

An Introduction to Franchising



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Franchising



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The Money Institute

www.themoneyinstitute2000.com

FOREWORD & ACKNOWLEDGEMENTS

An Introduction to Franchising is designed to introduce young people to the fascinating world of franchising. Many people think of fast food restaurants like McDonald's, Burger King, and Wendy's, when they think of franchising. But there are many more types of franchise businesses. One out of every three dollars spent by Americans for goods and services is spent in a franchised business. Homes are bought and sold through franchised real estate companies. The same homes can be cleaned, painted, and carpeted through a franchise. Cars can be purchased, tuned and washed through franchises. We can have our hair cut, clothes cleaned, pets cared for – all in franchised businesses. We can travel from one area of the world to another through franchised businesses.

The idea of this book was inspired by Ron Harrison, Senior Vice President, Global Diversity and Community Affairs, PepsiCo. At the time, Ron was serving as Chairman of the IFA Educational Foundation. The idea was to introduce young people to franchising, to the many facets of the franchising business, and to the many opportunities that franchising offers – for both employment and professional careers and for business opportunities and business ownership. There are many opportunities for people who want to explore careers and business ownership.

We would like to express our sincere thanks to the many individuals who have worked on this project and to the PepsiCo Foundation for their sponsorship. Our sincere thanks to — Barbara Beshel, the author. To Catherine Marinoff, the graphic designer. To Peter Muth and Eastern Publishing for their permission to use graphics and materials from *Franchising: Aspects of the Market Economy*. To Philip Zeidman, author of *Franchising: Aspects of the Market Economy*, to Michael Seid and Dave Thomas, authors of *Franchising For Dummies*, for their assistance.

We would like to express our thanks to the team of high school and college instructors who worked with us on the pilot project – Kay Frazier, Townview Magnet School, Dallas, TX, Jacques Leblanc, Youth Opportunity Movement, CDC of Tampa, FL, Robert Rubin, Norman Thomas High School, New York, NY, Chi Yansi-Archibong, North Carolina State University, Greensboro, NC, and William Ziegler, Bethune Cookman College, Ormond Beach, FL.

Many thanks to Mat Burton, senior director-university relations, Students in Free Enterprise and Tim Coffey, director of corporate development, Distributive Education Clubs of America, for their assistance and for the cooperation of these organizations.

Lastly, we would like to thank the Foundation staff for their efforts in coordinating the project – John Reynolds, president, Kathryn Morgan, director of research and education, and Rose DuPont, operations coordinator.

Franchising is a wonderful way to go into business for yourself, but not by yourself. Franchising is an example of teamwork at its best, bringing together the talents of a dedicated corporate staff and management team with the hard work, zeal and entrepreneurial spirit of franchisees at the local level to serve our customers here in the U.S. and around the world. We hope that you will enjoy reading this book and that you will learn more about this fascinating business and marketing system.



Sidney J. Feltenstein
Chairman
IFA Educational Foundation
Chairman and CEO
Yorkshire Global Restaurants (A&W and Long John Silver's)

Chapter 1:

An Introduction To Franchising

What is a franchise? What are common franchise terms?

What are the alternatives to franchising?

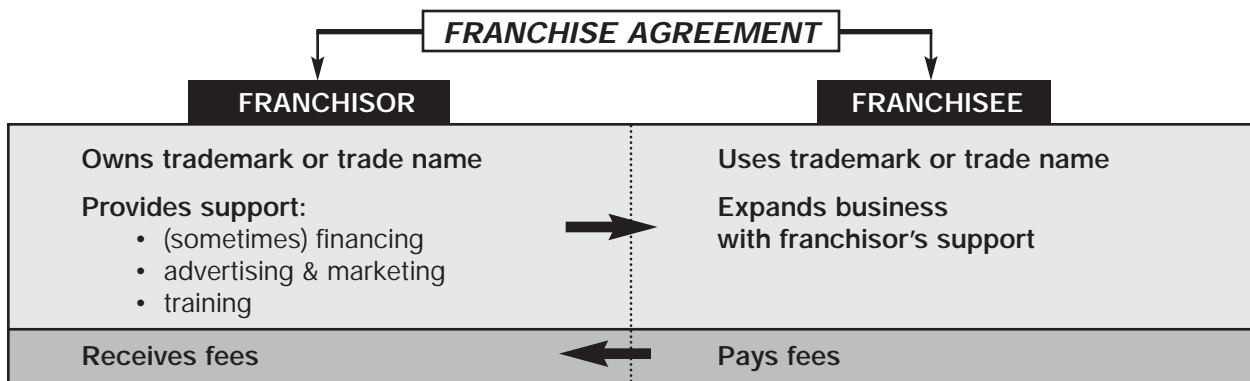
What are the advantages and disadvantages of owning a franchise?

