Agency Theory in Franchising
Some Empirical Results

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Abstract

The article provides an empirical assessment of various agency problems in franchising. Agency theory is one of the explanations for franchising. This theory specifies the relationship between the principal (franchisor) and the agent (franchisee). Based on the incompleteness of the franchise contract and self-interest for both parties, the franchisor needs to adopt monitoring mechanisms to maximize the principal’s interest. However, due to the natural unfair status between franchisors and franchisees, cheating will take place to act against the franchisor’s unreasonable policies. Therefore, franchisors have to think how to minimize the agency problems to maximize the synthetic power of a franchise brand. This paper will discuss agency problems from the perspectives of precontractual and postcontractual stages. The sources of data are 84 from the in-depth interviews with franchisors and franchisees in two different contrast industries and ownership patterns. Convenience store is characterized by product-based and a plural system whereas estate agency is service-based and a purely franchised system. The findings suggest that both parties use different criteria to sort out the best agents in the precontractual stage and in the postcontractual stage, some are conflict with the existing theories, such as the cost of monitoring multi-unit franchisee, the relationship between the incompleteness of contract and monitoring mechanism.

Key words: franchising, agency theory, monitoring cost, cheating

INTRODUCTION

Why do some firms rely on expansion by franchising or a mix of franchising and company owned outlets rather than expansion by company owned outlets? One of the explanations offered by the literature is agency theory. Due to the essence of self-interest for both franchisors and franchisees, franchising is a good mechanism to motivate both parties for the same objectives. However, based on the unfair of franchise contract, agency problems will arise and therefore franchisors need to monitor and manage franchisees. This paper explores principal-agent explanations for franchising in the context of the Taiwanese retail and service industries. The study is distinct from previous research in two aspects. One is the comparison of ownership pattern between pure franchising and plural system; the other is to compare the interactions between two different natures of sectors (convenience store and estate agency), which are product and service based industries. Therefore, the research objectives are twofold: first, to explore the agency problem from the perspective of precontractual stage, i.e., the criteria franchisors and franchisees use to select the other party. Second, after a franchise contract is being signed by both parties, potential agency problems will arise in the postcontractual stage, therefore, four agency issues will be explored, they are ‘the relationship between monitoring cost and incompleteness of the contract’; ‘the cost of monitoring multi-unit franchisees’; ‘the potential for franchisees to cheat on performance’ and ‘attention to risk’. By the examination of agency problems from the precontractual and postcontractual stages, both franchisors and franchisees can gain and improve the relationship between each other to create a win-win status by maximizing the brand power. In-depth interviews were taken to compare the perceptions of agency problems from both franchisors and franchisees. From these answers, we can explore the potential relationship and conflict between both parties. Further, it helps the franchisor think about how to design a better contract or a better monitoring and rewarding system to satisfy franchisees.

FRANCHISOR OWENRSHIP PATTERNS AND AGENCY THEORY
In franchising, the ownership patterns can be varied from company to company and industry to industry. Tikoo (1996) suggests that there are two kinds of ownership systems, one is the purely franchised system and the other is the plural system. Each system has advantages. In the pure franchise system, the firm has access to franchisee capital and labour. Oxenfeldt and Kelly (1968-69) suggest that franchisors use franchising to obtain resources from franchisees. This argument assumes that retailers prefer to own their outlets; it is only because the option is not available to them that they choose to franchise. Resource constraints include financial capital, human capital, management talent and local market expertise (Oxenfeldt and Kelly, 1968-69; Minkler, 1990 and Lafontaine, 1992) and these resources allow franchisors to expand quickly. Aside from gaining these resources from franchisees, the franchisor can transfer the business risk to franchisees and because of self-interest, the franchisees will work hard to maximize performance. This mutual reliance allows franchisors to reduce monitoring costs. Tikoo also suggests that this approach happens when franchise is young and lacks of resources. Through pure franchising, rapid expansion will occur, however, there is a risk that the brand value may be damaged by unqualified franchisees. The second system is the mixed system; Tikoo (1996) suggests there are three ways to establish this. First, a firm can start by franchising all locations, and then take over some of the stores later. This allows a firm to gain the initial benefits of franchising, and is related to the life cycle of a franchise first put forward by Oxenfeldt and Kelly (1968-69). The second method is by initially opening only company-owned stores, then franchising some new locations at a later stage. This is suitable for a firm willing to grow gradually and steadily. One of the advantages of this approach is that the franchisor can pre-test the business know-how or products mix in the company-owned outlets in order to prevent potential conflict with franchisees afterwards. Third, a firm can establish both franchised and company-owned outlets simultaneously. This approach provides a means to combine the advantages of the other two options. In this study, convenience store is a plural system; the franchisor ran company owned outlets in the beginning, then franchised some new locations or profitable company owned outlets to franchisees. Due to the combined ownership of the store outlets and equipments, the relationship between franchisors and franchisees is closely linked. In contrast, within estate agency, it is a purely franchised system, in other words, franchisees own the store outlets and their ownership is independent of the franchisor.

