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Differences in Contracting: Anchoring Formal and Relational Norms within BPO Governance

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DIFFERENCES IN CONTRACTING:  
ANCHORING FORMAL AND RELATIONAL NORMS  
WITHIN BPO GOVERNANCE

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Abstract
Within IS outsourcing research there is an ongoing discussion whether formal contracts and relational norms function as substitutes or as complements to each other. However, even those deals which are based on relational norms usually comprise a contract as their foundation. We therefore aim at analyzing differences in contracting between both governance modes (i.e. contract-based or based on relational norms) and exploring their impact on outsourcing satisfaction. Based on a survey with 335 Business Process Outsourcing (BPO) deals in the German banking industry we show that clauses on problem resolution are most important in BPO contract design. Furthermore, we find that deals focusing on formal governance put a lot of emphasis on the design of Service Level Agreements (SLAs) whereas deals focusing on relational governance pay special attention to the unambiguousness of outsourcing objectives.

Keywords
Business Process Outsourcing, Outsourcing Contract, Outsourcing Risk, Penalty-System

Introduction and Research Objective
Within IS outsourcing literature, there is an ongoing discussion whether formal contracts and relational norms (contracts) function as substitutes or complements to each other (Poppo and Zenger 2002). The general importance of both has been stressed by various IS researchers (e.g. Kern (1997); Miranda and Kim (2006); Useem and Harder (2000); Uzzi (1997)). With respect to the formal contract, it has been stated that it is an important tool to attain the expected benefits (Grover et al. 1996) and to mitigate outsourcing risks (Aubert and Patry 2005; Willcocks and Kern 1998). Regarding relational norms it has been claimed that trust (Koh et al. 2005), commitment, and flexibility (Goles and Chin 2005) are important mechanisms that contribute to outsourcing success.

Within IS research on outsourcing deals, there are only few contributions on the composition of contracts and contract clauses (e.g. Aubert and Patry (2005); Goo et al. (2006)). So far, research has focused more on the importance of the contract in general (e.g. Beulen and Ribbers (2002) and Domberger et al. (2000)).

Moreover, research has paid little attention to the fact that even outsourcing deals driven by relational norms are based on a contract and somehow use it one way or another. Therefore, the goal of our research is to analyze if outsourcers already set the stage for one of the two forms of governance (i.e. formal or relational) during contract design. We take the existence of a Penalty-Reward-System as indicator that the governance of an outsourcing deal is more likely to be based on formal (i.e contractual) than on relational norms (details on this can be found in section 3, “Research Model and Construct Development”).
To address this goal, we first analyze a general research model, which examines the impact of those contractual elements, which are related to the daily working relationship between the outsourcer and their service provider, on the achievement of outsourcing expectations. Within this context, we consider clauses concerning SLA quality, unambiguity of objectives, problem solving, and contractual flexibility as contractual elements that relate to the daily working relationship. As a second step, we then analyze whether or not a Penalty-Reward-System affects the impact these contractual elements have on the achievement of outsourcing satisfaction. We thereby aim at investigating if one or the other form of governance has already been implemented during contract design.

Therefore, based on the outsourcer’s perspective and considering the two different modes of governance, we aim at answering the following research questions:

- What is the impact of those contractual elements, which are related to the daily working relationship between both parties, on the achievement of outsourcing expectations?
- Do agreements on penalties for non-fulfillment of SLAs affect the impact contractual elements have on the achievement of outsourcing satisfaction?

These research questions are answered in the context of Business Process Outsourcing: BPO can be defined as the delegation of one or more, or entire, business processes to third party providers, including the software and hardware supporting those processes (Halvey and Melby 2000). Therefore, BPO combines the outsourcing of application development and maintenance, of IT infrastructure, and of manually performed business activities, such as business process redesign. Answering the research questions in this rich context offers the advantage that results provide insights not only for BPO deals but also for many other IT-related types of outsourcing.

To approach these research questions, we first review current IS literature on formal contracts and relational norms (section 2). Using these insights we develop our research model (section 3). Based on the Partial Least Squares Method (PLS) and data from 335 BPO deals in the German banking industry we test our model and discuss the results (section 4). Finally, we summarize the contributions and limitations of our research (section 5).