What are the legal issues in franchising?

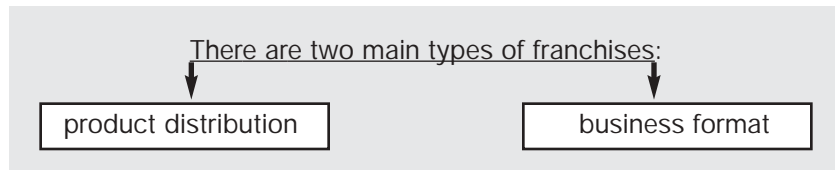
WHAT IS A FRANCHISE?

A franchise is the agreement or license between two legally independent parties which gives:

- a person or group of people (franchisee) the right to market a product or service using the trademark or trade name of another business (franchisor)
- the franchisee the right to market a product or service using the operating methods of the franchisor
- the franchisee the obligation to pay the franchisor fees for these rights
- the franchisor the obligation to provide rights and support to franchisees



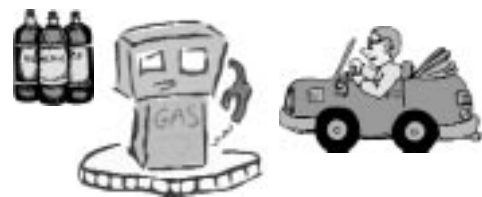
Types of Franchises



Product distribution franchises simply sell the franchisor's products and are supplier-dealer relationships. In product distribution franchising, the franchisor licenses its trademark and logo to the franchisees but typically does not provide them with an entire system for running their business. The industries where you most often find this type of franchising are soft drink distributors, automobile dealers and gas stations.

Some familiar product distribution franchises include:

- ✓ Pepsi
- ✓ Exxon
- ✓ Ford Motor Company



Although product distribution franchising represents the largest percentage of total retail sales, most franchises available today are business format opportunities.

Business format franchises, on the other hand, not only use a franchisor's product, service and trademark, but also the complete method to conduct the business itself, such as the marketing plan and operations manuals. Business format franchises are the most common type of franchise.

USA Today reported that the 10 most popular franchising opportunities are in these industries:

- | | |
|-----------------------------|---------------|
| ◆ fast food | ◆ retail |
| ◆ service | ◆ automotive |
| ◆ restaurants | ◆ maintenance |
| ◆ building and construction | ◆ retail—food |
| ◆ business services | ◆ lodging |

Some popular business format franchises include:

<p><u>Restaurants</u> KFC McDonald's Pizza Hut Taco Bell</p> <p><u>Retail</u> Blockbuster Video Radio Shack The Athlete's Foot GNC Franchising</p> <p><u>Lodging</u> Choice Hotels Bass Hotels/Holiday Inn Marriott Hotels</p>	<p><u>Health & Beauty</u> Merle Norman Costmetic Studios Supercuts Jenny Craig International Cost Cutters Family Hair Care</p> <p><u>Business Services</u> Mail Boxes Etc. H & R Block ACE America Cash Express Kwik Kopy</p>	<p><u>Maintenance/Cleaning</u> Jani-King International The ServiceMaster Company Merry Maids</p> <p><u>Automotive Service</u> Meineke Discount Mufflers AAMCO Transmissions Midas International Precision Auto Care</p> <p><u>Education/Training</u> Dale Carnegie Training Barbizon School of Modeling Berlitz International Sylvan Learning Systems</p>	<p><u>Real Estate</u> Century 21 RE/MAX International Coldwell Banker Residential Affiliates</p> <p><u>Convenience</u> 7-Eleven FamilyMart</p>
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Types of Franchise Arrangements

Because so many franchisors, industries and range of investments are possible, there are different types of franchise arrangements available to a business owner.

