



universität  
wien

# MASTERARBEIT / MASTER'S THESIS

Titel der Masterarbeit / Title of the Master's Thesis

“Allocation of Decision Rights in International Franchise Companies:  
Agency Theory-based and Transaction Cost Theory-based  
Explanations”

verfasst von / submitted by

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angestrebter akademischer Grad / in partial fulfilment of the requirements for the degree of

Master of Science (MSc)

Wien, 2016 / Vienna 2016

Studienkennzahl lt. Studienblatt /  
degree programme code as it appears on  
the student record sheet:

A 066 914

Studienrichtung lt. Studienblatt /  
degree programme as it appears on  
the student record sheet:

Masterstudium Internationale Betriebswirtschaft

Betreut von / Supervisor:

Univ.-Prof. Dr. Oliver Fabel

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## List of Abbreviations

ADF	area development franchising
AT	Agency Theory
BU	behavioral uncertainty
DF	direct franchising
DR	decision rights
EU	environmental uncertainty
JVF	joint venture franchising
M	mean
MF	master franchising
SD	standard deviation
TCT	Transaction Cost Theory
TSI	transaction-specific investment

# 1. Introduction

With franchised fast-food restaurants, retail outlets, hotels, and many more types of establishments opening up in vast areas, franchising has emerged as a ubiquitous practice, spreading across the entire planet. Since its earliest existence, dating back to the 17<sup>th</sup> century, franchising has managed to evolve into an omnipresent phenomenon, playing a crucial role in many peoples' lives (British Franchise Association, 2016; Shane, 2005, pp. 1).

Much attention has been given to the relationship between the two parties involved in this practice, the so-called franchisor and the franchisee, as well as the contractual agreement between the two and the offered business package (Grant, 1985; Norton, 1988a; Preble and Hoffman, 1995).

However, another substantial aspect that has only recently emerged in literature is the allocation of decision rights in franchising. While there are numerous studies examining several aspects of franchising such as residual income rights (e.g. Brickley and Dark, 1987; Lafontaine, 1992; Norton, 1988b), the allocation of residual decision rights still remains quite unexplored with only few exceptions (e.g. Arruñada et al., 2001; Azevedo, 2009; Mumdziev and Windsperger, 2013; Windsperger, 2004).

Furthermore, studies dealing with the allocation of decision rights often merely relate to a specific area instead of investigating its theoretical framework (Mumdziev, 2003). Additionally, most of the few existing studies often focus on Agency Theory and Property Rights Theory as a source of explanation (e.g. Arruñada et al., 2001; Azevedo, 2009; López-Fernández and López-Bayón, 2011a; Windsperger, 2004). Transaction Cost Theory however remains the most unexplored perspective in those investigations.

It is thus the main objective of this study to shed light on this particular element and to analyze its determinants. The two points of view chosen to explore structures and processes behind the allocation of decision rights are Agency Theory and Transaction Cost Theory. While Agency Theory's basic premise is the idea of diverging interests between two parties (Jensen and Meckling, 1976), Transaction Cost Theory deals with

costs incurred from administering relationships and from making governance decisions (Williamson, 1985). Both theories have already been applied within the context of decision rights in various areas. It is however worthwhile to carry out further research, as investigation in the context of international franchising continues to be scarce.

Therefore, it is the main purpose of this study to fill this gap in research and to explain the allocation of decision rights in international franchise companies from the perspective of Agency Theory and Transaction Cost Theory. The research question is thus phrased as follows:

*How do Agency Theory and Transaction Cost Theory explain the allocation of decision rights granted by franchisors to franchisees?*

In order to provide detailed information, as well as an extensive explanation of the answers to this question, the study will be structured as follows: The introduction states the study's main focus, the motivation as well as its aim. It then presents the research question. The literature review, which represents the second section of this study, consists of four major parts, which are (1) international franchising; (2) decision rights; (3) Agency Theory; (4) Transaction Cost Theory; and (5) decision rights in Agency Theory and in Transaction Cost Theory. The theories are first both presented from a general perspective and later specifically dealt with in the context of franchising.

After providing all information relevant to this research area, the hypotheses of this study are deduced and presented. The third section subsequently deals with the methodology of the study: Part 4 then presents both the empirical analysis of a quantitative survey carried out in this research area, and its findings. The final section of this study provides the conclusion and derives future implications.

## **2. Literature Review**

This section of the study is divided into four parts and presents findings from past and current literature dealing with franchising and related aspects that are relevant for the research question, which are: (1) general information about international franchising; (2) decision rights; (3) Agency Theory; (4) Transaction Cost Theory; and (5) decision rights in Agency Theory and in Transaction Cost Theory.

### **2.1. International Franchising**

This section presents the definition of franchising, its origin, and its characteristics. It further discusses franchising as a market entry mode and lists motives why companies decide to franchise and explains the market entry decision process of franchise companies.

#### **2.1.1. Definition**

Franchising is a business model that has existed in diverse forms for centuries. Its definition has consequently been altered throughout history. Research generally distinguishes between two generations. First generation franchising implies the relationship between two parties, where the franchise purchaser, i.e. the “franchisee” is granted relatively limited rights and resources to produce products or provide services under a trade name provided by the parent company, i.e. the “franchisor” (Felstead, 1993; Sanghavi, 1991). This form can thus be considered as a variant of the license entry mode (Burton and Cross, 1997).

The second generation, however, comprises a much more extensive package of rights and resources as part of the contractual agreement between the two parties. It also involves creating competitive edge by providing specific business methods and processes (US Department of Commerce, 1988). This currently prevailing form is therefore also referred to as “business format franchising” (Burton et al., 2000). It is defined as an organizational form, where the owner of a protected trademark grants the right to another person or firm

to make use of his previously established business package, which includes the corporate name, training, and support (Caves, 1976; Norton, 1988a). The elements of this package allow the franchise purchaser to replicate and operate his/her business according to the standards and format stipulated by the franchisor. It thus provides an entire business concept, which may include marketing strategy, quality control, and continuing guidance (US Department of Commerce, 1988) This type of franchising therefore entails a much more intimate relationship between the two parties than first generation franchising (Burton et al., 2000).

In franchising, the party granting the right is known as the “franchisor” and the party making use of it is termed the “franchisee”. The franchisee thus operates his/her business according to the standards and format required by the franchisor (Grant, 1985; Norton, 1988a). The franchisor receives an up-front fee and / or royalty depending on gross sales in return for granting the license and offering his support throughout the predefined or indefinite period of time agreed upon by the two parties (Burton et al., 2000). This specific right itself is known as the “franchise”. It permits franchisees to operate in one or several establishments, which are called the “franchised unit(s)”. Together, the franchisor, his company-owned units as well as all franchised ones make up the “franchise system” (Elango and Fried, 1997).

International franchising, by contrast, refers to a relationship and contractual agreement between the franchisor and the franchisee, where franchising is used as a foreign market entry mode. This can be accomplished either by granting such rights to a franchisee, a sub-franchisor, or via equity investment made by the franchisor himself (Burton and Cross, 1995).

### **2.1.2. Origin**

Derived from French, “franchise” translates to “granting of right” or “exemption” (Williamson, 1992). One of franchising’s earliest implementations can be found in the 17<sup>th</sup> century, where European beer brewers acquired the right of exclusivity in pubs and

taverns in return for financial support (British Franchise Association, 2016; Franchising.com, 2016a).

While many forms of granting rights similar to franchising have existed throughout history, one company can be identified as the initiator of its current form: In the 1850s, Isaac Merritt Singer, owner of I.M. Singer & Company, found himself faced with a lack of capital and opted for franchising as a means to distribute his famous sewing machines. He used licensing to provide services and repairs throughout the US and later developed a network. Companies such as Coca-Cola, as well as automobile manufacturers and oil companies soon copied this model (British Franchise Association, 2016; Franchising.com, 2016a; Rosenberg and Bedell, 1969, p. 9; Shane, 2005, p. 6).

Yet the modern-day notion of franchising only started to take off as convenience goods and services represented by brands such as McDonald's or Kentucky Fried Chicken emerged in post-war America in the 1950s and 1960s (Franchising.com, 2016a; Hogan, 1990).

Soon, however, several issues such as fraud started to emerge. This eventually led the Federal Trade Commission to come up with the so-called Franchise Rule in 1979, which demanded minimum disclosure requirements and thus turned it into a regulated form of business. Consequently, franchisors were required to be more specific regarding information provided to prospective franchisees (British Franchise Association, 2016; Franchising.com, 2016b; Shane, 2005, p. 7). Similarly, in 1972, the European Code of Ethics for Franchising was published by the European Franchise Federation (Franchise Direct, 2015).

Franchising started to grow as a form of business and reached oversaturation by the end of the 1980s and the beginning of the 1990s. As the years have gone by, franchising has been able to keep up with economic development by evolving and adapting to the given circumstances. Several governance forms emerged as part of this. Multi-unit franchising, for instance, became a popular solution (Franchising.com, 2016b).

### **2.1.3. Characteristics**

Some of franchising's characteristics, such as its risks and benefits for both the franchisor and the franchisee, the contractual agreement between the two parties, franchising fees, monitoring, its governance modes, and current facts and figures are listed and explained in the following section.

#### **Risks and Benefits**

As already mentioned, franchising is a business model based on a contractual agreement between two parties, i.e. the franchisor and the franchisee. Both parties enter this collaborative alliance while anticipating certain benefits from their relationship (Shane and Hoy, 1996).

Generally speaking, the franchisor allows his/her franchisee(s) to utilize his/her service or product and a brand name that have already proven to be successful on the market in return for financial compensation (Elango and Fried, 1997). The franchisor additionally benefits from raising capital at a lower cost and risk by entering this contractual agreement. For him, franchising can essentially be regarded as a less costly and less risky source of capital (Bercovitz, 1998; Norton, 1988a, Rubin, 1978). At the same time it allows him/her to maximize his ultimate returns (Brickley et al., 1991; Caves and Murphy, 1976). Moreover, he/she benefits from cost sharing with the franchisee, economies of scale, indigenous entrepreneurs, rapid market penetration, and accelerated business expansion (Brown Jr., 1998; Fladmoe-Lindquist and Jacque, 1995; Rubin, 1978).

The franchisee, on the other hand, benefits from acquiring the right to run a business that has shown to be functional. He/She considers the trademark and sold products as valuable and is thus willing to invest (Rubin, 1978). At the same time, he/she can rely on the franchisor's support, e.g. through training, marketing, or provision of operating procedures (Caves, 1976; Hoffman and Preble, 1991; Norton, 1988a). Also, he/she may be able to obtain more capital by entering this agreement if the franchisor, for example, consigns for a bank loan or buys plants and leases them to the franchisee (Rubin, 1978).

Lastly, franchisees may opt for this business model as franchises have a higher survival rate than independent ventures (Russell, 1997).

There is a certain amount of risk involved as part of entering such a franchisor-franchisee relationship for both parties. Regarding reputation, a two-sided moral hazard problem can occur, which can be detrimental for the other party. Therefore, monitoring is often an integral part of franchising, which serves the franchisor as a means to counteract or prevent opportunistic behavior (Elango, 2007).

Also, the franchisee's investment in the franchise puts him/her into a weaker position as his/her investment is less diversified than the franchisor's investment as the franchisor gets his/her revenues from different types of sources such as royalties and rent, which again come from different franchises with different levels of success (Norton, 1988a; Rubin, 1978).

### **Contractual Agreement**

Franchising can be regarded as a contractual vertical marketing system, where the contracts entered by its individual channel members essentially join them together into a unified system (Kotler and Armstrong, 1989). Especially first generation franchising had great similarities to licensing. Licensors would grant rights to intellectual property to their licensees for a specified period of time and a fee (Contractor, 1981). Business format franchising is by contrast a more elaborate form of licensing, as the package provided to the franchisee includes both intangible and tangible assets (Preble and Hoffman, 1995).

In business format franchising, the franchise contract entered by the franchisor and the franchisee states the conditions agreed upon by the two parties. Most of the time, it uses standardized clauses (Rubin, 1978). Such contracts are crucial, as high geographical distance between the parties may lead to imperfect information between them and may promote opportunistic behavior. Therefore, franchise contracts are also used to safeguard the two parties from such unfavorable circumstances brought about by either party (Elango, 2007; Klein, 1995).

One major component of franchise contracts is the type and extent of managerial assistance provided by the franchisor to the franchisee, such as training programs or advertising. Contracts also state the manner by which the franchise has to be operated by the franchisee. This may include hours of operation or prices charged. The contract also makes mention of the cash flows between the franchisor and the franchisee, such as the initial franchise fee, royalties, and rental costs (Elango and Fried 1997; Rubin 1978; Quinn, 1999).

Lastly, a franchise contract specifies the termination date. Franchise contracts usually last between 10 and 15 years (Preble and Hoffman, 1995). Renewals can normally be made if the franchisee agrees to the new terms of the contract. Miscellaneous clauses can deal with the franchisee's right to sell the franchise or open up a competing business after termination of his contract with the franchisor (Caves, 1976; Rubin, 1978).

### **Franchising Fees**

The fees paid by the franchisee to the franchisor are agreed upon in the franchise contract. They are generally determined by the industry, the number of employees, the age of the franchise system, the market share, the trademark value, and services provided to the franchisee. Franchising fees represent the franchisor's revenue from doing business with the franchisee. They include: the initial fee, royalties, sale of franchise products, sale or leasing of equipment, rental cost of premises, supplies and raw material, and sale of territorial rights (Elango and Fried 1997).

The so-called franchise fee represents the initial payment made to the franchisor. It might be refundable if the franchise is successful (Brown Jr., 1998). Franchisors may charge a high franchise fee as part of a self-selection process strategy when choosing their franchisees (Caves, 1976).

