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Strategic performance effects of misaligned formal contracting: The mediating role of relational contracting

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ABSTRACT

Studies show that failing to align formal contracts with transaction attributes reduces relationship performance. However, few studies consider either how the effects of misalignment differ across outcome types or the mechanisms through which misalignment affects performance. This study examines the effects of misaligned formal contracting on two types of outcomes, i.e., end-product enhancements and cost reductions, and on one mechanism through which misalignment affects performance, i.e., relational contracting. Using survey data from 305 buyer–supplier relationships in the Scandinavian wood industry, the findings suggest that (1) misalignment has a significantly stronger negative effect on end-product enhancements than on cost reductions, and (2) relational contracts mediate the effect of misaligned formal contracting on performance. Firms in the sample experience significant misalignment-related losses of 10.3% and 5.3% in end-product enhancements and cost reductions, respectively. The findings suggest that misalignment is particularly harmful to performance outcomes that rely on relational contracting, such as end-product enhancements.

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1. Introduction

One of the most important decisions facing business-to-business (B2B) marketing managers is the use of formal contracts to govern transactional hazards in customer relationships. Such contracts are implemented to realize strategic performance outcomes, such as cost reductions and improved products and services (Ghosh & John, 1999; 2005). Moreover, transaction cost economics (TCE) is a dominant perspective in B2B relationship management. TCE's primary recommendation is summarized in the discriminating alignment hypothesis: firms should "align transactions, which differ in their attributes, with governance structures, which differ in their costs and competencies, in a discriminating (mainly transaction cost economizing) way" (Williamson, 1991, p. 79). For B2B marketers and purchasers, this principle encourages high performance through consciously engineering formal contracts to account for transactional attributes, such as transaction-specific investments and uncertainty.

The TCE literature terms the failure to align governance forms with transaction attributes as *misalignment* or *misaligned governance*

(e.g., Mooi & Gilliland, 2013). We use the term misalignment[1] more narrowly and refer to *misaligned formal contracting*, which means that the parties have chosen a level of formal contracting that deviates from the appropriate or expected level of formal contracting under given transaction attributes. Prior research strongly supports the hypothesis that misaligned formal contracting erodes performance (see Web-Appendix A). However, two key areas remain unexplored.

First, although several studies of the relationship between contracting and performance consider multiple types of performance outcomes, few test for effect differences.[2] Ghosh and John (2005) is the only study that tests for performance differences by comparing cost reductions and end-product enhancements (i.e., improved end-product utility). These two outcome types have different strategic implications: whereas cost reductions are important in cost leadership strategies, end-product enhancements are essential in differentiation

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[1] The most common term in the TCE literature is "misalignment" (e.g., Mooi & Ghosh, 2010). Some authors, however, use "alignment", "fit", and "misfit". "Misfit" and "misalignment" are synonyms and antonyms of "fit" and "alignment", respectively. We use "misalignment" and "misaligned formal contracting" interchangeably.

[2] To our knowledge, only four studies formally test for effect differences. Ghosh and John (2005) study the difference between cost reduction and end-product enhancement outcomes. Bercovitz et al. (2006) examine the differences between current and expected future performance. Mesquita and Brush (2008) consider the differences between production and negotiation efficiencies. Finally, Mooi and Ghosh (2010) examine the differences between *ex ante* contract negotiation costs and *ex post* transactional problems.

strategies. Hence, we label these relationship performance outcomes *strategic performance outcomes*. Moreover, these two outcome types differ regarding how easily they can be written into contracts *ex ante* and the ease with which they can be enforced in court *ex post* (Ghosh & John, 2005). The contracting choices made by buyers and sellers thus have different effects on cost reductions compared with end-product enhancements. Ghosh and John (2005) find that contract flexibility (*i.e.*, the extent to which the contract leaves certain aspects open for later negotiation) has different effects on cost reductions and end-product enhancements depending on the level of the buyer's asset specificity and the buyer's position in the end-product market.

In this study, we analyze the effects of misaligned formal contracting on cost reductions and end-product enhancements. In contrast to Ghosh and John (2005), we study misalignment between transaction attributes and the *level of formal contracting*, which is the detail with which explicit contract terms specify the agreement and formalize the parties' roles and contingency plans (Lusch & Brown, 1996; Macneil, 1980). A detailed contract can be either rigid or flexible. The core functions of formal contracting are as follows: (1) to facilitate court enforcement, *i.e.*, a more detailed contract specifies a broader area of the parties' relationship (Klein Woolthuis, Hillebrand, & Nooteboom, 2005) and (2) to act as a coordination device (*e.g.*, Wuyts, 2007). Hence, the level of detail is often viewed as one of the most important aspects of formal contracting (Argyres & Mayer, 2007).