Two types of franchising arrangements:

- ✓ single-unit (direct-unit) franchise
- ✓ multi-unit franchise:
 - area development
 - master franchise (sub-franchising)

A **single-unit (direct-unit) franchise** is an agreement where the franchisor grants a franchisee the rights to open and operate ONE franchise unit. This is the simplest and most common type of franchise. It is possible, however, for a franchisee to purchase additional single-unit franchises once the original franchise unit begins to prosper. This is then considered a multiple, single-unit relationship.



A **multi-unit franchise** is an agreement where the franchisor grants a franchisee the rights to open and operate MORE THAN ONE unit.

There are two ways a multi-unit franchise can be achieved:

- ✓ an area development franchise or
- ✓ a master franchise.

Under an **area development franchise**, a franchisee has the right to open more than one unit during a specific time, within a specified area. For example, a franchisee may agree to open 5 units over a five year period in a specified territory.

A **master franchise agreement** gives the franchisee more rights than an area development agreement. In addition to having the right and obligation to open and operate a certain number of units in a defined area, the master franchisee also has the right to sell franchises to other people within the territory, known as sub-franchises. Therefore, the master franchisee takes over many of the tasks, duties and benefits of the franchisor, such as providing support and training, as well as receiving fees and royalties.

WHAT ARE COMMON FRANCHISE TERMS?

business format franchise – this type of franchise includes not only a product, service and trademark, but also the complete method to conduct the business itself, such as the marketing plan and operations manuals

disclosure statement – also known as the UFOC, or Uniform Franchise Offering Circular, the disclosure document provides information about the franchisor and franchise system

franchise – a license that describes the relationship between the franchisor and franchisee including use of trademarks, fees, support and control

franchise agreement – the legal, written contract between the franchisor and franchisee which tells each party what each is supposed to do

franchisee – the person or company that gets the right from the franchisor to do business under the franchisor's trademark or trade name

franchising – a method of business expansion characterized by a trademark license, payment of fees, and significant assistance and/or control

franchisor – the person or company that grants the franchisee the right to do business under their trademark or trade name

product distribution franchise – a franchise where the franchisee simply sells the franchisor's products without using the franchisor's method of conducting business

royalty – the regular payment made by the franchisee to the franchisor, usually based on a percentage of the franchisee's gross sales

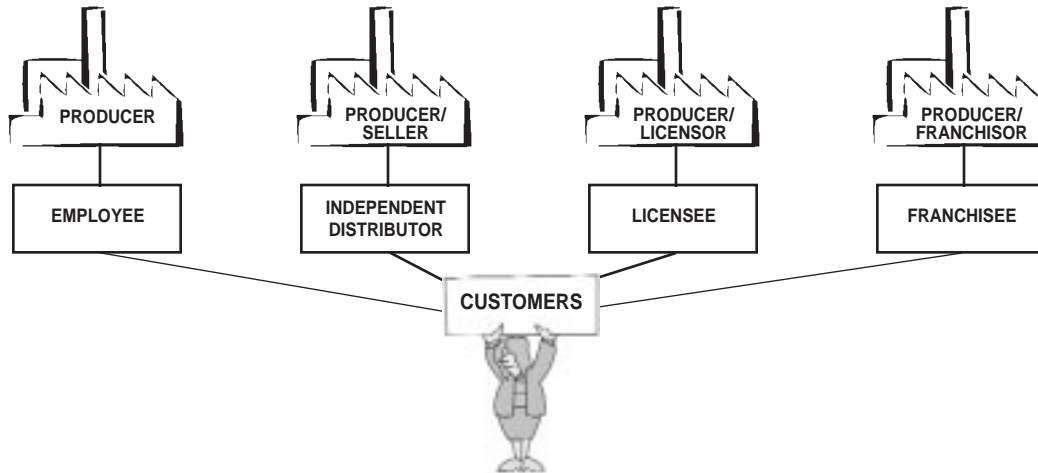
trademark – the franchisor's identifying marks, brand name and logo that are licensed to the franchisee

UFOC – the Uniform Franchise Offering Circular, UFOC, is one format for the disclosure document which provides information about the franchisor and franchise system to the prospective franchisee

WHAT ARE THE ALTERNATIVES TO FRANCHISING?

