CONFLICT OF INTEREST: A CRITICAL ANALYSIS OF FRANCHISING BUSINESS

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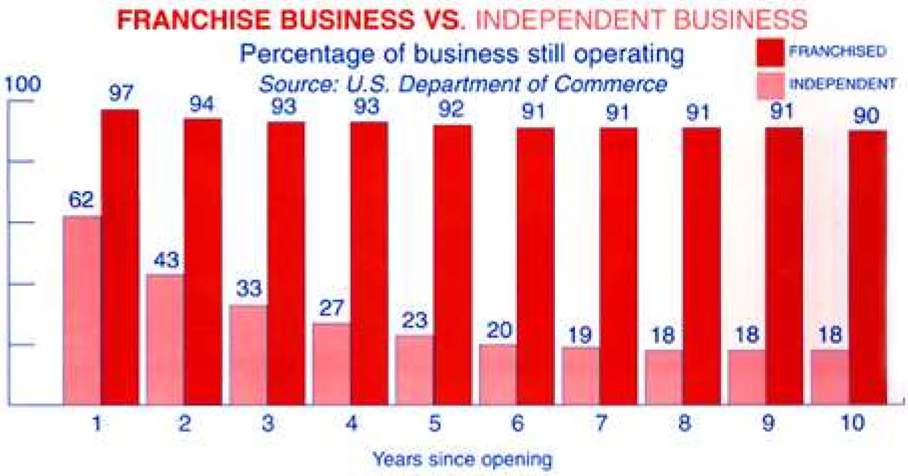
Abstract

There are many multinational companies engaging with the franchising mechanisms in order to expand the business opportunity, to explore new opportunities, and to develop businesses domestically and internationally. Even though this is a good opportunity for multinational companies to expand their market to achieve the company target, but there is a problem attached with this mechanism. The main problem of franchising business is mainly conflict of interest between the parties involved. Hence, this paper attempts to critically evaluate the potential of conflict of interest that arises among the parties. Apart from that, this paper also outlined certain way on how to avoid this problem from occurs continuously.

Keywords: *conflict of interest, franchising*

INTRODUCTION

As the world move towards globalisations era, many companies are trying to expand their business via promoting good and service, increase productivity level and also explore new market environment by emphasizing on franchising mechanism. This is because franchising business offers a good opportunity to various levels of capital and experience.



Sources:http://www.prefranchise.com/franchisestatistics.htmSource: Richard T. Ashman

The chart above, which is based on a survey by the U .S. Commerce Department, shows the percentage of businesses still operating after the first year, after five years, and after ten years. The study shows that franchise businesses still operating after the first year -compared to independent businesses -is 97% to 62 %. After five years, the comparison is even more telling -92% of franchised businesses are still operating, compared to 23% of independent businesses. After ten years. 90% of franchised businesses are still operating. compared to 18% of independent businesses.

This chart explains two things: (1) A franchised business offers a great deal more stability and security to the owner, operator and investor. (2) Franchising offers businesses that want to grow a method of expansion and development that has a greater chance for success over the long term. In short, Franchising gives individuals the opportunity to go into business for themselves with an excellent chance of success at a minimum of risk. It gives businesses the opportunity to expand on a far greater scale, with greater speed, and with significantly less capital requirements.

Franchising in recent years has become a major part of the American economy. Franchised businesses now account for one-third of all retail sales, more than $590 billion. There are more than 498,000 franchised outlets employing more than 7 million people. The American concept of franchising is expanding rapidly throughout the world.

The overwhelming success of franchising is not based on any secret formula or magic trick. It is based on ingenuity and hard work. It is based on creating and developing an excellent idea for a product or service that is needed by millions of people. It is based on developing this concept into a complete system of doing business that can be taught to other business people, and that can be replicated in business locations from Bangor, Maine, to Bangkok, Thailand. The franchisor applies his expertise, experience and capital to developing a trademark and a complete system of doing business. The franchisee receives assistance with site selection, personnel training, business set up, advertising, and product supply. The franchisee pays an up-front franchise fee and an on-going royalty which allows the franchisor to provide more training, research and development, and marketing support for the entire business.

