

## THE IMPACT OF ENTRY MODE ON SUBSEQUENT COMMITMENT TO POORLY PERFORMING SUBSIDIARIES

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### Abstract

Despite of the extensive research on the choice of how to structure a new foreign subsidiary in the international business literature, few studies have explored how the initial foreign entry mode impacts a multinational's subsequent activities in the host market. Drawing insights from prospect theory, this paper addresses how a multinational's entry mode influences the firm's reaction to negative subsidiary performance. Specifically, we argue that the entry mode (ownership structure of a multinational's subsidiary) affects the firm's potential for escalation of commitment to a poorly performing subsidiary. Further, we argue that the relationship between entry mode and a multinational's escalation of commitment is moderated by three factors – institutional distance between the home and the host country, cost of exiting the host market, and the parent firm's prior performance. This paper contributes to the literature by presenting the case that initial entry mode influences a multinational's post-entry activities.

**Keywords:** subsidiary performance, parent firm commitment, entry mode, ownership structure, escalation

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### Introduction

Despite the rich literature on firms' internationalization, researchers often have ignored the potential impact that initial mode of entry decisions can have on how the parent firm reacts to negative performance on behalf of the subsidiary. Our aim in this article is to provide a conceptual framework regarding several important factors influencing firms' subsequent commitment to poorly performing subsidiaries. The performance of foreign subsidiaries often has been considered as the dependent variable in most studies. However, the effects of foreign entry mode on subsidiary performance are not direct. Market entry is just the first step of a firm's operation in a foreign market. Further management and control are necessary to achieve the originally designed goals of the subsidiaries. Although several perspectives have been used to explain mode of entry into a foreign market, very few studies have specifically considered the impact of entry mode on a multinational firm's subsequent decisions and activities.

In this paper, we argue that the initial decision regarding the investment structure chosen as a mode of entry into a foreign country will impact the likelihood of an escalation of commitment to that investment. Our assertion is that the factors which make a given type of entry mode attractive may have different implications for the potential for escalating commitment should this foreign subsidiary experience negative performance. Although entry mode may help manage such uncertainty initially, certain ownership structures may actually increase the chances of escalating commitment to a foreign subsidiary facing subsequent uncertainty. We only focus on equity-related modes of entry (i.e., joint venture and wholly-owned subsidiaries) since the escalation of commitment to non-equity entry modes is difficult to observe and places no additional firm capital at risk. We rely primarily on the theoretical tools of prospect theory and institutional distance literature in this paper.

The rationale for employing prospect theory in this paper resides in the argument that upper echelons are the information interpreters in firms (Hambrick & Mason, 1984; Hambrick, 1989; Rajagopalan &

Spreitzer, 1996). An organization's strategic decisions are made by executives whose reading of the firm performance and the external business environment impacts these strategic decisions. People systematically violate the requirements of consistency and coherence in making decisions; such violations occur when people frame differently information available to decisions (Tversky & Kahneman, 1981). In the presence of subsidiaries' unsatisfactory performance in host markets, how executives interpret both financial and non-financial information will significantly influence their decisions on whether to escalate the firm's investment in these subsidiaries. We argue that the potential for a parent firm to escalate its commitment to a subsidiary which has not met performance expectations is greater when the parent firm has a larger equity stake in that subsidiary. Further, we suggest that this likelihood is influenced directly and also moderated by the institutional distance between home country and host country. In addition, we argue that the probability of escalation is also moderated by the parent firm's performance in the prior period. Finally, we suggest that the likelihood of escalation is moderated by the cost of exit. Our proposed conceptual framework is illustrated in Figure 1.

The paper starts with a review of prospect theory and escalation of commitment literature. Then additional related areas of interest related to a firm's likelihood to escalate its commitment to poorly performing subsidiaries are discussed. These additional areas include: institutional distance between a firm's home country and host country, the prior performance of parent firms, and the cost of exiting a host market. From each of the research streams presented here, we build on prior arguments to develop propositions related to the mode of entry chosen by a firm and the connection between the foreign subsidiary's ownership structure and the potential for escalation of commitment. Thus, herein we strive to clarify the role played by ownership structure in determining whether parent firms will escalate their level of commitment to poorly performing foreign subsidiaries.