**Related Literature**

The following highlights related literature on formal and relational contracts as well as insights from BPO success research.

**Formal Contracts and Relational Norms as Modes of Governance**

Lee and Kim (1999) distinguish between outsourcing deals that have a transactional style and deals that have partnership style. Deals based on the transactional style develop through the formal contract in which the ‘rules of the game’ are well specified and failure to deliver on commitments results in litigation or penalties. Miranda and Kavan (2005) classify these deals as arms-length relationships that are exclusively economic and rely solely on formal means of governance. In the following these arrangements are referred to as ‘contract-based’ outsourcing deals. Partnership style or ‘embedded’ relationships are those in which the economic and social content of the relationship overlap and the social relationship is tapped for regulating the relationship (Miranda and Kavan 2005). These deals focus on the relationship aspect and aim at fostering a cooperative relationship based on trust (Lee and Kim 1999). Here, these outsourcing deals will be referred to as arrangements based on ‘relational norms’.

**Outsourcing contracts**

In general, the formal contract is an important element of any complex business relationship (Macaulay 1963). The written outsourcing contract is the most important instrument for defining rights, liabilities and expectations of both parties (Lee 1996). According to Kern and Willcocks (2000a), the contract undergirds the outsourcing venture in a number of ways: its legal status, for example, encapsulates termination clauses, penalty demands, and dispute resolution procedures that client companies can legally enforce in court. Although companies emphasize that such extreme measures are seldom implemented, they still pose a strong means of putting pressure on the vendors to ensure contractual achievements.
Within outsourcing contract literature, special attention has been paid to the role of well-defined SLAs. Goo et al. (2006) highlight that practitioners often proclaim that SLAs are essential to outsourcing success. According to Alborz et al. (2004), the non-existence of SLAs has a negative impact on the quality of the relationship. Domberger et al. (2000) stress that well-defined expectations of an organization’s IT requirement are likely to lead to improved performance. SLAs help to specify expectations and objectives of an outsourcing deal.

On the one side, contracts set quality objectives. On the other side, they have been identified as prevailing instruments to prevent or limit possible contingencies, i.e. outsourcing risks (Aubert et al. 1999). Willcocks and Kern (1998) emphasize that the mitigation of outsourcing risks is mainly based on the contract, through, for example, exit arrangements and penalty clauses. Renegotiation options and penalty clauses help to mitigate risks emerging from opportunistic behavior of the vendor (Willcocks and Kern 1998).

**Relational norms within the outsourcing context**

The importance of relational norms within outsourcing arrangements has been stressed by various researchers. Dwyer et al. (1987), Henderson (1990), and Lee and Kim (1999), for example, highlight the importance of commitment within an outsourcing partnership. Trust and cooperation have been identified as important factors contributing to outsourcing success (Anderson and Naurus 1990; Kern 1997; Klepper 1995). Heide and John (1990) and Ring and Van de Ven (1994) emphasize that flexibility is very important for fostering a long-lasting relationship. Furthermore, a consensus regarding outsourcing goals and joint expectations are also key to outsourcing success (Kanter 1994; Ring and Van de Ven 1994). Goo et al. (2006) highlight that SLAs are an appropriate tool to contractually anchor relational aspects. However, in general, little is known how relational norms are reflected within the contract.

**Formal contracts and relational norms as substitutes or complements**

According to Dyer and Singh (1998), and Uzzi (1997) relational norms, such as trust and commitment, are viewed as substitutes for a contract. Within this view, contracts can even be interpreted as a sign of mistrust (Lyons and Mehta 1997). By contrast, Poppo and Zenger (2002) empirically explored a complementary relationship between formal contracts and relational governance. However, little attention has been paid to the fact that within all outsourcing relationships a contract has been signed – no matter if the relationship is ‘contract-based’ or based on ‘relational norms’. Therefore, what matters is the composition of individual contract clauses (i.e. what parts of the contracts are detailed and precisely defined and what parts are neglected).

**Business Process Outsourcing Success**

According to Kern (1997), success of an outsourcing relationship relies chiefly on the outsourcer’s satisfaction. Satisfaction can be defined as a positive affective state resulting from the appraisal of all aspects of a firm’s working relationship with another firm (Anderson and Naurus 1990). Within the outsourcing context, this positive state can be achieved on the one hand by attaining benefits and on the other hand by managing/mitigating risks (Aubert and Patry 2005).

