Transaction cost economics explicitly queries the efficiency of various “governance structures” around transactions. As early as Coase (1937) asked fundamental questions about the *raison d'être* of the firm and the determinants of the boundaries of the firm. Other important contributions to transaction cost economics are those by Williamson (1975, 1985, 1996, 2000). Why are not all transactions concluded in the market and why do they sometimes take place within the boundaries of a firm? The answer is to be found in the existence of market-related transaction costs. Such costs can result from the search for a suitable contract party, from writing the contracts and from monitoring and controlling the proper execution of contracts. The greater the uncertainty and complexity around transactions, the higher these costs will be.

But additional to uncertainty and complexity there is another major factor which entails transaction costs, a factor related to human characteristics. An important element in transaction cost economics is that economic actors may behave opportunistically: given the opportunity they are occasionally inclined to serve their own interests by using forms of trickery and deceit. Opportunism appears as adverse selection, moral hazard, shirking, subgoal pursuit and other forms of strategic behaviour. “Because human actors will not reliably disclose true conditions upon request or self-fulfill all promises, contract as mere promise, unsupported by credible commitments, will not be self-enforcing” (Williamson, 2000, p. 601). (Potential) opportunism may incur high transaction costs, which may not only become manifest to an outsourcer in high prevention, security and conflict-solving costs but also in missed profits (opportunities foregone), because the selected other party, secretly or barely visibly, unjustly monopolises advantages.

Williamson (1975) assumes, for expositional convenience, that at the beginning, there were markets. The existence of alternative governance structures is explained by transaction costs. Market-based transaction costs may be expected to be high whenever transactions reoccur in an uncertain and complex environment with asset specificity. In such a situation parties gradually become dependent on each other, effectually leading to a bilateral monopoly, in which parties can only switch to another party at huge cost (high switching costs). It is precisely the presence of transaction-specific assets that creates a fertile soil for opportunism, because such assets have no or only little value in another relationship. If the contractor has invested in specific assets the outsourcer may take advantage by unfairly forcing a price reduction. On the other hand, the contractor can unfairly take advantage of the situation, because he knows that the outsourcer will have to incur high costs in order to find and train a new contractual party. Whoever will be able to get most out of this depends inter alia on the power relationships in the market. In many cases there is asymmetry in transaction costs.

How can transaction costs be economised on? There are two main possibilities.

One is to place transactions under the umbrella of an organisation (a hierarchy). A governing body in a hierarchy will try to prevent and combat opportunism, facilitated by the hierarchy's ability to avoid conflicts of interests and to overcome information asymmetry. Within a hierarchy fixed compensation is usual. Rewards are not, or only to some extent, linked to the output of individual efforts. There is a lot of reliance on managerial discretion. However, the hierarchy also entails costs: information processing, coordination and control do not come for free. Moreover, there is the risk of overbureaucratisation and inefficiencies because of the absence of market forces.

Another possibility is to opt for a "hybrid". Efficient institutional arrangements (governance structures) within the context of a market can be designed in order to coordinate activities and to prevent and/or fight opportunism. This diminishes the risk of overbureaucratisation and inefficiencies that is inherent in the hierarchy. Precisely these governance structures form the infrastructure for management control devices in interfirm transactional relationships. In terms of Ouchi (1979), the dominant control mechanism in a market is a market mechanism. But in the "hybrid" management control is not only based on the working of a market mechanism (which essentially is a mechanism of "rewarding"/"punishing" and of "exit threats"), but also on the working of a bureaucratic mechanism (with a dominant role for authority, regulation and control). So there is a certain mixture of incentives working on the basis of a market mechanism and of incentives working on the basis of a bureaucratic mechanism. Although a relationship between economically independent parties is not based on a hierarchical relationship, the deployment of hierarchy-appropriate control devices can be contractually arranged.

These arrangements reflect the parties' credible commitments to the relationship. In addition to these credible commitments parties can agree to use credible exit threats based on a market mechanism (for instance, by agreeing to arrange competitive bidding rounds at a regular basis).

