



Contents lists available at ScienceDirect

Journal of Business Research



Untangling the safeguarding and coordinating functions of contracts: Direct and contingent value in China[☆]

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ARTICLE INFO

Article history:

Received 1 November 2015

Received in revised form 1 October 2016

Accepted 1 December 2016

Available online xxxx

Keywords:

Contract specificity

Exchange characteristics

Transaction cost economics

China

ABSTRACT

By untangling two distinct facets of contracting, this study investigates how task specificity and contingency specificity differentially affect relationship performance in an emerging economy. The paper posits that task specificity serves as safeguards in regulating interfirm transactions, and contingency specificity plays a coordinating role by offering response blueprints for uncertain events. The results from a survey of 334 manufacturer-supplier dyads in China suggest that task specificity fosters supplier performance. However, as exchange uncertainty increases, the role of task specificity declines, but the role of contingency specificity increases. Contingency specificity also exerts a stronger impact when exchange tacitness is high.

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1. Introduction

Contracts provide a framework for business transactions and coordination (Williamson, 1991). In buyer-supplier relationships, because vertical integration often is not feasible, scholars have widely addressed ways to leverage detailed contracts to boost exchange performance. For example, Wuyts and Geyskens (2005) suggest that detailed contracts deter partner opportunism; Gong, Shenkar, Luo, and Nyaw (2007) find that more complete contracts increase joint venture performance. The primary focus of this line of research is on the *safeguarding* function of contracts: By specifying concrete clauses that delineate each party's role and responsibilities, as well as sanctions for non-compliance, contracts minimize opportunities for deceit, manipulation, and haggling and thus safeguard the interests of the parties involved (Williamson, 1996).

More recently, emerging contracting literature adopts a new focus by positing that safeguarding is not the only function of contracting; rather, contracting also helps coordinate parties' cooperative and creative moves (Faems, Janssens, Madhok, & Van Looy, 2008; Weber & Mayer, 2011). Because uncertainty is a fundamental feature that challenges interfirm exchanges, exchange partners often draft explicit

clauses that facilitate adjustments as uncertain events unfold (Bazerman & Gillespie, 1998; Mouzas & Ford, 2006). By specifying resolution processes and guidelines for unexpected contingencies, those contractual terms coordinate future adaptations and thus facilitate ongoing exchanges (Argyres, Bercovitz, & Mayer, 2007). As Mouzas (2006) posits, contractual terms that flexibly guide future collective give-and-take decisions would promote the search for new opportunities and maximize joint gains. Lumineau and Malhotra (2011) argue that an emphasis on the coordination side of contracts induces cooperative framing and joint actions to resolve interfirm disputes. Mouzas and Blois (2013) similarly indicate that the inclusion of provisions for troubleshooting eases firms' uncertainty threats.

Despite this growing interest in contracting, studies on the safeguarding and coordinating facets of contracts and how to differentiate between them remain scarce. Even as conceptual developments start to explore the coordinating function of contracts (e.g., Weber & Mayer, 2011), empirical assessments continue to lag behind. Reuer and Arino (2007) differentiate safeguarding and coordinating facets in a post-hoc manner; Mesquita and Brush (2008) adopt improved production efficiency as a proxy for the coordination role of contracts and use improved negotiation efficiency to stand in for their safeguarding role. Empirical studies are limited in aligning distinct contractual provisions to the safeguarding and the coordinating functions (Gilliland & Rudd, 2013; Mouzas & Ford, 2012; Rhee, Kim, & Lee, 2014).

Moreover, whereas prior literature has long suggested that firms achieve better performance if they match their governance structures with their exchange characteristics, empirical evidence informing this

[☆] This study was supported by the General Research Fund from the Research Grants Council, Hong Kong SAR Government (Project no. HKU 793613).

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contingency effect is limited (Mesquita & Brush, 2008). Most studies focus on how transactional attributes affect governance choice (e.g., Crocker & Reynolds, 1993; Poppo & Zenger, 2002; Reuer & Arino, 2007). Only recently have researchers begun to examine the moderating role of exchange features. For example, Carson, Madhok, and Wu (2006) demonstrate that formal contracts can constrain opportunism in ambiguous but not in volatile environments. Carson (2007) finds that well-specified contracts increase supplier performance on tasks that require more creativity, and Hoetker and Mellewigt (2009) argue that formal governance mechanisms are best suited to exchanges that involve property-based, instead of knowledge-based, assets. Poppo, Zhou, and Li (2016) show that calculative and relational trust affect supplier performance differentially across various exchange characteristics. Therefore, the time is ripe to consider the efficacy of different facets of contracting as context-dependent.

