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INFORMATION ASYMMETRIES: A SOURCE OF COMPETITIVE ADVANTAGE FOR DIVERSIFIED SERVICE FIRMS

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Information asymmetries are generally considered as leading to costs for both parties in an exchange transaction. They can, however, also be a source of competitive advantage. Potential buyers face information asymmetries in evaluating services prior to purchase. Since such asymmetries impose costs on buyers, there exists an incentive to lower such costs. This incentive may be exploited by service firms that diversify into other services that meet the needs of existing customers.

Previous research on diversification has focused on the potential benefits from shared resources, both tangible and intangible, among the businesses of a diversified firm as a rationale for related diversification (Montgomery, 1979; Rumelt, 1974, 1982; Teece, 1980; Palepu, 1985; Porter, 1985, 1987; Chatterjee, 1986; Day, 1986). While economies of scope, especially in marketing costs, based on shared customers in multi-product firms are widely recognized, benefits of related diversification need not arise from such production cost savings alone.

Buyers face a difficult and costly task in ascertaining the attributes of services before purchase due to information asymmetries in buyer–seller relationships. Though information asymmetries present a problem to both buyers and sellers of services, such asymmetries could, in fact, be exploited by diversified service firms. Service firms can develop a competitive advantage by exploiting the potential buyer's incentives to lower information acquisition costs when buying new services. This constitutes a powerful potential revenue side benefit from related diversification in contrast to the potential cost side benefits from shared resources within firms. Such buyer incentives that indicate benefits from corporate diversification have previously neither been discussed in the literature on diversification nor explored in the vast literature on services.

Buyer incentives to lower information asymmetries suggest that 'exploiting' existing relationships with buyers in the provision of multiple services by diversified service firms could lead to significant competitive advantages. The search for such advantages may explain why American Express, a travel-related services company, diversified into financial services; why Sears, Roebuck & Co. is attempting to grow its financial services business; and why accounting firms have so successfully developed their management consulting practices.

An in-depth understanding of mechanisms, other than economies of scope, that underlie potential benefits from related diversification is crucial to determining corporate and business strategies for service firms and finding effective ways to actually realize those benefits. In this paper we depart from the 'internal focus' on resources owned by firms and, instead, adopt an 'external focus' on existing customers of service firms to suggest another potential benefit of related diversification by service businesses. This benefit does not rely on the traditional production

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cost reduction logic of related diversification, but on a new information asymmetry reduction logic that results in direct benefits to buyers. The potential for such benefits can lead to competitive advantages and economic benefits for diversified service firms.

INFORMATION ECONOMICS AND RELATED DIVERSIFICATION

Buyer behavior is crucially dependent upon the information that is available before and after purchase. In order to make choices, buyers need to at least know the price and quality of the various alternatives that they are considering. But service quality is difficult to evaluate due to the intangibility and simultaneous production and consumption of services (Holmstrom, 1985). Further, since service delivery is a social interaction in which service providers and customers are involved, significant quality variations could occur.

This potential for variation in service quality, and the general difficulty in assessing service quality, makes the evaluation of services difficult. This complicates the choice decision for potential buyers. Hence, buyers seek information to help make better choices. Information search, however, is costly (Stigler, 1961). Parties to an exchange transaction usually have different information sets about the object, tangible or intangible, that is the reason for the transaction. These information sets may contain relevant data on what is being exchanged such as its quality, price, performance, specifications, and circumstances of delivery. Differences in the information sets of buyers and sellers cause problems in the exchange transaction that leads to costs for both parties to the exchange.

COSTS OF INFORMATION ASYMMETRIES

When there exist information asymmetries between buyers and sellers, high- and low-quality goods and services can coexist in the marketplace (Akerlof, 1970). This coexistence requires buyers, *ex ante*, to determine the quality of goods and services they buy. Given information asymmetry, this is an inherently problematic, and costly, task.