3. Institutional context of the governance structure

The choice of the governance structure (the institutional arrangements) will be influenced by the institutional environment of the transactional relationship, which

consists of formal rules (constitutions, laws, property rights) and is to some extent designed by a government using to this end instruments like legislation, regulation and distribution of power. In addition, the institutional environment consists of powerful umbrella organisations such as trade unions, professional organisations, accreditation bodies and the like.

The institutional environment itself is embedded in an institutional atmosphere, with its norms, customs, mores and traditions, and linked to the concept of social embeddedness (Granovetter, 1985). In this atmosphere collectively accepted norms develop concerning business behaviour. These, and the institutions in the institutional environment, perform a latent function in a specific transactional relationship, of minimalising the risk of breach of trust (Bachmann, 2001). The institutional atmosphere is not static but evolves.

Viewed from a transaction cost economics perspective it may be claimed that the context of embeddedness to a certain extent influences the behaviour of the contract parties and may reduce the risk of opportunism (Granovetter, 1985). Williamson (1993a, b, c, 2000) in fact holds that within the framework of transaction cost economics theory there is certainly room for social embeddedness. According to Williamson, the institutional environment and the institutional atmosphere are important because they have the potentiality to economise on governance structures. They influence the transaction costs entailed by the various alternatives (Williamson, 1993b, c). Put differently, the institutional environment and atmosphere determine the choice of governance structure: market, hierarchy, or a hybrid form. Such a governance structure can be understood as a meta-institution: an institution supporting all kinds of taken-for-granted rules and routines and being relatively stable. It is in particular the meta-institution "market" that legitimises the efficiency criterion and deligitimises the use of power (Beckert, 1999). The hierarchy legitimises power and control.

4. Control mechanisms in meta-institutions: a market mechanism, a bureaucratic mechanism and a trust mechanism

Management control systems aim at influencing actors in order to promote the efficiency of transactions. Such transactions take place within meta-institutions, each of which has a dominant control mechanism. In terms of Ouchi (1979) the dominant control mechanism in the meta-institution "market" is a market mechanism (with a dominant role for prices) and in the meta-institution "hierarchy" this is a bureaucratic mechanism (with a dominant role for regulation and control). The reasoning to proceed to contracting out can in transaction cost-theoretical terms be characterised as a plan to replace the hierarchy by the market. In such a case, a complete replacement of a transaction in a hierarchy by a pure market transaction is conceivable. But supplementing market governance with specific institutional arrangements (the hybrid form) is conceivable just as well. In the latter case both competitive market forces and bureaucratic controls can be active.

In the analysis of hybrid forms of transactional relationships many authors (Bachmann, 2001; Sako, 1992; Van der Meer-Kooistra and Vosselman, 2000; Nooteboom, 1996, 2000; Nooteboom *et al.*, 1997; Zaheer and Venkatraman, 1995; Das and Teng, 1998) attach great importance to a third control mechanism, in addition to the market mechanism and the bureaucratic mechanism: trust as a control mechanism. Bachmann (2001, p. 338) claims that in the hybrid form trust is even the dominant

mechanism. This mechanism, which is closely related to the social mechanism as described by Ouchi (1979), cannot be derived directly from transaction costs theory, which can only accommodate a market mechanism and a bureaucratic mechanism. This implies that we will be refining the theoretical point of departure of transaction costs theory.

4.1 *Trust as a control mechanism and control instrument*

Trust can be defined as “having confidence that one’s expectations will be realised” (Luhmann, 1979). In his analysis, Luhmann does not restrict himself to trade transactions (economic transactions), but focuses on the coordination of social interaction in general. Luhmann, from a social system-theoretical approach, views trust as a mechanism to reduce uncertainty and complexity. Thus, trust has a function comparable to the underlying mechanisms in the governance structures distinguished by transaction costs theory. Furthermore, both Luhmann’s system theory and transaction costs theory reckon with the possibility of one or more other parties behaving opportunistically. But whereas transaction costs theory, in the choice of governance structure, holds that it had better be assumed that opportunism will occur, Luhmann’s system theory assumes that trust will be justified until the trustor cannot find any more reasons justifying this trust. A person that is willing to trust another person thinks it conceivable to give a “*Vorleistung*” (Luhmann, 1989) to that other person. This means, that he is willing to perform without having guarantees that the other person will perform in the way or in the sense that was agreed upon. But whereas trust is potentially able to reduce uncertainty and complexity it is at the same time at risk of being misplaced (ex post), for trust is based on less than full information about the future behaviour of the other actor. In this connection all trust, as Giddens (1990, p. 33) says, is “in a certain sense blind trust”. Therefore, the trustors will continue to look for good reasons that their trust is justified, and that hence the risk is acceptable. If they cannot find these reasons (any more) they will start looking for other control instruments or discontinue social interaction (in future).

