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RESEARCH WITHIN REACH

How companies can guard against cheating partners

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Cooperation between companies is good for business – but what happens when one of them tries to take advantage of the relationship?

More than ever before, companies rely on partnerships with other firms to bring in specialist expertise or specific goods and labour to stay ahead of the competition.

Take, for example, the pharmaceutical industry, in which the big players increasingly rely on partnerships with universities, startups and even other pharmaceutical firms to generate and develop critical innovations.

Because there are so many different aspects of making a drug, it can be too cumbersome to handle it all internally, so various steps are outsourced or completed in partnership with another organisation. The same is true of consumer electronics, space flight and many other fields.

As a result, companies are increasingly finding that they have to cooperate with outsiders to accomplish their goals – and that includes taking on the risk that one of those partners may behave badly.

"Cooperation puts companies at risk of shady behaviour by dishonest partners," says Glenn Hoetker, Professor of Business Strategy and MBS Foundation Chair of Sustainability and Business at Melbourne Business School.

"Many partners are honest, but because it's almost impossible to tell how honest a partner will be in advance, companies should organise their partnerships with an eye towards protecting themselves from potentially dishonest partners."

The problem is that predicting and protecting against bad behaviour can be extremely difficult. While some dishonest partners might resort to outright cheating such as stealing or lying, what is more likely is behaviour that is less obvious – and thus harder to detect – like withholding or distorting information, delivering low-quality goods or taking advantage of unforeseen circumstances to tilt the relationship to their advantage.

Over the last 40 years, researchers in the field of transaction cost economics have studied these kinds of situations and how companies can minimise opportunism when working with partners – where opportunism is described as "self-interest seeking with guile" or, in other words, what happens when a firm goes beyond legitimate means in order to advance its own interests.

This research has traditionally focused on the causes of opportunism, or the tools that can be used to guard against it – but for every answer, it has also introduced new questions, such as which tools are better at protecting against different kinds of opportunism, and whether some combinations of causes are more problematic than others.

Unfortunately, the research methods that led to the initial insights weren't able to resolve these more complex questions, leaving managers without a strong base of evidence for how to best manage their cooperation with other firms – until now.

Using new data and methods, Professor Hoetker and two colleagues – Thomas Mellewigt and Martina Lütkewitte – were able to create a multidimensional view of opportunism that allowed for new insights and comparisons. After six years of research, their study "Avoiding High Opportunism Is Easy, Achieving Low Opportunism Is Not" was published in *Organization Science.*

What causes opportunism?

The case of Theranos – the US biotech startup that falsely claimed to have invented a new way of processing blood tests – is a high-profile example of what outright cheating can look like. The story is compelling enough that it's being turned into a feature film.

However, incidents of such explicit deceit are rare. Most of the time, cheating isn't glamorous or well-planned – it is muddied by incompetence, opportunity or even panic. It was this sort of complexity that Professor Hoetker and his colleagues set out to account for in their research.

"In reality, most cheating has ambiguity," says Professor Hoetker. "It's a multifaceted mix of honest understanding and people being unethical, lazy, or not being fully transparent. So, it makes sense that the best response might be equally multifaceted. This is what this paper deals with – multifaceted solutions to multifaceted threats."

Taking into consideration the complexity of opportunistic behaviour by firms, Professor Hoetker and his colleagues looked at three situations that tended to increase the risk of cheating:

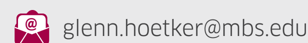
- **Asset specificity** happens when a firm is highly dependent on a service or asset provided by a certain partner and would find it very costly or time-consuming to shift to a different partner. Recognising this dependence, the supplier might be tempted to push or even cross the boundaries of honest behaviour to see how much it can get away with.
- **Technological uncertainty** occurs when it is difficult to foresee how the technological requirements of a relationship may change over time. When there is a lot of uncertainty, it becomes more likely that an unanticipated circumstance will arise and – because there aren't any rules in place to deal with that circumstance – one of the partners may try to take advantage of it by demanding, for example, that the agreement be renegotiated to their benefit.
- **Performance ambiguity** describes a situation in which a company is unable to evaluate the quality of the goods or service which it receives from its partner. This could be because the goods would only reveal their faults over time or when incorporated into a larger system. This situation can increase the likelihood of opportunistic behaviour, because the supplier may anticipate that poor behaviour is less likely to be noticed.

These situations become particularly daunting in combination. For example, high technological uncertainty may not be too much of a risk on its own when it applies to a relationship that's easy to walk away from – but when it's combined with high asset specificity, which makes the partnership more difficult to break, one of the parties could be left vulnerable to opportunism.