In addition to franchising, there are two other popular methods by which businesses expand their market and distribution channels:

- ✓ distributorships
- ✓ licensing



In a **distributorship**, the distributor usually:

- has a contractual relationship with the supplier
- buys from the supplier in bulk and sells in smaller quantities
- is familiar with local markets and customers
- may do business with many companies, more than just the supplier/producer
- may not receive contractual support and training from the supplier/producer like a franchisee

Some distribution arrangements are similar to franchises, and vice versa. A franchisee with a great deal of leeway in how to run the business may look like an independent distributor. A distributor may be subject to many controls by the supplier/producer and begin to resemble a franchise.

Some popular distributorships include:

- ✓ Amway
- ✓ Color Me Beautiful Cosmetics
- ✓ Mountain Life Spring Water
- ✓ Knorr Soup Vendor
- ✓ Campbell's Soup Vending Machines

Licensing, on the other hand, allows a licensee to pay for the rights to use a particular trademark. Unlike franchises, in which the franchisor exerts significant control over the franchisee's operations, licensors are mainly interested in collecting royalties and supervising the use of the license rather than influencing the operations of the business. Check out www.licensing.org.

Some popular licensors include:

- ✓ Netscape Communications
- ✓ Apple Computer
- ✓ Canon Inc.
- ✓ Woolmark
- ✓ Compaq Computer



WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF OWNING A FRANCHISE?

The many advantages and disadvantages of owning a franchise should be carefully evaluated before deciding to purchase one.

Advantages:

- ✓ "Owning a franchise allows you to go into business for yourself, but not by yourself."
- ✓ A franchise provides franchisees with a certain level of independence where they can operate their business.
- ✓ A franchise provides an established product or service which already enjoys widespread brand-name recognition. This gives the franchisee the benefits of customer awareness which would ordinarily take years to establish.
- ✓ A franchise increases your chances of business success because you are associating with proven products and methods.
- ✓ Franchises may offer consumers the attraction of a certain level of quality and consistency because it is mandated by the franchise agreement.
- ✓ Franchises offer important pre-opening support:
 - site selection
 - design and construction
 - financing (in some cases)
 - training
 - grand-opening program
- ✓ Franchises offer ongoing support
 - training
 - national and regional advertising
 - operating procedures and operational assistance
 - ongoing supervision and management support
 - increased spending power and access to bulk purchasing (in some cases)

Disadvantages:

- ✓ The franchisee is not completely independent. Franchisees are required to operate their businesses according to the procedures and restrictions set forth by the franchisor in the franchise agreement. These restrictions usually include the products or services which can be offered, pricing and geographic territory. For some people, this is the most serious disadvantage to becoming a franchisee.
- ✓ In addition to the initial franchise fee, franchisees must pay ongoing royalties and advertising fees.
- ✓ Franchisees must be careful to balance restrictions and support provided by the franchisor with their own ability to manage their business.
- ✓ A damaged, system-wide image can result if other franchisees are performing poorly or the franchisor runs into an unforeseen problem.
- ✓ The term (duration) of a franchise agreement is usually limited and the franchisee may have little or no say about the terms of a termination.

WHAT ARE THE LEGAL ISSUES OF FRANCHISING?

A good relationship between the franchisor and franchisee is critical for the success of both parties. Since franchising establishes a business relationship for years, the foundation must be carefully built by having a clear understanding of the franchise program. Unfortunately, understanding the legal language of franchising can be daunting. **The advice of an experienced franchise attorney should be sought to help a prospective franchisee understand the legal issues and to protect them from making costly mistakes.**

Franchising is governed by federal and state laws that require franchisors to provide prospective franchisees with information that describes the franchisor-franchisee relationship.