The reason that franchised businesses are still operating after five years, ten years, and even longer, is because of the unique combination of all the right elements that businesses need to prosper and thrive -brilliant ideas, commitment to the long-term, a good source of capital, and a lot of hard- working people as well as good commitment from top management to lower management.

Franchise is a method of marketing and distributing based on a two parties relationship; that is the franchisor (the owner and granter of right) and the franchisee (recipient of right) relationship. The right granted is for the purpose of running the business by using the trademark or trade name based on a specific system, at specified location or area within a specified period of time.

There are two types of franchising format. The first one is product-and-trade-name franchising. This type of franchising is the franchisee having a contract with franchisor to buy or sell particular products. Besides that, franchisee also will use the name, trademark, or product that provide by franchisor. The base or core of the value that they need to delivery to customer is certain types of products.

Another type of franchising is business-format franchising. Business-format franchising has five different types of format categories namely business opportunity, pattern or method of doing business, franchise opportunity, licensing relationship, and continuing relationship. It will be show as below:

Business Opportunity

This is a business format franchising where the producer or distributor of certain services that given right including their trademark to other individual to distributor their services in certain area. In the return of the right given, the producer or distributor will receive payment or loyalty and maintain the quality standard.

Pattern or Method of Doing Business

This is a business format franchising where the franchisee get the right from franchisor to distribute certain goods or services by using a particular marketing format which is fix by the franchisor. It needs to follow the way or the marketing format to distribute the goods or services to their customer.

Franchise Opportunity

This is a business format franchising where the franchisee need to follow the marketing plan and payment of royalty to franchisor after grant the trademark, logo, or the use of a product or services.

Licensing Relationship

This is a business format franchising where the distributor grant distribution right to affiliated dealers (franchisee) of a product, services, or business method. Normally it access to the geography area by this method.

Continuing Relationship

It is where a franchisor provides continuing management, technical assistance, and training to the franchisee where the franchisee need t grant the license from the franchisor first.

WHY DO MULTINATIONAL FIRM ENTERING TO FRANCHISE BUSINESS

Before examine the reason for a multinational company to enter into franchising in reducing conflicts of interest, a crucial point must be addressed to, which is the geographical factor. Multinational companies have companies around the globe or a specified region other than its domestic country. Difference in places contribute other factors that could influence the business environment of a company, such as the culture, preference of consumers, way of thinking and living, different time zone and so on. Hence, it is clearly a huge gap of separation in control if a company expands its business globally, the head quarters could not closely and effectively monitor the actions of its branches, creating opportunity for branch managers to operate business based on their interest and not the company's interest.

As described by a Kentucky Fried Chicken franchisee in Lincoln, Nebraska, a franchisor-franchisee relationship consists of three types – legal agreement, business relationship, and independent business owners. From here, is an important to note that company-owned relationships and franchisor-franchisee relationships are different, and these differences are the main reason a company chose to enter into franchising business as a means of expanding its business as well as reducing conflicts of interest **(Robert T. Justis & Richard J. Judd, 2002).**

Legal agreement is a set of guidelines and manuals which state the roles for each franchisor and franchisee in the franchising business. Legally speaking, franchisor has more authority than franchisee and franchisee has to abide the legal agreement drafted by franchisor. By here, franchisor has control over franchisee and its operations, rendering franchisee acting on its own self-interest, thereby reducing conflicts. Some of the contents in franchise agreement are the site selection and advertising. Franchisor will decide the site for a new franchisee to set up his business in order not to over-populate a territory with existing franchisees or taking into consideration of town development which affects the market and the continuity of the business. From advertising aspect, franchisee who wishes to advertise or conduct promotions to generate sales must get the approval of franchisor.

