



## Purchasing professional services: A transaction cost view of the antecedents and consequences of purchasing formalization



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### ABSTRACT

Professional services represent an increasing share of expenditures in contemporary organizations. While these services are often of strategic importance, they are also perceived as being difficult to purchase and use, which creates challenges for the purchasing process. In order to address these challenges, organizations are increasingly engaging in systematic efforts to improve their ability to purchase professional services. These efforts focus on formalizing the purchasing process by introducing policies, guidelines, and other measures for the hiring of service suppliers. Based on a transaction cost economic framework, the current paper investigates the nature, antecedents and consequences of formalization initiatives in the purchasing of professional services. The results from a cross-sectional study of 76 large Swedish organizations show that the formalization of purchasing professional services takes two different forms: the formulation of policies and the establishment of preferred supplier agreements. The former is driven by company size, whereas the latter is driven by the frequency of purchase transactions. Only the establishment of policies, however, is found to be positively related to organizations' perceived ability to purchase professional services.

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### 1. Introduction

Contemporary organizations spend an increasing proportion of their resources on services (Axelsson & Wynstra, 2002; van der Valk & Rozemeijer, 2009; van der Valk & Wynstra, 2012), which in many cases can account for 50% or more of total spend (Bals, Hartmann, & Ritter, 2009; Tate, Ellram, Bals, Hartmann, & van der Valk, 2009). Professional services represent a rapidly growing service category (Ellram & Billington, 2002; FEACO, 2010) that is of potential strategic importance to organizations, as they are instrumental in providing organizations with new knowledge and enabling innovation (Bessant & Rush, 1995; Muller & Zenker, 2001). As professional services are dependent on both the individual service supplier's expertise and the buyer–supplier interaction, selecting and hiring the right supplier is crucial to achieving the desired outcomes (Armbrüster, 2006; Clark, 1995). The ability to purchase professional services in a proficient manner has thus become a vital source of competitiveness, via which successful organizations can create advantages both in terms of cost reduction and innovativeness (Ellram, Tate, & Billington, 2004; Gadde & Snehota, 2000; Ogden, Rossetti, & Hendrick, 2007; Porter, 1998; Van Weele & Rozemeijer, 1996).

The increasing frequency and heightened strategic importance of professional service purchasing has placed new demands on the purchasing

function in organizations, as the purchasing of professional services to a large extent differs from and is perceived as more complex and difficult than the purchasing of goods and less complex services (Holma, 2012; Jackson, Neidell, & Lunsford, 1995; Smeltzer & Ogden, 2002; Stock & Zinszer, 1987). These complexities are related to the specific characteristics of professional services. Professional services are abstract, built on intangible qualities and dependent on the buyer–supplier interaction (Clark, 1995), which make it difficult for buyers to specify, compare and evaluate the services both ex-ante and ex-post (Clark, 1995; Day & Barksdale, 2003; Ellram, Zsidisin, Siferd, & Stanly, 2002; Lindberg & Nordin, 2008; Lynn, 1987; Perner, 2008). Many buyers therefore perceive professional services as risky to purchase and utilize (Glückler & Armbrüster, 2003; Mitchell, 1994; Mitchell, Moutinho, & Lewis, 2003). To manage these perceived risks, buyers have traditionally used a relational and trust-based purchasing approach (Agndal, Axelsson, Lindberg, & Nordin, 2007; Armbrüster, 2006; Axelsson & Wynstra, 2002; Lian & Laing, 2004; Lian & Laing, 2007; Tate et al., 2009), hiring suppliers that are well known and trusted. The buyer–supplier relationship thus often has a dyadic, personal character, with no or very little involvement of the purchasing department (Armbrüster, 2006; Lian & Laing, 2007; Ogden et al., 2007; Richter & Niewiem, 2009).

However, it has increasingly been argued that this approach to purchasing professional services may result in 'overembeddedness' (Uzzi, 1997), with the consequence that organizations stick with suppliers with which they have established relationships, in spite of the existence of cheaper and/or higher-quality suppliers (Armbrüster, 2006; Barney & Hansen, 2006; Glückler & Armbrüster, 2003). Organizations have thus

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started to change their purchasing behavior from using the traditional relational and dyadic purchasing approach to developing more formalized purchasing processes and involving purchasing professionals (Mohe, 2008; Ogden et al., 2007; Perner & Skjolsvik, 2012; Schiele, 2005; Werr & Perner, 2007). Examples of formalization initiatives include the establishment of policies, guidelines, checklists and formal contracts with, for example, preferred suppliers (Lau, Goh, & Phua, 1999; Perner & Werr, 2009; Sieweke, Birkner, & Mohe, 2012). But while existing research has noted a trend toward increased formalization, as well as variations in formalization practices among organizations (Rozemeijer, Van Weele, & Weggeman, 2003; Sieweke et al., 2012; Werr & Perner, 2007), the reasons for these differences, as well as their consequences, are less well understood.