In agency theory, the most widely accepted explanation is based on Robin’s argument in 1978. According to this theory, managers of company-owned units do not bear the full costs nor receive the full benefits of their efforts because there is a weak link between their compensation (salary) and the performance of their outlets (salaries and profits). They may therefore shirk the responsibility of the job. The agency theory relates to the perception that franchising is an effective solution to the problems of employee motivation and low levels of productivity, without incurring the costs associated with monitoring and supervising employees. This is because franchisees bear more of the costs of their shirking because they are compensated from the residual claims of their individual units. Thus, franchisee-owners tend to minimize shirking. This explanation receives strong empirical support (Brickley and Dark, 1987; Martin, 1988; Lafontaine, 1991). The simplest way to motivate the franchisee is to give him a share of the profits of the franchise (Rubin, 1978). Then he/she will work hard to be efficient, as any leisure he takes will cost him as an individual. Thus, Rubin suggested that the franchise contract should be written in such a way as to give the franchisee most of the profits of the operation.

Those adopting the agency perspective argue that franchising is cost effective when the marginal costs of monitoring company-owned units are higher than those associated with franchise contracts. These costs are lower because the franchisee has a similar perspective to the franchisor: revenue growth. According to the theory (Brickley and Dark, 1987; Carney and Gedajlovic, 1991), the costs associated with supervising company-owned operations are dependent upon:

- Availability of managerial talent;
- Importance of local knowledge;
- Geographic distance of units from headquarters;
- Local population density; and
- The relative proximity of the brand’s locations to one another.
Each of these factors affects the cost and efficiency of communications, travel and effective decision-making between unit managers and head office. Franchising can reduce many of these costs because the franchisee is motivated to realize a return on his/her initial investment. Also because of the franchisor’s power to refuse to renew franchise contracts without cause (Klein, 1980), the franchisee is less likely to shirk.

However, there are three weaknesses in this theory. First is the suggestion that franchisors weigh the cost drivers associated with monitoring company-owned units against the supervisory issues inherent in franchising, such as lack of investment and behaviour which is damaging to brand equity (Combs and Castrogiovanni, 1994). The second weakness is because of the characteristic of geographically dispersed franchisees. The approach does not wholly explain the tendency for the use of multi-unit franchisees (Kaufmann and Dant, 1996). As the costs of monitoring multi-unit franchisees should be cheaper, and the revenues accruing from them higher, it is possible that franchisors are attempting to reconcile capital accumulation motives along with motivational ones rather than just one alone. Finally, the third concern is that with the improvement in telecommunication, the advantages of scale in monitoring will be reduced. Therefore, geographic distance will not be so important.

With a basic understanding of agency theory, the following section will explore agency theory from two perspectives: ‘what’ and ‘when’ agency problems will occur.

As far as agency problems are concerned, there are three: they are ‘information imbalance’, ‘environment uncertainty’ and ‘performance assessment difficulties’. All of the problems are viewed from the principal’s standpoint because the principal is in the dominant position in the relationship. The principal has to think how to prevent and solve these problems; otherwise the principal has to stand the potential cost. Here, the agency issue is categorised as precontractual and postcontractual problems (Mark, Shantanu, Orville and Walker, 1992). Much of the agency literature refers to precontractual problems as problems of “adverse selection” and to postcontractual issues as problems of “moral hazard”.

As far as the precontractual problem is concerned, this arises before the principal decides to offer an agent a contract. The key issue here is whether a particular agent has the characteristics the principal is seeking and what kind of strategy the principal should employ to find out. The precontractual problem is also called ‘hidden information’ (Arrow, 1985), and arises mainly from information asymmetries. Before forming a relationship, the agent may know more about the principal than the principal knows about the agent. Therefore, Bergen et al. (1992) suggests that there are three strategies a principal can adopt to address this problem. The first one is ‘screening’, which means employing different screening skills to sort out the best agent. Many screening skills can be used, for example, interviews, pen and paper tests and so on. The second one is ‘examining signals from potential agents’. For example, when the principal wants to hire a local manager, if a candidate is from that location, then it means that he has the potential to qualify for the job. Through this approach, the principal can save a lot of time in finding the right person at the right time. Thirdly, the principal can adopt a policy of ‘providing opportunities for self-selection’. This means that if potential agents want to be considered they must have some qualifications. For example, when a franchisor looks for potential franchisees, there must be some limits, such as working experience, age limitation, capital requirement and so on. When the potential agent sees the basic requirements, he/she will know whether he/she is qualified or not. By employing these three policies, the principal can save a lot of time and money in choosing the right agent and preventing possible problems occurring in the postcontractual period.

In the postcontractual period, or ‘hidden action’ period, attention focuses on the problems after a contract has been signed by both parties. There are three assumptions at this stage. The first one is that ‘both parties are motivated and self-interested’. So, under this circumstance, both parties would try their best to achieve the best performance and then get the rewards from the other party. Lafontaine (1992) suggests that franchisees are more highly motivated than hired managers and that this is a major advantage of franchising. The second assumption is that the ‘principal’s labour is under conditions of incomplete information’. Basically, the principal is assumed to know something about an agent’s characteristics and abilities. However, the agent sometimes has information that the principal does not know and would like to know. This kind of situation is called information asymmetry—when one party has information the other desires but does not possess.
This also links to the first assumption-self-interest, it makes the agent reluctant to share the information with the principal. The third assumption is ‘the risk of environment factors’, such as economic and technical conditions in the market. However, this kind of risk is difficult to measure and forecast, therefore, both parties have to face the potential risk. Risk preference can be thought of as the degree of an individual’s or firm’s performance for adventure rather than security (Arrow, 1974; Pratt, 1964). Generally speaking, the principal tends to be risk neutral and the agent tends to be risk-averse. This may be because the principal has more power and resources to react to the external changes.

