Management Accounting Research 20 (2009) 129–145

Contents lists available at ScienceDirect

Management Accounting Research

journal homepage: www.elsevier.com/locate/mar

Determinants of contract terms for professional services

Carsten Homburg[a,*], Peter Stebel[b]

[a] Department of Management Accounting, University of Cologne, Albertus-Magnus-Platz, D-50923 Cologne, Germany
[b] PricewaterhouseCoopers AG WPG, Friedrichstr. 14, D-70174 Stuttgart, Germany

ARTICLE INFO

Keywords:
Cost contracts
Customer integration
Double moral hazard
Incentives
Professional services

ABSTRACT

This study provides evidence on the determinants of contract terms between professional services firms and their clients. Because professional services are typically characterized by a high degree of transactional uncertainty and a double moral hazard risk, contracts can be essential for the creation of incentives to control the behavior of those involved in the service encounter. Based on both agency and organizational theory, hypotheses on the determinants of implementing a specific type of cost contract are developed and tested empirically with respect to management consulting firms. Our results indicate that (1) service characteristics exert a significant impact on the chosen contract type, (2) performance-based contracts may not be optimal, even if service output is measurable and verifiable, and (3) experience-based trust and reputation impact on the choice of controls used in short-term contracts. These results contribute to the field of management accounting by providing insights into the design of management control systems in service organizations.

1. Introduction

Because co-production by service employees and clients is at the heart of many services (Larsson and Bowen, 1989; Solomon et al., 1985), clients themselves often exert a considerable impact on both the cost of the service process and its output (Glückler and Armbrüster, 2003, p. 277). Despite this insight, there is little research on how service organizations actually design management control systems to govern transactions at the organization–client interface (Chenhall, 2003; Hopwood, 1996; Modell, 1996; Otley, 1994; Shields, 1997).

In this paper, we focus on professional services, in particular management consulting services, and examine the determinants of contract terms between management consulting firms and their clients. Contracts are formal mechanisms of management control (Anderson and Dekker, 2005; Kirsch et al., 2002) and the analysis of contract terms yields insights into how transactions between both contracting parties are governed. Contractual relationships between management consulting firms and their clients have several relevant and important characteristics. First, consulting services are often complex and involve a high level of both transactional uncertainty and risk for the client, as he does not purchase a ready-made product (Glückler and Armbrüster, 2003, p. 269; Mitchell, 1994). Second, because of the interdependent and interactive character of co-production between consultants and clients in service delivery, both contracting parties can behave opportunistically, which results in a double moral hazard risk that needs to be considered in the design of a contract. Third, these contractual relationships are generally rather short-term in nature. It has been established that, in long-term inter-organizational relationships such as international joint-ventures (Groot and Merchant, 2000), outsourcing relationships (Anderson et al., 2000; Langfield-Smith and Smith, 2003; Van der Meer-Kooistra and Vosselman, 2000), strategic alliances (Dekker, 2004) and integrative buyer–supplier arrangements (Frances and Garnsey, 1996), the social context, i.e., trust and reputation, in which these business exchanges are embedded, is highly relevant as a means of mitigating potential opportunistic behavior.

* Corresponding author. Fax: +49 221 470 5012.
E-mail address: homburg@wiso.uni-koeln.de (C. Homburg).

1044-5005/$ – see front matter
doi:10.1016/j.mar.2008.10.001

However, little is known on whether this effect is also relevant to short-term inter-organizational relationships, such as those between service organizations and their clients.

In addition to defining the agreed-upon service, contracts also specify the monetary terms of the contract, that is, how the management consulting firm is to be remunerated. Contracts can be classified into two broad types, according to whether the remuneration of the consulting firm and therefore the cost to the client receiving the service, depend on the realized service output or not. Under a fixed-cost contract, the remuneration of the management consulting firm is invariant with regard to the realized service output, while under a variable-cost (performance-based) contract, it is contingent on the realized service output. The literature usually differentiates between two types of controls that can be used to direct the behavior of a contracting party: behavior-based and outcome-based controls (Eisenhardt, 1985; Ouchi, 1979). Following Eisenhardt, we operationalize a control strategy based on the monetary terms in the contract, that is fixed-cost contracts are a form of behavior-based control, while variable-cost (performance-based) contracts constitute outcome-based control (Eisenhardt, 1985, p. 144).