Problems resulting from incomplete or asymmetric information may be classified into either moral hazard or adverse selection problems, depending on the type of information asymmetry present (Holmstrom, 1984). Moral hazard refers to problems associated with the buyer's inability to observe actions taken by the seller. With service quality being difficult to judge, service being generally impossible to reverse, and service outcome being uncertain because of exogenous factors, it is impossible for the buyer of services to evaluate whether the sellers' actions were proper and adequate (e.g. did my attorney or physician exercise due care?). Adverse selection problems arise when the buyer is unable to observe either the seller's characteristics or the contingencies under which the seller operates. For instance, the seller often has greater information about the contingencies under which he or she operates than the buyer (e.g. did my car really need those expensive repair services?). Also, if buyers cannot ascertain the competence of the service provider, quality and value of the service and the risks of malpractice cannot be predicted. Further, in such a case, 'bad-quality' providers can enter the market and drive out the 'good quality' providers by so lowering price that the latter cannot obtain economic returns on their investments for competence enhancement (Akerlof, 1970).

REMEDIES FOR INFORMATION ASYMMETRIES

While there exist several potential remedies for information asymmetries, such as contingent contracts including liability contracts and warranties, signaling, and certification and monitoring (Holmstrom, 1985), most are generally not satisfactory. For instance, the inability to fully anticipate all contingencies that may arise in the execution of a contract prevents the writing of complete contingent claims contracts, and therefore limits their usefulness in information asymmetry reduction. Similarly, warranties covering services are impossible to administer since failure to perform a social interaction is generally indeterminable. Certification, too, is so widely prevalent as to make it of no consequence in consumer choice behavior. Further, it is no

guarantee of performance. Instead, it merely serves as an attestation to having met some minimally acceptable standards that are often unknown to buyers.

Monitoring is inadequate because it suffers from information asymmetries between the monitor and the person or facility being monitored. All the facts and contingencies prevailing at the time of service production and delivery cannot be fully known to the monitor, and sometimes are even partially unknown to the service provider as, for example, in the case of medical diagnostic and treatment services and automobile repair.

Firms may, nevertheless, attempt to signal the quality of their products by writing contracts (though they might be imperfect) and making firm-specific investments in specialized education and equipment and advertising (Nelson, 1970, 1974). Both approaches seek to assure potential buyers that the firm is committed to providing high quality. High prices, too, may act as signals of high quality (Klein and Leffler, 1981; Shapiro, 1983; Allen, 1984). In a competitive market for services, when quality is unobservable, each firm has no incentive to lower price to equal marginal cost since that would make it more profitable for the firm to produce low, rather than high, quality (Allen, 1984); but consumers know this. When faced with low prices they judge quality as being low and do not buy from the low-priced firm. Therefore, firms do not cut price because that would change their incentives and consumers would refuse to buy their services. Hence, in a competitive market, high prices signal high-quality services. The distribution of prices alone, however, is insufficient to reliably signal quality because of the existence of adverse selection problems. Fly-by-night, low-quality producers could also charge high prices, and thereby distort the expected monotonic relationship between prices and service quality.

THE ROLE OF REPUTATION

In addition to signaling quality, firms may attempt to provide potential buyers with greater information in order to reduce information asymmetries between buyers and sellers. Recall that buyers attempt to ascertain various attributes of goods and services prior to making their purchase decisions. Services (and goods) may be described by the mix of three qualities that consumers use to evaluate them: search qualities, which are attributes that a consumer can determine prior to purchase; experience qualities, which are attributes determined only after purchase or during consumption; and credence qualities, which are intangible qualities that a consumer may be unable to evaluate even after purchase and consumption (Darby and Karni, 1973).

The mix of search, experience, and credence qualities of goods and services in question moderates the role of information in buyer behavior. The availability of information before purchase is considerably more important in the case of services which are high on experience or credence qualities, such as medical services and consulting services, since they are more difficult for potential buyers to evaluate. Note that the value of prior information to buyers in assessing the quality of services is directly proportional to the severity of the consequences suffered by consuming services of less than anticipated quality.

Buyers seek information about quality and other characteristics of goods and services either by search prior to purchase or by experience through purchase and use. Search is limited by the cost incurred in obtaining information by experience. Experience is used to judge quality when search becomes too expensive. Prior to sampling different brands of a product, consumers may obtain information about various brands from several sources, such as advertisements and word-of-mouth.