One of the most important solutions to agency theory is related to monitoring mechanism, because agency problems arise from the incompleteness of the contract, in other words, the contract is written to benefit the franchisor. As a result, in the postcontractual stage, one of the assumptions is that the ‘principal’s labour is under conditions of incomplete information’. This means that under self-interest, franchisees may cheat franchisors to damage the franchisor’s benefits. Therefore, franchisors have to adopt monitoring mechanism and reward systems to make franchisees satisfy with the franchisor’s goal to reach a win-win status.

Summarising the above arguments, we can see that prevention is better than cure. If firms seek to adopt an organisational form to avoid costs, then becoming a franchising organisation is a good mechanism to reduce agency problems of firm growth (Shane, 1996). Also, Norton (1988) indicates that a hybrid organisational form, like franchising can reduce the problems of adverse selection and moral hazard and it can provide residual claimancy. By replacing a salaried outlet manager with a residual claimant on the profits of a retail outlet, franchising reduces agency problems in monitoring new employees and lowering initial investment costs per unit (Brickley & Dark, 1987).

METHODOLOGY

The purpose of this paper is to explore the agency problems from the perspectives of precontractual and postcontractual stages. By the comparative analysis of the franchisors’ and franchisees’ perceptions of specific agency problems, we can gain the nature of the interactions between franchisors and franchisees and find out the gaps between franchisors and franchisees.

In order to allow a comparison, two industries with different ownership patterns were considered. One is the convenience store industry (CVS) and the other is the estate agency (EA) industry. There are two reasons for choosing these industries; the first is the nature and characteristics of the industry, i.e., one sells primarily products and the other sells a pure service. The other is on the difference of ownership pattern. Within CVS, the ownership pattern is a plural one which mixes of company owned and franchised outlets whereas EA is a fully franchised type. The method adopted in this research is a form of exploratory qualitative research, because the purpose is to provide insights and understandings of the nature of marketing phenomena (Malhotra and Birks, 2000). In this study, the interactions between franchisors and franchisees were explored to uncover the potential agency problems. The sample frame was comprised of eight franchise brands in the Taiwanese retail market, four of them from the CVS sector and four from the EA industry. Within each brand, three interviews in each franchise head office, and ten interviews with franchisees from each system were targeted (see Appendix 1). The sample was selected through stratified (national/international brand and personal network) and random purposeful (phone lists and street visits) sampling methods. Owing to difficulties of access, 84 interviews were conducted in Taiwan. The interviews explored views from different industries and sub sectors to allow a comparative study from the franchisor and franchisee’s perspectives. The results of findings were shown in Appendix 2. All the interviews were recorded and transcribed, and cross case and within case analysis undertaken.

DISCUSSION OF FINDINGS

According to agency theory, there are three issues that provide an explanation for the motivation to franchising, namely: the selection of franchisees; monitoring costs; and risk considerations relative to the external environment. As stated in the literature review, agency theory suggests two areas which can lead to conflict, i.e., precontractual and postcontractual problems. Before signing a franchise contract, the
key issues are whether a particular prospective agent has the characteristics the principal is seeking and the kind of strategy the principal should employ. These problems mainly arise from information asymmetries. As to postcontractual problems, these, by definition arise only after a contract has been signed by both parties. In the following discussion, the views of those within the Convenience Store (CVS) industry are presented first followed by those from the Estate Agency (EA) industry.

1. Precontractual stage

   ● The criteria franchisors and franchisees use to select the other party

   In the CVS industry, due to the fact that candidates do not necessarily need specific skills to be franchisees, most people are “qualified” to become a franchisee. If somebody has an interest, he/she just phones the franchisor and asks for an interview. As to how franchisors make their selection, let us see what the franchisor said:

   “There are eight procedures to help select a suitable franchisee. These include an introduction day to let potential franchisees know about the franchisor. Then followed by a family visit, forty-hours of on-line practice, interviews with four managers and ends with educational training. Usually, it takes about two months to test whether he/she is a potential franchisee or not.”

   Another franchisor specified:

   “The criteria are whether he/she has enough capital, ability, human resources, family support, academic qualification (university degree), age limit and correct concept of this industry. As for the experience, it is not necessary.”

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   From the franchisors’ descriptions, we can find that there are passive and active qualifications. Passive qualifications include academic achievement (university or high school degree, varied with the brands), age (under 50), capital and human resource. Such qualifications make candidates examine themselves as to whether they are qualified for the task. After that, the franchisors use different screening skills such as interviews, pen and paper tests or on-line practice to sort out the potential agents. From these tests, both parties will decide whether the other party is suitable for them. If they are compatible, then the franchise contract will be signed and will last for at least five years. Clearly, both parties need to think carefully to prevent conflicts afterwards.

   The above-cited comments are from the franchisors’ points of view. Franchisees will have a different way of thinking; the following are typical of their selecting approaches to selecting a franchisor. One franchisee said:

   “…this is because this brand is the leading brand in Taiwan and the franchisor has a sound background. As a customer, when I have a choice, I prefer shopping in the brand’s outlets. Although the sharing percentage of sales is not the highest compared with other systems, I would be proud of being a franchisee of this brand.”