According to Grover et al. (1996), benefits can be either strategic, economic, or technological. Within our research, strategic benefits refer to the bank’s ability to focus on core competencies. Economic benefits are either associated with cost reductions through the utilization of economies of scale, scope and skill, or with an increase in quality. Technological benefits lie in the bank’s ability to exploit modern IT technologies.

Aubert et al. (2005) relate outsourcing risk to outsourcing success by illuminating the importance of risk analysis and risk management for the prediction of outsourcing outcomes. Within this context, the contract has been emphasized as an important tool for risk management in outsourcing (Aubert et al. 2003a).
Research Model and Construct Development

Research Model

Prior to this empirical research we conducted a series of ten expert interviews. Our interview partners were project managers or managers of the retained organization of different BPO deals in the German banking industry. The project managers had led the respective contract negotiations. They were therefore able to elaborate on the original intention behind different contract clauses. However, as project managers often leave an outsourcing project after hand-over to the service provider, we also interviewed managers of the retained organization to gain an understanding if the implemented contract mechanisms/clauses were actually ‘working’.

During these interviews it had been mentioned repeatedly that there are clauses that specify the daily working relationship, and clauses that are of a more general nature. Clauses of a more general nature refer to non-recurring issues or general agreements (see right hand side of Figure 1 below). These clauses provide a frame or setting into which the clauses that specify the daily working relationship fit and put some life.

Our research focuses on four contractual elements that shape the daily working relationship. These can be summarized in four categories (see left hand side of Figure 1 below). This classification is based on a listing of single contract clauses by Kern and Willcocks (2000b) and Anderson and Dekker (2005) and the outcome of the already mentioned expert interviews.

Within the course of this research, the level of completeness of the contract refers only to those clauses associated with the daily working relationship. “SLA Quality” comprises clear performance measures and targets leading to detailed and precisely defined SLAs. “Unambiguosity of Objectives” relates to well-defined expectations and goals. “Problem Solving” refers to contract clauses that describe procedures and processes of how potential problems between both parties may be solved. “Contractual Flexibility” enables the outsourcer to react quickly to changing market conditions or customers’ demands. Clauses regarding “Contractual Flexibility” allow the outsourcer to renegotiate terms at short notice when new requirements need to be fulfilled by the service provider.

We propose that these four contract elements greatly influence the completeness of the formal contract with regard to clauses concerning the daily working relationship (H1a – H4a, see Figure 2). As the contract plays a central role in mitigating outsourcing risk (see ‘related literature’), we furthermore hypothesize that the completeness level of the contract negatively influences outsourcing risk (H5a). To analyze outsourcing success, we investigate the overall

Figure 1. Classification of Contract Elements

Within the course of this research, the level of completeness of the contract refers only to those clauses associated with the daily working relationship. “SLA Quality” comprises clear performance measures and targets leading to detailed and precisely defined SLAs. “Unambiguosity of Objectives” relates to well-defined expectations and goals. “Problem Solving” refers to contract clauses that describe procedures and processes of how potential problems between both parties may be solved. “Contractual Flexibility” enables the outsourcer to react quickly to changing market conditions or customers’ demands. Clauses regarding “Contractual Flexibility” allow the outsourcer to renegotiate terms at short notice when new requirements need to be fulfilled by the service provider.

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satisfaction with the outsourcing venture (Lee and Kim 1999). Several studies have shown that risk has a negative impact on outsourcing success (e.g. Aubert et al. (1998)). Thus, we hypothesize that satisfaction with the outsourcing deal is negatively influenced by the severity of outsourcing risk (H6).

Within the context of the formal contract, several researchers highlight the importance of penalties for the non-fulfillment of SLAs. Legal experts on outsourcing share this view as they suggest that a minimum contract should include specified service levels and penalty clauses (Fitzgerald and Willcocks 1994). Beulen and Ribbers (2002) and Kern and Willcocks (2000a) emphasize the importance of penalties as a tool to enforce control over the vendor. On the other side, enforcement clauses are a sign of mistrust and make building a good relationship difficult (Lyons and Mehta 1997). The existence of a penalty-system can therefore be seen as an indicator whether the outsourcing venture is governed by a ‘contract-based’ or ‘relational-norms-based’ mode.