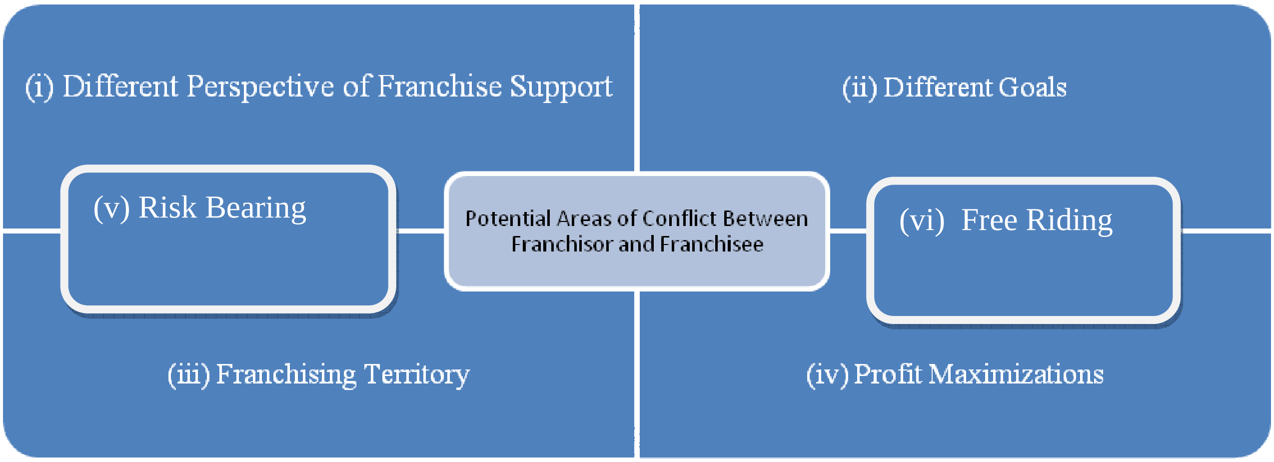
Business relationship deals with business interaction between franchisor and franchisee in daily operation of business. Franchisee communicates with franchisor either on a daily basis or weekly basis to update and report the current business performance, information includes franchisee's profitability and problems faced. Reports and financial accounts are synchronized with the head quarters at the end of specified period, allowing franchisor to check whether franchisee's business transactions are complying with franchisor's operation manual. Besides that, franchisee is obliged to deal with selected suppliers selected by franchisor. This measure prevents franchisee from selecting their own suppliers which sometimes these suppliers are franchisee's friends, allowing franchisee to reap under-table profits from his partner (supplier) and reducing the possibility of these supplies in bad quality **(Michael Webster, 2007)**.

Lastly, franchisee is an independent business owner unlike a manager of a branch which is an employee of a company. The different roles contribute to different attitudes in both franchisee and employee in their perception on business operation. A highly noted point here is that franchisee is more sensitive in business dealings than an employee. Franchisee is a self-employed business-person which joint venture with a franchisor rather than employed by the company itself. Therefore, franchisee is motivated to succeed because the business is fully owned by him alone and all profits generated solely belong to him. With that in mind, franchisee is constantly thinking creatively to generate sales and lower costs, going as far as to assimilate themselves with the community, getting to know the community and consumer preference in order to satisfy those needs. All these initiatives prove favourable to franchisor – high sales, high royalties and the continuity of the business.

PROBLEM IN FRANCHISING BUSINESS

The major problem exists in franchising business is that there is possibility that, the conflict of interest might be arises between the franchisor and franchisee. Conflict of interest (COI) is the situation that has the potential to undermine the impartiality of a person because of the possibility of clash between the person's self interest and professional interest or public interest. In other words, COI is the situation where a party's responsibility to a second party limits its ability to discharge its responsibility to a third party.

There are six potential areas that conflict of interest may occur:



i) Different Perspective of Franchise Support

Franchise support relates to supports provided to franchisee by franchisor in setting up the business and in return a fixed sum of payment known as franchising fee is charged. Simple as it seems, conflicts arise here with franchisees view that the support offered does not add value to their businesses or meet their expectations, and on the other hand, franchisors view that the costs of support diminish profitability or other benefits related to franchise model[1].