   Another different kind of answer from the internal franchisee is like:

   “…because I was an internal store supervisor but as the salary was not high enough for such high responsibility I transferred to being a franchisee. Even though the franchisor gave a discount to internal employees. As to other brands, I carefully thought about it, but finally, I still chose the one I am familiar with rather than the most popular one.”

   As well as from the above reasons, many others were provided, such as the franchisor gave giving a quick response; organisational atmosphere; capital requirement; easy recognition of the brand; a friend’s introduction; and the brand’s reputation. There is another interesting pattern of those who had previously been store managers. Nobody transferred from the original franchisor to another brand. The reasons for this could be that the franchisors gave them discounts, or that the franchisees were used to the particular management style.

   After precontractual selection, potential franchisees have a choice of five stores for all brands. The franchisor will show the candidate the historical sales of these company owned stores and let the franchisee choose one store from the five. Of course, all these stores are profitable; otherwise the franchisor would have to cover the deficit at the end of the year because the ownership pattern between franchisors and franchisees are closely linked. The link between the parties is stressed in order to maximize the store’s performance.

   From the above viewpoints, we can see that CVS franchisors have standardized their requirements when selecting franchisees. However, in the EA sector, due to the different working characteristics, the required qualities may vary from those of the
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convenience store industry. The criteria for choosing a suitable franchisee are more flexible and simpler than in the CVS industry, and the selection is more subjective. One franchisor said that:

“First, we will investigate his credit in the industry and if the candidate has other brand experience, we will evaluate his former operating records. Second, we will evaluate whether his performance was good and finally, we will take his moral standard into consideration. I will not consider those without previous experience. This is because the franchisee’s operation is related to the brand reputation, and inexperience will only increase the franchisor’s burden. Also, if the franchisee’s performance is not good, he will ask more from the franchisor rather than from himself.”

This kind of answer is applicable to other franchisors; therefore, most franchisors prefer those with working experience to be their franchisees, as this means that the franchisor does not need to supervise them too closely. Moreover, a franchisee’s past operating record is seen to be particularly important in determining his quality in this industry. However, the franchisees’ viewpoints may be different when they come to choose a franchisor. One franchisee said:

“Basically, this brand has a higher market share…and this franchise brand has stronger logistic support and the franchisor’s background is strong. In addition, the brand gives to the public a good impression.”

This is a positive attitude toward the franchise brand. However, not every franchisee is so lucky that can choose the leading brand, another brand franchisee said:

“There are three reasons why I joined this brand, one was that other chain brands had already occupied this trading area so that I had little choice. Second, the royalty for this brand is cheaper than others and finally, as this was a new it would give customers a fresh impression without any good or bad historical records.”

Summarising the above comments, we can see that what franchisees care about most is brand reputation. This is followed by market space, the background of the franchisor, royalties, friend’s introduction and so on. There is a tendency in the industry that shows that the earlier the franchisees enter the market, the more opportunities they have to choose between brands and locations. As a result, those following can only choose from the inferior options because every franchisee has an exclusive trading distance. However, this situation sometimes does not apply, if the original franchisee agrees.

From the above statements, we can see that in both industries, franchisors and franchisees have their own viewpoints on how they choose a good partner. However, there are some particular differences among them. For instance, the franchisors in CVS seem to adopt a standard selecting procedure to find out the most suitable franchisee. With EA, what franchisors care most are those whether the candidate has the industrial experience and his/her credit record. Generally speaking, the criteria are more flexible. With the franchisees, those in CVS care about the strength of the brand and/or the gross margin on offer. In the EA, what franchisees care most is the reputation of the brand.

2. Postcontractual stage

After entering into a business relationship with the franchisor, both parties’ behaviour is based on the contract. However, the contract in practice is usually more beneficial to the franchisor, and sometimes the franchisor even has the authority to change the contract without informing franchisees. As a result, the incompleteness and unfair of contracts leads to many agency problems. In order to prevent this, the franchisor usually adopts a system of monitoring to ensure that franchisees follow the principal’s policy. Even though, cheating still take place in both industries. Further, attention to risk will be examined to see whether the franchisor is more risk-neutral. First of all, we start with the issue of the contract issue.

● The relationship between monitoring costs and the incompleteness of the contract

Questions were asked of both franchisors and franchisees to see whether they thought that monitoring costs arise from the incompleteness of the contract. First let us see what the CVS franchisor said:

“I don’t think so, there is no relationship between monitoring costs and the incompleteness of the contract. The monitoring is to help the franchisee do
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better. The store supervisor will tell the franchisee where he/she should improve and there is no penalty, just rewards for those with good performance. As to whether the contract is equal or not, in fact, it is impossible to be equal. It is beneficial to the franchisor, especially on the points of obligations and power. But we don’t count on the contract too much, the main interaction is based on mutual communication.”