A penalty-system can only effectively be used in combination with detailed and precisely defined SLAs. Therefore, we hypothesize that, regarding the level of contract completeness, the quality of SLAs is of higher importance for outsourcers that contractually agreed upon a penalty-system than for outsourcers that did not do so (H1b).

Regarding relational norms it has been stressed that joint expectations (Kanter 1994; Ring and Van de Ven 1994) and agreements regarding objectives (Goles and Chin 2005) are important aspects of partnership style relationships. We therefore hypothesize that unambiguousness of objectives contributes to a higher level contract completeness for outsourcers that contractually did not agree upon a penalty-system than for outsourcers that did do so (H2b).

Furthermore, we propose that agreements on problem solving contribute to a higher level of contract completeness for outsourcers that contractually agreed upon a penalty-system than for outsourcers that did not do so (H3b). Agreements regarding problem solving often comprise a detailed description of processes and procedures both parties have to adhere to. Therefore, these agreements have a very formal character.

As stated before, flexibility is very important for fostering a long-lasting relationship (Heide and John 1990; Ring and Van de Ven 1994) and thereby emphasizes the partnership aspect of an outsourcing relationship. Therefore, we hypothesize that flexibility clauses contribute to a higher level of contract completeness for outsourcers that contractually did not agree upon a penalty-system than for outsourcers that did do so (H4b).

In a contract based governance mode, the contract is the most prominent instrument to manage the outsourcing venture. Thus, we hypothesize that the impact of contract completeness on outsourcing risk is higher for outsourcers who have agreed on a penalty-system (H5b). The degree of outsourcing satisfaction does not depend on the existence of a penalty-system as the relational based governance can guarantee outsourcing success in a similar manner. Thus, we hypothesize that there are no differences between the two modes of governance with regard to the impact of outsourcing risks on the satisfaction with the outsourcing venture (H6). Within our research, satisfaction with the outsourcing venture relates to the achievement of strategic, economic, and technological benefits.

Figure 2 shows our research model; Table 1 provides our research hypotheses.
Table 1. Research Hypotheses

<table>
<thead>
<tr>
<th>No.</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>H1a</td>
<td>The quality of SLAs contributes to a higher level of contract completeness.</td>
</tr>
<tr>
<td>H1b</td>
<td>The quality of SLAs contributes to a higher level of contract completeness for outsourcers that contractually agreed upon a penalty-system than for outsourcers that did not do so.</td>
</tr>
<tr>
<td>H2a</td>
<td>Unambiguousness regarding objectives contributes to a higher level of contract completeness.</td>
</tr>
<tr>
<td>H2b</td>
<td>Unambiguousness regarding objectives contributes to a higher level contract completeness for outsourcers that contractually did not agree upon a penalty-system than for outsourcers that did do so.</td>
</tr>
<tr>
<td>H3a</td>
<td>Agreements regarding problem solving contribute to a higher level of contract completeness.</td>
</tr>
<tr>
<td>H3b</td>
<td>Agreements regarding problem solving contribute to a higher level of contract completeness for outsourcers that contractually agreed upon a penalty-system than for outsourcers that did not do so.</td>
</tr>
<tr>
<td>H4a</td>
<td>Flexibility clauses contribute to a higher level of contract completeness.</td>
</tr>
<tr>
<td>H4b</td>
<td>Flexibility clauses contribute to a higher level of contract completeness for outsourcers that contractually did not agree upon a penalty-system than for outsourcers that did do so.</td>
</tr>
<tr>
<td>H5a</td>
<td>The completeness level of the formal contract negatively influences the extend of outsourcing risk.</td>
</tr>
<tr>
<td>H5b</td>
<td>The negative influence of the completeness level of the formal contract on outsourcing risk is higher for outsourcers that contractually agreed upon a penalty-system than for outsourcers that did not do so.</td>
</tr>
<tr>
<td>H6</td>
<td>Outsourcing risk negatively influences the satisfaction with the outsourcing deal.</td>
</tr>
</tbody>
</table>

Construct Development

The following table presents the operationalization of our constructs. The reference(s) in the first column indicate the respective IS literature where the operationalization has been taken from.