Royalties on gross sales represent a constant cash flow as opposed to the one-time franchise fee. Franchisees thus pay a percentage of their transaction in royalties to their franchisor (Brown Jr., 1998; Rubin, 1978). This percentage is usually between 3% and 5%. Franchisors prefer to tax sales instead of profits, as they are less variable and thus

less risky. This, however, can lead to the franchisor focusing on revenue maximization instead of profit maximization (Caves, 1976).

Contractual agreements might allow franchisees to purchase inputs from the open market if the franchisor finds their quality and standards acceptable. However, he/she might deny access to the open market and take advantage of providing those inputs himself/herself at prices that increase his/her profit (Rubin, 1978). This binding agreement is quite common in the fast food industry (Caves, 1976).

Additionally, a franchisor may choose to own and rent out the land the franchisee operates on. Such a sublease might be subject to subsidization if the location is beneficial for the value of his/her intangible assets (Caves, 1976).

### **Monitoring**

Franchisors often need to monitor their franchisees in order to prevent opportunism, which is why it is regarded as an essential part of franchising. For instance, a franchisee may feel inclined to lower the quality of the good or service he/she offers. Profits might go up but net returns to the franchisor will be reduced due to disappointment created among the customers (Rubin, 1978). This is extremely detrimental for the franchisor, as his/her intangible assets are determined by how they are used by his/her franchisee(s). Therefore, monitoring is also specified in the contractual agreement between the two parties (Alon and McKee, 1999b; Caves, 1976; Elango, 2007).

Geographical and cultural distance, as well as other factors can make monitoring difficult and complicated. Monitoring cost increases as geographical distance grows, to the point where it is greater than its benefits. Monitoring is therefore absolutely essential, especially when operating overseas (Fladmoe-Lindquist, 1996; Shane 1996b). While it is relatively easy to monitor capital, labor intensity cannot be monitored as easily and poses a significant problem as the labor/output ratio increases (Norton, 1988a). Greater capacities regarding experience, knowledge, and routine allow more established companies to develop better capabilities for monitoring (Alon and McKee, 1999b; Elango, 2007).

## **Governance Modes**

Franchisors are faced with several options when choosing the most suitable form of franchising in order to attain their goals. There are several different modes they can settle for: direct franchising (DF), master franchising (MF), area development franchising (ADF), joint venture franchising (JVF), and company-owned outlets (Konigsberg, 1991, pp. 91; Peterson and Welch, 2000; Preble and Hoffman, 2006).

In direct franchising, the franchisor grants the right to establish a franchise to each franchisee individually, i.e. without using an intervening organization (Fladmoe-Lindquist, 1996; Julian and Castrogiovanni, 1995). Each franchisee makes the payments agreed upon in the contract and receives assistance from the franchisor (Peterson and Welch, 2000; Preble and Hoffman, 2006).

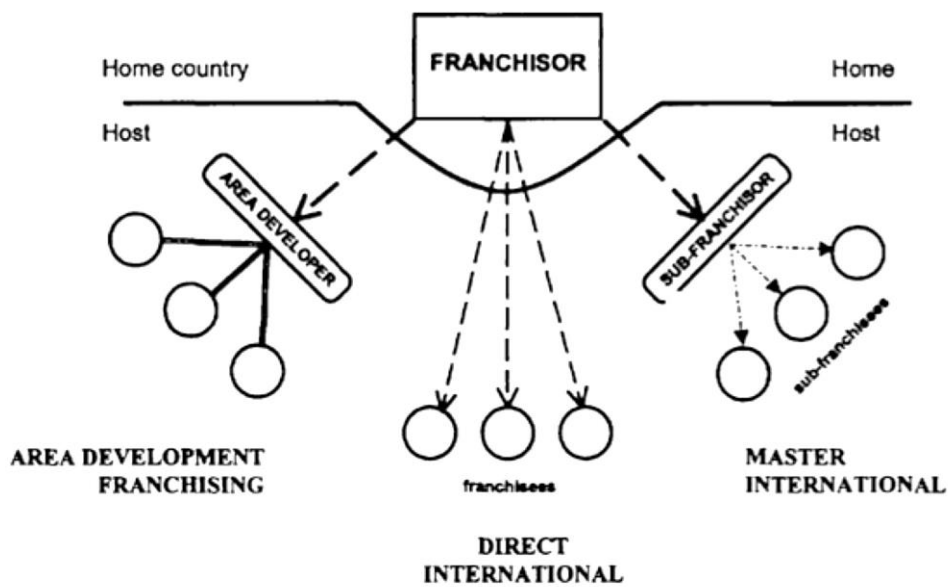
In master franchising, the franchisor licenses an independent company to establish a franchising operation in a specific market (Peterson and Welch, 2000). Kaufmann and Dant (1996, p. 50) defined master franchising as “a form of umbrella licensing agreement which differs from the standard unit or location-level franchise in two ways: (1) it provides for the granting of an exclusive territory extending beyond the trade area of a single unit, and (2) it envisions from the outset the introduction of an additional layer of control between store-level management and the franchisor.”

The master franchise entrepreneur can thus be regarded as a sequential owner and investor (Grünhagen and Mittelstaedt, 2002). The licensed company becomes the so-called sub-franchisor and is granted permission to sell the business format to other companies in the area, who subsequently become his sub-franchisees. He thus acts as an intermediary (Sashi and Karuppur, 2002). The sub-franchisor also manages and supports his sub-franchisees. He however does not own them (Konigsberg, 1991; Peterson and Welch, 2000; Preble and Hoffman, 2006).

Research has shown that MF is by far the most popular type of franchising among multinational franchisors (Ryans et al., 1999; Justis and Judd, 1986). Master international franchising further refers to such activities being carried out in a foreign country. Its

benefits include access to market-specific expertise, faster growth rates, speed to market, and low capital investment. There might be some drawbacks too, such as higher monitoring costs, legal issues, and poor choice of master franchisees (Alon, 2000).

Area development franchising is similar to master franchising, as there is an independent company too that manages a specific area. The difference between the two is that in area development, the area developer also owns those franchises while the master franchisor does not (Peterson and Welch, 2000). Just like a direct franchisee, he too pays fees and royalties to the franchisor and receives support from him (Preble and Hoffman, 2006). Figure 1 illustrates the relationship between the franchisor and his franchisees in the case of ADF, DF, and MF.



Dotted arrows represent the transactions costs (search, monitoring, policing, servicing costs) of transacting with independent buyers of the franchise

**Figure 1: Organizational forms of franchising (Burton et al., 2000)**

Joint venture franchising, by contrast, represents an equity relationship between the franchisor and an independent company, who together establish a joint venture company in a chosen market. The franchisor further grants exclusive rights to establish franchises

in that market to this joint venture company. The agreement between the joint venture company and its sub-franchisees is similar to a master franchising agreement (Konigsberg, 1991, pp. 235).

Franchisors are, however, not limited to opting for one of the abovementioned modes of governance. They can enter franchise agreements while running company-owned operations and opt for a mix that is best-suited for their goals (Fladmoe-Lindquist and Jacque, 1995; Peterson and Welch, 2000).

### **Current Facts and Figures**

Franchise businesses represent a growing part of the US economy. An estimate from 2009 showed that there were around 2,200 franchise brands located in the US (European Franchise Federation, 2010). Additionally, a January 2015 forecast estimated the number of establishments to be around 780,000, employing roughly 8.8 million workers and generating an output of USD 889 bn. Furthermore, growth rates have been steady in the past and projections show that the quick service restaurant segment will be among the growth leaders (IHS Economics, 2015).

Franchising is equally growing in the EU. A 2009 study revealed that there were around 10,000 franchise brands located in the EU-17, which had grown by 8.1% between 2007 and 2009. Most of these brands were of European origin. Europe is nevertheless also a popular location for American brands and is currently hosting around 2,500 of them (Franchise Direct, 2015). Growth rates were generally highest in Britain, France, Germany, the Netherlands, and Italy. The number of franchise brands in the EU is relatively high when compared to other parts of the world: There are around 2,800 in China, 1,800 in India, and 1,000 in Australia (European Franchise Federation, 2010).

Franchise businesses can be found in over 80 different industries, with a very high concentration in just a number of them. A 2004 study found that 15.2% of them operated in the fast food industry and ran 26.8% of all franchised units. Also, around 11% were operating in general retail (Shane, 2005, pp. 1). Other common areas include hotels and motels, automobile rentals, and automobile and gasoline dealerships (Caves, 1976).

Moreover, franchising is also favored in certain industries such as tax preparation, photocopying, and food retailing due to better performance and higher survival rates (Shane, 2005, pp. 1).

#### **2.1.4. Franchising as a Market Entry Mode**

Growing market liberalization (as illustrated by the EU common market, NAFTA, or the WTO) is providing more and more opportunities to interact on an international level. The increase in establishment of democratic political systems is further contributing to those opportunities. Some nations, which were formerly regarded as skeptical towards international companies operating on their soil, are now taking steps to facilitate such business as it has shown to be beneficial for the local economy. This entails reducing governmental and legal restrictions as well as upgrading the local infrastructure. In addition, as the world population grows, middle class society grows as well and so does demand for those services. Furthermore, information and communications technology has been developing and growing at a fast pace and long-distance travel has been on the rise (Hoffman and Preble, 2004).

International expansion can be attained by various means. Franchising with its many types is one of them. Furthermore, there are a variety of options to choose from, which include direct ownership, licensing, management contracts, joint ventures, and combinations of the aforementioned types. The choice of the most suitable entry mode must be made based on strategic goals and the ability to maximize shareholder value (Aliouche, 2011; Hoy and Hoy, 1994; Root, 1982). It further determines the company's involvement in developing and establishing its programs in the chosen market, the extent to which it controls those operations, and the level of success in that foreign market (Anderson and Gatignon, 1986; Hill et al., 1990).

As far as franchising is concerned, research has shown that franchisors favor geographically distant locations for setting up franchises (Brickley and Dark, 1987; Norton, 1988a). They expand to other locations as soon as their initial target market is saturated (Martin, 1988). Despite starting in developed countries due to similarity in

language and culture as well as geographic proximity, franchising has also been spreading to various emerging markets such as Mexico, Thailand, and the Philippines (Steinberg, 1991; Aydin and Kacker, 1990). It is regarded as an effective means to attain rapid business growth and it is praised for its high flexibility and adaptability, which is also reflected by the vast number of franchises in the United States' retail sector and other service economies (Castrogiovanni and Justis, 1998; Connell, 1999; Preble and Hoffman, 1995).

### **2.1.5. Motives to Franchise Domestically and Internationally**

There are numerous reasons why a company decides to turn its business into a franchise business, and why it may even decide to franchise internationally. The factors contributing to this choice can be internal, external, direct, and indirect (Altinay et al., 2007).

Franchise companies may feel the desire to initially expand in the domestic market and opt for this business model to minimize risk and attain fast saturation of the host market (Elango, 2007; Huszagh et al., 1992). With a proven franchise formula that has already been tested in the domestic market, they may choose to use franchising as an international entry mode and thus extend their operations to other countries. Sought-after benefits include growth, market expansion, increased sales and profit, exploitation of potential markets, as well as establishing international brand image (Altinay et al., 2007; Trankhiem, 1979).

Especially large firms often benefit from their cumulative experience, their brand name recognition, and their sophisticated recruitment and selection skills (Julian and Castrogiovanni, 1995). Their standardized site selection and monitoring skills further facilitate this process (Huszagh et al., 1992; Julian and Castrogiovanni, 1995). Also, companies that are large in size have more resources at hand and can overcome failure more easily (Altinay and Miles, 2006).

Other internal factors that might contribute to a firm's internationalization decision include top management's international experience, operating experience, tolerance for

risk, and how they perceive their competitive advantage (Altinay et al., 2007; Elango and Fried 1997).

Certain background factors, which are not regarded as direct, but also have an impact, are the company's expansion ethos, its learning process, and network spread. If combined with decision maker characteristics, background factors can also lead to international entry (Altinay et al., 2007).

Lastly, firms may receive inquiries from potential partners with whom they decide to enter a franchise agreement (Walker, 1989; Etzel and Walker, 1973).

While the franchise concept is often translatable and can be adapted to foreign cultures and business regulation, it still requires a different set of capabilities in order to achieve success in foreign markets (Hoffman and Preble, 2004). Distance management, host country policy evaluation, cultural adaptability, and exchange rate management are among those capabilities, which are crucial for international success (Fladmoe-Lindquist, 1996).

### **2.1.6. Market Entry Decision of Franchise Companies**

The Uppsala model of internationalization is based on the assumption that companies first expand their business to psychically close countries and later move on to conquer more distant markets due to higher risks involved. Such firms will also initially opt for lower resource commitment modes such as licensing when entering foreign markets and might choose higher commitment modes after having gained significant experience and knowledge with venturing abroad (Johanson and Vahlne, 1977).

This goes hand in hand with scientific findings. Most franchise companies that franchise internationally follow a staged process. In the first stage, they target neighboring markets with cultural similarities. A US-based company would thus first contemplate expansion to Canada or Mexico (Castrogiovanni and Justis, 1998). In the second stage, they will target countries that are culturally dissimilar and have different political regimes (Elango and Fried 1997; Hopkins, 1996; Welch, 1989).

Often, as part of their internationalization decision-making process, companies will first evaluate the risks involved with franchising in their target country and also juxtapose the opportunities borne by franchising internationally and base their decision on these factors (Aliouche and Schlenrich, 2011).

### **Risk Evaluation**

The risk evaluation process takes into consideration political and economic risks, legal and regulatory risks, as well as cultural and geographic distance involved (Aliouche and Schlenrich, 2011).

