ABSTRACT

This qualitative study identifies risks that are specific to service triads from the perspective of client firms. Using agency theory, we explain how these risks can be managed through suitable contractual arrangements. Behavior-based contracts offered a viable alternative to outcome-based contracts. We identify co-branding as an effective strategy for aligning the goals of the client and vendor.

KEYWORDS: Agency theory, Service outsourcing risks, Service triads
INTRODUCTION

Component services refer to services that are indirectly catered by a client firm to their customers through a third party service provider (Wynstra, Axelsson, & Van der Valk, 2006). A triadic relationship is formed amongst the client (buying) firm, its third-party service provider (vendor), and the client firm’s customers. Such a client-vendor-customer relationship is referred to as a ‘service triad’ (Li & Choi, 2009; Niranjan & Metri, 2008).

The structure of inter-organizational relationships in service triads is different from those in linear service-supply chains (Niranjan & Weaver 2011, Wynstra et al., 2006) (see Figure 1). Each entity in a triad is directly connected to the other two entities with frequent interactions (Wynstra, Spring, & Schoenherr, 2014). Since the vendor directly serves the customers, the client firm has little direct control over the service interactions between the vendor and the customers. With such autonomy, the vendor can potentially compromise on service quality or turn opportunistic in other ways. Increased vendor-customer interactions also tend to transfer power from the client to the vendor (Li & Choi, 2009). Thus, the very structure of service triads exposes the client to various operational challenges and risks. The complexities arising out of the interdependence of the three entities and the conflicts of interest and the information asymmetries amongst them make risk management in service triads an interesting area of research.

![Figure 1: Service triad structure](image)

Risk is a possibility of an undesirable event; an unanticipated variation in a business outcome (Miller, 1992). There are different types of triads (Hartmann & Herb, 2014; Zhang, Lawrence, & Anderson, 2014) each having unique risks and relationship challenges. In recent times, with the higher involvement of third-party service providers, it has become critical to identify and understand the risks associated with service triads. In addition, service triads create a peculiar case of an agency situation in which the agent (vendor) serves the customers on behalf of the principal (client firm) (Zhang et al., 2014). The vendor is a bridge between the client and the client’s customer and has to satisfy both the client and the customer who might have conflicting objectives (Niranjan & Metri, 2008). Opportunities for power shift and vendor opportunism are higher because the vendor directly interacts with the customers (Li & Choi, 2009). The risk of ‘moral hazard’ (where vendors might not put in the effort that is agreed) and ‘adverse selection’
(where the vendors might not have the required skill to serve the customers effectively) (Eisenhardt, 1989; Shapiro, 2005) also increase.

We find agency theory to be a useful perspective to understand risk factors and their role in behavior- and outcome-based contracting and alternative service control mechanisms. Our objective is to uncover the risk factors across the whole spectrum of service triads and inform better contract design.

**LITERATURE REVIEW**

Interaction amongst the three entities in service triads viz. client, vendor and customers, introduces unique risks to the client firm that are not found in other service/supply chains. The intermediary vendor can either act as a mediator, facilitating a conflict-free relationship between client and the customer or act as tertius gauden (Wynstra et al., 2014), and benefit from the conflict between the two (Simmel, 1950; Wynstra et al., 2014). The triadic interdependence and potential instability can have an undesirable effect on the service quality (Niranjan & Metri, 2008). In many cases, the vendor has access to confidential customer data (such as in banking) without being under contractual obligations with the customer (Van der Valk & Van Iwaarden, 2011). Given the difficulties in measuring performance remotely, especially in high contact services, the vendor becomes less accountable for the security of the customers’ data and the client becomes vulnerable to the adverse effects of service failure. The client depends on the vendor for direct feedback from customers’ (Wynstra et al., 2014) in order to continuously improve their products and service offerings. However, if the vendor is not incentivized, they may not care enough to investigate customer requirements and may even neglect to report such communications. Misjudgment of the vendor’s ability and intentions can severely hurt the client’s market reputation (Wynstra et al., 2014). There can be different forms of service triads across industries (See Figure 2). Understanding the risks that are specific to service triads (Hartmann & Herb, 2014; Zhang et al., 2014) across industries should benefit risk management through better vendor governance mechanisms (Van der Valk & Van Iwaarden, 2011) and forms the focus on our study.