\*\*\*Insert Figure 1 around here\*\*\*

## Theoretical Background

### Foreign Entry Mode

Several different theoretical approaches have been utilized to explain the choice of entry mode. Each of these approaches has a unique set of assumptions about the nature of the entry mode decision and factors influencing this decision. First, the Uppsala school views business operation in an overseas market as inherently risky; therefore, this view advocates a gradual involvement in the foreign market (Janhanson and Vahlne, 1977, 1990; Root, 1987). From a behavior perspective, the Uppsala model argues for

incremental investment in foreign markets. According to this model, exporting is the best choice when a firm first enters an overseas market; as the firm acquires more knowledge and experience in that overseas market, it will assume a higher level of resource commitment. Thus, various entry modes can be marked on a continuum of increasing levels of resource commitment, risk exposure, control, and profit potential.

Second, as the major stream of research in the entry mode field, transaction cost theory has arguably had the most impact on how researchers view the entry mode decision. Extant research, which has been heavily influenced by transaction cost economics, has focused on minimizing the costs of entry. This theory emphasizes the relationship between a firm's assets and its need for control. As a result, entry mode choice is often modeled from an economic perspective (Anderson, 1993; Anderson and Gatignon, 1986). Under conditions of high asset specificity, a high control mode is preferred to mitigate the threat of opportunistic behavior from transaction partners. Firms with highly-specific assets are likely to use a wholly-owned mode to fully appropriate the economic rents earned from the assets and to reduce the risk of unwanted dissemination (Teecle, 1981; Gatignon and Anderson, 1988; Hennart and Part, 1993; Beamish and Banks, 1987; Hennart, 1988).

Third, Dunning's Eclectic Framework (OLI – ownership, location, internalization advantages) highlights the importance of location-specific factors (Dunning, 1980, 1988; Hill, Hwang, and Kim, 1990). Environmental factors investigated include country risk, location familiarity, demand conditions, and volatility of competition. For example, Hill et al. (1990) proposed that national differences exert influences on entry mode decision. Similarly, Puxty (1979) focused on the relationship between cultural differences and ownership policies regarding overseas subsidiaries. The greater the cultural distance between the country of the investing firm and the country of entry, the mode likely a firm will choose a JV or WOS over an acquisition (Kogut and Singh, 1988). The greater the culture of the investing firm is characterized by high tendency of uncertainty avoidance regarding organizational practices, the more likely that firm will choose a JV or WOS over an acquisition (Kogut and Singh, 1988).

Recently a limited number of authors have linked the choice of foreign market entry mode to institutional conditions within the host market (Rodriguez, Uhlenbruck & Eden, 2003; Lu, 2002; Xu and Shenkar, 2002; Davis, Desai & Francis, 2000). This stream of research can be categorized into three groups: (1) how the external institutional environment affects a firm's mode of entry; (2) how the firm's internal institutional environment impacts its mode of entry; and (3) how the institutional distance between the home and the host influences a firm's mode of entry. Because of the relative paucity of extant

literature on the subject, this paper focuses on the last category of institutional theory research (institutional distance). Lu (2002) compared transaction cost theory and institutional theory in terms of their respective abilities to explain entry mode choices.

### Prospect Theory and Escalation of Commitment

In a seminal article on the subject of escalation of commitment, Staw (1976), noted that intuition suggests that negative consequences should modify behavior. However, situations arise in which negative consequences serve to solidify commitment to a course of action that has produced negative results. These escalation situations are, “predicaments where costs are suffered in a course of action, where there is an opportunity to withdraw or persist, and where the consequences of persistence and withdrawal are uncertain” (Staw and Ross, 1987). This commonly observed behavioral phenomenon has been labeled escalation of commitment by organizational researchers. The extent of commitment to a course of action can be described as a product of perceived costs and benefits (Staw and Ross, 1987). Escalation of commitment has been documented in various contexts such as the writing off of loans (e.g., Staw, Barsade, & Koput, 1997), waiting situations (e.g., Rubin, 1981), gambling (e.g., McGlothlin, 1956), season ticket use (e.g., Arkes & Blumer, 1985), group decision making (e.g., Whyte, 1993), and economic investment (e.g., Kanodia, Bushman, & Dickhaut, 1989; Thaler, 1980). In the case of multinational firms, unsatisfactory performance on behalf of the subsidiaries exposes their parent firms the decision of whether or not to escalate their commitment to the subsidiary; i.e., whether to invest more or to divest.