Political and economic risks are strongly related, as decisions made by governments affect the economic climate and thus have an impact on business. Simultaneously, a country's economy can affect its political structure. Furthermore, policies made by the government could discriminate against franchise firms. Also, economic and political instability can be precipitated if the government opts for more restrictive tax laws, if it increases tariffs and or quotas, or if it introduces expropriation of assets and nationalization measures. Furthermore, currency fluctuations, foreign exchange controls, inflationary pressures, capital flight, debt defaulting, strikes and boycotts have a negative impact on business (Cosset and Doutriaux de la Rianerie, 1985; Clark and Tunaru, 2003; Erevelles et al., 2005; Rothaermel et al., 2006). Locals might react to such issues with armed conflicts, rebellion, or social unrest (Hofer and Haller, 1980).

Second, legal and regulatory risks may be present as legal practices vary between countries. Problems could arise if there are restrictions on ownership and control of corporate property, registration of profits, discriminatory pricing, and tax policies (Boczko, 2005; Fladmoe-Lindquist, 1996). Furthermore, legal and governmental red tape have been identified as the biggest barrier to internationalization (Elango and Fried 1997).

Cultural difference refers to differences in language and culture between two countries (Eroglu, 1992; Rothaermel et al., 2006). It is identified as one of the major aspects on internationalization in the Uppsala model (Johanson and Vahlne, 1977). Culture can have

a strong impact on contract negotiations, on personnel management practices, and on operational business practices (Eroglu, 1992; Fladmoe-Lindquist, 1996; Alon and McKee, 1999a). Small cultural distance makes companies more likely to adopt similar business practices, whereas greater distance makes them more likely to sacrifice ownership (Anderson and Gatignon, 1986; Fladmoe-Lindquist and Jacque; 1995). Furthermore, literature puts a strong emphasis on Hofstede's four cultural dimensions, which are power distance (level of inequality), uncertainty avoidance, individualism vs. collectivism, and masculinity vs. femininity (Hofstede, 2001).

Lastly, as geographic distance between the host country and the home country increases, monitoring becomes more difficult and more expensive as well. Also, expenses on logistical support rise when inputs have to be imported from the franchisor's country. Research costs are also higher as it takes more resources to analyze potential franchise candidates (Rubin, 1978).

### **Opportunity Evaluation**

Market risks may discourage franchise companies from internationalization, while market opportunities represent incentives for them to do so. The bigger the market, the higher potential returns (Rothaermel et al., 2006). Furthermore, larger markets can yield economies of scale (World Economic Forum, 2007). Companies often choose the markets they want to expand to based on several indicators. Among those are GDP per capita, population size, and purchasing power. The larger these indicators are, the more attractive companies consider the country (Lafontaine and Leibsohn, 2005).

Generally speaking, GDP per capita is a good measure of individual income and general level of economic development. A positive correlation could be found between the number of international franchisors and their host countries' per capita income. Another measure is purchasing power. It is especially important to adjust GDP per capita in emerging markets, as input prices and costs of living are often lower in those countries compared to industrialized countries. GDP per capita alone, even if adjusted to purchasing power, however merely gives the average income per person, but does not

reveal anything about the distribution of income. Therefore, it is crucial to also assess markets by the distribution of income in order to figure out potential demand in that region (Alon, 2006).

Time has a higher opportunity cost in urban areas and people rather rely on services and ready-to-use items. There are also a proportional number of affluent consumers in large cities and average income is higher in urban areas because economic networks are more efficient. Furthermore, such areas offer franchise inputs in abundance (such as material, unskilled and skilled labor, infrastructure, and supporting industries). Urbanization in developing countries by itself however is not a sufficient reason to attract international franchise companies. Companies must pay close attention to local conditions such as a stable middle class, the availability of production resources, the proportion of female labor participation as well as the aforementioned indicators when choosing that location (Alon, 2006; Alon and McKee, 1999a; Flynn, 1997).

Lastly, success in the domestic market does, however, not guarantee international success (Hoy and Hoy, 1994). Expenses may be higher than expected due to communication problems as a result of geographic and cultural distance (Shane, 1996b). Also, political and economic uncertainty may cause unexpected issues (Kedia et al, 1995; Tuncalp, 1991).

## **2.2. Decision Rights**

Although not extensively studied in literature, the concept of decision rights has been the center of attention in some more recent studies, especially in the context of franchising (e.g. Arruñada et al., 2001; Azevedo, 2009; Windsperger, 2004).

Decision rights generally refer to the right to make own decisions as well as to take actions. Those who bear specific knowledge should thus be given the right to make related decisions in order to provide efficiency (Jensen and Meckling, 1992). Efficiency can thus be attained by either transferring decision rights to those who possess specific knowledge or by transferring specific knowledge to those who have the right to make decisions (Windsperger, 2004).

This section will thus deal with some components of decision rights, such as control and autonomy, as well as formal and real authority. Lastly, it will give a detailed explanation of decision rights in the context of franchising and present what research has revealed so far in this area.

### **2.2.1. Control and Autonomy**

The appropriate balance of the two conflicting forces, control and autonomy, can be a challenging task for franchisors. Excessive restraint can on the one hand lead to high costs incurred by the franchisor. However, it may lead to inefficient usage of a franchisee's specific know-how on the other hand (Dant and Gundlach, 1999; Windsperger, 2004).

Furthermore, extensive autonomy could result in franchisees acting opportunistically and causing great damage to brand equity (Dant and Gundlach, 1999). Therefore, it is absolutely essential for the franchisor to identify those areas that are most vital for his/her business and to enforce control in them. At the same time, he/she must grant autonomy to the franchisee regarding decisions and activities he/she considers relatively less significant. This sort of trade-off often leads to less substantial decisions being delegated to the franchisee (Aghion and Tirole, 1997).

### **2.2.2. Formal and Real Authority**

A clear distinction must be made between formal and real authority. While formal authority refers to the right to decide itself, real authority implies actual control over decisions. While a person of authority may be able to reverse their subordinate's decisions, they will not choose to do so if their subordinate possesses better or more specific information (Aghion et Tirole, 1997).

Also, formal authority increases for franchise companies operating both franchised units and their own units as their proportion of company-owned outlets grows. Running company-owned outlets may increase real authority as well, since it allows those companies to gather information about the franchisee's environment (Azevedo, 2009).

### **2.2.3. Decision Rights in Franchising**

Franchising contracts allow franchisors to transfer decision rights to their partners without transferring ownership to them (Baker et al., 2006; Lerner and Merges, 1998). They have a strong impact on both the capabilities and motivation of franchisors and franchisees to make system-specific investments and to invest in local market assets, which in turn affects residual income streams (Aghion and Tirole, 1997).

In franchising, decision rights are defined as the use of both the franchisor's system-specific assets and the franchisee's local market assets. For franchisors, they include site selection skills, product and brand development, store layout as well as buying and merchandising. Franchisees, on the other hand, may make use of their local market know-how, quality control, customer service, HR, and product management (Mundziev and Windsperger, 2011). Such decision rights are mostly specified in the franchise manual and in the franchise contract (López-Fernández and López-Bayón, 2011a).

Typically, the franchisor is often left with key decisions such as production, marketing, and ones related to their products in order to maintain standardization. The franchisee, on the other hand, will often be granted decision rights that require market-specific

knowledge. Such decisions may include pricing, location, recruiting, and operating hours (Michael, 1996).

Organizational economics further distinguish between two types of decision rights: non-residual (specific) ones and residual ones. The two differ in that non-residual decision rights can be specified in the contract and that they correspond to the use of tangible knowledge (Demsetz, 1998), while residual decision rights refer to the use of intangible local market and system-specific assets. Consequently, non-residual decision rights are easier to codify and incur fewer costs when being transferred than residual decision rights (Contractor, 2000; Kogut and Zander, 1993).

#### **2.2.4. Decision Rights in Research**

The role of decision rights has been studied in a variety of contexts. For instance, Arruñada et. al (2001) investigated the allocation of decision rights in Spanish car manufacturers and dealerships. They found that higher prices and greater reputation correlate with greater discretion. Also, greater reputations have shown to be affected more strongly by a franchisee's opportunistic behavior. Another positive interrelation was found between size of the network and centralization of decision rights.

Studies using data from Asian manufacturers on the other hand concluded that centralization of decision rights was less common in that part of the world due to the prevalence of nonverbal contracts. In those cases, the franchisors also possessed more rights regarding termination of contracts and monitoring. Such findings also support Agency Theory, which states that increased levels of autonomy granted to the franchisee potentially result in agency problems, e.g. free riding, as well as decreased brand value (Bercovitz, 2004; Klein, 1980; Lafontaine, 1992). Furthermore, Brickley (1999) has found that franchisors are more likely to impose additional restrictions if profit-related incentives are insufficient.

While the number of studies relating to decision rights in a specific context appears quite large, studies investigating theoretical aspects regarding the allocation of decision rights

are to date very limited (e.g. Arruñada et al., 2001; Azevedo, 2009; Mumdziev and Windsperger, 2013; Windsperger, 2004).

For instance, Windsperger (2004) dealt in his publication with the allocation of residual decision rights in franchise companies. His examination was carried out from the Property Rights perspective using data obtained from Austrian franchises. It revealed that the allocation of decision rights is more affected by the franchisor's intangible system-specific assets and by his brand name assets than by the franchisee's intangible local market assets.

Furthermore, Azevedo (2009) examined the allocation of formal and real authority in franchising. The study revealed a positive effect of allocation of decision authority to the franchisee if the amount years of franchising experiences were high. However, the extent of a franchisee's initial investment showed a negative impact on allocation of authority.

Lastly, López-Fernández and López-Bayón (2011b) studied the determinants of decision rights delegation from an Agency and Property Rights perspective in the Spanish franchise sector. Their research found that years of experience with the franchisee had a positive effect on delegation of authority due to trust being built between the two parties. Furthermore, it was revealed that the franchisor's intangible assets lead to less decision rights being granted to the franchisee. Generally, their study revealed that franchises with larger headquarters or ones that specialize in their franchise chain instead of opting for diversification show a tendency to restrict their franchisee's decision rights.

## **2.3. Agency Theory**

Agency Theory (AT) is often applied in order to explain certain phenomena in the context of franchising (e.g. Brickley and Dark, 1987; Carney and Gedajlovic, 1991; Doherty and Quinn, 1999). This section therefore deals with some aspects of AT such as the principal-agent model, AT's application in franchising, agency problems and costs, and it lists measures to remedy those issues.

### **2.3.1. The Principal-Agent Model**

Agency Theory emerged as a number of economists such as Arrow (1970) and Wilson (1968) explored risk-sharing among individuals and groups in the 1960s and early 1970s. The initial framework explained that risk-sharing problems occur when participants have diverging attitudes towards risk. AT added to this concept by stating that the root of such problems lies in the fact that the parties involved have different ambitions and division of tasks (Jensen and Meckling, 1976; Ross, 1973).

Agency Theory's central premise is the assumption that the interests of two participants, who enter a contractual relationship, diverge. In AT, the two parties in this relationship are known as the principal and the agent. The principal requires the agent(s) to perform a number of delegated tasks and thus attributes some decision-making authority to him/her (Bergen et al., 1992; Eisenhardt, 1989; Jensen and Meckling, 1976). While this relationship acts as a utility maximizer for both partners, the agent may not always perform his/her tasks as demanded by the principal. Consequently, the principal may need to establish certain incentives for the agent and may need to monitor his/her agent's behavior and limit the set of his/her activities (Bergen et al., 1992; Eisenhardt, 1989; Jensen and Meckling, 1976).

Figure 2 sums up the most important aspects of Agency Theory:

<i>Key idea</i>	Principal-agent relationships should reflect efficient organization of information and risk-bearing costs
<i>Unit of analysis</i>	Contract between principal and agent
<i>Human assumptions</i>	Self-interest, bounded rationality, risk aversion
<i>Organizational assumptions</i>	Partial goal conflict among participants, efficiency as the effectiveness criterion, information asymmetry between principal and agent
<i>Information assumption</i>	Information as a purchasable commodity
<i>Contracting problems</i>	Agency (moral hazard and adverse selection), risk sharing
<i>Problem domain</i>	Relationships in which the principal and agent have partly differing goals and risk preferences (e.g. compensation, regulation, leadership, impression management, whistle-blowing, vertical integration, transfer pricing)

**Figure 2: Agency Theory overview (Eisenhardt, 1989)**

### **2.3.2. Application of AT**

Agency Theory has often been applied in various organizational fields such as acquisition and diversification strategies (e.g. Amihud and Lev, 1981), ownership and financing structures (e.g. Argawal and Mandelker, 1987; Jensen and Meckling, 1976), or vertical integration (e.g. Anderson, 1985; Eccles, 1983).

The standard theory of the firm assumes that when applying the principal-agent relationship to companies, shareholders represent principals, and management represents agents (Doherty and Quinn, 1999). Correspondingly, in franchising the principal-agent problem can be found in the relationship between the franchisor and the franchisee. Similar to the principal, the franchisor delegates authority to two kinds of agents: employee-managers and franchisees (Brickley and Dark, 1987; Carney and Gedajlovic, 1991).

### **2.3.3. Agency Problems**

Generally speaking, agency problems arise in two cases: Either due to a conflict of goals of the principal and the agent, or if it is too difficult or costly for the principal to gather information about the agent's behavior (Jensen and Meckling, 1976; Ross, 1973).

Information asymmetry lies at the root of agency problems. It occurs due to imperfect market information. Several boundaries such as regulations, economic turmoil, social structures, and culture may inhibit proper transfer of information. Problems may arise due to differences in economic development or regulation between the home country and the host country. Also, cultural practices in the host country might differ from those in the home country, which can also compound the issues (Doherty and Quinn, 1999). Information asymmetry is less of a problem in firms listed on the stock exchange. It can, however, turn into an issue for companies with large amounts of intangible assets such as brand name, advertisement, and research and development (Hutchinson, 1995).

Goal conflicts between the principal and the agent, and the division of labor between the two, as well as their respective risk attitudes further add to information asymmetry. Either party may act opportunistically in order to additionally benefit from the relationship. There are several types of behavior, some of which are listed and explained below (Jensen and Meckling, 1976).