Advertisements provide direct information about the search qualities of a brand. However, in the case of experience qualities the most important information conveyed by advertising is simply that the brand advertises (Nelson, 1974). For experience qualities, word-of-mouth information may, reasonably, be considered as constituting better information than advertising since, in a sense, it provides an avenue for evaluation of the good or service through a vicarious experience. As buyers rely more on word-of-mouth, they will respond less to advertising (Nelson, 1974).

Each sampling, by search or experience, contributes toward the information bank which buyers maintain about the various brands sampled. When the producer of a brand

introduces another brand, buyers may draw upon their information banks to form associative evaluations of the likely properties of the new brand. This 'carry-over' of evaluative information tends to reduce information acquisition costs for buyers. Hence it can be expected that customers who have favorable impressions of current service providers will tend to favor such providers when making purchase decisions about other services that these providers may offer. As a corollary, service providers who have formed favorable impressions on existing customers may find it easier to influence them, as opposed to entirely new customers, to try the producer's new brands or, by extension, new goods or services. Hence, from the perspective of potential buyers, reputation is potentially a stronger remedy than signaling to reduce information asymmetries in buyer–seller relationships.

Reputation performs as an implicit contract. It is enforced by the seller's concern about future demand for the service provided. The size of demand, and the way in which information is disseminated among buyers, determines the efficacy of reputation as a remedy for information asymmetries. Subject to the constraints of legitimate transferability across services, reputation is likely to exhibit characteristics of a public good. Once acquired it can be used over and over again in the context of other services or markets. It should be cautioned, however, that it is equally possible that lapses in quality or value in these other services or markets could quite easily be transferred back to the original services provided by the firm and, quite literally, destroy the reputation built up in those services, too.

In the presence of difficulties in determining quality, when consumers are sure that firms will provide good quality, it pays firms to cheat and provide bad quality, since learning about quality will be very slow, or zero, due to the lack of information (Allen and Faulhaber, 1986). Consumers know this, however, and so they will expect some firms to supply bad quality. Consumers, therefore, will be skeptical and upon the receipt of new information they will rapidly adjust their beliefs about the quality of a firm's products. This rapid adjustment will make it very expensive for firms to cheat. Conversely, this same rapid adjustment will reward consistent good quality.

In sum, it can be expected that buyers of services will attempt to economize on information acquisition costs by exhibiting a tendency to transfer reputation effects to other goods or services offered by a firm. In fact a firm that diversifies into services that its existing customers may buy from it could create a competitive advantage, since it could potentially exploit the favorable alteration in the information asymmetry distribution faced by potential buyers when they consider buying the new service offered by the firm. Quasi-rents (Klein, Crawford and Alchian, 1978) may therefore be obtained, since the buyer–seller relationship represents a firm-specific investment on the part of the buyer which gives rise to switching costs (Porter, 1980).

Conversely, firms that offer a narrower line of services could potentially be at a competitive disadvantage in selling their services if their competitors are diversified. Potential buyers actively seeking to reduce their information acquisition costs when choosing service providers would favor the firm with a wider line of services. The similarity in the portfolios of many diversified service firms is likely a result of such imperatives.

Hence, possible differentiation through the lowering of information acquisition costs for potential buyers constitutes a legitimate potential benefit for service firms that leverage customer relationships across service businesses. Related diversification may, therefore, be beneficial even without any resource-sharing economies. Unrelated diversification, however, does not derive benefits from information asymmetry reduction. Of course, firms also face costs in alleviating information asymmetries. Assuming that firms wish to maximize profits (or shareholder wealth), they will seek to economize on information dissemination costs by leveraging whatever reputation they have built on other goods or services offered.