Arguably, one of the most intriguing areas of business research involves the act of framing and decision-making (Edwards, 1996; Sharp and Salter, 1997). Among the major determinants<sup>45</sup> of escalation of commitment (Staw and Ross, 1987), psychological determinants are focused on for this paper. Psychological determinants of escalation of commitment are, “factors that influence one’s goals and beliefs about the consequences of an action” (Staw and Ross, 1987). Several psychological explanations are mentioned in the literature, most prominent of which appear to be those of *self-justification* and *prospect theory* (Brockner, 1992). Explanations of commitment escalation drawing upon self-justification posit that receiving negative feedback can motivate individuals to justify initial behavior and thus persist in a course of action (Staw, 1976; Staw and Ross, 1987). Integral to the self-justification explanation is the responsibility

hypothesis, which posits that personal responsibility will lead to an increase in the tendency to escalate commitment (Staw, 1976).

Several organizational scholars have pointed to the power of prospect theory to explain escalation decisions (Chattopadhyay, Glick & Huber, 2001; Garland, 1990; Richardson, Amason, Bucholtz & Gerard, 2002; Schweitzer, Ordenez & Douma, 2002; Whyte, 1986; Whyte, 1993). In a test of the universality of prospect theory explanations of escalation of commitment, framing effects were found to be significant in both Asian and North American managers (Sharp and Salter, 1997). In an attempt to further explain and predict decisions given certain conditions and circumstances (Edwards, 1996), especially with regard to risk, researchers have proposed several possible explanations. Tversky and Kahneman (1981) contend that prospect theory involves framing outcomes as either positive/negative or gains/losses. In this process, an outcome is framed relative to a neutral reference outcome, or something which is assigned a value of zero. According to this zero value, if the outcome is viewed as more favorable, then it will be framed positively or as a gain. On the other hand, if the outcome is viewed less favorably relative to the neutral reference point, then the outcome is framed as a negative, or as a loss. This framing of a given decision ultimately impacts the behavior or action taken. For instance, prospect theory indicates that a positively framed event (or gain) will result in the decision maker behaving in a risk-averse manner, whereas a negatively framed event (or loss) will result in the decision maker being more risk seeking.

Kahneman and Tversky (1979) argued that individuals have a preference for certainty when making their assessment of possible financial losses or gains. This “certainty effect” means that individuals are likely to give higher weights to outcomes that are certain of occurring versus those that are merely probable. In the context of firms with foreign subsidiaries, this suggests that parent firms are likely to frame post-entry decisions as choices between certain wealth (maintaining an investment in a subsidiary) versus uncertain wealth (potentially withdrawing from the subsidiary). Prospect theory explanations of commitment escalation argues that escalation of commitment is a natural outcome of the way people frame risky decisions (gain or loss) with respect to a neutral reference point<sup>46</sup>. Upon receiving negative feedback about a project, decision makers in an escalation situation will frame future decisions as a choice between certain and uncertain losses (Whyte, 1986). Given the uncertainty affect often surrounding potential losses, in some circumstances decision makers will choose the uncertain loss and thus escalate commitment to that project rather than withdraw.

<sup>45</sup> Staw and Ross (1987) specified the project, psychological, structural, and sociological determinants of escalation decisions.

<sup>46</sup> See Kahneman and Tversky (1979, 1981) for a more detailed explanation of prospect theory.

For firms with foreign subsidiaries, the notion of escalation of commitment is particularly important. Given that all firms face resource constraints and the increasingly competitive global market, it is critical for companies to make sound decisions regarding the allocation of resources to its foreign subsidiaries. In circumstances where competitive pressure is intense and foreign markets are viewed as an attractive source of new customers, it is possible to envision scenarios where more short-term leeway is given to a poorly performing foreign subsidiary than can be justified on a purely economic basis.

In addition, executives at parent firms may also be tempted to escalate commitment to a poorly performing subsidiary because of previous good performance by the subsidiary. When an existing subsidiary encounters a stretch of poor performance, the parent company may initially view this lower performance as a natural impact of cyclical markets. Once faced with negative performance information about a foreign subsidiary, the critical question becomes how the parent firm will react? If the parent responds by increasing the amount of resources allocated to the subsidiary, the parent is escalating its commitment.

For purposes of this paper, no assessment is made regarding the soundness of a decision to escalate commitment to a subsidiary. Whether or not the decision is a good one cannot be made until after the impact of the escalation has occurred. Once new performance information (for periods post-escalation) is available, only then it is possible to determine the wisdom of such an escalation. We now turn to the discussion of how the foreign entry mode affects the parent firm's escalation of commitment when the foreign subsidiary's performance does not meet pre-set goals.