Williamson (1993a) does not see any active role for trust in a governance structure. His argument is as follows: if trust does not go beyond the notion of calculative self-interest it can add nothing to the reasoning in transaction cost economics. On the other hand, if trust does go beyond calculative self-interest it is blind. Williamson is convinced that blind trust will not be deployed intentionally as an instrument in a governance structure. It can at most play a role in personal relationships, but in transactional (trade) relationships trust will be redundant.

Does a concept that goes beyond calculative self-interest really lead to blindness? This may at the very least be questioned. Nooteboom (2000) claims that the idea of trust extends beyond what is calculable as well as beyond self-interest. With respect to the latter: actors are, to varying extents, willing to take into consideration the interests of others and sometimes even to hurt their own interests by doing so. This is inter alia dependent on the norms and values in the institutional atmosphere, the significance of the institutions in the institutional environment and the degree to which institutional arrangements are based on friendship. And with regard to what is calculable: given that there are limits to rationality and hence to available future-oriented information decision makers cannot always calculate, and will therefore, fall back on existing institutions, accepted patterns of thinking and acting that are embedded in the group

customs (and are hence active in the institutional atmosphere), or on institutes, such as accreditation bodies and professional bodies, which have proved their value and are part of the institutional environment. Such bodies and institutions, which have over time proved their survival value, provide system trust and reduce the risks for an actor.

4.2 System trust

In the first stages of a transactional relationship the outsourcer can acquire or purchase contractual trust and/or competence trust. Sako (1992) distinguishes the two concepts in her comparative study into contractual relationship patterns in the UK and Japan. Contractual trust is based on moral values of honesty. "Keeping your word" is considered of great value. This trust makes one expect that the other party will honour the (possibly written) agreement. Such values are transmitted to individuals by means of processes of socialisation and education, and in fact form the precontractual basis for transactional relationships (Durkheim, 1947). The degree of contractual trust is thus derived from the institutional atmosphere of the transactional relationship – it is as it were embedded in this relationship. Neu (1991, p. 245) refers to this form of trust when he claims that "in less than perfect markets, trust must exist *prior to* contracting". The extent of this trust can be considered in conjunction with elements from the institutional environment and atmosphere. Thus, a refined system of contractual legislation will facilitate contractual trust.

Though contractual trust is hence mainly system trust there will certainly be a person-related component. One person can be trusted contractually more than another, simply because for the one "keeping your word" is more important than the other. In this connection earlier experience with a contract party or market reputation can be important indicators for the degree of contractual trust accorded to a potential party. The extent of contractual trust will influence how detailed written contracts will be and also how much information is gathered after the conclusion of the contract. A high degree of contractual trust will lead to exclusively framework agreements, which will be tested only marginally. This way savings in transaction costs will arise.

Competence trust refers to the expectation that the potential supplier will have the necessary technical and managerial competences. This form of trust can also be derived from the institutional environment of the transactional relationship. Thus, certification of suppliers by, for instance, professional organisations can provide trust. It is also possible for certain suppliers to acquire a certain reputation in the market which can as it were be bought. The outsourcer can in this way buy trust as an asset. This purchase can be weighed against extra costs of inter alia information exchange which may arise when competence trust has to be gradually developed in the relationship. The transaction costs connected with the gradual development of competence trust can thus be weighed against the costs of contracting a party with a good reputation.