#### **Moral Hazard**

While the principal and the agent enter their relationship in order to benefit from mutually satisfying results, one participant may decide to strive for higher goals at the cost of optimal outcomes for both of them. For example, the agent may not put in as much effort as needed to perform his/her task. This type of misconduct is known as moral hazard (Arrow, 1963; Jensen and Meckling, 1976).

## **Adverse Selection**

Adverse selection occurs when the agent's abilities are misrepresented. A principal may select an agent who is not suitable for the chosen activities. The principal may not know about this when hiring his/her agent or even while delegating tasks to him/her (Brickley and Dark, 1987; Eisenhardt, 1989).

## **Free Riding**

Free riding occurs when a franchisee acts recklessly without thinking of potential consequences of his/her behavior for the franchisor and other franchisees. He/she may lower the quality of his/her goods, harm his/her franchisor's reputation or cause other types of damage (Shane, 1996b). This is particularly predominant if franchises only have few or no repeat customers. Customers making bad experiences are less likely to return to outlets of the same chain, which in turn is detrimental for all other units, for the franchisor himself/herself, and for the value of his/her trademark. The free riding franchisee will however benefit from cost savings from lowering the quality of his/her products (Brickley et al., 1991).

## **Hold-ups**

So-called hold-ups occur when one party acts opportunistically by trying to renegotiate the terms after entering the franchise agreement and after franchise-specific investments have been made (Williamson, 1985).

### **2.3.4. Agency Costs**

According to Jensen and Meckling (1976), there are three types of agency costs: monitoring expenditures (incurred by the principal), bonding expenditures (incurred by the agent), and residual loss.

The principal's costs of monitoring and observing his/her agent's activities are known as monitoring costs. They increase due to physical distance in two ways: Employees have to

travel greater distances to observe behavior in the host market and they have to invest time and effort into familiarizing themselves with local conditions (Minkler and Park, 1990).

Secondly, the principal will ask his/her agent to spend resources on entering the agreement between the two, which is also known as bonding costs (Hill and Jones, 1992).

Lastly, welfare will be reduced by the divergence between decisions made by the agent and the ones that would lead to welfare maximization. This type of reduction in welfare borne by the principal is referred to as residual loss (Jensen, 2003, p. 86).

### **2.3.5. Countermeasures**

Several actions taken by the principal have shown to alleviate the effects of opportunism. Three of them, namely monitoring, fees, and allocation of ownership, are explained below.

#### **Monitoring**

Information asymmetry especially becomes detrimental if it is coupled with moral hazard, which refers to the agent acting in his self-interest. Therefore, the principle may feel compelled to monitor the agent's activities in order to minimize such behavior (Doherty and Quinn, 1999).

Internal uncertainty may be high if the company lacks experience in global markets, which in turn may lead to difficulties in monitoring franchisees (Fladmoe-Lindquist and Jacque, 1995). It is therefore essential to develop sophisticated monitoring skills in order to reduce or prevent moral hazard and shirking by franchisees. Research has shown that franchise companies with foreign franchisees had developed better monitoring skills and operating experience than ones that only operated domestically (Huszagh et al., 1992). Furthermore, internationally experienced companies are less confronted with adverse selection. This is due to the fact that they have developed better skills to screen and select suitable franchisees that will not misrepresent their company due to low quality potential

(Sashi and Karuppur, 2002). Lafontaine (1992) further found that royalty rates negatively correlate with the importance of monitoring franchisees.

Geographical distance adds to opportunism in the principal-agent relationship. Monitoring plays an essential role as physical distance between the two participants increases. Its costs rise with growing distance between the two (Rubin, 1978). Research has shown that franchise companies often choose to open up franchised units in areas located further away from the headquarters, while running company-owned outlets closer to them. Also, it is easier to monitor franchised units when they are concentrated in just a few areas (Brickley and Dark, 1987; Fladmoe-Lindquist, 1996; Norton, 1988a).

### **Fees**

The initial fee may be kept by the franchisor if the franchisee does not adhere to the standards and obligations agreed upon in the franchising contract (Carney and Gedajlovic, 1991; Norton, 1988a). High initial fees also act as a screening mechanism to find potential franchisees that are more suitable to enter an agreement with. It can be assumed that the ones showing interest in running a franchise are those who see great value in this opportunity and believe they are able to successfully realize that value. The issue of adverse selection can thus be somewhat reduced by imposing higher initial fees (Sashi and Karuppur, 2002).

Furthermore, franchisors can counteract moral hazard and opportunism by demanding royalty payments and fees and also through strict contracting. The franchisee would thus have to make a higher investment in order to obtain his/her residual claims to profits. This measure has proven to be effective in international retail franchising, where information asymmetry is regarded as a particular problem (Doherty and Quinn, 1999; Sashi and Karuppur, 2002).

Lastly, the choice of fees charged also plays an important role with regards to value addition. Value addition generally occurs depending on the product category. It can be added by service, by image characteristics, or physically. This either happens at the point of sale or during production. Costs of coordination and monitoring can be reduced if a

firm decides to centralize its value-adding functions. Local value addition can thus lead to several issues as franchise companies incur higher costs from the need to monitor, coordinate, and communicate (Sashi and Karuppur, 2002). Local managers therefore may feel inclined to shirk if their remuneration is not closely linked to the performance of their unit (Norton, 1988a). Imposing a higher initial fee if value addition occurs locally can thus reduce opportunistic behavior. Further, royalty rates decrease as local value addition gains importance and as monitoring costs increase (Lafontaine, 1992). This is due to the fact that royalty rates have a negative impact on the level of service provided by the franchisee (Agrawal and Lal, 1995).

### **Allocation of Ownership**

Franchising somewhat reduces the risk of adverse selection and moral hazard, as it allows agents to obtain ownership of their residual claims when operating a franchised unit (Eisenhardt, 1989; Shane 1996a). This in turn leaves them with the consequences of their own actions (Brickley and Dark, 1987). Also, residual claims to intangible assets somewhat help overcome agency problems as they represent an opportunity for the franchisee to successfully run his/her unit as prescribed by the franchisor (Sibley and Michie, 1982). Therefore, interests of the parties can be better aligned if the principal hires an entrepreneur instead of a manager to run his/her establishment and if he/her grants him/her residual rights to that unit (Williams, 1999).

## **2.4. Transaction Cost Theory**

Transaction Cost Theory (TCT) is another popular framework applied to explain economic exchanges (e.g. Anderson, 2008; John and Weitz, 1988). This section therefore deals with some aspects of it such as the transaction cost approach, application of TCT, determinants of transaction costs, governance problems associated with TCT, and a comparison of TCT with AT.

### **2.4.1. The Transaction Cost Approach**

TCT emerged as part of the New Institutional Economics. Its basic premise is the consideration of the firm as a governance structure. TCT was initially approached by Coase (1937) and further developed by Williamson (1975b). Coase (1937) argued that firms and markets have different transaction costs and that they are alternative governance structures. He further stated that economic exchange in a market may be costlier than organizing it within a firm. Transaction costs can therefore be considered the “costs of running the system”. This includes ex ante costs such as contract negotiations and ex post costs such as monitoring.

Williamson (e.g. 1975b, 1985) substantially added to Coase’s argument by analyzing the kinds of exchanges that are better to be conducted within firms than within the market. He also stated that transaction costs are made up by direct costs of administering relationships and possible opportunity costs arising from making inferior governance decisions. Williamson (1985) also stated that it is very difficult to measure transaction costs as opposed to measuring production costs. This is due to the fact that transaction costs represent the potential outcome of alternative decisions.

According to Williamson (1981) a transaction occurs “when a good or service is transferred across a technologically separable interface”. Similar to friction being part of the process in mechanics when several machines are involved, transaction costs arise in economics due to lack of harmony, misunderstandings, conflicts, and other malfunctions. Williamson (1981) further stated that “transaction cost analysis supplants the usual preoccupation with technology and steady-state production (or distribution) expenses

with an examination of the comparative costs of planning, adapting and monitoring task completion under alternative governance structures.” Lastly, Williamson (1979) also defined three critical dimensions associated with transactions: uncertainty, the frequency of transactions, and the extent to which transaction-specific investments are needed to realize least cost supply.

TCT therefore assumes two conditions: (1) There is uncertainty about the future of the environment, and (2) decision makers have limited ability to process information. Furthermore, there is a small number of buyers and suppliers who are prone to behaving opportunistically. One of these conditions on its own does not present a problem; the two combined do however cause issues (Williamson, 1975a). TCT further states that firms will internalize activities they can perform at a lower cost and turn to the market when other providers have a cost advantage (Williamson, 1975b; Williamson, 1985).

Lastly, TCT also takes into account the phenomena of bounded rationality and opportunism, which are explained below.

### **Bounded Rationality**

Bounded rationality refers to constrained cognitive capabilities and limited rationality of decision makers. Decision makers may be unable to act rationally due to their limited ability to process information and to communicate (Simon, 1957). Issues arise according to TCT when the circumstances cannot be identified *ex ante*, i.e. due to environmental uncertainty, or when performance cannot be verified *ex post*, i.e. due to behavioral uncertainty (Rindfleisch and Heide, 1997).

### **Opportunism**

Opportunism refers to self-interest seeking, which includes cheating, lying, and other forms of deceit (Williamson, 1985, p. 47). Opportunism becomes particularly problematic when specific assets are involved in the relationship between the two partners and those assets only have limited value outside that agreement (Rindfleisch and Heide, 1997).

Due to the existence of bounded rationality, only incomplete contracting can be achieved since the complexity of all relevant aspects cannot be fully known *ex ante*. Incomplete contracts would generally still be feasible if opportunism did not exist. It is however very difficult and costly to figure out *ex ante* whether selected partners in a principal-agent-relationship are honest regarding their preferences, provided data, and issues they deal with (Williamson, 1981).

### **2.4.2. Application of TCT**

TCT is most commonly applied for vertical integration decision, e.g. manufacturing firms contemplating integration into supply of materials etc., or into distribution and sales. Research has explored various fields of TCT. John and Weitz (1988), for example, explored TCT using direct versus indirect distribution channels in forward integration into distribution. Anderson (2008) and Weiss and Anderson (1992) also applied TCT when exploring selection of integrated versus independent sales forces by manufacturing firms.

One major problem that can be identified in franchising in the context of TCT is the potential of quasi-rent appropriation. A quasi-rent represents the difference between the value of an asset and its salvage value (Klein et al., 1990). Quasi-rent appropriation is especially risky when initial fees are high. Franchisees will consequently ask for higher rates of return that allow them to depreciate the value of their investment in order to balance out this type of inefficient risk-bearing. As a consequence, franchisees will also demand greater company ownership if initial investment is high (Brickley and Dark, 1987; Carney and Gedajlovic, 1991).

### **2.4.3. Determinants of Transaction Costs**

TCT has identified three major determinants causing transaction costs: behavioral uncertainty, environmental uncertainty, and asset specificity (Anderson and Gatignon, 1986).

Uncertainty is a major factor involved in forward vertical integration decisions. The inability to predict the future has a strong influence on the completeness of the contract. Therefore, when unforeseen contingencies occur and contracts do not specify obligations of either party in such events, one party may try to use the given circumstances to its own advantage (John and Weitz, 1988).

### **Behavioral Uncertainty**

Behavioral uncertainty occurs due to difficulties associated with monitoring contractual performance (Williamson, 1985). It represents a performance evaluation problem, i.e. it is difficult for the principal to verify compliance with established agreements (Rindfleisch and Heide, 1997).

Cultural distance further adds to related issues according to TCT. Such differences imply differences in methods, customs, and values between markets. These differences in turn have an effect on transactions being made within the company (Anderson and Gatignon, 1986). This entails higher transaction costs for transferring management skills or new business approaches when cultural distance is substantial. Furthermore, products and promotions may have to be altered and adapted to local markets, e.g. omission of Christmas-themed displays in non-Christian countries (Quinn, 1999). Again, companies will opt for lower ownership arrangements if cultural distance is high. They will also ask for higher initial fees in order to prevent franchisees from shirking (Sashi and Karuppur, 2002).

### **Environmental Uncertainty**

Environmental uncertainty comprises three types, namely economic, political and currency uncertainty. The first one, economic uncertainty, is associated with greater levels of inflation, higher demand fluctuations, and higher interest rates. These factors have a strong impact on the choice of business operation in a foreign market as both its costs and returns are affected by such conditions. Low ownership, particularly franchising, will therefore often be favored, especially when value addition occurs

locally. Risk-averse franchisors will furthermore demand a high initial fee but low royalty payments (Sashi and Karuppur, 2002).

Political uncertainty may bring about frequent changes in policies and imposition of restrictions. Investors therefore often undervalue their investments in such markets. Due to the risks involved, firms will usually opt for low ownership and hire local partners. Consequently, the two major alternatives chosen by firms when entering a market with high political uncertainty are either franchising or one-time sales of technology (Sashi and Karuppur, 2002).

Lastly, currency uncertainty refers to the unpredictability of the exchange rate between the currency of the local market and major international currencies (Terpstra and Sarathy, 1999). It can affect both the value of the investment and the repatriation of earnings. Therefore, companies must monitor exchange rates and also hedge against such risks. One-time sales of technology seem appropriate in such cases. However, they do not offer their companies to further exploit the market or to gain a steady stream of income from it. Again, franchising may be the business model to opt for, as it does not require the franchisor to invest his/her own resources (Sashi and Karuppur, 2002).

Fluctuations of the aforementioned environmental conditions have a strong impact on the selection of the business type and incurred costs (Herring, 1983). High uncertainty thus leads to the choice of low ownership arrangements that allow more flexibility (Anderson and Gatignon, 1986).