The two main franchising legal documents are the:

- ✓ the Disclosure Document, which may be in the format known as the UFOC.
- ✓ franchise agreement

The UFOC

The purpose of the UFOC is to provide prospective franchisees with information about the franchisor, the franchise system and the agreements they will need to sign so that they can make an informed decision.

In addition to the disclosure part of the document, the UFOC includes the actual franchise agreement as well as other agreements the franchisee will be required to sign, along with the franchisor's financial statements.

The UFOC is designed to give you some of the information you need in order to make an informed decision about investing in a particular franchise.

By law, a franchisor cannot offer a franchise until the franchisor has presented the prospective franchisee with a Disclosure Document. In fact, 14 states require franchisors to register their UFOCs with the state or to notify them that they will offer franchises before they begin to conduct any franchising activity in the state.

The UFOC includes information about:

- ✓ the franchisor
- ✓ the company's key staff
- ✓ management's experience in franchise management
- ✓ franchisor's bankruptcy and litigation history
- ✓ initial and ongoing fees involved in opening and running the franchise
- ✓ required investment and purchases
- ✓ territory rights
- ✓ responsibilities of the franchisor and franchisee
- ✓ other franchisees in the system with contact information

Receipt of the UFOC is governed by the "ten-day rule." This is a cooling-off period in which franchisors must give prospective franchisees 10 business days to think about their decision before they are allowed to sign the franchise agreement.

The Franchise Agreement

The franchise agreement is more specific than the UFOC about the terms of the relationship between the franchisor and franchisee. A typical franchise agreement may include specifics about:

- ✓ the franchise system, such as use of trademarks and products
- ✓ territory
- ✓ rights and obligations of the parties: standards, procedures, training, assistance, advertising, etc.
- ✓ term (duration) of the franchise
- ✓ payments made by the franchisee to the franchisor
- ✓ termination and/or the right to transfer the franchise

The franchise agreement is the legal, written document that governs the relationship and specifies the terms of the franchise purchase. Like the UFOC, the franchise agreement also enjoys a "cooling off" period. Prospective franchisees are legally entitled to have the final franchise agreement for at least 5 business days before they are allowed to sign. This gives them time to review and consider the terms of the agreement.



Chapter 2:

Beginning Your Search

What are your options when you begin your business?

How do you investigate your options?

How do you investigate a franchise?

What are your criteria for selecting a franchise?

WHAT ARE YOUR OPTIONS WHEN YOU BEGIN YOUR BUSINESS?

Once you make the decision to start your own business, you need to decide whether you want to be an independent business owner or a franchisee.

Options for beginning a business:

- ✓ start a new business
- ✓ buy a new franchise
- ✓ buy an existing franchise

Starting A New Business

Advantages

- + usually lower start-up cost
- + independence and creative freedom
- + freedom with location and procedures
- + no inherited problems from an existing business

Disadvantages

- requires more time and energy
- high risk of failure
- takes longer to become profitable
- financing may be more difficult to obtain



Buying A New Franchise

Advantages

- ◆ reduced risk of failure
- ◆ proven methods and products
- ◆ start-up assistance
- ◆ on-going training and support
- ◆ local, regional and national advertising
- ◆ collective purchasing power
- ◆ research and development
- ◆ association and synergy with other franchisees
- ◆ easier to obtain financing

Disadvantages

- ◆ costs more (fees, royalties, supplies)
- ◆ smaller profit margins
- ◆ lack of independence and freedom
- ◆ difficult to achieve redress if franchisor fails to meet obligations
- ◆ a franchisor's problem may become your problem

Buying An Existing Franchise

Advantages

- ◆ the business is already up and running
- ◆ risk and uncertainty may be reduced
- ◆ the basic infrastructure is in place:
 - ☞ established location
 - ☞ existing customers and reputation
 - ☞ employees
 - ☞ vendors
 - ☞ policies and procedures
 - ☞ cash flow
 - ☞ no start-up period—quicker profitability
 - ☞ easier to obtain financing

Disadvantages

- ◆ tangible limitations:
 - ☞ design problems
 - ☞ location problems
 - ☞ merchandise problems
- ◆ intangible limitations:
 - ☞ customer or employee ill will
 - ☞ pricing problems
 - ☞ inadequate procedures
 - ☞ lease problems
- ◆ potentially higher costs to buy
- ◆ legal liability in inheriting lawsuits

HOW DO YOU INVESTIGATE YOUR OPTIONS?

