Ex Ante Voluntary Information Disclosure in "Take It or Leave It" Contracts in Distribution Channels: Evidence from Franchising

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Abstract

Entrepreneurs often signal their profitability, through voluntary information disclosure, to attract suppliers of managerial and financial resources. Franchisors, like other entrepreneurs, need these resources to develop their businesses and face the problem of how to communicate their quality to prospective franchisees. This issue is reflective of the classical adverse selection problem in agency theory. An Earnings Claim (EC) is an example of an ex ante voluntary information disclosure by franchisors in the U.S. ECs (now known as Financial Performance Representations) are documents that franchisors use to provide financial performance information to prospective franchisees. Although the provision of ECs are at the discretion of franchisors, they are forced by law to provide truthful information if they decided to provide them. Thus, ECs are a source of credible information to prospective franchisees. According to extant economic theory, all franchisors should provide ECs to prospective franchisees; not doing so would be perceived as a signal of poor quality. However empirical studies show that only a small portion of franchisors provides ECs. Extant research views cost, quality and competition as the primary predictors of a franchisor's willingness to signal through an EC. We develop a model that uses organizational economics and institutional theories to posit effects of signaling cost, franchisor quality, competition, partner qualification, information asymmetry and institutional isomorphism on voluntary disclosure of financial performance information by franchisors.

In our study, we first evaluate prior research results estimate for cross-sectional, single industry data by assessing them across multiple industries and by using a relatively larger and newer multi-year panel dataset. Second, we develop and test an enhanced model, using alternate operationalizations to arguably better capture the quality, cost, competition and institutional isomorphism-related factors that have been identified by extant research as predictors of franchisor use of ECs and addressing potential causality issues by using lagged independent variables. Third, we go beyond these factors and also examine the effects of the level of information asymmetry and partner qualification on the use of signaling through ECs. Finally, we attempt to reconcile potentially conflicting views on signaling in franchising - given that a franchisor can use multiple mechanisms (e.g., ownership proportion, royalty rate, ECs) to signal to prospective franchisees, are these signals potential substitutes or are they potential complements?

Speaker Profile

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