### **Asset Specificity**

Asset specificity refers to the extent to which another user can use an asset for alternative purposes without losing productive value. Williamson (1979) distinguishes between five kinds of asset specificities: physical asset specificity, site specificity, human asset specificity, dedicated assets, and brand name capital. Examples of valuable and durable transaction-specific assets may include know-how, equipment and working relationships (Williamson, 1985).

According to Williamson (1981), the issue associated with asset specificity is not its size but rather its specialization to a particular transaction. Unspecialized items can thus be obtained from alternative sources and they can also be sold to alternative buyers if one deal does not materialize. Problems arise when the items are nonmarketable.

High levels of asset specificity have a strong impact on forward vertical integration, as the transactions involved can be subject to opportunistic behavior. If such assets are non-redeployable, switching to alternative partners can be quite costly. TCT states that internalization of the transaction can safeguard in such cases. This is due to the fact that the firm can better monitor and survey internal behavior. Also, profits from opportunistic behavior will be reduced, as employees do not benefit from profit streams of the company (John and Weitz, 1988).

One factor that facilitates transaction is brand name. Customers are often unable to evaluate the selection of products they are presented. They therefore often rely on the merchandiser's reputation, past experience, or the brand name (Barzel, 1982). The asset specificity of a brand name can be assessed by measuring brand image, brand awareness, or advertising expenditure (Sashi and Karuppur, 2002). Again, since transfer of this firm-specific asset is not free, franchisees may choose to act opportunistically, which can result in a free riding problem (Norton, 1988b). Therefore, franchisors may decide to charge a higher initial fee if brand recognition is high in order to prevent opportunistic behavior (Shane, 1996b).

Technical knowledge cannot be transferred freely outside the company and is thus also a firm-specific asset (Anderson and Gatignon, 1986). Firms acquire technical knowledge by investing in research personnel, facilities, and equipment. Problems may arise when technical knowledge is complex and franchisors must pass it on to franchisees during the evaluation process. This may lead to the franchisees not needing to acquire aforementioned technology by acting opportunistically and putting similar products on the market. Franchisor must therefore often safeguard against such behavior by writing detailed contracts, or by familiarizing themselves with foreign legal systems (Sashi and Karuppur, 2002). Costs further increase due to several factors such as organizational

culture. Therefore, franchising is not a favorable mode of operation when asset specificity is high (Anderson and Gatignon, 1986).

#### **2.4.4. Governance problems in TCT**

Rindfleisch and Heide (1997) have identified three major problems associated with transaction costs, namely safeguarding, adaptation, and performance evaluation problems.

Firstly, safeguarding problems are issues that arise when a firm uses specific assets that can be opportunistically exploited by partners. The two components of safeguarding problems are therefore opportunism and asset specificity (Rindfleisch and Heide, 1997).

Secondly, an adaptation problem occurs when decision makers of a firm, who are limited by bounded rationality, are faced with difficulty altering contractual agreements to environmental changes (Rindfleisch and Heide, 1997).

Lastly, performance evaluation problems refer to the difficulty in assessing contractual compliance of partners due to bounded rationality. Therefore, the two components of performance evaluation problems are bounded rationality and behavioral uncertainty (Rindfleisch and Heide, 1997).

TCT assumes that if safeguarding, adaptation, and performance evaluation are low or inexistent, decision makers will favor market governance. However, if such costs are higher than production cost advantages of that given market, decision makers will opt for internal organization. Another assumption made in this framework is that internal organization is able to minimize transaction costs. This is due to the fact that firms have better control and monitoring mechanisms than markets, as they can also measure and reward behavior (Eisenhardt, 1985; Anderson and Oliver, 1987). Therefore, firms have better abilities to identify opportunism and to realize adaptation. Also, firms can offer rewards as an incentive to reduce the perceived benefits of opportunistic behavior. Lastly, opportunism can be reduced ex ante through socialization processes and organizational culture, which can establish convergent goals between the parties (Williamson, 1975b).

Figure 3 provides a comprehensive illustration of the abovementioned problems as well as the type of transaction costs they are associated with:

	<b>Asset Specificity</b>	<b>Environmental Uncertainty</b>	<b>Behavioral Uncertainty</b>
<b>Source of transaction costs</b>			
Nature of governance problem	safeguarding	adaptation	performance evaluation
<b>Type of transaction costs</b>			
Direct costs	cost of crafting safeguards	communication, negotiation, and coordination costs	screening and selection costs (ex ante)  measurement costs (ex post)
Opportunity costs	failure to invest in productive assets	maladaptation, failure to adapt	failure to identify appropriate partners (ex ante)  productivity losses through effort adjustments (ex post)

**Figure 3: Sources and types of transaction costs (Rindfleisch and Heide, 1997)**

### 2.4.5. Comparison of TCT with AT

TCT and AT emerged from different economic perspectives, which is why they differ in some of their views (Spence, 1975). However, both incorporate self-interest and bounded rationality into their assumptions. Also, the dependent variables in both theories are similar: The hierarchies used in TCT resemble behavior-based contracts in AT. Furthermore, markets analyzed in TCT represent outcome-based contracts in AT (Barney and Ouchi, 1986).

However, TCT and AT are dissimilar in certain ways. TCT mostly deals with organizational boundaries, while AT focuses on the contract between principals and agents and is not concerned with boundaries. Most importantly, both theories use unique independent variables: asset specificity and bargaining from the limited number of

companies in the market in TCT, and risk attitudes, information systems, and outcome uncertainty in AT (Spence, 1975).

## **2.5. Decision Rights in AT and TCT**

The last section of chapter 2 of this study discusses the relevance of decision rights in AT and TCT. In the following step, it also generates the hypotheses needed for the empirical study presented in the next chapter.

### **2.5.1. Decision Rights in Agency Theory**

As mentioned earlier, Agency Theory deals with two basic assumptions. It states that the two parties involved have conflicting interests and that monitoring the agent's behavior is difficult and costly (Eisenhardt, 1989; Jensen and Meckling, 1976). Franchisors thus use residual profits as an economic incentive in order to alleviate monitoring costs (Rubin, 1978). Principals are therefore faced with the choice to either increase monitoring to prevent agency problems and reduce residual loss, or he/she could grant more decision rights to his/her partner and thus increase his/her partner's incentives. Research has shown that monitoring costs affect the allocation of decision rights as well as that increased monitoring costs lead to greater decentralization of decision rights (Brickley et al., 2003).

Furthermore, López-Fernández and López-Bayón (2011a) found that franchisors who make more substantial investments in their system, e.g. by providing a valuable brand name or by developing larger headquarters, also tend to allocate less decision rights to their franchisees. This means that the risk of opportunism as well as firm-size effects have a negative impact on the degree of decentralization.

Monitoring costs accrue due to information asymmetry, which is especially high when geographical and cultural distance are high (Fladmoe-Lindquist and Jacque, 1995; Carney and Gedajlovic, 1991). Therefore, firms will allocate more decision-making authority to their local partners when monitoring costs are high and local market knowledge is indispensable (Brickley et al., 2003). By doing so, firms can reduce their monitoring costs and optimize decision-making by establishing a stronger link between the partner's performance and his/her residual income, which would otherwise be affected by undesirable behavior such as shirking.

Consequently, the following hypothesis can be derived:

*Hypothesis 1: The higher the franchisor's monitoring costs due to behavioral uncertainty, the more decision rights he/she will grant to the franchise partner.*

### **2.5.2. Decision Rights in Transaction Cost Theory**

According to Transaction Cost Theory, decision rights are allocated in order to reduce transaction costs, which originate from transactional uncertainty and transaction-specific investments (Mumdziev and Windsperger, 2013).

In Transaction Cost Theory, behavioral uncertainty is viewed as the result of several kinds of dishonest behavior, e.g. from shirking and free riding (Hennart, 1993; Rindfleisch and Heide, 1997). Furthermore, research has revealed a positive relationship between behavioral uncertainty and vertical integration (John and Weitz, 1988; Sutcliffe and Zaheer, 1998). With regard to franchising, franchisors will opt for greater control over their transaction partners' activities in order to reduce the risk of franchisees acting opportunistically. This can be done by centralizing decision-making processes (Mumdziev and Windsperger, 2013).

#### **Environmental Uncertainty**

Transaction Cost Theory also takes into account environmental uncertainty, which is defined as the difficulty to predict contingencies related to economic exchange as well as the inability to specify them ex ante in contracts (Geyskens et al., 2006). Environmental uncertainty thus encourages firms to implement elements of hierarchy due to an increased need for coordination and control (Noordewier et al., 1990; Williamson, 1975b).

Consequently, franchisors are expected to choose governance structures that allow them to better react to unpredictable environmental conditions. Franchisors will thus increase control over decision-making at local markets. Therefore, the following hypothesis can be derived with regards to environmental uncertainty:

***Hypothesis 2:** The higher the franchisor's transaction costs due to environmental uncertainty, the more decision rights he/she will grant to the franchise partner.*

### **Transaction-Specific Investments**

Transaction-specific assets, on the other hand, are assets that are difficult to use otherwise, as they were tailored for a specific transaction (Geyskens et al., 2006). Franchisees make several transaction-specific investments (TSI) when entering a contract with a franchisor, e.g. by adapting premises, by buying tools and equipment, or through advertising costs (Dnes, 1993). In theory, increasing franchisee transaction-specific investments will lead to greater quasi-rents than potential gains from acting opportunistically. This in turn creates a bonding effect, which has a self-enforcing effect on contracts (Klein, 1995).

The cost of controlling and monitoring franchisees should therefore decrease and the need to exercise control over the franchisee's actions should therefore decrease as well. Consequently, the franchisor should allocate more decision rights to the franchisee:

***Hypothesis 3:** The higher the franchisee's transaction-specific investments relative to those of the franchisor, the more decision rights will be granted to the franchise partner.*

Conversely, it could be stated that:

***Hypothesis 4:** The higher the franchisor's transaction-specific investments relative to those of the franchisee, the less decision rights will be granted to the franchise partner.*

### **3. Empirical Study**

Part 2 presented the conceptual framework of this study. It provided state-of-the-art knowledge in the context of franchising, decision rights, and AT and TCT. Its last section presented the four hypotheses that were derived based on information gathered from respective literature.

This part of the study will subsequently link the conceptual framework to its operationalization, which in turn enables testing of the four hypotheses. It will thus provide information regarding the choice of instruments and variables, sampling, measurement, and methodology.

#### **3.1. Instrument Design**

The measuring instrument chosen for testing of the four hypotheses is a standardized questionnaire. The questionnaire was part of a research project carried out by the Department of Business Administration at the University of Vienna in late 2014 and early 2015, which was based on the research paper “The Choice of Governance Modes of International Franchise Firms — Development of an Integrative Model” published by Jell-Ojobor and Windsperger (2014).

In their publication, Jell-Ojobor and Windsperger examined the choice of governance modes in international franchise firms and further derived a model based on their findings. The model incorporates a variety of theories, including AT and TCT. The questionnaire was subsequently designed in order to test the hypotheses presented in the publication.

The main aim of the project was to gather quantitative data from international franchise firms headquartered in seven European countries and in the US. The questionnaire was consequently designed in a manner that allowed quantitative research to be carried out based on the answers provided.

The questionnaire was comprised of a variety of questions. It included some single-choice questions, e.g. asking in which country the participating company is headquartered. Furthermore, some of its single-choice questions had to be answered on a seven-digit Likert scale ranging from 1 (e.g. “strongly disagree”) to 7 (e.g. “strongly agree”). The questionnaire also contained some multiple-choice questions, e.g. for specifying the region and choice of market entry mode. Lastly, there were also some open questions, usually only requiring a figure or number for an answer such as the number of franchised outlets abroad.

### **3.2. Sampling**

The project targeted international franchise companies headquartered in Austria, Germany, Spain, France, the US, the UK, the Netherlands and Italy. Company information was gathered from an internal database and adjusted after consulting some of the companies’ websites, or based on information provided by them over the phone.

### **3.3. Measurement**

Initial questions in the survey deal with general information about the participating company such as the year it was established and the number of domestic and foreign outlets available. The second part of the questionnaire deals with key information for testing theoretic approaches such as AT and TCT. Such questions include information about environmental uncertainty and franchisor transaction-specific investment. The final part of the survey asks to provide franchise agreement terms such as the initial fee and to evaluate the company’s performance during the past three years.

### **3.4. Methodology**

The questionnaire was sent out both online and by post to international franchise firms, i.e. a link to the online version was sent out via email and a printed copy was mailed via airmail. The average time needed to complete the questionnaire was between 15 and 20 minutes. All answers were submitted anonymously unless the participating company

chose to provide its contact details or mailed back a printed or scanned copy with its details.

The initial response rate in December 2014 was considerably low. Therefore, the questionnaire was sent out by airmail to international franchise companies again in early 2015. An email providing the online link was sent out again as well. Additionally, companies were contacted via phone call. These subsequent attempts yielded a much higher response rate than the initial one.

### **3.5. Variables**

This section of the study presents the choice of the dependent variable, the independent variables and the control variables, which will subsequently be used for hypothesis testing.

#### **3.5.1. Dependent Variable**

Decision rights allocated to franchisees were chosen as the dependent variable. As mentioned in section 2, decision rights generally refer to the franchisor's system-specific assets and the franchisee's local market assets (Mundziev and Widnsperger, 2011). Franchisors often find themselves struggling to find an appropriate balance between the two conflicting forces of control and autonomy (Dant and Gundlach, 1999; Windsperger, 2004). Typically, the ones who bear specific knowledge will thus be given the right to make related decisions in order to attain efficiency (Jensen and Meckling, 1992). Therefore it would be worthwhile to find out whether the chosen independent variables influence the amount of decision rights granted to the franchisee.