The purpose of this paper is to add to the limited body of knowledge on the design of management control systems in service organizations. Based on both agency and organizational theory, hypotheses on the determinants of implementing a specific type of cost contract are developed and tested empirically in the context of management consulting. This paper contributes to management accounting in several ways. First, we present empirical evidence with regard to the circumstances under which service companies use behavior- and outcome-based controls to govern transactions at the organization–client interface. Second, our results indicate that both the characteristics of the service and the characteristics of the contracting relationship exert a significant impact on the chosen contract type. This indicates that trust and reputation can be effective in the provision of incentives and the mitigation of moral hazard risks also in contractual relationships that are short-term in nature. Third, the paper provides evidence that in contracting situations characterized by a double moral hazard risk it might be, under specific conditions, optimal not to tie the remuneration of a service provider to actual performance. This adds to our knowledge of the cybernetic process of monitoring and rewarding performance in inter-organizational relationships.

The remainder of the paper is organized as follows. In Section 2, the contracting problems specific to professional services are discussed with reference to management consulting. In Section 3, hypotheses on the determinants of implementing a specific type of cost contract in the presence of double moral hazard are developed, and tested empirically in Section 4. Section 5 concludes the study with a discussion of the results.

2. Contracting problems for professional services

Professional services firms, such as management consultancies and their clients, need to take a number of potential problems into account when designing a contract. First, the client does not purchase a ready-made product and is thus not able to evaluate its characteristics before signing the contract (Glückler and Armbrüster, 2003, p. 276). Second, in order to produce a service, a (written or oral) agreement between the service provider and the client, which details the service to be performed, is necessary. However, in consulting projects, the details of the required service are often unclear at the beginning and many relevant details are thus not conclusively established when a project commences. Contracts are therefore frequently incomplete with respect to the service output as well as to the input of the contracting parties. Third, because of their complexity and intangibility, it is often difficult to observe the effort of a contracting party and to define verifiable performance measures for evaluating the service output. Verifiability not only requires that output be observed and evaluated by the contracting parties, but also by an independent third party. The intangibility of services, however, often renders it difficult to define objective quality and quantity measures for services (Dornstein, 1977, p. 119; Mitchell, 1994, p. 325). Fourth, professional services are typically characterized by a high level of customer involvement in the provision of the service (Larsson and Bowen, 1989; Solomon et al., 1985). In this paper, we use the term 'integrativity' to refer to the level of customer involvement. Integrativity means that the agreed-upon service cannot be finalized without the integration of external factors. External factors are defined as production factors relating to the client that, temporarily and restricted to a specific service process, enter into the service provider's domain, where they are combined with the latter's internal production factors in order to produce the service (Fließ and Kleinaltenkamp, 2004, p. 394).[1] While simple services often require only a low level of interaction between the service provider and the client, professional services like those of management consultancies are typically characterized by a high level of interaction. In many cases, the client therefore has a considerable impact on both the cost of the service process and its output (Glückler and Armbrüster, 2003, p. 277).

In the case of asymmetric information between the service provider and the client with regard to each others' inputs, both contracting parties can behave opportunistically before and during their contractual relationship (Martin et al., 2001). Before signing the contract, the service provider can overstate his qualifications and experience in order to secure the contract, whereas the client can downplay the difficulty of the task or overstate his cooperation. During the service process, there is the risk that both contracting parties choose a lower than agreed upon level of effort. In order to minimize costs, the consulting firm can, for example, use results from other projects without adapting them sufficiently to the specific needs of the client. Similarly, a client can minimize costs by not assigning his best-qualified employees to the project. After the service is finalized, there is the risk that the service provider will take advantage of any leeway in billing, for example, by charg-

[1] External factors can take various forms: people (e.g., the customer himself), objects, rights, money and information.