A Multi-Sector Examination of Antecedents of Voluntary Information Disclosure by Franchisors

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Presented at the 29th Annual
International Society of Franchising Conference
Historical Building
University of Oviedo
Oviedo, SPAIN
June 18-20, 2015

ABSTRACT

Franchisors, like other entrepreneurs, need financial and managerial resources to develop their business and face the challenge of providing ex ante communication of their quality to (and acquire these resources from) prospective franchisees. This issue is reflective of the classical adverse selection problem in agency theory. An earnings claim is an example of ex ante voluntary information disclosure by franchisors. According to extant theory, all franchisors should provide an earnings claim to prospective franchisees; not doing so will be perceived as a signal of poor quality. However empirical studies show that only a small portion of franchisors provide earnings claims.

In this paper, we first replicate prior research results regarding factors influencing a franchisor's decision to offer an earnings claim by assessing their predictions across multiple industries and by using a relatively larger and newer dataset. Second, we develop and estimate an enhanced model, using additional variables to capture the quality, cost and competition-related factors that have been identified by extant research as predictors of franchisor use of earnings claims and addressing potential causality issues by using lagged independent variables. Third, we go beyond quality, cost and competition-related factors and also examine the effect of the level of information asymmetry on the use of signaling through earnings claims. 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, earnings claims) to signal to prospective franchisees, are these signals potential substitutes or complements?

We conceptualize a model that uses agency and institutional theories to posit effects of signaling cost, quality, competition, qualification and information asymmetry on voluntary disclosure of financial information by franchisors. We test our model and hypotheses using secondary data. Our results show that less than half of the franchisors make these voluntary financial disclosures. They do so when the cost of gathering information is low and when competitors do so. These results confirm the robustness of prior findings by showing that they hold up for a wider range of industries, with newer data, with alternate operationalizations of key constructs and with lagged independent variables. Finally, we address potentially conflicting views on substitutes or complements signals in franchising when a franchisor can use multiple mechanisms. Our findings support the latter view and are consistent with economic models that entail the use of multiple signals.

Key words: Earnings Claim, Signaling, Asymmetric Information, Contracting, Entrepreneurship.