There is total of seven questions in the questionnaire dealing with decision rights. Answers could be provided using a seven-digit Likert scale, where 1 represents "not at all" and 7 stands for "to a very large extent". The questions addressed the following areas in which decision rights can be granted to franchisees:

- development of new products and processes
- accounting and control systems
- HR practices (e.g. recruitment and training)
- marketing and promotion strategies
- procurement strategies
- pricing at the local market
- financial investment strategies at the local market

### **3.5.2. Independent Variables**

A total of four independent variables were chosen for hypothesis testing, namely behavioural uncertainty, environmental uncertainty, franchisor TSI, and franchisee TSI.

#### **Behavioral Uncertainty**

Behavioral uncertainty is a frequently discussed subject in AT. AT states that the principal and the agent have conflicting interests and that monitoring the agent's behavior is difficult and costly (Eisenhardt, 1989; Jensen and Meckling, 1976). Therefore, firms will allocate more decision-making authority to their local partners when monitoring costs are high and local market knowledge is indispensable (Brickley et al., 2003).

Four of the questions asked in the questionnaire related to behavioral uncertainty. Answers were given using a seven-digit Likert scale, with 1 indicating "strongly disagree" and 7 indicating "strongly agree". Participants were asked to assess how difficult it is to carry out the following activities:

- evaluate the qualification of foreign partners
- monitor the franchise product / service quality in foreign countries
- monitor the misuse of proprietary knowledge by foreign partners
- assess the performance of foreign partners

## **Environmental Uncertainty**

TCT defines environmental uncertainty as the difficulty to predict contingencies related to economic exchange and as the inability to specify them *ex ante* in contracts (Geyskens et al., 2006). As a consequence, environmental uncertainty drives firms to implement elements of hierarchy due to this increased need for coordination and control (Noordewier et al., 1990; Williamson, 1975b).

There were eleven questions in the questionnaire asking about environmental uncertainty. Participants provided answers using a seven-digit Likert scale, where 1 indicates “strongly disagree” and 7 stands for “strongly agree”. Participants were asked to assess the following statements with regards to their own company:

- cultural differences between their home and the foreign countries are high (e.g. norms, values and habits)
- business practices in their home and the foreign countries are quite different
- language barriers between their home and the foreign countries are high
- legal protection of intellectual properties such as patents and trademarks is weak in the foreign countries
- the political environment is quite uncertain in foreign countries
- the risk of ownership restrictions is high in foreign countries
- the quality of local infrastructure, such as telecommunication, road networks and IT, is under-developed in foreign countries
- customer demand is highly volatile in foreign countries
- sales forecasts are not easily predictable in foreign countries
- market shares are pretty unstable in foreign countries
- the number of existing potential competitors is high in foreign countries

## **Franchisor Transaction-Specific Investment**

By definition, TSI refers to assets that are difficult to use otherwise, as they were intended and designed for a specific transaction (Geyskens et al., 2006). Entering a

franchise contract will require both parties to make several transaction-specific investments (Dnes, 1993). This independent variable thus addresses franchisor TSI, whereas the one below deals with franchisee TSI.

A total of four questions in the questionnaire asked about franchisor TSI. Answers were given on a seven-digit Likert scale, with 1 relating to “strongly disagree” and 7 relating to “strongly agree”. Questions dealing with franchisor TSI asked whether franchisors:

- invested heavily in personnel dedicated to foreign partners
- made significant investments in displays etc. dedicated to franchise relationships
- developed specialized procedures and systems for foreign partners to follow
- showed considerable commitment of time and money to training and increasing the qualification of foreign partners

### **Franchisee TSI**

Lastly, franchisee TSI was addressed in three questions in the questionnaire. Answers were provided using a seven-digit Likert scale, where 1 indicates “strongly disagree” and 7 stands for “strongly agree”. Questions regarding franchisee TSI asked whether franchisees:

- have made significant investments in tools, equipment and procedures dedicated to the franchise relationship
- have committed substantial time and money in employees’ (or sub-franchisees’) training of the franchise-specific techniques
- would lose a lot of their investment made to develop the local franchise network, if they decided to stop working with the franchisor

### **3.5.3. Control Variables**

The two measures chosen as control variables were system size and international experience:

## **System Size**

Survey participants were asked to provide the number of both company-owned and franchised outlets located in the home country and abroad. The total sum of outlets was thus measured by summing up all outlets associated with a franchise company. It can be assumed that companies with a large number of outlets will incur greater monitoring costs (Shane, 1998). High monitoring costs would in turn justify more decision rights being delegated to the franchisee (Brickley et al., 2003).

## **International Experience**

Monitoring skills of franchise companies are more developed in businesses that have more years of experience (Alon and McKee, 1999b; Elango, 2007). Since this study focuses on international franchise companies only, the total amount of years of international operation will thus be considered. This figure will be obtained by subtracting the year of internationalization from the year the survey was conducted (2015).

## **4. Results**

This section of the study presents the results obtained from analysing the data provided by participating international franchise companies. The analysis was carried out using SPSS Statistics software.

### **4.1. Descriptive Statistics**

Section 4.1. presents descriptive statistics of respondents, as well as the dependent variable, independent variables, and control variables.

#### **4.1.1. Overview**

The Department of Business Administration received a total of 162 valid responses from international franchise companies. Responses were provided by 24 US-American, 8 British, 41 German, 16 Austrian, 10 French, 18 Dutch, 22 Italian, and 23 Spanish companies. Descriptive statistics results of the study are provided below in table 1.

The average founding year of participating companies was 1995 with a standard deviation of roughly 16 years. On average, they owned 53 outlets and had entered a relationship with about 336 franchises in their home country. This implies a ratio of over 1:6 company-owned outlets to franchised outlets in the home country.

Furthermore, the average year of internationalization was 2003 with a standard deviation of about 10 years. The average number of company-owned outlets abroad was 33, while the average number of franchised outlets abroad was 106. The ratio between company-owned outlets and franchised ones abroad is thus approximately 1:3. Overall, most outlets were operated as franchises domestically.

Lastly, companies also provided with information regarding franchise terms of agreement. The average initial fee per franchise unit was approximately USD 16,000 with a standard deviation of almost USD 18,000. The mean of total investments required to open a franchise outlet was close to USD 600,000 with a standard deviation of over USD

2.5 million. The average development fee for a master franchise license was approximately USD 63,000 with a standard deviation of roughly USD 93,000.

	N	min	max	M	SD
founding year	138	1896	2014	1995	15.96
number of company-owned outlets in home country	137	0	1,500	53	160.35
number of franchise outlets in the home country	134	0	12,000	336	1,286.80
year of internationalization	133	1965	2015	2003	10.14
number of company-owned outlets abroad	132	0	1,277	33	142.87
number of franchise outlets abroad	136	0	3,000	106	322.95
initial fee for a single franchise unit in \$	87	0	100,000	16,189	17,743.38
total investment required for opening a franchise outlet in \$	86	0	22,000,000	599,011	2,520,380.14
development fee for a master franchise licence in \$	52	0	447,890	63,241	93,437.01

**Table 1: Descriptive statistics of study results**

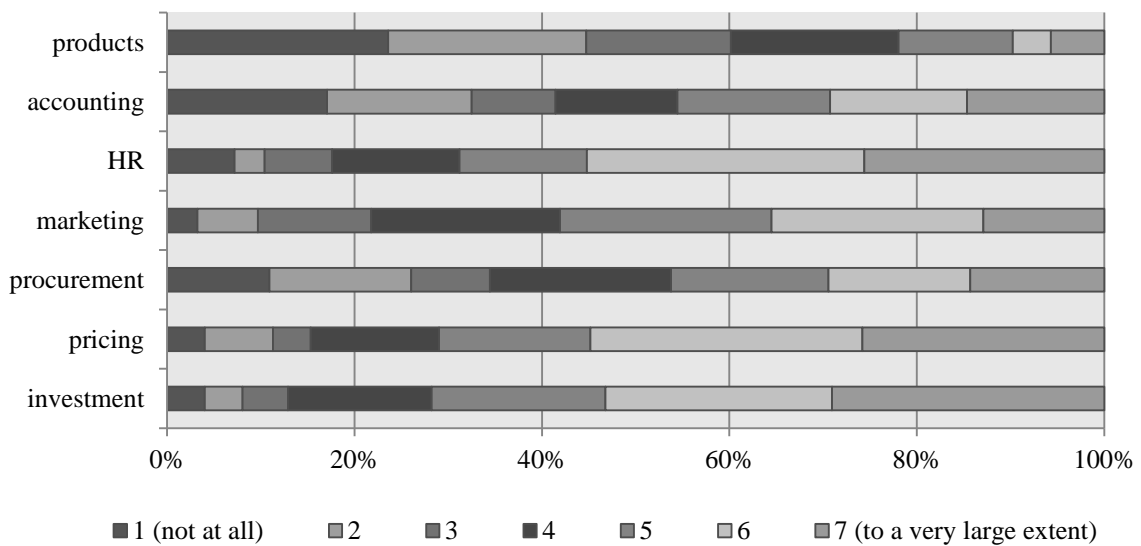
#### 4.1.2. Dependent Variable

The dependent variable in this study was represented by the decision rights (DR). They consisted of a total of seven items. The total number of answers provided per item, as well as their mean and standard deviation can be seen in table 2. The mean value index of DR has a reliability coefficient of Crohnbach's alpha = 0.84, which again indicates good reliability.

	N	min	max	M	SD
products	123	1	7	3.09	1.77
accounting	123	1	7	3.98	2.08
HR	125	1	7	5.14	1.79
marketing	124	1	7	4.72	1.57
procurement	119	1	7	4.18	1.93
pricing	124	1	7	5.21	1.70
investment	124	1	7	5.29	1.64

**Table 2: Descriptive statistics of DR**

Furthermore, a frequency analysis of answers provided per item is presented below in figure 4. When looking at the results, it becomes obvious that DR were least likely to be granted with regards to products, whereas DR related to marketing, pricing, and investment were more likely to be transferred to franchise partners.



**Figure 4: Frequency distributions of DR**

### 4.1.3. Independent Variables

Descriptive statistics regarding the four independent variables, i.e. behavioural uncertainty, environmental uncertainty, franchisor TSI and franchisee TSI, are provided in this section.

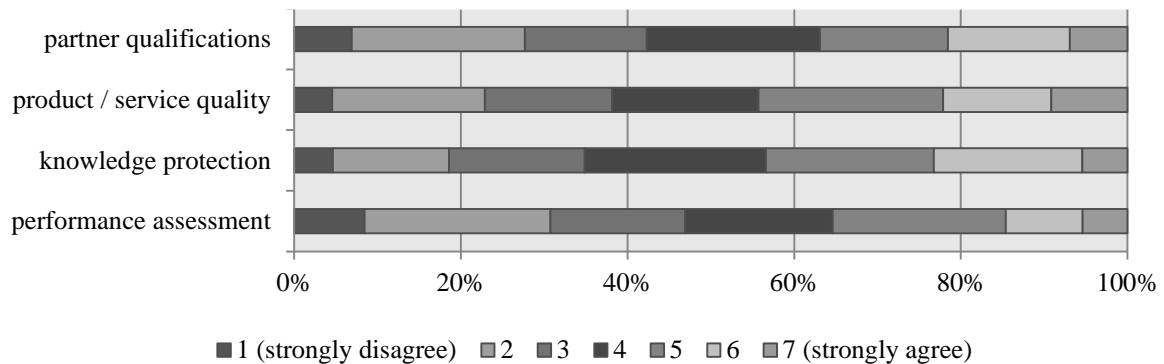
#### Behavioral Uncertainty (BU)

This variable consisted of four items. The total number of responses as well as their mean values and standard deviation are provided below in table 3. Their mean value index has a reliability coefficient of Crohnbach's alpha = 0.87, which indicates good reliability.

	N	min	max	M	SD
partner qualifications	130	1	7	3.88	1.72
product / service quality	131	1	7	4.10	1.70
knowledge protection	129	1	7	4.14	1.60
performance assessment	130	1	7	3.69	1.67

**Table 3: Descriptive statistics of BU**

Furthermore, frequency distributions of BU's four items is illustrated in figure 5.



**Figure 5: Frequency distributions of BU**

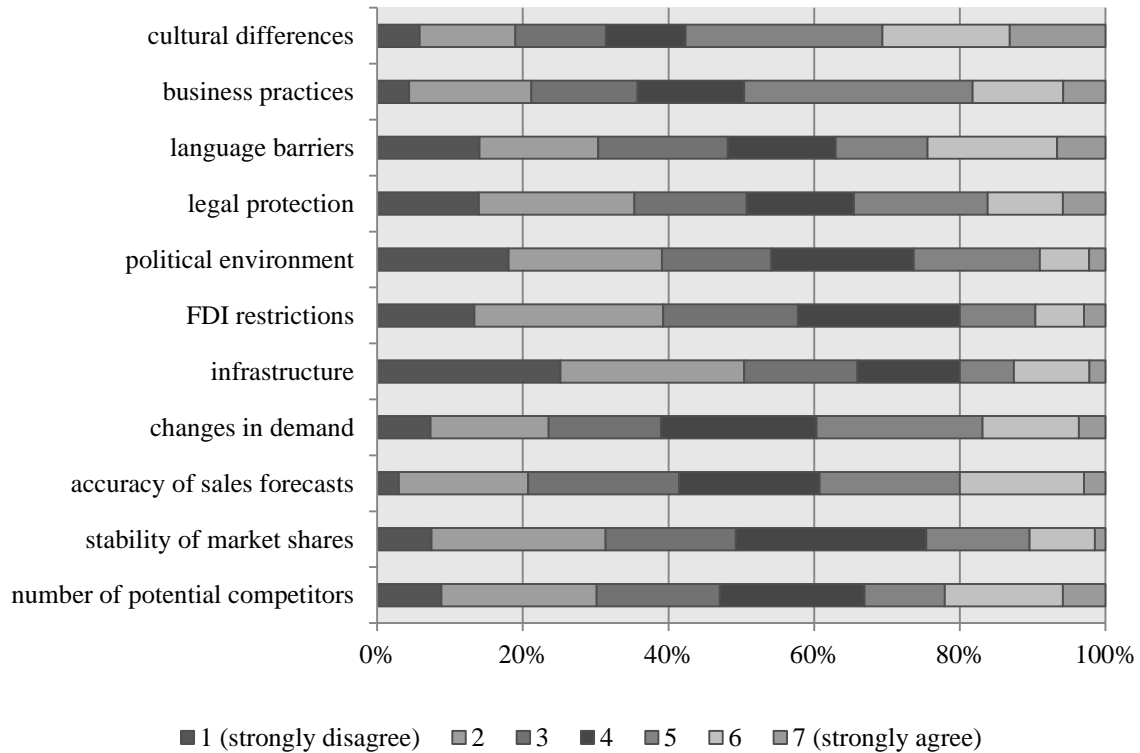
## Environmental Uncertainty (EU)

The variable EU included a total of eleven items. Table 4 illustrates the total number of answers provided per item, as well as the mean and standard deviation of answers. The mean value index of EU has a reliability coefficient of Cronbach's  $\alpha = 0.86$ , which again indicates good reliability.