None of the CVS franchisors think that monitoring is related to the incompleteness of the contract, this is because even if there were no franchisees but all company-owned outlets, the franchisors would still follow the same system to maintain quality. Further, the contract specifies the policy rather than operational guidelines. Franchisors argue that the function of the store supervisor is to help franchisees become familiar with the store operations. However, franchisees have a different view when they were asked whether they are monitored by franchisors. One franchisee said:

“The monitoring is done by the store supervisor and a computer network, such as POS. The store supervisor will ask me to improve the efficiency via the computer system. For example, from the computer he can see which kinds of products are best sellers and if you do not have any stock at all, and then he will no doubt ask why you do not order more. Also, he will evaluate the layout of products, and the cleanliness of the store. If the result is good enough (the top 100s), then you will be rewarded by a free trip abroad and it is an important criterion on your application to be a multi-unit franchisee. If the result is not good, you will need to attend the retraining course to improve the service quality. Such kind of monitoring is not related to the incompleteness of the contract. But the monitoring is somehow related to the incompleteness of the contract. But the monitoring is very unreasonable, for example, the franchisor may check the store at midnight, when he/she comes, you have to be sure that you do not have any shortage on the display shelves, otherwise, you will be fined. Take fast food for example, it is unreasonable to audit at midnight. As a result, the problem is on the communication channel, i.e., the people who are in the franchisor office do not know the practices on the front line so that they give many poor and bad directions.”

Obviously, some franchisees complained about the franchisor’s monitoring mechanism because of the inappropriate of the franchisor’s policy. Some of the franchisors use a positive rewards system but others use punishments. From the research, it seems that more complaints arose when the franchisor used coercive power. In reality, most franchisors used both powers to manage franchisees. However, most franchisees say they welcome some kind of monitoring, because the store supervisor can assist the franchisee in running the store especially if the franchisee is unfamiliar with the operations. The supervisor can tell him about other franchisees’ experiences so that he can learn and improve his own performance. Some franchisees think it depends on the attitude and ability of the store supervisor. Most franchisees said it should be called assistance rather than monitoring, and most of them do not think monitoring is related to the incompleteness of the contract because monitoring is already specified in the contract. As for the contract itself, most of them think the contract is unequal, especially on the sharing percentage, exclusive territory, the power to change the contract at any time without notice to the franchisees and the prices of commodities. One franchisee even said that the franchisor can franchisor asks too much on the hot product lines, i.e., you cannot be short of 5 product items among the 200 hot product lines. If you are found such kind of a situation, you will be fined. Performance is based on how the franchisee operates the store. If the performance is not good for 3 times within one year, then the franchisor has the power to terminate the relationship. If the franchise is terminated, he/she has to pay the penalty as well. The monitoring is somehow related to the incompleteness of the contract. But the monitoring is very unreasonable, for example, the franchisor may check the store at midnight, when he/she comes, you have to be sure that you do not have any shortage on the display shelves, otherwise, you will be fined. Take fast food for example, it is unreasonable to audit at midnight. As a result, the problem is on the communication channel, i.e., the people who are in the franchisor office do not know the practices on the front line so that they give many poor and bad directions.”

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sue the franchisee for breaking the rules and can terminate the relationship at any time, but on the other hand there are no contract terms to regulate the franchisor’s bad service and management.

After examining the case of the CVS industry, we can see that the views expressed conflict with agency theory on some points, but as to the EA industry, is it the same? In the estate agency case, the transaction frequency with end customers is not so high as in the CVS industry. Also, the ownership pattern is independent between the franchisors and franchisees. As a result, the franchisors have different policies from the CVS. One EA franchisor said:

“I don’t think the monitoring cost is from the incompleteness of the contract. Rather, the contract is equal to both parties. The difference is just in the responsibility. The monitoring is to check whether franchisees follow the franchisor’s policy so that the brand value can be reserved. If the contract were not equal, franchisees would not join the system. The contract should be an interactive tool, each party stands on the negotiated point to maintain and promote the brand to benefit with each other and coexist without the absence of the other party.”

Another franchisor also specified:

“The purpose of monitoring is to protect customers rather than to make franchisees’ troubles. As to whether the contract is fair, to be the truth, it is not fair. This is because the franchisor paid so much on acquiring the know-how and promotes the brand but franchisees just pay a little and then can benefit from the brand. But on the right and duty, it is equal for both parties. So, on the protection of the brand and customer satisfaction, the franchisor has its subjectivity. As a result, conflicts are usually from these two points. ”

Again, none of the franchisors think that monitoring comes about from incompleteness of the contract. Rather, most of the franchisors think the contract terms are reasonable and fair, because they have to limit the actions of worst franchisee and protect both themselves and the customers. In this light, monitoring is believed to protect both franchisors and customers. However, monitoring depends on the franchisor’s ability to carry it out. If the franchisor has difficulty in surviving financially, then monitoring is worth nothing. Unless customers complain directly to the franchisor about a franchisee’s bad service, the franchisor usually ignores the franchisees’ operations.

Regarding EA franchisees’ opinions, the typical responses were:

“… monitoring intensity relates to the degree of dependence on each other. Being an old franchisee, what I use is just the brand name. In theory, the contract should be equal, but in practice, some rules are more beneficial to the franchisor. For example, franchisees have to pay the guarantee fee so that franchisors can take it for the prevention of franchisees’ illegal behaviour. However, the contract does not specify that the franchisor have to compensate the franchisee’s loss if the franchisor damages the franchisee’s benefits. So, basically, the contract is not equal.”

The other franchisee’s opinion is that:

“I have never been monitored by the franchisor, but I would welcome some kind of monitoring. As to the contract, it is not equal since if the franchisee does something which is different from what is specified in the contract, then the franchisor has the power to terminate the contract and the franchisee cannot get back the guarantee fee. But the question is what is “Different from the Contract”. There is no specification in the contract and as a result, the franchisor can give any reason to allege a breach.”