**Figure 2: Examples of service triads in various organizations**

<table>
<thead>
<tr>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
</tr>
</thead>
<tbody>
<tr>
<td>IT provider</td>
<td>Bank</td>
<td>ATM</td>
</tr>
<tr>
<td>Hardware Support</td>
<td>Maintenance</td>
<td>Agro-Pump</td>
</tr>
<tr>
<td>Art Gallery</td>
<td>Painters</td>
<td>Hospital</td>
</tr>
<tr>
<td>(d)</td>
<td>(e)</td>
<td>(f)</td>
</tr>
<tr>
<td>Security</td>
<td>Call centre</td>
<td>Logistics</td>
</tr>
<tr>
<td>Hospital</td>
<td>Patients</td>
<td>Cement</td>
</tr>
<tr>
<td>Patients</td>
<td>Cement</td>
<td>Builders</td>
</tr>
</tbody>
</table>
As risks in service triads, find their roots in the agency problem, apparently, it is argued that such risks and influencing factors could be most realistically understood under the theoretical lens of agency theory (Eisenhardt, 1989; Ikediashi, Ogunlana, Boateng, & Okwuashi, 2012). Agency theory is well-suited for the study of issues of information asymmetry, incentive alignments and opportunism in inter-organizational relationships (Fayezi, O’Loughlin, & Zutshi, 2012; Wiseman, Cuevas-Rodriguez, & Gomez-Mejia, 2012)—foundations to triadic risks. Recent studies highlight the success of agency theory at explaining even triadic relationships (Fayezi et al., 2012; Zhang et al., 2014).

Agency theory is “directed at the ubiquitous agency relationship, in which one party (the principal) delegates work to another (the agent), that performs that work” (Eisenhardt, 1989, p. 58). The theory investigates and resolves two primary problems, namely, (1) conflicting goals between the principal and the agent, with difficulty in verifying the agent’s actions and activity, and (2) the problem of risk-sharing due to differing attitudes toward risk. The theory helps to determine the most effective contracts that govern the principal-agent relationship, when assumptions about “people (e.g., self-interest, bounded rationality, risk aversion), organizations (for example, goal conflict among members), and information (e.g., information is a commodity which can be purchased)” are given (Eisenhardt, 1989, p. 58). An effective governance mechanism is necessary, not always or solely for the agent’s selfish and opportunistic nature, but more importantly because it is difficult to know when there is a conflict of interest between principal and the agent and when agent’s interpretation of what is good for the organization is different from the principal’s (Wiseman et al., 2012). This holds true even for service triads.

RESEARCH METHODOLOGY

To address the goals of this study, we adopt a qualitative interview-based, inductive methodology. Interviews were conducted in two phases. In the first phase, we interviewed eight senior professionals from multiple industries. The purpose of the second phase was to streamline our thoughts, advance our understanding, and further investigate the antecedents to the apprehensions that emerged in the first phase. Based on selective/purposeful sampling logic (Coyne, 1997; Glaser, 1978) we selected firms various industries interviewed their leading professionals who had experience in various service triads (Bluhm, Harman, Lee, & Mitchell, 2011). We transcribed the recordings after every interview and studied the transcripts and compared these with our prior interview data before moving to the next interview. Gioia technique was adopted for data analysis (Gioia, Corley, & Hamilton, 2013).