Table 2. Operationalization of Constructs

<table>
<thead>
<tr>
<th>Construct</th>
<th>Indicator</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>SLA Quality (Aubert et al. 2003a)</td>
<td>SL-1</td>
<td>The service provider received clear performance targets through our SLAs.</td>
</tr>
<tr>
<td></td>
<td>SL-2</td>
<td>Through our performance measures and performance targets we were able to make clear what we expect from our service provider.</td>
</tr>
<tr>
<td></td>
<td>SL-3</td>
<td>Overall, we have implemented very detailed and precisely defined SLAs.</td>
</tr>
<tr>
<td>Unambiguousness of Objectives (Goo et al. 2006)</td>
<td>O-1</td>
<td>Based on the contractual agreements, our service provider knows exactly which expectations have to be fulfilled.</td>
</tr>
<tr>
<td></td>
<td>O-2</td>
<td>Based on the contractual agreements, our service provider knows exactly which goals we associate with the outsourcing project.</td>
</tr>
<tr>
<td></td>
<td>O-3</td>
<td>Based on the contractual agreements, our service provider knows exactly which outcome we expect from outsourcing.</td>
</tr>
<tr>
<td>Problem Solving (Aubert et al. 2003a; Goo et al. 2006)</td>
<td>P-1</td>
<td>According to defined contractual clauses, problems and disputes with the vendor can be solved easily.</td>
</tr>
<tr>
<td></td>
<td>P-2</td>
<td>According to defined contractual clauses, we are expected to meet with our service provider regularly to discuss problems and open issues.</td>
</tr>
<tr>
<td></td>
<td>P-3</td>
<td>According to defined contractual clauses, both parties know how to act if problems and disputes occur.</td>
</tr>
<tr>
<td>Contractual Flexibility (Aubert et al. 2003a; Goo et al. 2006)</td>
<td>F-1</td>
<td>Our contract enables us to renegotiate terms at short notice.</td>
</tr>
<tr>
<td></td>
<td>F-2</td>
<td>In our contract, it is defined in detail when and how new requirements can be implemented and to which conditions.</td>
</tr>
<tr>
<td></td>
<td>F-3</td>
<td>It is very costly to change SLAs.</td>
</tr>
</tbody>
</table>
Methodology and Sample Characteristics

The research model was operationalized and transferred into a structural equation model (SEM) to be analyzed with the PLS approach (Chin 1998; Wold 1985). PLS is particularly suitable if a more explorative analysis close to the empirical data is preferred. As there is no elaborated theoretical framework for the impact of penalty-systems on outsourcing risk and success, an explorative approach is appropriate for this research.

All constructs used in the model have been derived from other studies and adapted to the specific research domain. Each variable in our research model was measured on a 7-point Likert scale. The construct “risk” was measured using scales from “very high” (risks) to “very low” (risks); all other scales ranged from “strongly agree” to “strongly disagree”. To identify the groups using a penalty-system, a single question (“If SLAs are not met, the service provider receives less money (malus).”) with the possible answers “yes” or “no” was used. The groups were statistically analyzed using PLS multi-group analysis (Chin 2000).

Demographics

As unit of analysis four banking back-office processes were selected which are generally not regarded to belong to core competencies for banks (Lamberti and Pöhler 2004): settlement of securities, consumer credits, credit cards and domestic payments. In 2006, our questionnaire was sent to managers at Germany’s top 500 banks responsible for one of these back-office business processes. As not in every bank all these processes are outsourced, we asked managers to indicate whether the process was not externally provided. Out of 1,931 processes, we received information that 761 processes were outsourced and 904 processes were not outsourced. The outsourcing status of the remaining 266 stayed unknown to us. Overall, 335 usable questionnaires from 247 banks were returned. Assuming that processes without any information about their outsourcing status are outsourced, this equals a response rate of 32.6%. The cumulated assets of the responses accounted for more than 90% of the total cumulated German banking balance sheet. This is only a rough estimate, as the questionnaire asked for the sum of assets on an interval scale to ensure anonymity. The response rate amongst large banks (assets > EUR 20bn) was exceptionally high (60.4%). The outsourcing duration ranges from early ventures starting in 1960s to late adopters in 2006 (median = 2001).