4.3 Trust at the level of the transactional relationship

The institutional environment and the institutional atmosphere are hence important sources of contractual and competence trust. Williams (1988) in this connection speaks of "macro sources". But on the level of transactional relationships there may also take place a gradual process of institutionalisation generating trust. In this case trust originates from a "micro source" (Williams, 1988). This process may be connected with

the institutionalisation of competence trust by means of joint investments in the competences of the contractor. The outsourcer who himself has the necessary technical and managerial competences can, for example, transfer knowledge or technology to the contractor. But such a process of institutionalisation may in particular also relate to the third form of trust distinguished by Sako (1992): goodwill trust.

Goodwill trust is based on the expectation that parties have an open commitment towards each other, which can be defined as the willingness to do more than can formally be expected. This “more” may involve concrete activities, but also the provision of information. In the first case the contractor also carries out activities that were not explicitly requested. The contractor then shows that he feels committed to the performance of the outsourcing firm and is ready to do more than was agreed. Trust-creating behaviour will then be demonstrated in activities increasing the contractor’s vulnerability with respect to the outsourcer and vice versa (Gambetta, 1988). When there is such a development of goodwill trust parties are willing to be “in one another’s debt”. There is in such a case a temporary lack of balance between tasks performed and rewards received (*quid pro quo*). Sometimes an even exchange is not even appreciated, since it is interpreted as a quiet hint that the party wishes to terminate the relationship. In the second case the development of goodwill trust involves the provision of information. In a relationship there will initially be a certain degree of goodwill trust, arising from former transactional or amicable relationships. Goodwill trust can develop by means of information exchange and then causes the information flow to congeal. This will be illustrated in the next section.

4.4 Trust and information exchange on the level of the transactional relationship

According to Wicks *et al.* (1999) growing trust will be accompanied by a decrease in the exchange of information. According to them there is an inverse relationship between the willingness and readiness to trust and the need for information. In this (static) view, trust is an alternative to the provision of information in the framework of a management control system. In a more dynamic perspective the relationship between information exchange and trust is, however, much more complex. An increase in trust may be accompanied not only by an increase in information exchange but also by a decrease or stabilisation. Tomkins (2001), for example, supposes that in the initial phase of a transactional relationship there is an increase in information as well as in trust. We add that what is involved here is not the performing party’s “*ex post*” (accountability) information gathered by a client about actions performed and/or their results; such information will before long be viewed as lack of trust. An atmosphere of strong accountability does not fit well with the creation of trust, whereas an atmosphere of open commitment does. Therefore, what is important is information that is provided voluntarily and informally by principal and client in order to increase the transparency of the activities (or competences). In this way, there is purposive information exchange for the creation of trust. In Luhmann’s (1989) terms this information exchange enables the trustor to make sure that the risk he takes with his “*Vorleistung*” is low. Especially in the upswing of a relationship this form of information exchange will be able to fulfill an important function. During later phases the situation may change: from a certain moment the trust will be so strong that this information exchange can come to a halt. This situation, in which after the conclusion of the contract it becomes gradually clear what competences actors have and what they

are in fact doing, bears similarities to what Speklé (2001) arguing from a transaction costs-theoretical analysis, refers to as “exploratory control”.

In practice information exchange in the context of management control cannot be dissociated from information exchange in the context of the necessary coordination of activities, referred to by Tomkins (2001) as “mastering of events”. In this connection there is in a situation of “exploratory control” a continuing interaction between actors, in which through the pooling of information a learning process develops in which the quality of decisions and actions is enhanced. Viewed from a transaction costs-theoretical angle a problem presents itself here: an honest exchange of information may be frustrated by incompatibility with the self-interest of the actors. This self-interest will according to this theory at any rate play a certain role and may cause a certain bias in the exchange of information. In situations of “exploratory control” transaction costs theory, therefore, in particular suggests deploying instruments preventing this “information asymmetry”.

Information asymmetry is a situation in which information relevant to the transaction is known to one or more parties but cannot costlessly be obtained by others (Williamson, 1975, pp. 31-7). Speklé (2001) argues that here too informal systems from a transaction costs-theoretical perspective are the best option. A rigid delineation of responsibilities coupled with a tight definition of duties and competences is counter-productive in this archetype of exploratory control, because this frustrates a joint problem-solving attitude. Within this archetype the tendency to let self-interest and, related to this, opportunism prevail is best combatted by the creation of mutual dependence between actors and with the supportive attitude of a possible supervisory body. So what is involved here is a lot of interaction in personal face-to-face contacts.