FINDINGS

Strategic Partnership

Co-branding is a form of brand partnership in which two companies form an alliance to work together, creating marketing synergy (Blackett & Boad, 1999). It is a mechanism to attain win-win collaboration and a bilateral relationship (Spekman, 1988) in which the cooperating parties (client and the vendor) reach a consensus when all of them find themselves in a position of gain (Lehoux, D'Amours, & Langevin, 2010; Li-jun, 2012). In order to maximize customer satisfaction, the client-vendor relationship should be effective and efficient. Sustainable business is only
possible through win-win collaborations in which both the vendor and the client firm gain substantially from each other.

Co-branding is only suitable when the core business function of the client firm and the outsourced service objectives are completely different, and yet, the value of the service adds to the value offered by the core function of the client firm. For example, in an art gallery where high priced paintings are displayed, security is a major concern. The image of the art gallery depends on the reliability of the outsourced security service. In such a case, the gallery may choose to display the name of its security service provider without any threat. This would also help the security service provider to perform better, in order to market its safety services, thus leading to a win-win situation. However, along with the advantages, it also poses a threat to the client’s business operation, as discussed below (see Figure 3a).

Figure 3a: Strategic partnership

<table>
<thead>
<tr>
<th>Contextual risks</th>
<th>Risk category</th>
<th>Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer might directly approach the vendor sidelined</td>
<td>Threat to clients’ business</td>
<td>Strategic Partnership</td>
</tr>
<tr>
<td>lining the client for personal gains (as in tourism).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vendors’ performance impact clients’ market image.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Client has to take all responsibility for vendor’s activities.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Replacing vendor suddenly has consequences.</td>
<td></td>
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</tbody>
</table>

Threat to Client’s Business

Co-branding creates a win-win collaborative relationship between the client and vendor. The performance outcome through such an arrangement is perceived to be high because the collaborating firms, that is, the client and the vendor, have their independent objectives to serve the customer to the best of their abilities. However, it is not suited to all client-vendor collaborations. The collaborating partners should be mature and recognized for their functional expertise.

First, the client firm in such collaborations is always concerned whether it has co-branded with the most suitable partner, and whether the partner matches its quality of performance and standards. If the partner’s performance turns out to be lower than the client’s expectations, nullifying the relationship is difficult because abrupt break-ups can have a negative impact on the customers. Second, co-branding gives visibility to the vendors when the customers, in specific cases, have a chance to bypass the client firm and interact with the vendors to get the service at a lower price. For example, in tourism, if a travel agency co-brands with a particular group of hotels, the customer who might not be aware of good hotels in the region (the customer may be from a different country) can directly communicate the hotels now, bypassing the higher-priced travel agency.

Monitoring Mechanism

In a service-triad context, monitoring the performance of the service vendor plays a prominent role. In most cases, the client firm’s business growth has high impact on the quality of services
provided by the vendors. Monitoring is an integral part of organizations’ relationship-management strategy. Some of the well-accepted monitoring mechanisms may include continuous monitoring by a client representative in the vendor’s work site; it may also include vendors working at the premises of the client firm (usually followed when the sourced service deals with sensitive customer information); internal quality checks; quality records (snapshots); and external audits.

SLA monitoring and process compliance are important measures. A senior manager in the retail sector explained, “business reality does not work in black and white, such as ‘you perform I pay, you do not, I penalize’. You have to be with them, monitoring and supporting continuously. It is not out of your mind once outsourced.” We identified three risk categories that necessitate effective monitoring efforts, especially in the service-triad context (see Figure 3b).

**Figure 3b: Monitoring mechanism**

<table>
<thead>
<tr>
<th>Contextual risks</th>
<th>Risk categories</th>
<th>Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Differences between client’s and vendor’s preferences, client prefers - high paid manpower, best equipment’s etc, while vendor prefers - low cost manpower, cost effective equipment’s, low spending on maintenance of the equipment’s.</td>
<td>Client-Vendor operational preferences</td>
<td></td>
</tr>
<tr>
<td>Some client firms offer ‘within 24 hours service/delivery’. Vendor might not adhere to such promises. Services being intangible, client firms often find it difficult to quantify and this leads to a gap between the quality of service it promises and what the vendor delivers.</td>
<td>Promised vs actual service quality</td>
<td></td>
</tr>
<tr>
<td>Client’s competitors might lure good vendors.</td>
<td>Competitors influence</td>
<td></td>
</tr>
</tbody>
</table>