Other franchisees also specified that the franchisor now have difficulties in monitoring and assisting franchisees because that the franchisor faces loss owing to the outlet number not reaching an economic figure. All EA franchisors in Taiwan have difficulty in choosing good quality franchisees, and that leads to damage to the franchisor’s brand. The frequency of the visit by the franchisor to the franchisee is about every four months. The aim is to communicate each other’s concept. It is difficult for the franchisor to monitor and check the contracts of the franchisees. As a result, the visit is just to keep up a basic relationship. From their comments, we can see that franchisees would usually welcome some kind of monitoring but franchisors lack the manpower to provide it and as a result, the basic service quality is usually maintained by the formula contracts, computer networks and transactional procedures. This is quite different from the CVS industry, which is based on daily operations. Compared with CVS, franchisees in both industries think the contract is unfair. One
difference is that the purpose of monitoring within CVS is to monitor franchisees, whereas with EA, the main aim is to protect customers. In common, both industries think that it should be called assistance rather than monitoring. Having examined monitoring methods, the following section will discuss another dimension highlighted in agency theory, the costs of monitoring multi-unit franchisees.

● The costs of monitoring multi-unit franchisees

Kaufmann and Dant (1996) suggest that the costs of monitoring multi-unit franchisees should be cheaper than for a single franchisee. However, according to the field study the answers were varied. In the CVS industry, this view conflicts with the statements gathered. On the other hand, in the EA industry, the conclusion is as suggested in the literature. In order to find out the reasons for this contrast, let us see what the franchisors said in the CVS. One franchisor specified:

“It should be the same, as a store supervisor has to supervise eight outlets no matter whether they are company owned or franchised outlets. In theory, the supervisor will spend more time on franchisees to exchange each other’s thoughts. While, for company owned outlets, the supervisor just tells them what/how to do it directly rather than using a personal communication style. But for both of them, the supervisor has to do the performance evaluation four times a month, so as a result, the cost basically is the same even though it is a multi-unit franchisee.”

All the other franchisors’ comments are similar, therefore, we see that every outlet, whether company-owned or franchised is treated in the same way. Maybe this is because there are so many product lines and promotional activities that franchisors have to check that everything runs well to keep a united impression. However, in the EA sector, because business is based on personal interactions, the style of monitoring is very different from that in the CVS. For example, one EA franchisor said:

“In theory, it should be the same, but for the multi-unit franchisee, there is an advantage on communication cost. This is because we just need to communicate with the owner of these franchised outlets rather than every store manager. Concerning how to monitor, it is based on the paperwork, customers’ free phone or the non-periodical check of franchisees.”

From the above statement, we get the impression that it is cheaper to monitor multi-unit franchisees in the EA industry, the franchisors just set up the game rules, which are based on the transactional process and safety between franchisees and customers. If the franchisees follow the rules, and then there will be no problems. However, if the service quality of some franchisees is not good enough, the franchisor has to get busy fire fighting. Generally speaking, the most important role during all the transactions is that played by the store manager. If he/she adequately checks all the details then the salesmen will not cheat customers. After all, the salesman is also an agent of the store outlet and hence agency problems take place not only between the franchisor and franchisee but also between the franchisee and salesman.

In the case of the CVS industry, we can suggest that monitoring is related to ownership and transaction frequency. However, generally speaking, it is easier to manage a multi-unit franchisee because if the franchisee’s quality is not good enough, the franchisor will not give him the opportunity to damage the franchisor’s brand name. Having examined the relative questions about monitoring. The following section will discuss another important agency problem: whether a franchisee could cheat the franchisor and mislead him so that the franchisor makes wrong decisions.

● The potential for franchisees to cheat on performance

Since franchisors and franchisees are both self-interested parties, it could be that the agent is reluctant to share information with the principal and in that situation, information asymmetry will develop. In order to minimize this problem, franchisors design mechanisms to prevent this, but for their part, in order to get more profit from the sales or for themselves, franchisees usually know how to cheat franchisors. In the CVS, one franchisor said:

“No, never, this is because that all the operational details are controlled by the computer system. Also, there are other staff in the store, so, it is difficult to have the opportunity to cheat.”

But another interviewee said:
“Few franchisees will do so to protect their benefits. For example, they will cheat on performance details to prevent the franchisor opening another outlet nearby. For the franchisor, not all the information from franchisees is taken into consideration.”

In order to prevent such kind of situation, most franchisors use computer systems to prevent cheating, but data input is by people; so, there is still the opportunity to cheat. However, the cost of cheating is huge since it would most likely lead to termination of the relationship. Now, let us see how franchisees perceived cheating. One said:

“No, I don’t think so. The franchisor already knows how to prevent this kind of cheating before franchising and all transactions are recorded by computer network.”

However, other franchisees said that cheating is possible. For example, the delivery companies sometimes do not check the quantity of products with franchisees so then franchisees can say there are shortages of some products. But the franchisor will say this is impossible, because they also received a copy the delivery invoice. The final decision is made from the franchisor’s computer system rather than franchisees’. Therefore, many examples illustrate why the frequency of monitoring is so high in the CVS industry.