As such, this study raises two research questions: (1) how do the safeguarding and coordinating facets of contracts affect supplier performance? (2) how do such impacts vary with exchange characteristics? To address these research questions, this study firstly untangles two related, distinctive aspects of contract design: task specificity and contingency specificity. Task specificity functions primarily to safeguard transactions, whereas contingency specificity mainly addresses coordination in the face of unpredictability. Second, this paper examines the exchange hazards arising from information asymmetry related to task performance. Because information asymmetry arises from both external, rapidly changing environments (Heide, 2003) and internal, tacit exchange knowledge (Hoetker & Mellewigt, 2009), this research assesses the moderating role of two exchange features: exchange uncertainty and exchange tacitness. Third, this study uses the rich setting of the Chinese economy to examine the effects of task and contingency specificity, since the rapid economic growth in China has required firms to engage heavily in knowledge-intensive exchanges in uncertain environments (Zhou & Li, 2012), challenging the very use of contracts in China. Fig. 1 depicts the proposed conceptual model.

2. Theory and hypotheses

2.1. Contract specificity

In interfirm exchange research, transaction costs economics (TCE) is one of the most influential theoretical frameworks that explains the use of contracts (Williamson, 1985, 1996). TCE maintains that firms are opportunistic and have bounded rationality. Opportunistic conducts incur the safeguarding problem; bounded rationality brings along the adaptation and evaluation difficulty (Rindfleisch & Heide, 1997). To curtail transaction costs and easy exchange interactions, TCE suggests the use of governance mechanisms. Whereas the original framework supports a selection of hierarchical integration, hybrid governance such as contracts is available when internalizing monitoring and control is unavailable (Williamson, 1985, 1996). In interfirm exchanges, contracts serve as an alternative device that enable firms to gain a quasi-unilateral authority against their counterparts (Heide, 1994).

A contract is a legally binding agreement to exchange goods or services. By specifying clauses ex ante, contracts provide a formal governance structure that facilitates transactional interactions ex post. Contractual clauses should be selected with an eye to the attributes of the exchange (Argyres et al., 2007). Because specific investments and uncertain situations characterize interfirm exchanges, contractual design should take those attributes into consideration (Williamson, 1985). Specific investments increase the risk of opportunistic exploitation as the invested side may hold up the investor by extracting quasi-rent from the investments (Williamson, 1996). Uncertain situations create the coordination problem since exchange parties face great amount of asymmetric information and need to adapt accordingly (Zhou & Poppo, 2010). Therefore, contracts should include not only safeguarding provisions but also coordinating clauses.

By detailing each partner's roles and responsibilities, *task specificity* provides a formal evaluation template that deters opportunism and safeguards the transactions (Argyres et al., 2007; Vanneste & Puranam, 2010). By codifying actions in responding to complex and uncertain situations, *contingency specificity* reduces rationality limits and coordinates interdependent efforts (Lumineau & Malhotra, 2011; Mesquita & Brush, 2008; Reuer & Arino, 2007). When Foxconn, the leading original design manufacturer in China, transacts with its electronic component suppliers, the task part of its contracts codifies the price, the quality of the delivered components, and a delivery date. Then the contingency part includes provisions for any necessary departures from the delivery agreement, designed ex ante.

Task and contingency specificity differ in their *purposes* and *functions*. First, task clauses articulate a certain state, whereas contingency terms deal with a future, uncertain state of the exchange. Task provisions codify the roles and responsibilities that must be carried out to fulfill the project (Weber & Mayer, 2011). Because those duties entail behaviors that are within firms' control, the purpose of task specificity is to create a shared, clear understanding of what controllable tasks must be performed. In contrast, contingency provisions articulate uncertain situations that may or may not occur during the exchange. Because the occurrence of these contingencies is beyond a firm's control, and their handling often requires combined knowledge from both sides (Argyres & Mayer, 2007), contingency specificity seeks to plan for these potential but uncontrollable conditions.

Second, to secure respective value in the exchange, partners design specified task clauses that constrain each self-serving action and sanction potential deviations (Argyres et al., 2007). Accordingly, the primary function of task specificity is to address the safeguarding problem by providing a regulating scheme that ensures individual contributions to the focal transaction. In contrast, firms design specified contingency clauses to facilitate coordination during potential disturbances (Barthelemy & Quelin, 2006). By offering an adaptation blueprint for contingencies as they unfold, contingency specificity mainly plays a coordinating function in the face of uncertainty.

Recent advances in contracting literature increasingly recognize the multidimensional nature of contractual governance. Mouzas and Ford (2012) advance that contracts should include the definition of the

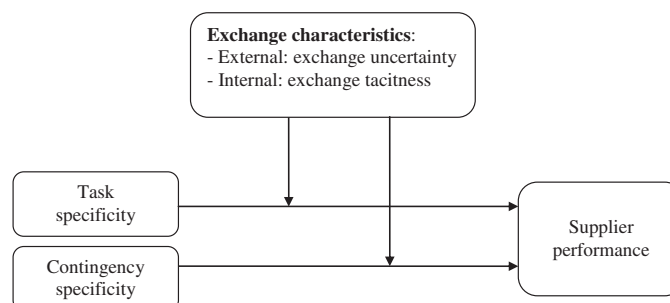


Fig. 1. Conceptual model.

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