**Client-Vendor Operational Preferences**

The client and the vendor often have differences in preference of resources and service processes. In large firms, the cost of manpower is high. Large firms prefer equipment that is most effective and high in quality. They encourage regular scrutiny of service processes. Most vendors might not be willing to share the same expenses as clients in order to generate maximum profit from the transactions. The cost of manpower is kept low, which affects an individual's service motivation, and in turn influences performance. Cost effective processes and low cost equipment is preferred, along with minimum spending on maintenance. Such differences directly affect customers’ service experience and the client firm must have a suitable mechanism to overcome such inefficiencies.

**Promised Versus Actual Service Quality**

In many situations, the vendor is unwilling to serve according to the standards set by the client firm. As a senior professional in pump industry said, “Some client firms have policies that state that customers will be given instant services within 24 hours of their complaint.” Such policies
shape the customers perception of the brand and have a high impact on the success of the business. However, if the vendors are unwilling to adopt the organizational culture of instant service support, it inversely impacts the client firm’s reputation. In addition, since services are intangible, it is difficult to quantify performance standards to efficiently monitor the vendors. The vendor should be able to deliver quality services within the required time that is promised by the client firm to its customers; for example, in logistics, the on-time availability of trucks; and in maintenance services, the availability of regular spare parts that must be monitored in order to speed up services.

Competitor’s Influence

High performing service vendors in many businesses play a crucial role in their client’s success. The manner of their interaction with the customers, and their capabilities and sense of responsibility toward the services influence the repurchase decisions of the customers. Skilled vendors are always on demand and there are high chances that the client firm’s competitors will lure good vendors to partner with their organization with higher benefits. Regular monitoring is necessary to avoid such sudden disruptions, in case the vendor finds the alternatives more lucrative. Competitive benefits for the vendors, monitoring their actions and requirements, and building strong, trustworthy relationships are key to successful business.

Vendor Development Initiative

In service triads, vendors play a critical role in shaping customers’ perception of the client firm. Their service performance has a high impact on the success of the client’s business. It helps firms to improve their service quality and remain competitive (Modi & Mabert, 2007). Since services are intangible and difficult to quantify, with more service performance variances among vendors, vendor-development initiatives are deemed necessary (Monczka & Trent, 1991). In service triads, the manner in which the vendors interact with the customers can “make or break the business” and influence customer loyalty (Liao & Chuang, 2004). As most of the respondents agree, vendors look forward to training sessions. Such initiatives help to minimize cultural differences align organizational values (See Figure 3c).

Figure 3c: Vendor development initiative
Customer Facing

The client has to depend on a third-party vendor to ensure customer delight. The vendor is expected to report to work in a neat, well-groomed way, speak in an appropriate manner, and present themselves as part of the client firm. Only with adequate training on customer-facing, customer delight can be achieved. Motivating the vendors is very important. It is one of the most important segments in the value chain. A senior professional with experience in the home appliances segment said, “You may have the best plant, supply chain, and technology, but the last mile delivery is dependent on someone else, and that has a significant role in customer delight.”

For example, transit damages (by logistics service providers) are frequent and there are replacement mechanisms. However, a senior professional reported, “Vendors are reluctant to take the responsibility and accept their negligence”. Unless acknowledged by the vendors, the customer has no tangible proof of transit damage, which makes replacement procedure complicated. Such issues at the time of delivery annoy customers and affects customer loyalty. Such issues can be reduced through appropriate vendor training. For most component services, behavioral training of the vendors is as important as technical training.