We claim that in this operations-led process it will not only gradually become clear what the desired outcomes and adequate procedures are, but that between actors trust also develops which in the course of time will lessen the necessity (and the desirability) for information exchange. With respect to this, there emerges a clear difference of opinion between the transaction costs-theoretical views and Luhmann’s system theory. Whereas from transaction costs theory it can be observed that the control archetype of exploratory control only recognises “low powered incentives” (Speklé 2001, p. 434) (based on a bureaucratic mechanism or a market mechanism), Luhmann’s system theory’s more positive concept of man will argue that the trust that has been created will lead to strong bonds and a positive effect on performance. The consequences of possible breaches of such trust can be considerable, given the emotions involved. In fact, by a process of continuous interaction with the trustor the trustee has arrived at a stage where the “trustee recognizes and accepts the validity of the trustor’s needs, choices and preferences” (Maguire *et al.*, 2001, p. 290). Here we witness a really solid form of “goodwill trust” in which opportunism remains absent because of intrinsic convictions and values.

4.5 The level of analysis: groups of actors

Though up to now the analysis has concerned persons, it is organisations that enter into transactional relationships with each other. Can trust at all exist or develop between organisations entering into transactional relationships and thus forming new organisations? Tomkins (2001) shows that this is in fact the case. Because an organisation is in reality a group of actors and such a group can conclude that other

things, persons or groups can be “trusted” there certainly is “inter-organisational trust”. There are, though, a number of complicating factors: there is a certain hierarchy in organisations or at least an arrangement of positions, and these organisational positions are through time occupied by various actors. The first complicating factor may cause an actor in an organisation to develop trust less quickly than an individual actor outside a hierarchy. For the risk connected with “misplaced trust” is greater: in case of misplaced trust the actor will have to justify his actions to other actors within his own organisation (his principals). So compared to the situation in which individual actors enter into transactional relationships the need for information exchange will be relatively strong in order to satisfy the principals. But if in the course of the relationship it turns out that no or hardly any problems occur the need for information on the part of the principal will also decrease and the development of trust will show good returns.

Changes in staffing (the second complicating factor) may at a certain time have an impact on the degree of trust in other organisations with which transactional relationships have been entered into. But the principle that trust can develop and grow remains intact.

4.6 The economics of trust: some conclusions

Viewed from an economic perspective it can be claimed that exploratory control and the trust resulting from it become more efficient as uncertainty and complexity increase. The necessity to prevent or combat opportunism is especially urgent under conditions of asset specificity, for then parties are highly dependent on each other. So it is especially under these circumstances that system trust as well as trust on the level of transactional relationships may be powerful instruments. In such situations no detailed contracts can be drafted, and in the course of time adjustments to and changes in agreements will have to be made. As trust grows among parties expectations will increase that parties will act in the interests of the joint undertaking and that revisions, if any, will be made to the satisfaction of both parties. The need for information exchange in the framework of management control will diminish and ultimately stabilise. This has a favourable effect on transaction costs.

5. Controlling transactional relationship: alternative patterns

Up to this stage of the analysis control mechanisms have been linked to meta-institutions: markets, hierarchies and hybrids. The market mechanism is assumed primarily to belong to the market, the bureaucratic mechanism primarily to the hierarchy and the trust mechanism primarily to the hybrid. It is, however, possible to go beyond generics (Speklé 2001). Thus, within hierarchies market-driven instruments can be found (Van der Meer-Kooistra, 1994; Vosselman, 2002) and in (imperfect) markets bureaucracy-driven instruments can be found. Moreover, the trust mechanism is not the prerogative of the hybrids. Within hierarchies, too, we find trust. In this paper we will in some detail go into the mechanisms and control instruments within a hybrid: the transactional relationship.

On the basis of the above (transaction costs-theoretical) insights we claim that control structures of transactional relationships may have three different patterns. Within each pattern another control mechanism is dominant: a market mechanism, a bureaucratic mechanism or a trust mechanism. In this section, we will present a

description of these patterns. In a following section, we will relate the choice of a pattern (or elements thereof) to relevant situational and institutional features. In doing so we will consistently assume the perspective of the outsourcer.

