The Asymmetric Benefits of Relational Flexibility: Evidence from Software Development Outsourcing

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Abstract

In this paper, the interacting effect of formal contracts and relational governance on vendor profitability and quality in the software outsourcing industry are examined. We focus on a critical manifestation of relational governance—the presence of relational flexibility in the exchange relationship—and argue that the enacted observation of relational flexibility is driven by perceptions of exchange hazards but, in a departure from extant literature, we propose that the benefits accruing from it are asymmetric and depend on how the exchange risks are apportioned by the formal contract. Formally, we hypothesize that relational flexibility provides greater benefits to an exchange partner that faces the greater proportion of risk in a project, induced through the contract. In addition, we hypothesize that these benefits manifest on the performance dimensions that are of importance to the risk-exposed partner. We test our hypotheses on 105 software projects completed by a software outsourcing vendor for multiple clients. The results show that relational flexibility positively affects profitability in only fixed price contracts, where the vendor faces greater risk, while positively affecting quality only in time and materials contracts, where the client is at greater risk. We thus provide evidence for the asymmetric benefits from relational governance, thereby arguing for a more contingent and limited view of the value of relational governance, based on risk-exposure, rather than the more expansive view prevalent in the literature contending that relational governance provides benefits for all parties to an exchange. We conclude with a discussion of the research and managerial implications of our findings.

Keywords: Relational governance, relational flexibility, formal contracts, software development outsourcing, exchange hazards, regression analysis, quality, profitability