Measurement Model Validation

The quality of the reflective measurement model is determined by (1) convergent validity, (2) construct reliability and (3) discriminant validity (Bagozzi 1979).

Convergent validity is analyzed by indicator reliability and construct reliability. In the model tested, all loadings are significant at the 0.001 level and above the recommended 0.7 parameter value — significance tests were conducted using the bootstrap routine with 500 samples (Chin 1998); for results see appendix.)
Construct reliability was tested using two indices: (1) the composite reliability (CR) and (2) the average variance extracted (AVE). Estimated indices were above the recommended thresholds (Bagozzi and Yi 1988) of 0.6 for CR and 0.5 for AVE (see appendix).

Discriminant validity of the construct items can be analyzed by looking at the cross-loadings. As for our reflective indicators, the loadings of each indicator are higher for their respective constructs than for any other construct. Furthermore, the square root of the AVE for each construct is higher than correlations between constructs. Therefore, the indicators of different constructs are not related to each other and discriminant validity of the latent variables is high.

Structural Model

After reviewing the measurement model, the explanatory power of the structural model is evaluated. The explanatory power is examined by looking at the squared multiple correlations (R²) of the dependent variables. 56% (R²=0.56) [for BPO deals with a penalty-system 70% (R²=0.70), for BPO deals without a penalty-system 53% (R²=0.53)] of the variation in completeness of contract is explained by SLA quality, objectives agreement, problems solving and flexibility clauses. The R² values for overall risk (R²=0.33; for BPO deals with a penalty-system R²=0.48 and for BPO deals without a penalty-system R²=0.30) as well as for satisfaction (R²=0.49; for BPO deals with a penalty-system R²=0.68 and for BPO deals without a penalty-system R²=0.48) are also encouragingly high.

Predictive power is tested by examining the magnitude of the standardized parameter estimates between constructs together with the corresponding t-values that indicate the level of significance. Additionally, as bootstrapping reveals, all path coefficients are highly significant (at the 0.001 level). Analysis of the overall effect size (f²) of the antecedents of BPO attitude reveals that all constructs have moderate effect. The following Figure 3 shows the structural model findings and includes results of the overall model as well as results related to the implementation of a penalty-system.

Figure 3. Structural Model Findings
Results

Analysis of the Overall Structural Model

With respect to the results of the structural model, problem solving clauses have been identified as the most important contractual element (H1a). This is in line with the findings from Clark et al. (1995) that a contract should provide well-defined procedures for problems resolution. Second, contract clauses that explicitly state expectations and objectives of the outsourcing deal are seen as an important element in contributing to a high completeness level of the contract (H2a). Defining expectations and objectives has been stressed as an important element of relationally-governed exchanges. Relational norms, such as trust, joint action and commitment can only emerge if expectations and objectives have been specified previously (Poppo and Zenger 2002). SLAs are only the third most important contractual element. This adds to the discussion of incomplete contracts (Harris et al. 1998; Kern and Willcocks 2000b). It is hardly possible to design perfectly detailed and precise service level objectives that last during the entire lifecycle of the outsourcing venture (H3a). Therefore, the impact of SLAs on contract completeness is lower than the impact of clauses related to problem solving and objectives.

Surprisingly, flexibility clauses do not seem to play an important role with regard to the completeness level of the contract (H4a). The low necessity might be specific to BPO as in an environment with short innovation cycles, such as IT outsourcing, flexibility clauses are much more important.

The contract has been seen as a tool to effectively mitigate outsourcing risks (H5a). Thereby, the central role of the contract to prevent possible contingencies has been highlighted. This adds to findings from Aubert et al. (2003b) where the contract has been found to effectively counter risks emerging from opportunistic behavior.

The overall satisfaction with the outsourcing deal is strongly affected by the presence/severity of outsourcing risks (H6) which supports the findings from Aubert et al. (1999).