For the first control pattern the market mechanism is dominant. During the exploratory phase of the relationship the search for a suitable contractual partner is supported with competitive bidding: a large number of market parties can compete for the order. During the contract phase little effort will be spent on writing detailed contracts. For, the more strongly the market mechanism operates the more necessary information has been put into the price set in the market. Given the market conditions in a more or less perfect market there is no or hardly any need for supplementary information. The quid pro quo of the outsourcer (the price to be paid) is directly related to the output of the supplier's production process. In the execution phase the outsourcer's assessment and evaluation will be restricted to this output (in terms of quantity, quality and delivery time). Moreover, there will periodically also be competitive bidding. Other potential market parties can make a bid, which disciplines and stimulates the current supplier(s) to perform their work effectively and efficiently.

A second control pattern in principle operates on the basis of a bureaucratic mechanism. The presence of (technical) standards, norms and rules specified by the outsourcer is essential. Strict monitoring, evaluation and adjustment of activities are directly related to this mechanism. In the exploratory phase the outsourcer will seek extensive information about the competences of potential parties. Potential contractors are selected on the basis of specified criteria. Prior to this, they submit a quotation in a framework of well-described procedures. During the contract phase detailed contracts are written. Various possible future circumstances are specified and the possible consequences for the transactions are described. Concerning the outsourcer's quid pro quo the agreement is made that it will be based on realised activities or their output. In the execution phase there will be frequent performance measurement and assessment, not only of the output but also of the activities of the contractors. There is, in other words, an extensive ex post information flow to the outsourcer.

In a third pattern one can clearly discern a trust mechanism. Principles of reasonableness and commitment will dominate the relationship. In the exploratory phase the suppliers will be selected on the basis of trust. Competence trust can be derived from the institutional environment (system trust) or from earlier business contacts. Goodwill trust may also be purchased via personal commitment (ties of friendship). In the contract phase there will be no detailed contracts; the more contractual trust can be derived from the institutional environment or atmosphere, the more even oral agreements will be relied on. Detailed agreements will be made in the course of time. There will only be a tenuous link between the outsourcer's quid pro quo and the activities of the contractor or the output of these activities. There are, for instance, lump sum payments. Moreover, a lot of risk sharing will be agreed between the contract partners. In the execution phase the control instruments are focused on the further development of competence and goodwill trust. There is exploratory control with an informal organisation and intensive face-to-face interaction. There is pooling of information, but the information flow will gradually dry up. Parties will again and again be willing to perform "Vorleistung": there is an open commitment. Table I summarises this.

| | Market governance pattern | Bureaucratic pattern | Trust pattern |
|-------------------|---|--|--|
| Exploratory phase | “Competitive bidding” | Preselection of potential bidders; quotation procedures; detailed selection criteria | System trust; trust on the basis of friendship, reputation or earlier business relations |
| Contract phase | No detailed contracts; payment based on standardised output | Detailed written contract; payment based on real activities or their output | System trust; framework agreements; weak link between payment and activities or their output |
| Execution phase | “Ex post” measurements restricted to output; periodical “competitive bidding” | Frequent performance measurement and evaluation; extensive “ex post” information flows | Intensive interaction; pooling of information; informal organisation; open commitment; gradual cessation of information flow |

Table I.
Control patterns and phases in a transactional relationship

6. Control patterns: situational and institutional features

We assume that two groups of factors determine the choice of a control pattern or elements therein: the features of the transactional relationship and the features of the institutional environment and atmosphere. Basing ourselves on our theoretical remarks we include inter alia the elements shown in Table II in the groups of factors.