There exist, however, limits to the transferability of reputation effects that, in turn, limit the diversification opportunity set for any service firm. Reputation must transfer legitimately in order for information asymmetry to be reduced. In other words, potential buyers must believe that the diversifying service firm can and will deliver the expected quality in the new service. For example, it is reasonable to expect an accounting firm also to provide some management consulting services, since it has a proven expertise

in evaluating accounting and management control systems. In addition, the typical accounting firm also has a rich knowledge base on the design of such systems derived from its experience in auditing several clients. Similarly, advertising agencies could legitimately claim to provide good-quality market research and media planning services. In contrast, it is highly unlikely that potential clients will believe that an accounting firm can also operate an airline. Also, a reputable retailer does not necessarily appear to possess the requisite skills and competence to provide a wide array of specialized financial services, just as even a reputable management consulting firm does not appear to have the skills required to provide accounting services.

These limits to the transferability of reputation effects arise from the difficulty in evaluating services high on experience and credence qualities. Prerequisites, whether real or perceived, for providing good quality differ across some services while being similar across others. In the former case reputation does not play an important role in informing potential buyers about the likely quality of the new service, while in the latter case it does. A retail services firm diversifying into financial services is an example of the former case.

Further, even if reputation effects do transfer, there exist several organizational and other barriers to successful related diversification. Note that related diversification implies interrelationships among business units in diversified firms. The need for a clear conceptualization of the services offered, and the intimacy of the buyer and service provider in the service delivery process, limit the flexibility of service firms to grow without limits by offering new services and entering new markets (Carman and Langeard, 1980) since the presence of interrelationships contaminates each service delivery process. Porter (1985) lists several impediments to achieving interrelationships among businesses in diversified firms. Among these are asymmetric benefits to the business units involved, perceived or actual loss of autonomy and control, biased incentive systems, and differing business unit circumstances. In a similar vein, Riordan and Williamson (1985) discuss internal transaction costs that arise in managerial hierarchies due to governance structures, bureaucratic distortions, and incentive degradation. These internal transaction costs need to be balanced against the potential benefits of relatedness. When the former exceed the latter, firms limit their growth. Similarly, Reed and Luffman (1986) and Kanter (1989) have noted that the benefits of synergy among businesses in diversified firms are not automatically attained. They suggested that firms often forego the potential benefits of related diversification when they incur substantial costs in seeking synergies.

CONCLUSIONS

Information asymmetries cannot be viewed as merely another obstacle in the competitive battle, because they can be a potent source of competitive advantage for those service firms that consciously develop new services for their existing customers. This source of competitive advantage for diversified service firms does not rely on any resource-sharing mechanisms within the firm. It relies, instead, on information asymmetry reduction by potential buyers through the transfer of reputation for quality services across multiple services offered by diversified service firms. The mix of search, experience and credence qualities of the services involved moderates the role of reputation in reducing information asymmetries between buyers and sellers. Reputation plays a more important role when services high on experience and/or credence qualities are involved. In the case of services high on search qualities, however, potential buyers do not rely on the reputation of the service provider since they can adequately assess service quality prior to purchase. Hence, we have:

Proposition 1: If reputation can legitimately be transferred, diversification into services high on experience or credence or both qualities will reduce information acquisition costs for potential buyers.

Proposition 2: Diversification into services high on search qualities will not reduce information acquisition costs for potential buyers.

These variations in the importance of information asymmetries in buyer behavior with variations in the characteristics of services with respect to the mix of search, experience and credence qualities suggest that the strategy of sharing customers across businesses in a diversified service firm

offers greater potential benefits when services high in experience or credence or both qualities are involved. In fact, the value of such a strategy when services high on search qualities are involved is questionable. Hence, we have:

> *Proposition 3: If reputation can legitimately be transferred, service firms will gain a competitive advantage by serving multiple needs of their clients for services high on experience or credence or both qualities.*
>
> *Proposition 4: Service firms will not gain a competitive advantage by serving multiple needs of their clients for services high on search qualities.*

Finally, since the benefits of relatedness do not flow automatically, effective customer sharing needs to be consciously managed by diversified service firms in order to ensure that information asymmetry is attenuated, not accentuated, by the multiple sources and pieces of information about the multiple services offered by the firm that are available to potential buyers. This management of information about the firm and its services translates to the dual requirements for the need for an appropriate organization design and an effective communications strategy to reinforce the information asymmetry reduction mechanisms discussed in this paper.

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