### **Foreign Entry Mode and Escalation of Commitment**

Although there are different perspectives from which one can analyze a firm's escalation of commitment once its foreign subsidiary fails to achieve an expected performance level, we focus on how the firm's initial entry mode influences the likelihood of escalation (see Figure 1). This topic is important and interesting because entry mode selection is not only a fascinating dependent variable but also an influential independent variable argued to have an impact on a multinational firm's sequential activities in the host market. However, both strategic management and international business literature have often ignored this link. The decision a firm makes regarding which mode of entry to use for a particular foreign market is widely viewed as critical to MNE performance and has received much attention in the international business literature (for reviews see Chang & Rosenzweig, 2001, Davis et al., 2000, and Buckley & Casson, 1998). Yet, how the initial entry mode affects firm performance has remained as a black box and the

internal mechanism between the independent and dependent variables has been neglected.

## **II. Mode of Entry and the Parent Firm's Escalation**

Although there remains a lack of consensus concerning the antecedents of entry mode choice (Lu, 2002), there is general agreement regarding the categorization of entry modes as a continuum from exporting to wholly-owned subsidiary (WOS). The specific classifications by different authors sometimes vary slightly based on disparate research purposes and level of detail. For instance, Griffin and Pustay (2001) state that entry modes can be categorized as home country production (exporting), host country production in firm-owned factories (FDI), or host country production performed by others (licensing, franchising, and contract manufacturing). This is only slightly different from Agarwal and Ramaswami's (1991) classification. According to Agarwal and Ramaswami (1991), the options available to a firm entering a foreign market include exporting, licensing, joint venture (JV), and wholly-owned subsidiary (WOS).

The selection of different foreign entry modes is associated with different levels of the parent firm's commitment in the local market, in terms of resources invested and control retained. The greater control a firm seeks over the foreign assets/operation, the greater the amount of resources it has to commit. With a larger investment being made in the local market, the foreign parent firms are actually exposed to higher levels of risk (Delios & Beamish, 1999). Therefore, local investment is often associated with more control retained by the parent firms. According to prospect theorists, individuals place more weight on "certain" wealth than on "uncertain" wealth. Thus, commitment escalation is more likely to occur in an attempt to salvage existing wealth than to acquire additional wealth. We expect to observe this phenomenon in play when it comes to multinational firms dealing with unsatisfactory performance by foreign subsidiaries in which equity has been invested. Before we move on to a methodical discussion of how entry mode may influence a parent firm's escalation decision, we will examine important aspects of various types of entry mode.

We only focus on equity-related modes of entry (i.e., joint venture and wholly-owned subsidiaries) since the escalation of commitment to non-equity entry modes is difficult to observe and places no additional firm capital at risk. Different foreign entry modes involve different degrees of parent firm commitment, and consequently achieve different levels managerial control. For example, exporting involves the least control by the parent firms while foreign firms selecting a wholly-owned subsidiary (WOS) are completely responsible to their subsidiaries' performance and have the highest level of control. Since our interest is how foreign entry

modes affect the parent firm's escalation of commitment, equity-based entry modes serve as better subjects than non-equity ones. Escalation of commitment can only be observed when managerial control is present. Parent firms' commitment escalation refers to their continuous investment in a given subsidiary even though the subsidiary is losing money or performing at lower than expected levels in the host market.

Equity entry modes include joint ventures (JV) and wholly-owned subsidiaries (WOS). A JV is established when two or more firms join together to create a new business entity that is legally separate and distinct from its parent firms. This new entity can involve almost any combination of foreign and local owners. A WOS is a business entity established solely by one multinational firm. A WOS can be established through building a new venture, or through merger/acquisition of local firm(s). The WOS mode is a high investment option and consequently involves high risk/return potential. The parent firms have different levels of managerial control when adopting different modes. JVs require some equity investment by the firm but which also includes investment by other parties. That is, a JV serves as a means to pool necessary resources and to share the risk. In contrast, a firm using a WOS as a mode of entry contributes all necessary resources and also possesses absolute ownership control over the subsidiary. Therefore, JVs provide the parent firm with a relatively higher level of managerial control than non-equity entry modes, while a WOS offers the parent the total control of the foreign subsidiary.