	N	min	max	M	SD
cultural differences	137	1	7	4.45	1.77
business practices	137	1	7	4.12	1.60
language barriers	135	1	7	3.76	1.87
legal protection	136	1	7	3.57	1.80
political environment	133	1	7	3.26	1.66
FDI restrictions	135	1	7	3.22	1.57
infrastructure	135	1	7	2.93	1.73
changes in demand	136	1	7	3.90	1.60
accuracy of sales forecasts	135	1	7	3.97	1.53
stability of market shares	134	1	7	3.49	1.48
number of potential competitors	136	1	7	3.75	1.75

**Table 4: Descriptive statistics of EU**

The frequency analysis below (figure 6) provides a visual illustration of all answers given.



**Figure 6: Frequency distributions of EU**

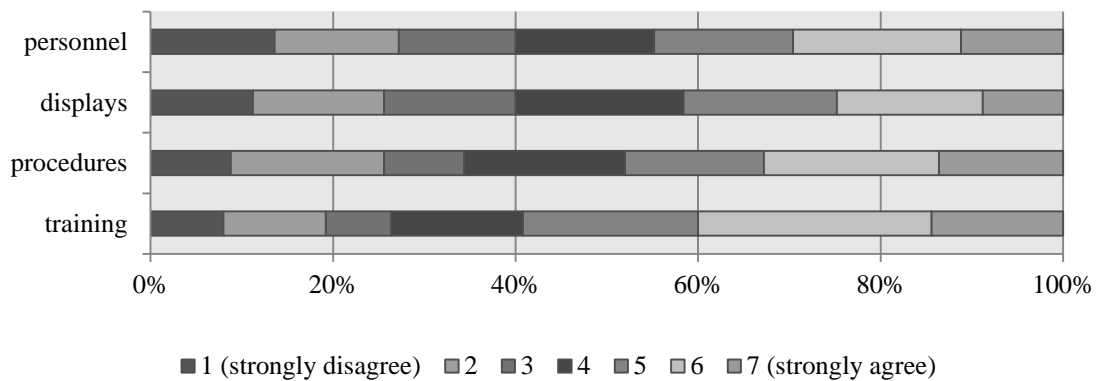
### Franchisor TSI

This variable had a total of four items. Table 5 below illustrates their descriptive statistics. The mean value index of franchisor TSI has a reliability coefficient of Cronbach’s alpha = 0.85, which indicates good reliability as well.

	N	min	max	M	SD
personnel	125	1	7	4.05	1.96
displays	125	1	7	3.98	1.83
procedures	125	1	7	4.26	1.91
training	125	1	7	4.60	1.85

**Table 5: Descriptive statistics of franchisor TSI**

Furthermore, the frequency distributions of answers can be seen below in figure 7.



**Figure 7: Frequency distributions of franchisor TSI**

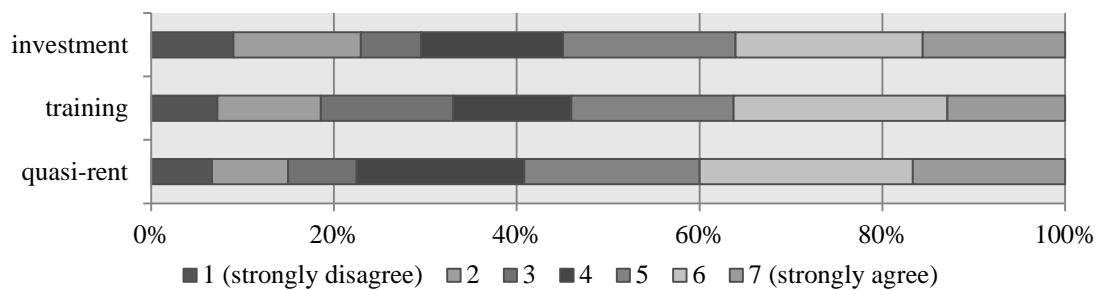
### Franchisee TSI

This variable consisted of a total of three items. The total number of answers provided per item, as well as their mean and standard deviation can be seen in table 6. The mean value index of franchisee TSI has a reliability coefficient of Cronbach's alpha = 0.79, which indicates acceptable reliability.

	N	min	max	M	SD
investment	122	1	7	4.45	1.92
training	124	1	7	4.44	1.83
quasi-rent	120	1	7	4.72	1.77

**Table 6: Descriptive statistics of franchisee TSI**

The frequency of answers provided per item is further illustrated below in figure 8.



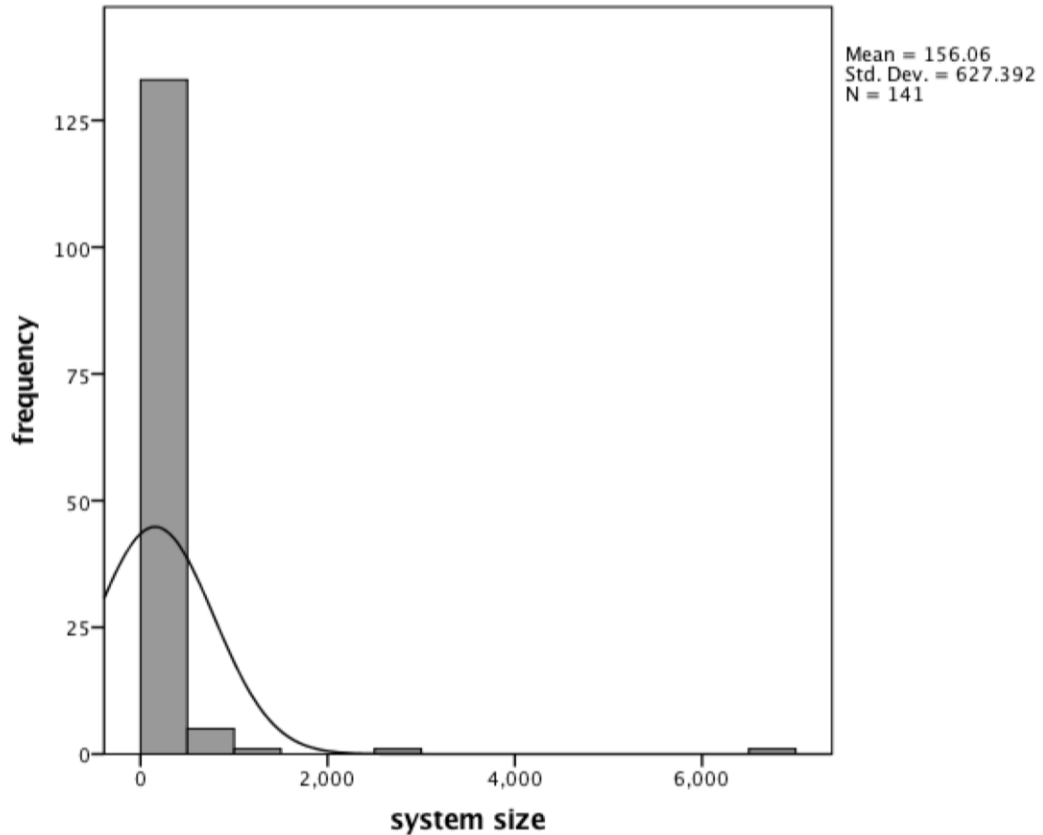
**Figure 8: Frequency distributions of franchisee TSI**

#### 4.1.4. Control Variables

The study used the measures ‘system size’ and ‘international experience’ as control variables. Their descriptive statistics are provided in this section.

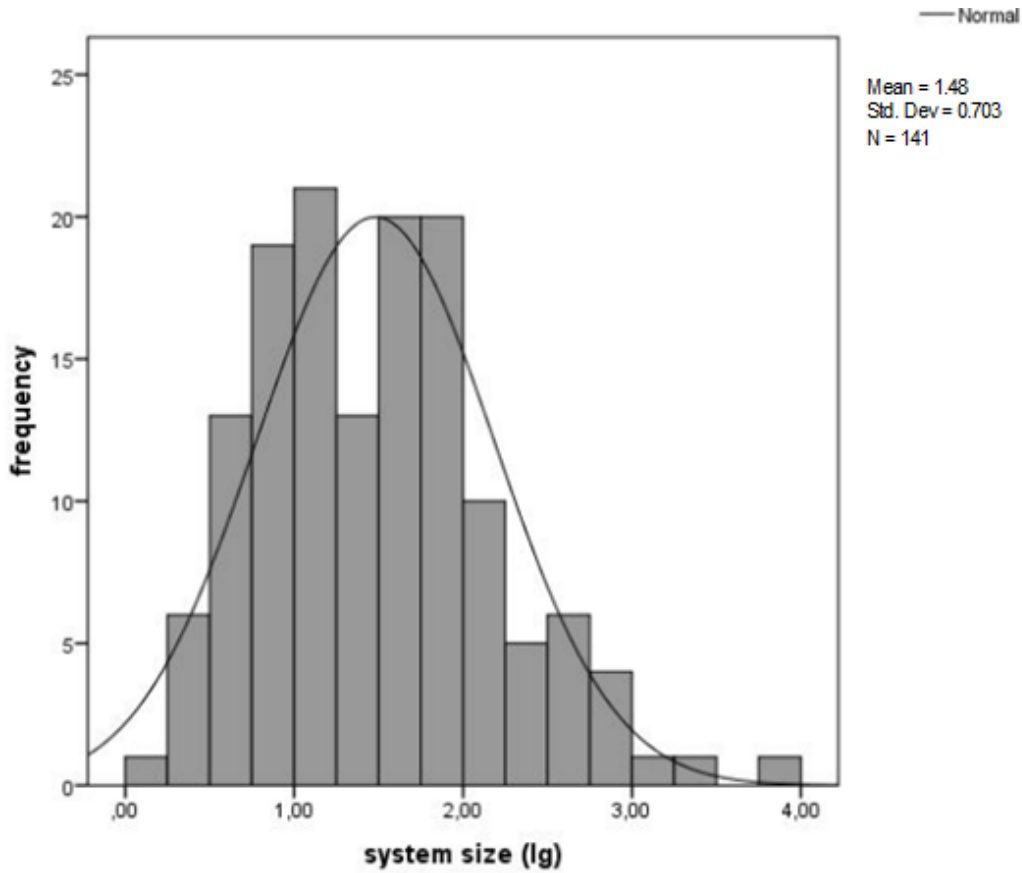
##### System Size

The variable system size had a mean value of 156.06 and a standard deviation of roughly 627.40. Figure 9 shows that the distribution of this variable is significantly skewed due to some outliers.



**Figure 9: Frequency distributions of system size**

Due to the skewness of its distribution it was necessary to perform a logarithmic transformation of this variable. This reduction of skewness in turn helped interpret patterns in the data more easily. The results of the logarithmic transformation are illustrated below in figure 10. System size (lg) had a mean of 1.48 and a standard deviation of approximately 0.70.

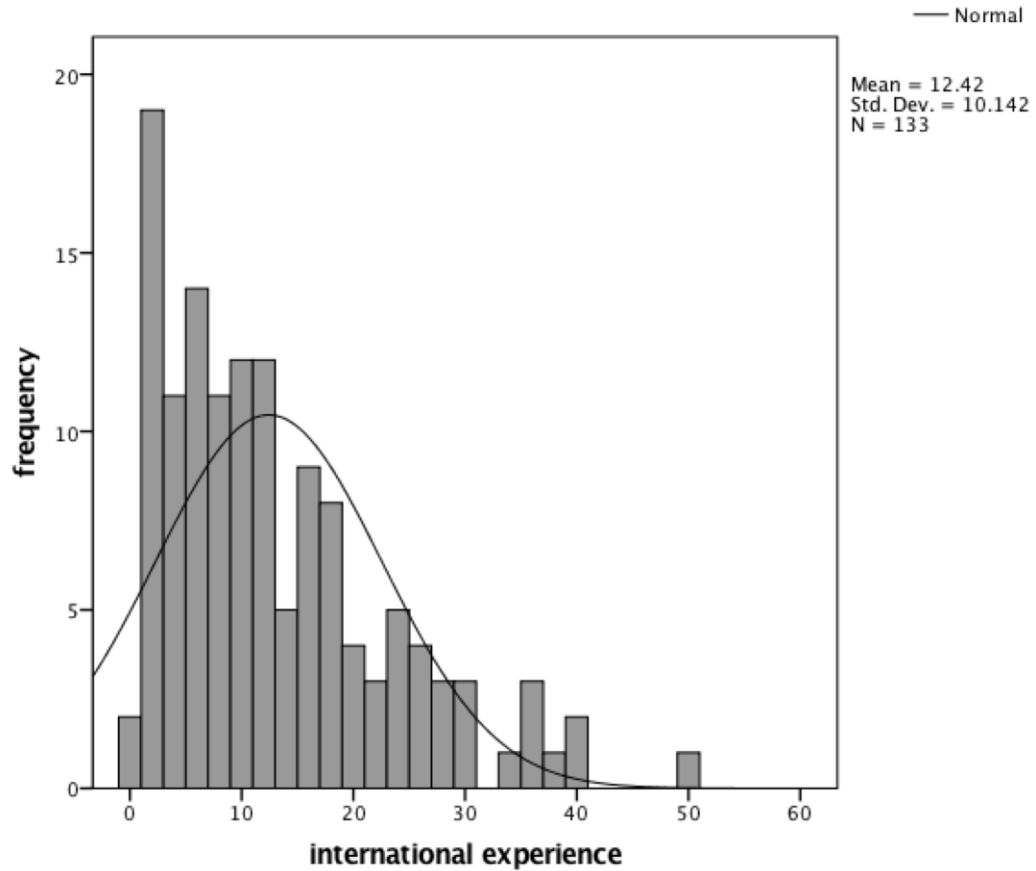


**Figure 10: Frequency distributions of system size (lg)**

Furthermore, the data was standardized via z-transformation to attain a standard normal distribution with a mean of 0 and a standard deviation of 1. Standardized values were then used to carry out the regression analysis.