In the EA industry, from the previous sections, we have established that there are many franchisees complaining about the franchisor’s services. Hence, franchisees do not like to give the franchisor all the information that they possess. Let us see what were the franchisors’ reactions to this. One franchisor said:

“Yes, cheating is possible, franchisees may hide sales and market information. This is because they are afraid that the franchisor would raise the royalty or give another franchise right within the exclusive trading territory.”

The interview also emphasized that this kind of cheating will not influence the franchisor’s benefits, otherwise, franchisees may ally together to cheat the franchisor. Also, the franchisor can get the relative information from the public media, so, it is difficult to mislead the franchisor’s decision. From their opinions, we can see that franchisors believe that what franchisees care about are royalties and exclusive trading territories. As to whether franchisees think so, most franchisees said yes, one typical answer is like:

“Yes, cheating is possible, but both party’s relationship is based on the mutual trust. If the franchisor’s behaviour cannot be trusted by franchisees, then, why should franchisees want to offer correct information to the franchisor?”

From the franchisee’s statements, we see that franchisors have always known where the problems are but they do not want to tackle it. This may be the reason why the degree of franchisee loyalty is so low. So, even if there are computer systems, franchisees still input the wrong information. Many franchisees felt that the mutual trust and reliance between both parties are quite low and franchisees just use the brand at most. These conflicts between the franchisors and franchisees lower the collective power of franchising. No wonder the leading brand in the market is a company owned brand rather than a franchise brand.

Comparatively, it therefore seems that the powers of franchisors are stronger in the CVS than in the EA industry. This is because franchisors can positively intervene rather than just take the royalty and do nothing. This explains why the brand-transferring rate is so high in the EA industry.

● Attention to risk

One of the considerations of agency theory is ‘the risk of environment factors’, such as economic and technical conditions in the market. However, such kinds of risk are difficult to forecast and measure. In general, franchisors tend to be more risk-neutral because they have more resources than franchisees. But does this differ across the industries? One CVS franchisors said:

“The risk should be the same, the franchisor even bear a higher risk than franchisees. For example, if one franchised outlet is closed down, the loss for the franchisee is just to terminate the relationship. But for the franchisor, the public will have a negative impression of the brand to doubt whether the brand has financial problems or not. It is harmful to the brand value.”

From this description, we see that franchisors not only have to face the risk of the stability of the franchisee but also of external changes. For franchisees, their loss is just some part of a guaranteed fee if they do not want to run the outlet anymore. But some franchisees think the risk is similar, this is because franchisors have to face competition from other brands, and
franchisees have to face the potential inventory loss and the risk of theft at night. Compared with the loss of the franchisor, this is quite tiny. This is because most of the products in the store belong to the franchisor. As a result, we can infer that the franchisor is more risk-neutral than franchisees. Concerning the EA industry, as the ownership pattern is different; the result may be also different. One franchisor in the EA said:

“The franchisor has a higher resisting ability than franchisees. The risk of the franchisor is from that the franchisee offers improper service to customers so that it damages the franchisor’s brand value. The franchisee’s risk is whether the brand could be lasted or not. If the franchisor disappears someday, then franchisees have to face such kind of loss. So, franchisees can dodge such kind of loss before signing the contract. The other risk franchisee has to face is the store manager himself. If he/she cannot adapt to the external change, then it is very easy to fail the business.”

Another franchisor has another kind of thinking, he said:

“What the franchisor can dodge is the daily operations under the recession. In other words, the franchisor gets the same royalty per month, even though franchisees don’t have any income. If the franchisee closes down, there are still many people waiting to enter the market. So, the franchisor on the one hand has more resources to resist the external risk, on the other hand, the franchisor can dodge the operational risk. Hence, the franchisor should be more risk-neutral than franchisees.”

From the above statements, EA franchisors claimed that they were more risk-neutral; this is because they have more resources and their view is wider than that of franchisees, so, franchisors must be in charge of prevention. One franchisee stated that one source of risk for the franchisor is the stability of franchisees; this is because they may transfer to another brand, so, the franchisor’s revenue will be reduced. However, if there are many people waiting to become franchisees, then the impact on the franchisor will be low. Another said there are some other risks for franchisees; they are the legal funds required for being a franchisee and the quality of salesmen. As a result, we can see that the risks franchisees face are more related to the store operations, rather than the whole system and external changes, which are what franchisors have to face. Hence, as far as the resistance to external risk is concerned, the franchisor is more risk-neutral than franchisees, as is specified in agency theory. Both parties have different types of risk, which were not specified, and sometimes, such kinds of risk cannot be measured to say which one is more important than the others.

In comparison to the CVS, we can see a common point in that franchisors in both industries emphasize the risk to brand value. One difference between the sectors is in the ownership pattern, the CVS is characterized by combined ownership, whilst the EA is independent. So, franchisees in the EA will face a higher risk than those in the CVS.