### III. Impact on Escalation of Commitment

When a foreign subsidiary encounters unsatisfactory performance, the parent firm has three general choices – immediately exiting the host market, doing nothing (“wait and see”), or escalating the investment (increasing the amount of resources allocated to the subsidiary) (Witteloostuijn, 1998; Mone, McKinley, & Barker III, 1998). In our opinion, the latter two alternatives both can be labeled as “escalation of commitment”. Choosing to “do nothing” in the face of unsatisfactory performance can be considered as one type of escalation because of the opportunity costs that exist related to the next best alternative of utilizing the invested resources.

\*\*\*Insert Figure 2 around here\*\*\*

As mentioned previously, we argue that the ownership structure of a firm's foreign subsidiary impacts its likelihood of escalating its commitment in the local market. Figure 2 illuminates the difference between the scenarios in which the parents of a WOS or a JV will be either risk seekers or risk averse. Further, it shows that the slope of the value function curve for each of these ownership structures is different. This difference is attributable to the

different levels of equity required by each mode of entry. A WOS is completely owned by the foreign parent while a joint venture represents the pooled resources from, and the shared risks by, two or more firms. The parent firm of a WOS commits more energy, time, money and personal responsibility than in a comparable JV. Thus, a parent firm is likely to value the wealth of the assets in wholly-owned subsidiaries more than those firms do whose subsidiaries are jointly held with other companies. Therefore, WOS' parent firms are more likely to contribute further resources to their foreign subsidiaries to keep them alive and to attempt to avoid losses. This means that the parent company of a WOS will generally be more risk-seeking than a parent firm of a JV when their decision alternatives are framed as losses and more risk-averse when their decision alternatives are framed as gains. Based on prospect theory arguments, they are more reluctant to admit the potential failures indicated by the unsatisfactory performance of the subsidiaries than their counterparts investing in joint ventures.

Because of higher levels of equity involved, the slope of the value function curve for companies entering foreign markets via a WOS is steeper than those entering via JVs. This is because the subsidiary's performance will be viewed as either a positive deviation or negative deviation from the overall firm reference point. It is likely that, in the case of prior good performance, parent firms with a WOS will under-evaluate the risks and over-evaluate the potential market opportunities in the host country. In contrast, parent firms with JVs will be less likely to escalate their commitment to a poorly performing foreign subsidiary. This propensity is reversed when decisions involve certain versus uncertain gains. Wholly owned subsidiaries will be more risk averse when a certain gain is involved, and because of their lower levels of equity invested, JVs will be less risk averse. Hence, our first proposition follows:

Proposition 1: The ownership structure of a firm's foreign subsidiary will impact the likelihood of the parent escalating its commitment to the subsidiary. Parent firms with more equity invested will be more likely to escalate their commitment, all else equal.

### IV. Other Effects

#### Institutional Distance

Institutional distance provides scholars with a more comprehensive measure of differences between a firm's home country and host country than does culture distance (Xu and Shenkar, 2002). It is a measure of the similarity or dissimilarity of the regulatory, cognitive, and normative institutions of two countries (Kostova, 1996). The notion of institutional distance is an extension of institutional theory, which was initially developed in response to classical organizational theory's neglect of social

influence processes that might influence the behavior of organizations (Tolbert & Zucker, 1996; Granovetter, 1985).

Scott (1995) suggests that institutions may either be regulatory, normative or cognitive. Regulatory institutions constrain behavior through rules, monitoring, and sanctions. Actors conform to these rules, as failing to do so would be detrimental to them. Normative institutions specify the roles, rights, and responsibilities of the individual. These norms, values, and cultures may be imposed by others, or may also be internalized. Morally governed behavior creates stability in the social order as actors comply with their roles. Cognitive institutions emphasize the importance of symbols, routines that are taken for granted as the way things are done, and social identification (Scott, 1995).

Kostova (1997) developed the construct of country institutional profile to help measure and explain differences between different national institutional environments. The construct of institutional distance is particularly useful in examining MNE behavior (Xu and Shenkar, 2002). Xu and Shenkar (2002) examine MNE investment and entry mode decisions by utilizing the construct of institutional distance. They argue that institutional distance impacts a firm's choice of which country to enter as well as its decision regarding the ownership structure of the foreign subsidiary.

Furthermore, several studies have shown that larger differences between the home country of a firm and the host country of a subsidiary tends to lead to higher levels of equity participation by local partners (Contractor & Kundu, 1998; Kim & Hwang, 1992; Kogut & Singh, 1988). Having local partners contribute to the subsidiary's equity may help establish local legitimacy. Xu and Shenkar (2002) argue that (1) a firm is more likely to enter a foreign market via a WOS or a majority JV where *regulative* distance is small and via a minority JV where *regulative* distance is large; and (2) a firm is more likely to pursue high equity control over a JV where *normative* distance is small and low equity control where *normative* distance is large.