### **International Experience**

This variable had a mean value of roughly 12 years and a standard deviation of about 10 years. The frequency distribution of answers provided is shown below in figure 11.



**Figure 11: Frequency distributions of international experience**

## 4.2. Correlations

Table 7 below reveals the correlation between the respective variables of the model. The dependent variable DR significantly and positively correlates with the independent variables BU and EU. Furthermore, a significant and positive correlation could be found between DR and the control variable ‘international experience’. There is also a significant correlation between the following independent variables: EU and BU, EU and franchisor TSI, and franchisor TSI and franchisee TSI. Lastly, the control variables system size (lg) and international experience show a positive significant correlation as well.

	DR	BU	EU	franchisor TSI	franchisee TSI	international experience	system size (lg)
DR	1						
BU	0.23	1					
EU	0.19	0.52	1				
franchisor TSI	-0.10	-0.02	0.27	1			
franchisee TSI	-0.04	0.01	0.12	0.42	1		
international experience	0.27	0.03	0.16	-0.03	-0.07	1	
system size (lg)	0.01	-0.01	0.11	0.12	0.13	0.37	1

**Table 7: Correlations**

### 4.3. Regression Analysis

Regression analysis helps determine the composition of independent variables and control variables that represent the dependent variable. In this case, the dependent variable is represented by the decision rights allocated to the franchisee. The independent variables are behavioral uncertainty (BU), environmental uncertainty (EU), franchisor TSI, and franchisee TSI. System size and international experience are the control variables in this model.

Thus, the regression equation should read as follows:

$$DR = \beta_0 + \beta_1 BU + \beta_2 EU + \beta_3 \text{FranchisorTSI} + \beta_4 \text{FranchiseeTSI} + \beta_5 \text{SystemSize} + \beta_6 \text{InternationalExperience}$$

Furthermore, carrying out the regression analysis will test the following hypotheses:

***Hypothesis 1:** The higher the franchisor's monitoring costs due to behavioral uncertainty, the more decision rights he/she will grant to the franchise partner.*

***Hypothesis 2:** The higher the franchisor's transaction costs due to environmental uncertainty, the more decision rights he/she will grant to the franchise partner.*

***Hypothesis 3:** The higher the franchisee's transaction-specific investments relative to those of the franchisor, the more decision rights will be granted to the franchise partner.*

***Hypothesis 4:** The higher the franchisor's transaction-specific investments relative to those of the franchisee, the less decision rights will be granted to the franchise partner.*

The first hypothesis to be tested thus implies a positive correlation between DR and BU. The second one suggests a positive correlation between DR and EU as well. According to hypothesis 3, DR should also positively correlate with franchisor TSI. Lastly, hypothesis 4, which reflects the franchisee's perspective, suggests that DR holds a negative correlation with franchisee TSI.

The correlations assumed in hypotheses 1 and 2 conform with the results depicted in table 7. No significant correlation could however be found between DR and franchisee TSI and DR and franchisor TSI (hypotheses 3 and 4).

The control variable system size has shown in research to have a negative impact on the amount of decision rights granted to the franchisee (e.g. Arruñada et al., 2001). Thus, it can be assumed that DR shows a negative correlation with the variable system size. Again, this correlation could not be backed by the results in table 7.

Research has found that franchise companies with more years of experience are also equipped with better monitoring skills (e.g. Alon and McKee, 1999b). Azevedo (2009) further found a positive link between years of experience and the amount of decision rights allocated to franchisees. It can thus be inferred that DR positively correlates with

the variable international experience. This assumption is supported by the correlations found in table 7.

Hierarchical multiple regression analysis was subsequently carried out in order to test the four hypotheses. First, the covariates c1 and c2 were included in the regression model. The independent variables uv1 to uv4 were then added.

Regression analysis shows that the model with the covariates is significant ( $F(2,112) = 4.79, p = 0.01$ ). This is also illustrated below in table 8.

	model	sum of squares	df	mean square	F	sig.
	regression	14.39	2	7.20	4.79	0.01 <sup>b</sup>
cov	residual	168.09	112	1.50		
	total	182.48	114			
	regression	26.04	6	4.34	3.00	0.01 <sup>c</sup>
cov*uv	residual	156.44	108	1.45		
	total	182.48	114			

a. dependent variable: decision rights

b. predictors: (constant), international experience, system size (lg)

c. predictors: (constant), international experience, system size (lg), environmental uncertainty, franchisee TSI, franchisor TSI, behavioral uncertainty

**Table 8: ANOVA**

Table 9 below further reveals that system size has no significance in the model ( $B = 1.96, \beta = 6.02, p = 0.75$ ). The variable international experience, however, does hold a significant position ( $B = 0.03, \beta = 0.25, p = 0.01$ ). Since the regression coefficient has a positive sign, it can be inferred that longer international experience positively affects the allocation of decision rights.

model	unstandardized coefficients		standardized coefficients	t	sig.	collinearity statistics	
	B	std. error	beta			tolerance	VIF
(constant)	1.77	5.94		0.30	0.77		
1							
system size (lg)	2.36	5.99	0.04	0.39	0.70	0.96	1.04
international experience	0.04	0.01	0.27	2.94	0.00	0.96	1.04
(constant)	1.47	5.91		0.25	0.80		
2							
system size (lg)	1.96	6.02	0.03	0.33	0.75	0.92	1.09
international experience	0.03	0.01	0.25	2.71	0.01	0.93	1.08
behavioral uncertainty	0.17	0.09	0.19	1.76	0.08	0.69	1.46
environmental uncertainty	0.09	0.12	0.09	0.77	0.44	0.61	1.63
franchisor TSI	-0.06	0.08	-0.08	-0.77	0.45	0.76	1.32
franchisee TSI	0.00	0.08	0.00	-0.01	0.99	0.82	1.22

a. dependent variable: decision rights

**Table 9: Coefficients**

Table 8 further reveals that the model remains significant when adding the independent variables ( $F(6,108) = 3.00, p = 0.01$ ). However, table 10 below shows that adding the independent variables does not considerably add to the proportion of variance explained ( $F(4,108) = 2.01, p = 0.10$ ).

model	R	R square	adjusted R square	std. error of the estimate	change statistics				
					R square change	F change	df1	df2	sig. F change
1	0.28 <sup>a</sup>	0.08	0.06	1.23	0.08	4.79	2	112	0.01
2	0.38 <sup>b</sup>	0.14	0.10	1.20	0.06	2.01	4	108	0.10

a. predictors: (Constant), international experience, system size (lg)

b. predictors: (Constant), international experience, system size (lg), environmental uncertainty, franchisee TSI, franchisor TSI, behavioral uncertainty

**Table 10: Model summary**

While the proportion of variance explained was 6% in the first model (cov), it merely increases to 10% in the second model (cov\*uv). This increase is regarded as insignificant. Further, when examining the regression coefficients of the independent variables in table 9, it becomes clear that none of them are significant either.

The results stated in table 8-10 thus lead to the following conclusions regarding the four hypotheses:

***Hypothesis 1:** The higher the franchisor's monitoring costs due to behavioral uncertainty, the more decision rights he/she will grant to the franchise partner.*

While a positive significant correlation was found between DR and BU, evidence from the regression analysis could only slightly support this assumption ( $p = 0.08$ ).

***Hypothesis 2:** The higher the franchisor's transaction costs due to environmental uncertainty, the more decision rights he/she will grant to the franchise partner.*

Again, a positive significant correlation was revealed between DR and EU. However, its p-value level was far too high to derive significance.

***Hypothesis 3:** The higher the franchisee's transaction-specific investments relative to those of the franchisor, the more decision rights will be granted to the franchise partner.*

The interrelation between DR and franchisee TSI could neither be supported by correlation results (table 7), nor by regression analysis.

***Hypothesis 4:** The higher the franchisor's transaction-specific investments relative to those of the franchisee, the less decision rights will be granted to the franchise partner.*

Similar to hypothesis 3, no significant results could be found regarding an interrelation between DR and franchisor TSI.

## 5. Conclusion

The present study analyzed the impact of Agency Theory and Transaction Cost Theory on the allocation of decision rights in international franchise companies. Particularly, aspects such as monitoring costs, free riding, adverse selection, opportunism, and asset specificity were taken into consideration in order to examine the two aforementioned theoretical approaches and their effect.

Data used for analysis was taken from a research project that was carried out between late 2014 and early 2015. Empirical evidence was provided by franchise companies from seven European countries and the US.

While examination of the data pointed towards significant correlations between some of the variables, hierarchical multiple regression analysis could only slightly support one of the assumptions made regarding the two theories – stating that increasing monitoring costs incurred by the franchisor due to behavioural uncertainty positively impact the amount of decision rights granted to franchise partners.

The study further incidentally revealed that longer international experience positively affects the allocation of decision rights. These findings are also supported by research carried out by Azevedo (2009) and López-Fernández and López-Bayón (2011b) and further support evidence of this interrelation.

Due to the lack of concrete evidence provided regarding AT and TCT, managerial implications can merely be derived in the context of international experience. An international franchise company's previous experience may therefore entail better knowledge of the sector and greater familiarity with processes, more established routine, and more developed skills. The company therefore may benefit from these attributes and allocate more DR to its franchisees. Future research could further investigate this condition and provide more detailed answers. Furthermore, some additional components in this interrelation, such as the role of trust, have also been examined by some authors, albeit very few (e.g. Herz et al., 2016, Mumdziev and Windperger, 2013). It would thus

be worthwhile to further investigate the determinants of this phenomenon and to analyze their impact.

Eventually, findings in this study are considerably limited due to the scarcity of data. Evidence was provided by a total of 162 companies. Such a low number cannot be regarded as representative of all international franchise firms in the respective host countries. Furthermore, not all participants filled out the entire questionnaire – some merely provided basic information about their operations and completely skipped questions regarding DR and aspects derived from AT and TCT.

As a consequence, it would be worthwhile to carry out further research in this context, preferably using more reliable and complete data. It would be of particular interest to analyze the impact of TCT on DR, where evidence is even scarcer than in the AT-context. At the same time, it would be worthwhile to continue investigation in the area of AT as well as Property Rights Theory, which has so far also been the basis of research carried out in the context of decision rights (e.g. Mumdziev, 2011; Mumdziev and Windsperger, 2011).

Lastly, it could be particularly interesting, especially in an international context, to extend the sample of the survey to non-Western countries, where cultural distance and other barriers could have an even larger impact on the allocation of decision rights. Additionally, responses would be even more comprehensive if not just franchisors, but also franchisees were given the possibility to report back from their perspective.

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# Appendix

## 1. Abstract (English)

This thesis investigates the impact of Agency Theory and Transaction Cost Theory on decision rights allocated to franchisees of international franchise companies. The study used quantitative data obtained from a project carried out by the Department of Business Administration at the University of Vienna in late 2014 and early 2015, which surveyed international franchise companies headquartered in Austria, Germany, Spain, France, the US, the UK, the Netherlands, and Italy. The analysis was carried out using hierarchical multiple regression analysis. The findings of this study were generally inconclusive regarding the impact of Agency Theory and Transaction Cost Theory on the allocation of decision rights, with merely one of the hypotheses relating to the theoretical framework being slightly supported. The thesis however revealed an impact of international experience (measured in years) on the allocation of decision rights, i.e. it concluded that longer international experience positively affects the allocation of decision rights.

## **2. Abstract (German)**

Die vorliegende Masterarbeit beschäftigt sich mit der Erteilung von Entscheidungsrechten an Franchisenehmer internationaler Franchise-Unternehmen aus Sicht zweier theoretischer Ansätze (Agent-Prinzipal-Theorie und Transaktionskostentheorie). Die Studie bediente sich quantitativer Daten, welche von internationalen Franchise-Unternehmen mit Hauptsitz in Österreich, Deutschland, Spanien, Frankreich, den USA, dem Vereinigten Königreich, den Niederlanden und Italien stammen und im Zuge eines Forschungsprojekts der Fakultät für Wirtschaftswissenschaften der Universität Wien Ende 2014 und Anfang 2015 erfasst wurden. Die Analyse der Daten erfolgte mittels hierarchischer multipler Regressionsanalyse. Aus den Ergebnissen der Auswertung konnten hinsichtlich der beiden theoretischen Ansätze keine aussagekräftigen Rückschlüsse gezogen werden, da sich keine der Hypothesen bestätigen ließ. Es konnte lediglich eine der Hypothesen geringfügig gestützt werden. Dennoch konnte ein positiver Einfluss internationaler Erfahrung (gemessen in Jahren) auf die Vergabe von Entscheidungsrechten an Franchisenehmer erkannt werden.