Performance Implications of Organizational Signaling and Screening in Interfirm Networks: Evidence from Franchising

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Abstract

We examine performance consequences of signaling (through ex-ante voluntary disclosure of organizational performance metrics) and screening at the exchange relationship formation stage in interfirm business networks. Entrepreneurial network developers (such as franchisors) seek to improve organizational performance by attracting high-quality business partners as well as preventing low-quality partners from joining the network. The presence of a double-sided adverse selection problem makes this a nontrivial endeavor, since good quality prospective partners need assurances about the quality of business opportunity offered by the network developer. In a franchising context, a franchisor may use a screening mechanism to assess the quality of prospective franchisee partners, to alleviate the adverse selection problem the franchisor faces. Also, the franchisor can choose to voluntarily disclose private information to signal the quality of the business opportunity it offers to prospective franchisees, to address the adverse selection problem faced by the latter. We draw on agency and transaction cost theories as well as the voluntary information disclosure literature to develop a theoretical framework to investigate the direct and interactive impact of screening and signaling (as well as their interaction with key transaction attributes) on firm performance. We evaluate the predictions from our theoretical framework through econometric analyses of a unique multi-sector unbalanced panel dataset for the U.S. franchising industry. In our empirical analyses, we control for attrition bias and endogeneity with a selection model and instrumental variables respectively. Our study yields novel insights on the interactive effects of signaling, screening and transaction properties on firm performance. We find that ex-ante signaling and screening in new network relationships are complementary mechanisms that enhance firm performance when they are used simultaneously. Additionally, we find that key transaction attributes (relationship specific investments by the focal firm and by the partners) moderate the effects of screening and signaling respectively.

Keywords: Signaling, Screening, Double-Sided Adverse Selection, Transaction Cost Theory, Entrepreneurial Networks, Franchising, Voluntary Information Disclosure, Organizational Performance.

Speaker Profile

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