Xu and Shenkar (2002) contend that the normative dimension of institutional distance has the most direct influence on organizational practice, and therefore, on a firm's decisions about how to structure the ownership of new foreign subsidiaries (Xu and Shenkar, 2002). In addition, they propose that the choice of ownership structure of a foreign subsidiary will be directly impacted by institutional distance. Greater institutional distances are expected to be associated with lower levels of equity investment. Wholly-owned subsidiaries are expected to be the preferred ownership structure only when institutional distances are relatively small. Joint ventures, which require less equity contribution from the focal firm, are expected to be more likely when institutional distance is greater.

Proposition 2a: Institutional distance between host country and home country environments directly impacts the likelihood of escalation of commitment, regardless of whether the subsidiary is a JV or WOS.

Institutional distance between the home and the host not only affects a foreign firm's selection of entry mode between WOS and JV, but it also is likely to have an impact on the firm's decisions on post-entry operations. When the institutional distance between the host and the home countries is large, foreign firms are more likely to choose JVs as the mode to enter the host market. However, the parent firms may still have to use WOS to enter the local market because of certain strategic concerns, such as the concern for reducing the potential for proprietary knowledge being disclosed outside the firm. In this condition, firms are actually taking more risks than those that enter through JVs. When unsatisfactory performance of a subsidiary is detected, parent firms of WOS will be more likely to take further risks than those of JVs. This is a result of the relative difficulty the parent firm will have in fully comprehending the environment in the host country. Having one or more partners (often from the host country) enables parents of JVs to generally have less difficulty comprehending the host country environment. Thus, we propose that institutional distance has both a direct effect on the likelihood of a parent firm's escalating its commitment to a foreign subsidiary and a moderating effect between the mode of entry and escalation.

Proposition 2b: Institutional distance between host country and home country environments moderates the relationship between subsidiary ownership structure and the likelihood of escalation of commitment.

### Parent Firm's Prior Performance

When faced with a poorly performing foreign subsidiary, how will the parent firm respond? We argue that the answer to this question depends in large part on how well the parent company has performed as a whole in prior periods. Given that decision makers frame decisions differently depending on their starting reference point (Tversky and Kahneman, 1981; Kahneman and Tversky, 1979), whether escalation occurs after receiving negative performance information about a subsidiary depends on whether the loss is framed as certain or uncertain. In essence, our argument here is that the prior performance of the parent company changes the reference point from which a judgment is made about whether to escalate commitment to the subsidiary. When the loss is framed as an uncertain loss (meaning that key decision makers within the parent company believe that the loss is recoverable and have not cognitively come to grips with the reason for the loss), we argue that escalation is likely.

The probability of a parent company allocating additional resources to a poorly performing subsidiary will be moderated by the way in which this decision is

framed. Positive overall performance in prior periods is expected to establish a generally positive reference point from which the parent firm will evaluate its ownership of the subsidiary. Thus, poor performance on behalf of the foreign subsidiary will be framed as a loss, leading to risk-seeking behavior. In the context of allocating resources to foreign subsidiaries, committing additional resources would be risk-seeking behavior.

Negative overall firm performance is expected to be associated with a more negative reference point, and a lower probability of the parent escalating its commitment to the subsidiary. This is because executives of the parent company are expected to more quickly come to grips with losses at the subsidiary level than if the parent experienced positive overall performance in the prior period. For example, when the firm's overall performance have previously been satisfactory, parent firms of WOS are likely to adjust their perceptions of local market and environmental conditions more slowly than those of joint ventures. Figure 2 graphically illustrates the differences between the value function curves for parent firms with WOS and those with JVs. The purpose of using these graphs, which are extensions of Kahneman and Tversky's work (1979, 1981), is to conceptually highlight that the propensity to be risk-seeking or risk-averse is impacted by the level of equity invested in a foreign subsidiary.

Proposition 3: A parent firm's prior performance moderates the relationship between the subsidiary ownership structure and the likelihood of escalation.

### Cost of Exit

of the factors that a firm considers when making a foreign direct investment decision is whether the investment can be withdrawn from the host country. Staw and Ross (1987) argue that if the cost to withdraw from a course action is high, the subject will be likely to extend its commitment. This is thought to be of particular importance for multinationals when the closing cost associated with exiting a foreign market may exceed the short-term losses from continuing to operate the subsidiary. We classify the costs of closing a foreign subsidiary into two general groups – financial and social costs.