"It's a multifaceted mix of honest misunderstanding and people being unethical, lazy, or not being fully transparent."

Research by

Glenn Hoetker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Glenn Hoetker is Professor of Business Strategy and MBS Foundation Chair in Sustainability and Business at Melbourne Business School. He was previously at Arizona State University, where he held appointments in Business, Law and Sustainability, and has a PhD in business and a Master of Applied Economics from the University of Michigan.

Glenn's research ranges from how firms cooperate to understanding what happens to the innovative knowledge created by firms that fail. He is particularly interested in the strategic implications of environmental sustainability.

His research has appeared in leading journals such as the Strategic Management Journal, Organization Science and the Academy of Management Journal, as well as the Australian Financial Review.

Glenn teaches strategy in our MBA programs, as well as commercialising technology for the University of Melbourne's Department of Biomedical Science.

Ways to guard against cheating

With so many factors and complexities to consider, there's no "one size fits all" solution when it comes to guarding against opportunism – but there are some ways to mitigate the risk.

Professor Hoetker and his colleagues focused primarily on three tools that can be used to minimise cheating: **contracts, relationships** and **reporting mechanisms.** No one tool is a silver bullet on its own, but they can be effective when used appropriately – and sometimes in combination.

"Until now, we tended to think that there was one solution for one problem, which we found is not the case," Professor Hoetker says.

"Take contracts, for example. Contracts are good at the things you can state clearly, such as delivery dates, measurable standards of performance and so on. They're also useful during a dispute, as a contract is something you can take to court.

"But there are limits. They can help when it comes to asset specificity, but you can't use a contract to measure how much effort someone puts into their work, or – if the partnership is research-based – to require that they find the exact solution you want in the time-frame given."

"The other tools are to develop strong relationships between the people at each company, which helps to build trust and accountability, and to establish formal reporting systems, like sending regular progress reports to help keep track of how things are progressing.

"When it comes to relationships, there are options like transferring a manager between companies or setting up a committee to manage relationships – anything that brings people together and enables information-sharing, particularly in areas which are difficult to write down in a contract."

Generally, using more tools leads to more protection – but doing so can be costly. Each tool requires a certain amount of resources: developing and enforcing complex contracts runs up legal fees; building strong relationships requires a lot of time spent in meetings; formal reporting can create significantly more paperwork.

Not every relationship will be valuable or risky enough to make using multiple tools appropriate. While opportunism may be costly, the costs to guard against it can be as well.

Using a new approach

Prior research approaches to opportunism provided some insights, but they were limited by only being effective at examining one risk scenario or tool at a time – rather than multiple risks and tools at once.

For example, they may have been able to analyse whether contracts were effective in the face of high asset specificity, but they couldn't reliably determine whether they were effective in the face of both high asset specificity and high technological uncertainty – or how useful it was to combine contracts with relationships in that situation.

Similarly, they weren't good at revealing effective trade-offs. For example, both relationships and formal reporting can reveal when a partner is breaking the terms of a contract, so in some situations it may be useful enough to combine a complex contract with either relationships or formal reporting, without needing to use both of them in addition to contracts.

These trade-offs mean there are often different paths to the same outcome which can be more cost-effective – something prior approaches didn't reveal.

None of these limitations fit with the experiences that Professor Hoetker and his colleagues had had while working with industry, so they turned to a methodology initially developed in political science called "fuzzy set qualitative comparative analysis", or fsQCA. That allowed them to separate what lead to the best outcome (low opportunism) from what made the worst outcome (high opportunism) less likely.

The researchers applied the methodology to data on 137 supplier partnerships from a top-selling German car manufacturer and a large German producer of automotive components. For each partnership, a manager had recorded how prevalent each risk of potential opportunism was, how much they used each tool to mitigate it and how much opportunism actually occurred.

"Until now, we tended to think that there was one solution for one problem, which we found is not the case."

Key findings of the study

Professor Hoetker and his colleagues found that for simple partnerships without any of the risk factors present, formal reporting on its own was usually enough to achieve low opportunism. In those situations, it didn't matter how complex a contract was or how heavily relationships were used.

But when any of the risk factors were present, formal reporting by itself ceased to be enough. Some of the study's key findings were that:

- For most types of relationships, using any tool heavily will reduce the chance of high opportunism. To consistently achieve low opportunism, companies had to use at least two and sometimes all three tools heavily. When managers used all three tools heavily, they almost always achieved low opportunism – but doing so can be costly.
- Performance ambiguity is especially problematic as a risk factor. When it's hard to measure the quality of what a supplier provides, opportunism is likely to be rife. The most useful mechanism in this case appears to be formal reporting, because it gives the buyer the best chance to detect cheating.