In which situations can a choice in favour of each of the three control patterns be expected? One pattern, that of market governance, fully matches the alternative “market” from transaction costs theory. So here situational features apply which are directly derivable from transaction costs theory. With respect to the other two patterns it must, however, be concluded that transaction costs theory as such does not offer enough clues to be able to discriminate between them. Especially the trust pattern is not distinguished as such in transaction costs theory. Therefore, for the bureaucratic and the trust patterns, only comparable situational features can be derived from transaction costs theory. Formulated negatively, in both cases we have conditions where the operation of the market is inefficient. We expect that a trust pattern will be chosen more often in case of relatively extreme scores on the situational features, in particular on the features “complexity of the operations” and on the degree of contractually hard

| Features of the transactional relationship | Institutional features |
|---|--|
| Complexity of the operations (the measurability of the activities and their output) | Market (im)perfections |
| The uncertainty about (future) circumstances and possibilities | The institutional environment and atmosphere: values and norms, the legal system, economic politics, technological system, trade union, professional organisations, etc. |
| The frequency and the rate of repetition of transactions | |
| The character and degree of “asset specificity” | |
| The duration of the relationship | |
| Reputation (competence, trustworthiness) | |
| Bargaining power | |

Table II.
Situational and institutional features

to protect types of asset specificity. A bureaucratic pattern will then rather belong to more moderate scores on these features.

First of all, the nature of the circumstances expected to lead to a choice of a pattern of market governance. With respect to the features of the transactional relationship the complexity of the operations is relatively low. The measurability of the (output of) activities will, therefore, hardly cause any problems. There is little uncertainty about future circumstances and possibilities. There will be frequent repetition of transactions. Moreover, there is no or hardly any "asset specificity". The "bargaining power" is relatively evenly distributed among the parties, for the environment of the transactional relationship is in the first place characterised by a meta-institution "market" without real imperfections, where the risk of becoming fully dependent on each other is low. The institutional environment and the institutional atmosphere play no or hardly any (latent) role.

Which circumstances make for a choice of a trust pattern of control? With respect to the features of the transactional relationship there will be great complexity of operations and uncertainty about future conditions. There is, therefore, little programmability. Hence, the continuity of the relationship is of great value to the parties. The measurability of the activities and their output is highly restricted and individual transactions in the relationship are not repeated frequently. The frequency of the transactions may be high, but the nature of separate transactions changes continuously as a consequence of unanticipated changing circumstances. There is a high degree of transaction specific investments ("asset specificity") and hence of a strong mutual dependence between the contractual parties. There will often be "business process asset specificity" including components of "human asset specificity" as well as procedural "asset specificity" (Zaheer and Venkatraman, 1995). "Human asset specificity" is about knowledge, skills and experience tailored to the outsourcer's needs. Procedural asset specificity involves knowledge of and experience with the workflows and the operational processes at the outsourcer, which can be invested in through training and learning by doing. Parties are highly dependent on each other. The institutional environment of the transactional relationship is in the first place characterised by an imperfect market, where parties are mutually fully dependent on each other. These imperfections will be accompanied by asymmetrically distributed information and knowledge among parties, but reputation and/or previous experiences instill a confidence that this will not be abused. To the extent that there is asymmetrically distributed bargaining power the difference in negotiating power is not used. There are furthermore powerful institutions embedded in an institutional atmosphere, which reduce the risks for both parties of placing trust.

Which circumstances lead to the choice of a bureaucratic control pattern of transactional relationships? In practice the situational features take up a position between those belonging to a market governance pattern and a trust pattern. With respect to the features of the transactional relationship it can be claimed that there is comparative uncertainty, but that the future circumstances are more or less foreseeable. The frequency of the comparable transactions is high. As the nature of the transactions will not change greatly in the course of time and is relatively easy to specify in advance, the measurability of the activities or their output will not cause problems. That is why the outsourcer will use control instruments which are more aimed at direct intervention. Because his bargaining power is relatively strong the

outsourcer tends to behave like a backseat driver during the execution of the activities. There is moreover asset specificity, but less so than with a trust pattern. The specificity is not of the strong “business process asset specificity” type, but rather a type that can be protected by contractual rules: “physical asset specificity” and “dedicated assets”. The institutional environment of the transactional relationship is characterised by market imperfections and an institutional environment, which is less relevant and has less latent influence on the behaviour of the actors than with a trust pattern. The contract contains the rules and procedures, which structure the relationship. As the outsourcer employs bureaucratic instruments on the level of the transactional relationship in the form of agreements and monitoring the observance the power of the institutional environment and atmosphere is less relevant. It is important that the institutional environment and atmosphere should further the reputation of the contractor, in the sense of leading to competitional and contractual trust. The bargaining power will be to the advantage of the outsourcer. Sanctions imposed by the outsourcer are relatively highly valued. There is no or hardly any risk-sharing.