The financial costs include the losses of transaction-specific investments; payments to release the physical assets, which may be more than the salvage value of these assets; payments to terminate employees; and penalties for breaching the contract. When the investment is transaction-specific, there will be no alternative use for the invested assets, or the switching to any alternative usages will be costly. The specificity of invested assets can be classified as physical asset specificity, location specificity, human asset specificity, and dedicated specificity (Williamson, 1979, 1985). When a firm makes an international investment, all of these types of asset specificity may occur and impact the parent firm's

escalation decisions. For instance, political risks have been one of the important considerations that the multinational concerns when choosing investment location and entry mode. Should the nationalization of a foreign investment occur, it would be impossible for the foreign investors to withdraw the investment. As a result, the time and money spent on such things as factories, equipment, and employee training would be totally lost. In contrast, a JV serves as a buffer that limits the foreign parent's exposure to potential nationalization of assets in a foreign country. The financial costs will be shared with other partners. Therefore, we argue that, in the occurrence of high financial costs of exit, the parent firm of a WOS would be more likely to exhibit an escalation of commitment than those of JVs.

Proposition 4a: The financial cost of exit moderates the relationship between the ownership structure of a foreign subsidiary and the parent's likelihood of escalation of commitment. When financial costs of exit are high, parent firms with a WOS are more likely to escalate their commitment than are parent firms with a JV in the same market.

In addition, another potential source of financial costs may reside in the firm's switching between strategies. These costs depend on both the strategy the firm is switching from and the strategy the firm is switching to (Buckley, 2003). A WOS represents a higher commitment of the parent firm to a given strategy than does a JV. Therefore, the switching cost for a WOS is normally higher than that for a JV.

The social costs may not be observed directly at the time of exit but may make any sequential investment difficult or costly. These costs include the damage of the relationship with local partners; the damage of the relationship with third-party partners; the damage of the relationship with local stakeholders, such as the host government, local labor union, and local suppliers; and damage to the overall reputation that MNEs of the same home country may share. We observe that parent firms of JVs are actually exposed to the social costs of exit. A joint venture implies the simultaneous commitment of all parents of the entity. The dissolution of the joint entity may involve significant social costs that do not exist for wholly-owned subsidiaries. Therefore, in the presence of high social costs of exit, we expect that the foreign parent of a JV escalates more than that of a WOS.

Proposition 4b: The social cost of exit moderates the relationship between the ownership structure of a foreign subsidiary and the parent's likelihood of escalation of commitment. When the perceived social costs of exit are high, parent firms with a JV are more likely to escalate their commitment than are parent firms with a WOS in the same market.

### Discussion and Conclusion

Numerous studies have explored how foreign entry modes are determined while ignoring the question

how a multinational's entry mode impacts its post-entry decision making and performance. The selection of different foreign entry modes is associated with different levels of the parent firm's commitment in the local market, in terms of resources invested and control retained. It is critically important for firms operating in globally competitive markets to make good decisions when deciding how to allocate resources to their foreign subsidiaries. Some of factors which are thought to have the greatest influence whether a firm is likely to allocate resources to a poorly performing subsidiary were discussed in this paper.

In this article we have attempted to clarify the role played by ownership structure in determining whether parent firms will escalate their level of commitment to poorly performing foreign subsidiaries. We have argued here that the initial decision regarding the investment structure chosen as a mode of entry into a foreign country, whether it be JV or WOS, will impact the likelihood of an escalation of commitment to that investment. Drawing insights from prospect theory and from the concept of institutional distance, we proposed that the ownership structure of a multinational's subsidiary directly affects the firm's potential for escalation of commitment. We have further suggested that the relationship between entry mode and a multinational's escalation of commitment is moderated by three factors – institutional distance between the home and the host country, cost of exiting the host market, and the parent firm's prior performance. Each of these factors affect the level of commitment parent firms demonstrate towards their poorly performing subsidiaries in foreign markets.

The contribution of this article is in highlighting the connection between the factors influencing entry mode decisions and subsequent decisions and performance by the foreign subsidiary. Other researchers have tended to focus on identifying the antecedents of entry mode decisions. We have purposely focused on the important post-entry phenomenon of escalation of commitment to a poorly performing foreign subsidiary. Our paper offers practical implications. While making initial foreign entry mode decisions, executives should devote more attention to the potential effects of their current decisions on future decisions. Also, when making decisions about whether or not to escalate their commitment to a poorly performing foreign subsidiary, managers should partial out the influences of the initial foreign entry mode as much as possible.