Further into franchisees point of view, they believe the amount of franchising fee paid for such as royalties and franchising fee do not match the support given. To them, marginal cost is higher than marginal benefits and conflicts arise as they will question the capability of the company as a franchisor. Supports include supply chain, site allocation, staff training, opening promotion for the new franchisee and others failed to match the worth of every dollar the franchisees invested when buying an existing business. Other supports that are expected but not meet are on-site operational assistance during the opening days or weeks of business and an experienced representative of franchisor that franchisees can rely on for advises in resolving problems as franchisees are inexperienced. But at some point of time, franchisees might be expecting too much from their on-going payment of royalties which lead them to request support outside the core operational areas offered by the franchisor, such supports are incapable for franchisor to accomplish.

As from the franchisors' point of view, generally franchisors view franchising is a way of creating endless income stream for their business with on-going payments of royalties by franchisees. Mistakenly, royalties are assumed to be passive returns, which means returns will come flowing in without any effort. This brings about franchisors leaving franchisees alone by themselves and has not much involvement in their daily operations after the initial set up business, in which could cause tensions as franchisees require support as they are inexperienced and new to the market. Due to the fact that franchisors have knowledge and expertise far exceed franchisees in franchising business at territory level, unconsciously they place high expectation on franchisees grasping the concept and knowledge of the business but many franchisees do not meet that expectation, which will result in energy and time consuming. Franchisors will begin to be frustrated at the length of time and may resolve to reduce efforts

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[1] Online source: Jianguo Chen, 2009, "Determinants of Dividend Policy: The Evidence from New Zealand" viewed on March 11.2010.
http://www.eurojournal.com/finance.html

elsewhere to compensate for the additional perceived additional costs or demand more upfront fee from franchisee.

ii) Different Goal

In the case of franchising, the conflict of interest may arises due to the franchisors and franchisee pursue different goals. As long as franchisors received a major part of their revenue from royalties on gross sales and/or the sale of supplies, franchisor will judge franchisee according to their sales volume. Franchisee on the other hand, will more concern to achieve their own profit. This is clearly show that the existence of goals which are inconsistent or at odds with one another (franchisor and franchisee) – goal heterogeneity.

iii) Franchising Territory

The basic economics of the franchise arrangement is behind many franchisor-franchisee disputes. Franchisees run outlets according to systems sold to them by franchisors. Under the standard arrangement, franchisees pay franchisors a royalty of a few percent of their gross sales for access to an operating system and a brand name, which is how franchisors make money. Like most businesses, franchisees earn a profit when their revenues exceed their costs. The difference in how franchisors and franchisees make money is behind much of the conflict between franchisees and franchisors. Because franchisors earn royalties on franchisees' sales, anything that increases franchisees' revenues benefits franchisors. If, as the Wall Street Journal reported, franchisees generate an extra $30 in revenue for each additional hour they are open, the franchisors benefit from longer operating hours. More revenues equate to higher royalties. Franchisees, on the other hand, don't necessarily make money when their revenues increase. Consider operating hours again. According to the attorney for the franchisees suing Burger King, staying open late costs the typical franchisee $100 per hour. Assuming these numbers are true, franchisees lose $70 each hour they are open late at night. If a particular policy makes money for a franchisor, but loses money for his or her franchisees, conflict between the franchisor and franchisee over the policy shouldn't surprise anyone.

iv) Profit Maximizations

Franchisors are more concern on generation of sales by franchisees, the increased in sales will directly increase royalties which is a percentage charged on sales. As such, franchisors favour in maximizing sales and the common way to do it is through offering coupons to induce consumers to buy products in the future with the benefit of discount. However, the increased use of coupons will increase costs along with sales. Franchisees bear the cost of the discounted item, whereby frequently used coupons will result in higher sales occurs at a lower profit per unit, leaving franchisees' profits to suffer. Hence, franchisees always disagree with the use of discount to increase sales as required by franchisor but to suggest a better way, which by all means will fall to deaf ears.