As such, the purpose of the current article is to contribute to the body of knowledge about formalization in the purchasing of professional services. The first aim is to identify the specific formalization measures adopted by firms and the extent to which they have actually been implemented. In doing so, we go beyond prior studies that have treated purchasing formalization as a rather general concept, without examining its anatomy and magnitude in more detail (e.g., Alejandro, Kowalkowski, da Silva Freire Ritter, Marchetti, & Prado, 2011; Auh & Menguc, 2007; Dawes, Lee, & Midgley, 2007). A second aim is to explore the antecedents to formalization in order to explain observed differences in purchasing formalization. A number of studies have identified enablers and barriers to the establishment of a more formalized purchasing of professional services (Ellram & Billington, 2002; Mohe, 2005; Werr & Perner, 2007; Bals, et al., 2009), as well as to the development of the purchasing department into a more professional and strategic function (e.g., Ellram & Carr, 1994; Van Weele & Rozemeijer, 1996; Ellram & Billington, 2002). However, these mostly case-based studies fall short of offering theory-based explanations for different degrees of purchasing formalization in the context of professional services. Third, the current study aims to assess the performance consequences of purchasing formalization. The literature relates a number of positive outcomes to purchasing formalization, such as a more efficient use of professional services, a clearer division of roles and responsibilities between managers and purchasing professionals, and increased bargaining power (Baker & Faulkner, 1991; Schiele, 2005; West, 1997). Systematic evidence for the achievements of these effects is, however, scarce, and relatively little is known about the impacts of purchasing formalization. Against this background, the current paper develops a conceptual model founded in transaction cost economics (TCE) linking antecedents and outcomes to the formalization of purchasing in professional services. TCE is used as it is a dominant theoretical perspective offering explanations as to why organizations select different governance forms, such as markets, hierarchies and hybrid models (Rindfleisch & Heide, 1997; Williamson, 1975, 1979).

The context of the study is the purchasing of management consulting services in Sweden. With this empirical focus, we focus on the purchase of management consulting services, a type of professional service that is costly, of high strategic importance, and often referred to as the most complex and difficult service to purchase (Mitchell, 1994; Schiele, 2005; Soriano, 2001). As a neo-professional service (von Nordenflycht, 2010), management consulting lacks a professionalized workforce characterized by a well-defined and exclusive knowledge base. This makes management consulting an extreme case (Eisenhardt & Graebner, 2007) exemplifying the uncertainties in the purchasing process, and thus one that is well suited to illustrate the specific challenges involved in purchasing and using professional services. Sweden provides a suitable context for this study, as it, despite its relatively small economy, is one of the countries with the most developed management consulting industries in Europe (the Swedish management consulting sector constitutes 0.95% of Sweden's GDP, which is the third-highest percentage in Europe, exceeded only by the UK and Germany) (FEACO, 2010). Survey data from 76 large Swedish

firms collected in 2008 are used to test the conceptual model developed in this article. This empirical study complements previous studies of the purchase of professional services, which have to a large extent focused on marketing services (Bals, et al., 2009; Cater & Zabkar, 2009; Guercini & Runfola, 2009; Ivens, Pardo, & Tunisini, 2009; Sheth & Sharma, 2008; Tate et al., 2009), and which have offered mainly qualitative case-based evidence.

The paper is structured as follows. In the next section, the focal concept of purchasing formalization is discussed and the related conceptual model is developed, including hypotheses regarding the antecedents and consequences of purchasing formalization. After a presentation of the methodological approach, results regarding the degree of formalization, the salience of the antecedents and their consequences are presented. The paper concludes with a discussion of the found empirical results, their implications and their limitations.

## 2. Conceptual model

### 2.1. A transaction cost economic lens

Formalization in organizations, defined as “the degree to which rules define roles, authority relations, communications, norms, sanctions, and procedures” (Jaworski & Kohli, 1993: 56), has been understood mainly from three different perspectives: i) life-cycle theory, which contends that organizations tend to become more formalized as they grow and mature (Barnett & Carroll, 1995); ii) institutional theory, which contends that organizations formalize in response to institutional pressures and in order to gain legitimacy (Meyer & Rowan, 1991; Suchman, 1995); and iii) rationalistic-economic theory, which explains formalization via its assumed positive effects on organizations' effectiveness and efficiency (Heckman, 1999; Laios & Xideas, 1994; Lau et al., 1999; Sölvell, 2008). This last perspective is dominant in the purchasing literature (Axelsson, 2005; Gadde & Håkansson, 1994; Hartmann, Kerkfeld, & Henke, 2012; Juha & Pentti, 2008: 253; Laios & Moschuris, 2001; Narasimhan & Das, 2001; Rozemeijer et al., 2003; Spekman, Kamauff, & Salmund, 1994; Watts, Kim, & Hahn, 1995). The current paper pursues the rational-economic line of inquiry by assuming that organizations formalize their purchasing behavior in an attempt to minimize their costs for a specific service, thereby adding to the organizations' performance and competitiveness (cf. Carr & Pearson, 1999; Carr & Pearson, 2002; Chen, Paulraj, & Augustine, 2004; Hartmann et al., 2012; Paulraj, Chen, & Flynn, 2006).

A theoretical underpinning for this line of reasoning is provided by transaction cost economics (TCE). TCE proposes that organizations choose the way in which transactions are governed – whether in markets, hierarchies or hybrid forms such as networks – in an effort to minimize their costs (Rindfleisch & Heide, 1997; Williamson, 1975, 1979). While the market is generally seen as the governance form offering the lowest production costs because of its ability to exploit economies of scale and scope (Grover & Malhotra, 2003), certain conditions (e.g., bounded rationality, opportunism and asset specificity) may create transaction costs (costs involved in carrying out the transaction) that offset the potential production cost advantages of the market and thus make other governance forms, such as hierarchical and trust-based network models, more economic (Grover & Malhotra, 2003; Rindfleisch & Heide, 1997; Williamson, 1975, 1979).

There are two kinds of transaction costs: direct transaction costs and opportunity costs for a specific choice of governance mode (Rindfleisch & Heide, 1997). Direct transaction costs comprise both ex-ante transaction costs incurred by, for example, the search for, evaluation of and contracting of suppliers, and ex-post transaction costs incurred by, for example, monitoring and enforcing agreements. Opportunity costs include the costs of making inferior governance decisions (Rindfleisch & Heide, 1997). Under conditions of environmental uncertainty, firms may, for example, fail to adapt their governance structures to changes in the environment, or under conditions of behavioral uncertainty,

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