Group Findings

Our results show that the impact of the completeness level of the contract (regarding clauses that concern the daily working relationship) on outsourcing risk is greater for BPO deals with a penalty-system than for BPO deals without a penalty-system (H5b). This implies that outsourcing deals (and contracts) which are based on formal norms tend to have a greater ability to mitigate outsourcing risk than deals based on relational norms. This is in accordance with Willcocks and Kern (1998) who emphasize that the mitigation of outsourcing risks is mainly based on the contract. Nonetheless, the possibility to mitigate outsourcing risk of deals without a penalty system also exits.

Regarding the completeness level of the contract

- the importance of SLAs is greater for BPO deals that comprise a penalty-system (H1b)
- the relevance of unambiguousness of objectives is greater for BPO deals without a penalty-system (H2b).

Differences for clauses on problem solving and flexibility have not been supported (H3b and H4b).

The statistical results for all these findings are presented below in Table 3. Path differences were derived by applying PLS multi-group analysis as suggested by Chin (2000).
Table 3. Path differences where a penalty-system exists

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>t-value</th>
<th>degrees of freedom (df)</th>
<th>Sign Niv</th>
</tr>
</thead>
<tbody>
<tr>
<td>H1b SLA quality ➔ Contract completeness</td>
<td>2.91</td>
<td>335</td>
<td>&lt; 0.01</td>
</tr>
<tr>
<td>H2b Objective agreement ➔ Contract completeness</td>
<td>-2.03</td>
<td>335</td>
<td>&lt; 0.05</td>
</tr>
<tr>
<td>H3b Problem solving ➔ Contract completeness</td>
<td>-0.18</td>
<td>335</td>
<td>&gt; 0.1</td>
</tr>
<tr>
<td>H4b Contractual flexibility ➔ Contract completeness</td>
<td>-0.85</td>
<td>335</td>
<td>&gt; 0.1</td>
</tr>
<tr>
<td>H5b Contract completeness ➔ Risk</td>
<td>-2.32</td>
<td>335</td>
<td>&lt; 0.05</td>
</tr>
</tbody>
</table>

These results contribute to the discussion on the relation between formal and relational governance modes: it neither supports the argument that they are substitutes nor the argument that they are complements (Klein Woolthuis et al. 2005). It rather emphasizes the fact that already during contract negotiations and design outsourcers set priorities in their governance activities. Outsourcers that favor the formal governance mode seem to put more emphasis on specifying high quality SLAs. For outsourcers that focus on relational norms the clearness of objectives seems to be of higher importance. In essence, the contract is much more effective for countering risk when it is incentive based, i.e. by introducing a penalty-system.

However, within our sample, it has been shown that clauses emphasizing formal or relational aspects of governance are both able to contribute to satisfaction with the outsourcing deal. It therefore depends on the execution of the one or the other form of governance whether or not an outsourcing deal is successful.

**Conclusion and Further Research**

Our data are limited as we have been able to analyze the use and impact of formal contracts in one point of time only. Such instruments are usually dynamic in nature and their impacts might take some time to become effective.

Our data from 335 BPO deals show that – regarding the daily working relationship – clauses on problem resolution play a very important role. Furthermore, unambiguousness of objectives and high quality SLAs are important factors that contribute to the outsourcer’s satisfaction with the deal. Flexibility clauses have been found to be of less importance. Since flexibility has been found to be important for outsourcing ventures (Tan and Sia 2006), it might be achieved on a relational instead of a contractual level.

The presence of a penalty-system – which has been accompanied by SLAs of a high quality – greatly increases the ability of the contract in mitigating risks and achieving outsourcing success. Outsourcers prioritizing relational governance put more emphasis on the formulation of outsourcing objectives within the outsourcing contract and also value flexibility clauses.

Further research should analyze how (1) a penalty-system can be designed and how (2) such a system can be used while not affecting the behavior in a less innovative and trustworthy manner. In addition to analyzing contractual elements, differences in relational factors, i.e. those building a good relationship, should be evaluated by comparing formal and relational governance modes.

**Acknowledgement**

The authors gratefully acknowledge the support of the E-Finance Lab at Frankfurt University.
References


## Appendix

*Reflective Measurement Model*

### Table 4. Convergent validity and construct reliability

*(N.B.: all items are significant at the 0.001 level)*

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