CONCLUSIONS AND IMPLICAITONS

From this analysis of agency theory, we can see how this theory is related to the franchise market in Taiwan. In the research questions, many issues were explored and some interesting results were found. First, on the selection of franchisor/franchisee, both parties used different criteria. The franchisors adopted both active and passive qualifications to sort out the best franchisees. In contrast, franchisees mainly considered the percentage share, brand power and so on. Second, concerning the relationship between monitoring costs and the incompleteness of the contract, almost every interviewee said the activity should be called assistance rather than monitoring and the cost of it is not related to the incompleteness of the contract. Monitoring is just a mechanism, which can make the franchise system run more smoothly and create a win-win-win situation among franchisors, franchisees and customers. Third, agency theory specifies that monitoring costs should be cheaper with multi-unit franchisees, but in fact, this is not true. Within CVS, the cost is the same as monitoring a single franchisee. Fourth, both CVS and EA agreed that franchisees would cheat franchisors if they could and franchisees admitted that this was true. Fifth, on the point of risk-taking, all the franchisors thought they were more risk-neutral than franchisees in relation to the external environment. A gap exists in the theory, since it does not take other factors into consideration, such as operational issues. In fact, many risks are very difficult to evaluate and they are quite subjective. As a result, we can say that only in some ways, are franchisors more risk-neutral.

By the comparative analysis of the franchisors’ and franchisees’ perceptions of
Agencies in Franchising Some Empirical Results

Specific agency problems, we have gained some insights of the interactions between both parties from the perspectives of precontractual and postcontractual stages. The findings also suggest that the interactions will vary with the difference of ownership patterns and the nature of the sectors. However, one of the objectives for both parties is the same, to maximize the profit, in other word, how to maximize the brand power is the key issue. Therefore, the franchisor has to design a better franchise package which is beneficial to both parties to minimize the potential agency problems. The ideal interaction is just like one franchisee put forward from an old Chinese proverb: “Fish help water and water help fish.” In other words, the relationship between franchisors and franchisees are closely interacted and one party cannot survive without the other party’s participation.

REFERENCE


Appendix 1  The Details of Interviewees

<table>
<thead>
<tr>
<th>Industry</th>
<th>Brand</th>
<th>Franchisor Interviewees</th>
<th>Franchisee Interviewees</th>
<th>RC/FC1/FC2/SIgle/Multi-Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate Agency (EA)</td>
<td>EAA</td>
<td>2</td>
<td>10</td>
<td>Single unit franchisee 4</td>
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<tr>
<td>Industry</td>
<td>EAB</td>
<td>2</td>
<td>10</td>
<td>Multi-unit franchisee 6</td>
</tr>
<tr>
<td></td>
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<td>10</td>
<td>Single unit franchisee 10</td>
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<tr>
<td></td>
<td>EAD</td>
<td>1</td>
<td>10</td>
<td>Multi-unit franchisee 2</td>
</tr>
<tr>
<td>Convenience Store (CVS) Industry</td>
<td>CVSa</td>
<td>2</td>
<td>10</td>
<td>RC</td>
</tr>
<tr>
<td></td>
<td>CVSb</td>
<td>2</td>
<td>10</td>
<td>FC1</td>
</tr>
<tr>
<td></td>
<td>CVSd</td>
<td>1</td>
<td>5</td>
<td>FC2</td>
</tr>
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</table>

RC: Regular Chain
FC1: Franchise Chain 1 (the ownership of the store outlet belongs to the franchisee)
FC2: Franchise Chain 2 (the ownership of the store outlet belongs to the franchisor)

Appendix 2  The Summary of Agency Problems

<table>
<thead>
<tr>
<th>Variables</th>
<th>CVS (Franchise)</th>
<th>EA (Franchise)</th>
<th>CVS (Franchise)</th>
<th>EA (Franchise)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>RC</td>
<td>FC(S)</td>
<td>FC(M)</td>
<td>I</td>
</tr>
<tr>
<td>The monitoring is from the incompleteness of the contract</td>
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<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>The contract is unequal</td>
<td>N/A</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>The potential for franchisees to cheat on performance</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

✓: it means over 50% agree  
✗: it means it depends, the same, has no relationship or over 50% disagree
N/A: it means the case is not applicable to the party

RC: Regular Chain, also called company-owned chain, FC(S): Franchise Chain (Single-unit franchisee), FC(M): Franchise Chain (Multi-unit franchisee),
I: Internal franchisee, E: External franchisee, S: Single-unit franchisee, M: Multi-unit franchisee, O: Original franchisee, T: Transferred franchisee
代理商理論在連鎖加盟上之應用
實務上之探討

黃振誼*

摘 要

此篇文以實證的方式探討加盟連鎖體系內之代理商問題，代理商理論是用來解釋連鎖連盟的動機理論之一，此理論詳述了加盟總部和加盟店之間的關係，基於加盟合約本身的不平等和加盟總部及加盟店各為自己的利益做著想，因此，加盟總部採用了監督的機制來管理加盟店並使自己的利益最大化，然而，因為實質上的不平等，加盟店有時會欺騙加盟總部以因應總部的一些不合理要求和政策，因此，總部必須思考如何降低代理商問題並且使加盟品牌的效益達到極大化，此篇論文是從簽定加盟合約前和合約後兩個階段來探討連鎖加盟的代理商問題，此研究針對加盟總部及加盟店進行了共計 84 家的深度訪談，並且以兩個對比的產業和所有權模式來做探討，換言之，一個是以產品為導向和複數所有權模式為主的便利超商，另一個是以服務為導向和完全加盟型態的房屋仲介業為例子。研究結果發現，在簽定加盟合約前的階段，不同產業有不同的方法來篩選彼此的合作伙伴，簽定合約後，有些實證結果與現有理論相衝突，如監督複數加盟店的成本在便利商店產業並不會比較便宜，及監督機制並非來自合約的不完全性等。

關鍵字：加盟連鎖、代理商理論、監督成本、欺騙行為

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