A suggestion by franchisees will be the use of loyalty cards, instead of offering coupons to customers, loyalty cards not only fulfil the objective of coupons but it also an indirectly method to gather data on customers – data mining. Customers that patronize the store who wish to sign up for a loyalty card, are required to fill in forms and these forms will provide franchisees the information to learn customers' preferences and satisfying those preference in pursuit to purchase customers' loyalty towards the company. In other words, coupons is regard as claiming value by trading-off company profits while loyalty cards is regard as creating value by fulfilling customers' satisfaction to generate sales.

v) Risk Bearing

Following the agency theory, the franchisors are the risk takers and prefer high risk whereas the franchisees are risk adverse. This is due to the percentage of each parties wealth which is invested into the franchise. To the franchisee, typically a large portion of their wealth and income would be tied to their store. Due to this, when making business decisions such as increasing advertising or offering a sales promotion, the franchisees are less likely to make those decisions as the returns from such an investment would not guarantee full benefits to their stores so they would not take those risks. They would also need to find methods to increase their profits in order to pay the franchising fees to the franchisor, which would give rise to the problem of inefficient risk-bearing where there is under-investment by the franchisee and yet they expect high returns.

To the franchisor, however, their wealth is spread across many stores which continuously provide steady income to them. They have less risk and the effects of any advertising or promotions would be more beneficial to them since it affects all the stores. They might then try to make the franchisees invest more in such things which would give rise to conflict.

vi) Free-riding

This problem arises from the fact that a typical franchise has an established brand name attached to it. The franchisor would seek to constantly maintain and improve the brand name. Some franchisees would then take advantage of it. This is because the brand name itself would signal quality to their customers and reduce the customers' ability to detect differences of quality from different stores. These franchisees can therefore potentially 'free-ride' without losing business because of the spill over benefits from other stores or franchisees that do their best to maintain the quality of the franchise.

THE WAY TO SOLVE THE CONFLICT OF INTEREST THAT ARISEN BETWEEN FRANCHISOR AND FRANCHISEE IN FRANCHISING BUSINESS.

Conflict arises when one party believes that its goal attainment is being impeded by another (Gaski 1984). In a franchising relationship, the franchisor and franchisee usually have different objectives (Boe, Ginalski, and Henward 1987). The franchisor generally will be considering performance of the entire system while the franchisees are focusing on their individual outlets. Both franchisor and franchisee will attempt to maximize profits for themselves. As each organization within the franchise system strives to meet its own goals, the problem of self-interest can create serious difficulties for the harmonious operation of the franchise relationship.

One problem which must be addressed is the responsibility of the franchisor to properly select those franchisees whose goals complement their franchising system. Training can also be provided on an ongoing basis to ensure that the franchisees' goals remain consistent with those of the franchisor. In both cases, market research can prove to be a valuable tool to understanding franchisees' goals and aspirations. When a suitable franchisee is enlisted, the franchisor must continue to monitor and analyze the sales and profits of each unit. Such research can provide insight into the customers' buying habits and the demand for the product or service being offered. Of course, franchisors need to adequately understand the end consumers and their desire for the franchisors' products in order to ensure their own survival.

But even more important, the franchisor can collect information which can identify and define the marketing opportunities and problems for a particular business. The ability of the franchisor to understand demand from a total systems perspective yields greater coordination of franchisor/franchisee effort, greater capacity to take advantage of economic efficiencies in the research process, and more openness and adaptiveness to change on the part of franchisees (Mc Cammon 1970). The decision by franchisors to conduct marketing research is generally centered around a recognized need for specific information and the desire to manage and maintain proper organizational functions.