As a conceptual piece, this paper suffers from several limitations that are common to all theoretical articles. Both entry mode and escalation of commitment are broad fields in management research and numerous related topics may be explored from different perspectives. However due to the exploratory nature of this paper, we only cover the essential sections of how entry mode may influence multinational firms' escalation. A totally

comprehensive review of these topics would have made this article significantly longer and more difficult to read. Additionally, although we argue that the local performance can serve as a standard to examine whether the foreign firm accumulates correct knowledge about the host country, we have no intention to deny the function of "luck" in strategic management literature. Given the unpredictable nature of luck, this paper left it out as one exceptional case in management research.

In addition to the potential research avenues which are inherent in the limitations of this paper, we noticed several other promising areas for future research. Although the propositions presented in this paper are extensions of previously-tested theory, it is important for empirical analysis to refute/verify our propositions. We believe that each of the propositions presented in this paper lend themselves to the operationalization which will be required for such empirical testing. Survey instruments are recommended given the subjective interpretation of social costs and unavailability of financial information at subsidiary levels like performance and escalating investments from the parents. Measurements of major constructs can be found in management and economics literature. For example, ownership structure can be operationalized as either dichotomy (i.e., JV or WOS) or continuous (i.e., equity percentage owned).

Another area which appears to hold promise for additional research is investigating the relationship between escalation of commitment to foreign subsidiaries and the subsequent performance of those subsidiaries. Often researchers treat escalation of commitment as a purely negative phenomenon. However, it is easy to come up with scenarios and anecdotal examples where escalation of commitment could turn out to be a positive choice. As a result, methodical analysis of post-escalation performance would be helpful in better understanding escalation of commitment.

Finally, it would be beneficial for researchers to investigate the way in which decisions are framed plays in what international markets are chosen for foreign direct investment. For example, when deciding between two markets with the same potential for new customers, how do executives weight the importance of such issues as economic turmoil, government corruption, and social differences? This is another area where prospect theory and institutional distance both appear to hold promise in explaining decision making by executives faced with considerable uncertainty.

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**Appendices**

**Figure 1. Conceptual Framework**

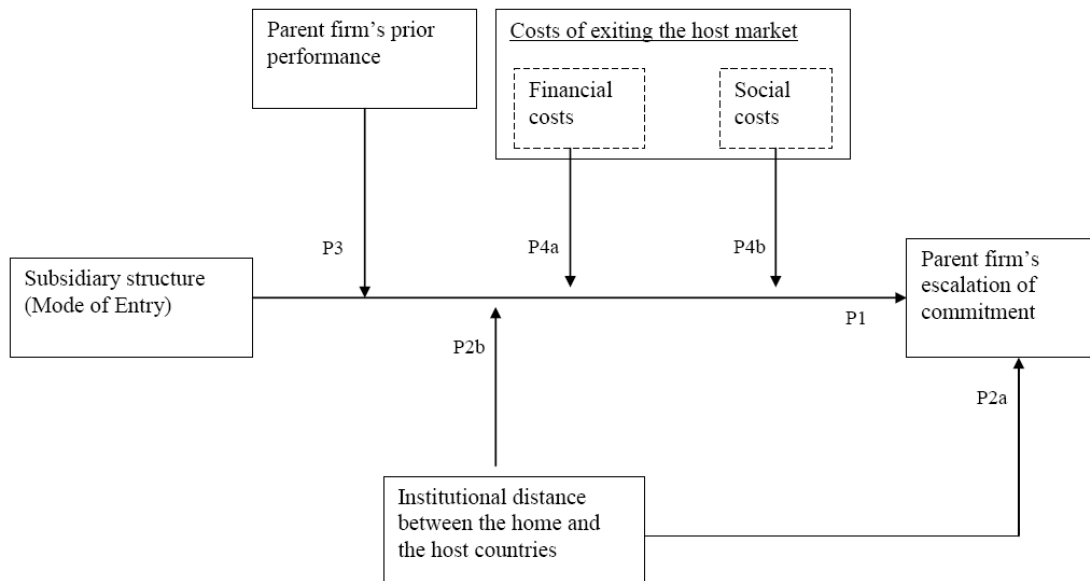


Figure 2. Value Functions of Parent firms of WOS/JV