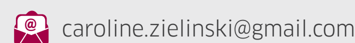
  "This suggests that spending extra effort to reduce performance ambiguity before a partnership starts may be a worthwhile investment," says Professor Hoetker. "Companies may want to develop technical specifications more fully before finalising a contract or, in the extreme, change their technical approach to make it easier to measure performance."
- While relationships are important, they fall short as a preventative measure when used on their own – and are particularly inadequate when faced with high performance ambiguity. Relationships are most useful when they are combined with either a contract or formal reporting.

Because dishonesty is a part of human nature, it is impossible to avoid or eliminate opportunism altogether – and given the costs of trying to prevent it, a certain level may even be considered acceptable.

What Professor Hoetker and his colleagues have done through their research is show business leaders how to use their resources strategically, by deploying cost-effective methods to reduce the risk of opportunism in partnerships where it is most important to do so.

Interview by

Caroline Zielinski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Caroline Zielinski is a journalist and media specialist who has worked at the country's biggest newspaper publishers, News Corp Australia and Fairfax Media. She completed a Master of Journalism at Monash University, where she also worked as a Senior Communications Officer.

Caroline's articles have appeared in *The Age*, *The Sydney Morning Herald*, *The New Daily*, *The Daily Telegraph* and *news.com.au*. She is a media advisor for organisations including Refugee Legal and OneRoof, a co-working space for female founders in Melbourne.

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Recent research publications

Three of the Most Common Challenges Women Face in Negotiations

Harvard Business Review

Mara Olekalns, Ruchi Sinha, Carol T. Kulik

When women sit at the negotiating table, gender bias is a silent player. Bias creates unique challenges for them, increasing their reluctance to negotiate. We asked 84 women about a recent, challenging negotiation moment, which highlighted three challenges that are unique to women.

Women recognised the costs of self-advocacy and the need to develop skills that allowed them to make a self-advocating request without compromising their workplace relationships.

Managing anxiety and anger also emerged as a strong theme, with high levels of anxiety about poor outcomes identified as contributing to their reluctance to negotiate. Women also talked about the damage to their relationships from failing to manage their own and others' anger.

The third challenge was overcoming interpersonal resistance, with developing the ability to persist through setbacks and navigate around resistance identified as critical workplace skills.

The Role of Affect in Shaping the Behavioural Consequences of CEO Equity Incentives

Journal of Management

Leon Zolotoy, Don O'Sullivan, Geoff Martin, Madhu Veeraraghavan

While executives are expected to act rationally, emerging research suggests that mood could influence their judgments. In this study, we examined the influence of weather-driven mood on the relationship between executive stock options and strategic risk taking.

We used deviations from normal sunshine levels near firms' headquarters to capture variation in CEOs' mood and constructed an indicator of the extent to which CEOs engage in risk taking, based on firms' investment and financing choices.

When sunnier than normal, the power of stock options becomes more potent. One standard deviation brighter than average significantly amplifies the extent to which CEOs take speculative bets in response to option incentives and shun big bets as their options' value increases – the former rising by 36.9 per cent and the latter by 43.6 per cent.

Our findings suggest boards should consider executives' mood and the stimuli that induce it. We focused on weather, but positive feedback and social engagement are among other options for influencing executives' mood. Importantly, positive mood is likely to have a contrasting impact on risk behaviour, depending on the relative weights of risk-taking and risk-shunning incentives in option-based pay.

Earnings Management: The Relative Role of Economics and Ethics in Managers' Decision Making

Accounting, Organizations and Society (under review)

Paul Coram, James R. Frederickson, Matt Pinnuck

Using interviews with Australian CFOs and CEOs and their responses to a case-based survey, we provide insights into their decision to manage earnings or not if their firm were in danger of missing the market's earnings benchmark.

We find that ethical perceptions are the most important factor in their decision, as they trade off two ethical concerns. The first concern is the ethics of managing earnings, which decreases the likelihood of earnings management. Interestingly, the belief that managing earnings equates to lying drives a significant proportion of this concern, but with considerable heterogeneity on this point.

The second concern is the ethics of not managing earnings and missing the earnings benchmark, which increases the likelihood of earnings management.

The primary economic motivation for managing earnings is to shield current shareholders from the short-term costs of missing market expectations, with these costs traded off against those on future shareholders and debtholders from managing earnings.

We find no evidence that economic self-interest motivates earnings management.

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