Alternative Profitability Measures and Marketing Channel Structure: The Franchise Decision

Patrick J. Kaufmann
Boston University
Richard M. Gordon
University of Florida
James E. Owers
Georgia State University

Analysis of marketing channel structure in general, and the decision to franchise in particular, has assumed that the decision maker is seeking to maximize the long-term economic value of the firm. In this article, we consider an alternative accounting-based objective function. We explore some circumstances that might lead to the use of an accounting-based objective function, including the incentive structure faced by non-owner managers, the life cycle of the firm including an impending initial public offering, and data availability considerations. A simple model of franchisor performance is developed and several scenarios of franchise system expansion examined. Decisions to open franchised or company-owned outlets are compared using the competing objective functions. J BUSN RES 2000. 50.217–224. *© 2000 Elsevier Science Inc. All rights reserved.*

One of the most important methods of distribution in the United States is franchising. Because it provides a quasi-integrated alternative to markets or hierarchies, it raises interesting questions involving marketing channel structure decisions. The most central and unresolved question is "What factors influence a retailer to distribute its products or services through company-owned vs. franchised units?"

While this question can be examined using a variety of approaches (e.g., behavioral, economic/financial, or managerial), most of the research addressing the question has been conducted within an economic/financial framework (Rubin, 1978). The economic/financial framework assumes that business firms seek to maximize their long-run profits and wealth (Koutsoyiannis, 1982), using performance measures that focus on the firm's economic value (EV).

This assumption is critical because of the influence that the choice of performance measures has on financial structure, and the influence that financial structure has on the scope of a business enterprise (Li and Li, 1996). Theoretically, markets value a firm with reference to long-term economic profit, and economic value and financial market value should be one and the same. Although we do not contest the fact that in the long run the market will reflect economic value, we suggest that there may be circumstances in the short run that lead the market (and firm management) to attend to accounting measures of performance (AV measures). In doing so, we show how a franchisor's choice of EV or AV measures is related to its decisions concerning the mix of franchised and company-owned outlets. The choice of financial measures, therefore, is closely linked to a marketing decision: the design of the firm's distribution channel.

In subsequent sections, we also examine the implications of the finance–marketing link with respect to an important sub-issue: the strategic conversion of franchised to company-owned channels (i.e., ownership redirection). We develop a simple model of franchise system economics and simulate the expansion of the system under various scenarios. The model shows the choices of an optimal mix of franchised and company-owned outlets may turn on whether a firm uses EV or AV measures. We end by discussing the importance of these findings to the ownership redirection issue.

Comparison of AV and EV Measures

AV measures, such as net income (NI) and earnings per share (EPS), are calculated using Generally Accepted Accounting Principles (GAAP). GAAP "encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time" (AICPA, 1995, p. 485).

In a franchising firm with a simple capital structure, NI

Address correspondence to Patrick J. Kaufmann, Marketing Department, School of Management, Boston University, 595 Commonwealth Ave., Boston, MA 02215. E-mail: patk@bu.edu.

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is calculated by deducting ordinary expenses from ordinary income. Ordinary expenses include the costs related to the selling of franchises (e.g., recruiting franchisees), of servicing (i.e., monitoring) franchised units, and of operating and servicing company units. EPS is calculated by dividing NI by the number of shares of stock outstanding.

In contrast, EV measures, such as net operating profit after tax (NOPAT) and *r* (the operating return on assets), are calculated by making adjustments to their AV counterparts (NI and EPS). There are numerous residual income or EV-based measures of firm performance. We use a simplified version of the most familiar measure Economic Value Added or EVA® (Stewart, 1991), noting that there are over 160 versions of that particular measure (Myers, 1996). EVA relates NOPAT to capital employed as follows: EVA = [(NOPAT/Capital) − Cost of Capital] × Capital. The component (NOPAT/Capital) is the EV performance measure and must exceed the cost of capital to add value to the firm. In our model, we assume the proportion of debt to equity (i.e., the capital structure) to be invariant with respect to the franchising decision. Thus, the cost of capital is not affected by that decision, and our EV analysis focuses solely on the NOPAT/Capital component.

In a firm with a simple capital structure, NOPAT starts with NI, and adds back two categories of expenses that were deducted in calculating NI: (1) expenses paid to providers of capital other than holders of common stock, and (2) expenses deemed to lack "economic reality" with respect to company valuation. The purpose of the first category of add backs is to reflect the firm's total operating return. In a firm that incurs debt, these add backs include interest expense after tax. The second category of add backs is made because GAAP conventions represent compromises between reporting the operating economics of the firm and reporting information that is usable for other purposes (e.g., for decisions about extending credit). The EV measure, *r*, therefore, is calculated by dividing NOPAT by total invested capital (not just equity capital, as in EPS) (see Table 1).

Although the EV measure, *r*, and the AV measure, EPS, differ both with respect to their numerators (the income-derived term of the measures) and with respect to their denominators (the capital-base-derived term), it is the difference in their denominators that has the greatest impact on the decision to favor either franchised or company-owned outlets. The effect of the differences in the denominators is that franchisors who use AV measures may favor asset accumulation (company-owned outlets) in circumstances in which EV measures, which focus on asset efficiency, may discourage asset accumulation (and thereby favor franchised units).

Economic and Alternative Assumptions in Franchising Research

From the outset, the assumption that franchisors pursue an economic value maximizing approach (using EV measures) has been the foundation of most of the research concerning franchising (Rubin, 1978). As March (1962, p. 670) has noted, however, "modern observers of actual firm behavior report persistent and significant contradictions between firm behavior and the classical assumptions" (i.e., the assumptions of profit or utility maximization). Consequently, some researchers have considered other goals for franchisors, such as growth (Kaufmann and Dant, 1996), survival (Shane, 1996), and power and control, for example, the greater ability to control strategic input from franchisees as compared with heavily invested venture capitalists (Lafontaine and Kaufmann, 1994). Nevertheless, because relatively few researchers have applied non-economic approaches directly to the questions of franchise ownership structure and ownership redirection, the standard economic assumption has dominated research in this area.

We contend that the assumption that franchisors invariably seek to maximize economic value is too strong and may lead to a misinterpretation of observed choices with respect to the ownership of units. We are not suggesting that franchisors act irrationally. We do suggest that there are circumstances in which a franchisor may be guided directly by AV measures or by an alternative objective function that involves the use of AV measures. Empirical evidence suggests that improving a firm's performance on AV measures has been an important goal for many senior executives in the United States. In fact, Jensen (1989) suggests that one of the critical problems with the public corporation is that managers traditionally seek to maximize earnings (an AV measure) instead of value.

Size-Based Managerial Compensation

One driving force behind a franchisor's focus on AV measures may be executive compensation. The connection between increases in executive pay and increases in firm size has been consistently demonstrated (Murphy, 1985). Thus, senior managers of publicly held franchise companies may favor building the company's asset base by increasing the proportion of company-owned units, even if a lower proportion would maximize EV measures of performance. On the other hand, if firms move toward the use of compensation plans based on residual income or firm value, the importance of AV measures to top management would diminish (Wallace, 1996).

Data Availability

It is quite difficult for inside management to compile the data necessary to create accurate EV measures (Myers, 1996); it is even more difficult for outside investors to get independent access to the data necessary to construct the measures [although some proprietary measures are available for purchase, see Biddle, Bowen, and Wallace (1996)]. EV adjustments, such as the valuation for goodwill amortization and changes in reserves, often are too idiosyncratic to permit efficient comparisons across firms. On the other hand, AV data concerning franchisors and public companies are readily available, and