World Franchise Council's; Principle of Ethic's

In Management of the Franchise Business, world franchise council has been come out with certain way in order to build healthier relationship between franchisor and franchisee in franchising business as shown below;

The franchisor's general commitments**:**

- The franchisors develop and maintain the commercial and technical know-how that supports the franchise network and favours' a permanent and structured dialogue with the franchisees to aid the protection and development of the franchisor's know-how;
- In case of non respect of the concept by the franchisee, the franchisor must allow when appropriate the franchisee a reasonable delay to conform to his obligations, after due notification;
- The franchisor must ensure that each franchisee respects their obligations and commitments for the general interest of the network.

The franchisee's general commitments**:**

- The franchisee takes an active part in the life of the network and contributes to safeguarding its interests;
- The franchisee cannot compete with the network, in particular by appropriating or diverting the know-how transmitted by the franchisor;
- The franchisee provides the franchisor with the operational information concerning his franchise business;
- The franchisee has a duty of confidentiality during and after the franchise contract.

Commitments common to franchisor and franchisee**:**

- Franchisor and franchisee co-operate in all loyalty and in respect of their mutual obligations and commitments;
- In case of litigation, the franchisor and/or the franchisee will seek, when appropriate, to resolve the conflict through mediation;
- Franchisor and franchisees commit themselves according to their responsibilities to protect the interests of the consumers.

Meeting the network expansion challenge

Franchise systems have been able to expand and grow by creatively and proactively meeting the network expansion challenge, using approaches built on mutual trust, integrity, and realistic expectations between the franchiser and its franchisees.

Here are four things a franchisee can do to meet the network expansion challenge**:**

- Make sure to carefully review the franchise agreement particularly on the territory provision. Most franchise agreements are non-exclusive and site-specific, giving the franchiser the opportunity to explore other marketing channels. Although franchise agreements are site-specific, there is also a section that indicates the procedures to be followed when there is an opportunity to open another outlet within the area. Usually, the franchisee operating in that area has the right of first option to open a new outlet.
- Seek the advice of your franchiser on how to market the brand and effectively capture the target market. Based on the experience of its company-owned branches, a franchiser normally knows the population and demographics needed by a particular branch to succeed, and makes it a point to discuss this with the prospective franchisee during the application process. After that, the responsibility for tapping the potential of a particular franchise location rests on the franchisee. Problems can arise if some franchisees who are not successful in doing local branch marketing demand to be given an unreasonably big market area, heedless of the fact that if no marketing effort is done, success would not be guaranteed no matter how large the market area is.
- Maintain an open two-way communication line. From the application process to the actual operation of the franchised branch, franchisees should keep in mind that the franchiser normally would look after the interest of their franchises in their decision-making. On the other hand, since the franchiser is the "big brother" in the relationship, it has to take the extra mile to explain and convince franchisees that they have the latter's best interests in mind at all times.
- Draw clear procedures on resolving territorial issues. For instance, Burger King has come up with procedures for resolving disputes even if the company makes it clear that it reserves the right to approve the site for a franchise. These procedures were developed with the participation of its franchisees. Burger King and its franchisees realize that they share the common goal of maximizing the brand's market potential by securing the best locations and developing new outlets as quickly as possible.

Again and again, franchisers and franchisees have realized that resolution to national expansion conflicts are best resolved not in courtrooms or by recourse to legal processes but by going back to what franchising is all about: working together to achieve mutual benefits.

CONCLUSIONS

As analyzed above, there is highest possibility for any organizations to gain from franchising business but at the same need to bear the cost that is conflict of interest. One of best example is in the Enron Case; the writer of "Rise and Fall of Enron; When a company looks too good to be true , it is usually is", C.William Thomas clearly mentioned that; one of the main causes for the fall of Enron is because of conflict of interest between top management and lower management. In order to gain from franchising mechanism, organizations need to manage the business activity carefully, increase monitoring level as discuss above etc. By doing this, there are chances to gain from this mechanism. As a conclusion, franchising business is not only deal with profit maximisation but with relationship between franchisor and franchisee, image or reputation of the organisations, development of organisations domestically, commitment between related parties as well as meeting corporate goals.

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