An often overlooked function of detailed formal contracting is to facilitate the self-enforcement of relational contracts (Klein, 1996). By contrast, contract flexibility (rigidity) presupposes or implies that a relational contract already exists (does not exist) (Carson, Madhok, & Wu, 2006). In relational contracting, the parties implicitly or informally agree on the terms of exchange and self-enforce the contractual agreement rather than relying on enforcement through the judicial system (Gilson, Sabel, & Scott, 2010). Based on TCE, we argue that misaligned formal contracting undermines relational contracts and that more extensive use of relational contracting is required to realize end-product enhancements than to realize cost reductions. Thus, misalignment should have a stronger negative effect on end-product enhancement than on cost reduction. By examining these effects empirically, we deepen our understanding of the role of formal contracting in realizing these two outcomes and shed light on important tradeoffs that firms should consider when designing contracts.

Second, few empirical studies use mediation tests to examine the mechanisms through which misalignment affects performance. Testing mediation hypotheses may provide additional support for TCE and its core arguments, thereby increasing our understanding of how misalignment affects performance. Although Jap and Ganesan (2000) test for mediation, their proposed mediator, supplier commitment, does not mediate the effect of misalignment. Therefore, other mediators should be considered. Considering the importance of relational contracting to relationship performance (*e.g.*, Bercovitz, Jap, & Nickerson, 2006; Jap & Ganesan, 2000), we expect it to act as a key mediator.

In summary, we hypothesize that the negative effects of misalignment are stronger on end-product enhancements than on cost reductions, and that relational contracting mediates these effects. Importantly, comparing two different outcomes is a form of moderator analysis in which the outcome type is a moderator describing the characteristics of the outcome. Outcome types should thus offer insight into the mechanisms through which misalignment affects performance (Ghosh & John, 2005). Hence, testing for effect difference complements mediation tests when assessing a proposed mechanism, and consistency between the results of testing the two hypotheses lends additional confidence to the results.

In this study, we provide theoretical argumentation for these two hypotheses and report the results from testing them on a sample of 305 buyer–supplier relationships in the Scandinavian wood industry. The analysis accounts for the endogeneity of both formal and relational contracting, and we discuss the implications of our findings. The

Web-appendices report more detail regarding the data and methods presented in the paper.

2. Theory and hypotheses

2.1. The discriminant alignment hypothesis and its implications

The discriminant alignment hypothesis suggests that firms should align formal contracts with transaction attributes. Williamson (*e.g.*, 1985) describes three transaction attributes – asset specificity, uncertainty, and frequency – and he identifies asset specificity as "the big locomotive to which TCE owes much of its predictive content" (1985, p. 56). In addition, the empirical literature suggests that performance ambiguity and complexity should be included as transaction attributes (*e.g.*, Mooi & Ghosh, 2010). These attributes create exchange hazards that may create temptations for opportunistic behavior.

To 'align formal contracts with transaction attributes' means two things. First, when a relationship is characterized by hazards such as asset specificity, firms should safeguard these investments by means of formal contracts. Second, when there are no hazards, firms should not use formal contracts. Empirical research typically finds a strong positive association between asset specificity and formal contracting, which suggests that firms tend to align asset specificity with more detailed formal contracts (*e.g.*, Mooi & Ghosh, 2010). Because firms *should* align governance structures with transaction attributes, firms that fail to do so will experience weaker performance (Masten, Meehan, & Snyder, 1991; Williamson, 1985).

2.2. Misalignment and the fit-as-matching perspective

A large number of published studies examine the performance implications of misaligned governance, of which several have been published in marketing journals (Brettel, Engelen, & Müller, 2010; Cannon, Achrol, & Gundlach, 2000; Ghosh & John, 2005, 2009; Ghosh, Dutta, & Stremersch, 2006; Jap & Ganesan, 2000; Mooi & Ghosh, 2010). The vast majority of empirical TCE studies support the idea that misalignment results in performance reductions, regardless of the context.

Within the TCE literature, two major perspectives regarding misaligned governance dominate: fit-as-moderation and fit-as-matching. The *fit-as-moderation perspective* conceptualizes misaligned governance as interaction terms between governance and transaction attributes. Because individual interaction terms in isolation do not offer any theoretical meaning, the fit-as-moderation perspective does not distinguish between the existence and the effect of misalignment (Venkatraman, 1989).

In this study, we rely on the *fit-as-matching perspective*. This perspective conceptualizes misaligned governance as *a variable in itself*, representing a theoretical match between one variable and one or several other variables (Venkatraman, 1989). For each transaction, there is an optimal or appropriate level of formal contracting, given transaction attributes. Both positive and negative deviations m_i from this level affect performance negatively. Therefore, the absolute value of m_i, $|m_i|$, defines misalignment as the distance from the optimal decision (Venkatraman, 1989). Hence, we define *misalignment* or *misaligned formal contracting* as the deviation between the chosen level of formal contracting and the appropriate or expected level of formal contracting under a given set of transaction attributes. Hence, a misaligned formal contract has either too much or too little detail.

How do we know if the contract contains too much or too little detail? The most common analytical approach to the fit-as-matching perspective is "residual analysis" (Venkatraman, 1989, p. 431). Residual analysis has been used in studies of both continuous and discrete governance variables in marketing (Mooi & Ghosh, 2010) and related fields (*e.g.*, Bercovitz et al., 2006; Nickerson & Silverman, 2003). Residual analysis is a two-stage procedure in which the first stage involves regressing the governance variable onto transaction attributes. The second stage involves regressing