DISCUSSION

We identified four risk factors in service triads, grouped into three broad categories: relationship adoption, relationship development and relationship control (Table I). We now synthesize our findings using agency theory and explain how and why some of the factors affect contractual arrangements and strategies in service triad risk management.

Table I: Representative categories of factors

<table>
<thead>
<tr>
<th>Categories</th>
<th>Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relationship adoption</td>
<td>Strategic partnership</td>
</tr>
<tr>
<td>Relationship development</td>
<td>Vendor development initiative</td>
</tr>
<tr>
<td>Relationship control</td>
<td>Monitoring mechanism</td>
</tr>
</tbody>
</table>

Relationship Adoption

Risks related to the moral hazards and adverse selections are prominent (Shapiro, 2005) even in service triads. The vendor might be dominant, and unwilling to align with the client’s organizational values. This might have implications on the customer service experience. To deal with this, the client can have two alternative strategies as per agency theory (Bergen, Dutta, & Walker Jr, 1992; Eisenhardt, 1989; Zu & Kaynak, 2012): (a) Invest heavily on information systems and mechanisms to discover and monitor the behavior of the vendors through a behavior-based contract. (b) Contract on the outcomes of the vendors’ performance and co-align client-vendor interests at the cost of transferring risk to the vendors.

In service triads, as the vendors often serve at customer sites; this makes monitoring the vendor’s actions and intentions difficult and expensive, and at times, infeasible. In addition, monitoring can be perceived as a noticeable form of control, and might offend the vendors
sense of autonomy leading to reactance and discontent (Van der Valk & Van Iwaarden, 2011). Thus, alternative client-vendor collaboration is through an inter-firm strategic partnership. Extending the goal conflict assumption of agency theory to service triads, where the vendor is the bridge (Li & Choi, 2009), we argue that an outcome-based contract would be needless when the goals are different but are not in conflict and instead achieving one’s goal, benefits the other. Such situations can be achieved through strategic partnership such as co-branding with the vendors.

**Relationship Development**

Vendor development workshops and information exchange on the customers’ expectations and service standards convey how serious the client is about the quality of services they promise to their customers. Vendor development helps to establish benchmarks for services. This helps in comparing the performances between competing vendors. Although vendor development is not always possible, periodic interactions with the client firm helps to reduce the gap between the service promised to the customers and the service delivered by the vendors (Cox, 2001). Such efforts build trust in relationship and the vendors feel more connected to the client firm.

The way the vendors interact with the customers, their onsite performance, capability, and even motivation toward work is difficult to assess ahead of time. Extending the assumptions of the purchasable information in agency theory (Eisenhardt, 1989) in service triad context, we argue that when information cannot be purchased or can only be obtained post service failure leading to outcome uncertainty and customer dissatisfaction, vendor development initiatives have a distinct role in minimizing information asymmetry related issues. Vendor development improves the service performance and reduces vendor opportunism and shirking by understanding the vendors through regular interactions and efforts toward developing them professionally in order to serve to the benchmark standards.

**Relationship Control**

Contracts are the most prevalent control mechanism in inter-firm relationships that enforce service quality, especially when there is less information on vendors’ actions and intentions. However, it does not guarantee compliance. Where the customer is a business, any service failure leads to immediate loss of reputation for the client firm. Thus, effective monitoring becomes important. However, over a period of time, it is likely that the client will learn about the actions and intentions of their vendors. The length of the agency relationship can reduce information asymmetry and opportunism and can develop mutual trust which reduces the need for monitoring or outcome based contracting.

**CONCLUSION**

In conclusion, service triads have received considerable attention from the academic communities in recent times. However, there is little research presenting detailed understanding about the risks involved. Risks have been studied in the (service) outsourcing and (service) supply chain literature mostly in dyadic context. We conduct a qualitative study to uncover risks and the underlying risk factors in service triads and explain how they might inform contract
design using agency theory. We believe our findings have strong implications on risk management within inter-firm operations in a triad.

REFERENCES


Sengupta et al.

Risks in Service Triads