The above can be summarised as in Table III.

7. Conclusion and discussion

A transaction costs-theoretical approach may be considered to be a variant of the “rational-choice” approach, of which Coleman (1990) is an important representative.

| Situational/institutional features | Market governance pattern | Bureaucratic pattern | Trust pattern |
|---|--|--|--|
| Features of transactional relationships | Good measurability of output; a lot of repetition; little asset specificity | Some uncertainty; comparable transactions are repeated; good measurability of the activities or output; average to high asset specificity; asset specificity can contractually be protected; relatively great deal of bargaining power at the outsourcer | Great uncertainty; frequent transactions that continuously change in nature; output not or hardly measurable; “business asset specificity”; importance of long-term relationship; difference in bargaining power is not made use of; importance of trustworthy behaviour |
| Institutional features | Large number of potential market parties; great importance of the market price; institutional environment and atmosphere of little relevance | Imperfect market; power of institutions is less relevant; institutional atmosphere supports competence and contractual trust | Highly imperfect market; powerful institutions; institutional atmosphere has strong latently sanctioning influence, and supports trustworthy behaviour |

Table III.
Control patterns and
situational features

This does not mean that our approach is identical to a formal-calculatory approach, in which social actors are supposed to maximise their own interests in a strictly rational manner. Agreeing with Bachmann (2001), we hold that a formal-calculatory approach starts from highly unrealistic assumptions. But nevertheless, practitioners can and do construct conscious choice processes in which choices are based on efficiency considerations. These processes are in particular characterised by qualitative considerations, in which relevant factors are given maximum consideration. Transaction cost economics with an incorporation of the trust concept as described in this paper, provides us with a strong theoretical background for developing a model usable to practitioners.

To practitioners, opting for a trust-based pattern implies a certain way of coping with the boundedness of their rationality. Despite the uncertainty and complexity, actors can perform by interacting and exchanging information as the future unfolds. In this connection institutions and institutes in the environment and in the atmosphere of the transactional relationship can be viewed as means that can facilitate or hamper the choice of trust, depending on their nature. If in the institutional environment and atmosphere there are sufficient guarantees for granting trust actors may be expected to primarily choose instruments on the basis of a bureaucratic mechanism, for this choice is a choice of power. Similarly to Bachmann (2001) it may be supposed that, in the design of a control system for transactional relationships, the outsourcer would rather risk an open conflict than misplaced trust, for then the emotional damage is often less serious due to the smaller emotional impact of an open quarrel. After an open battle with bureaucratic means the relation can be more easily continued than in the case of violating trust.

Of course, we would not want to make a normative claim that practitioners (always) have to make conscious decisions when adopting a pattern of management control or elements from it. It is quite possible that in some sectors of economic life certain choices become institutionalised in the course of time. Such institutionalised choice patterns ("taken for granted" choice patterns) cause actors not to be permanently (over)burdened with rational choice processes and justifying their choices.

A transaction cost economics approach to the adoption and design of management control structures is rather static of nature. Transaction cost economics has been criticized for its lack of attention to gradual developments. In practice design of management control systems is only part of the story; there also is gradual development or evolution. Gradual changes occur through interaction of actors. In terms of Greenwood and Hinings (1996) many of these changes will be of a convergent and evolutionary nature: they will be within an existing pattern and a result of constant reproduction and reinforcement of existing modes of thought and organisation. It is also possible for gradual changes to imply a gradual transition to another pattern. This is, for example, the case when an outsourcer, given the (institutional) circumstances, in principle chooses in favour of a trust pattern, but still has to adopt the second best bureaucratic pattern, due to circumstances (for instance, the non-availability of a suitable partner). Little by little he may then still consciously try to develop a trust pattern.

In conclusion we claim that professional managers and management accountants with a responsibility for the economic rationality of the organisation and of organisational arrangements will have to try and take rational decisions on the

adoption and design of management control structures in interfirm transactional relationships. The theory developed in this paper could be of use to them.

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Further reading

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