Regardless of whether you choose to become an independent business owner or become a franchisee, research is the single most important activity in making your decision. Without adequate information, you may end up making the most costly decision of your life.

Steps for beginning a business:

- ✓ What business?
- ✓ Is there a market?
- ✓ Can you afford it?
- ✓ Can you make enough money to make it worthwhile?



What Business Should You Start?

“Find something you love to do and you’ll never have to work a day in your life.”
—Harvey Mackay

Sometimes people start a business because they think they’ll make a lot of money, only to find out that they do not enjoy the business. The adage, “know thyself” certainly applies here. You should start a business in an industry that you will enjoy for the next 10 to 15 years.

Ask yourself:

- ✓ What do you like to do? (interest and hobbies)
- ✓ What do you know how to do? (experience)
- ✓ What do you do well? (special skills and talents)
- ✓ Which industry(s) involve your interests and use your skills and talents?
(For ideas, refer to IFA’s *Franchise Opportunities Guide*’s listing of industries in the table of contents or visit www.franchise.org)
- ✓ What products or services could you sell in this industry(s)?
- ✓ Would you rather sell a product or service?
- ✓ What products or services would you like to sell the most?



Determine If There Is A Market

All successful businesses must:

- ✓ satisfy a need or
- ✓ solve a problem or
- ✓ respond to a trend

Before starting any business, determine if there is a market for your product or service.

Conducting market research:

- ✓ How many potential customers are in your area?
- ✓ Will your product or service sell?
 - What need does it satisfy?
 - What problem does it solve?
 - What trend or fad does it address?
- ✓ What should the appropriate pricing be?
- ✓ Who are your competitors?
- ✓ How many competitors do you have?
- ✓ What do they offer?
- ✓ How will your product or service be unique?
- ✓ What marketing niche can you capture?



Determine If You Can Afford To Start A Business

MAKE PROFIT POTENTIAL YOUR MOST IMPORTANT CONSIDERATION!

In order to start a business, you have to have money!
In order to stay in business, you have to make money!



The single most common reason new businesses fail is that they did not have enough money to begin with! Don't forget the old business adage: *"It takes twice as long and costs twice as much!"*

Costs to consider:

- ✓ Estimate your start-up costs:
 - location design and construction
 - professional fees
 - equipment and fixtures
 - furniture
 - opening inventory and supplies
 - insurance
 - Pre-opening labor
 - Opening advertising and promotion



- ✓ Estimate how much working capital you will need (the money you will need until the business becomes profitable—include your living expenses, if necessary)
 - salaries
 - insurance
 - utilities
 - advertising
 - rent
 - interest on a loan, if applicable



- ✓ Brainstorm where you might be able come up with money:
 - yourself
 - family
 - friends
 - savings and investments
 - a partner
 - selling personal assets
 - loans

Determine If You Can Make Enough Money To Make The Venture Worthwhile

- ✓ Estimate the profit potential for the business:
 - income
 - expenses
 - profit (income – expenses)

- ✓ Think about the amount of time and energy it will take to make the business successful.

- ✓ Make a decision as to whether you think you can make enough money to make the entire venture worth your time and energy!

HOW DO YOU INVESTIGATE A FRANCHISE?

Like starting any business, buying a franchise involves a risk. Studies show that successful franchisees:

- ✓ conduct their own marketing research
- ✓ use their own financial and legal advisors
- ✓ develop thorough marketing and business plans
- ✓ have prior work experience

Prospective franchisees must devote a vast amount of time researching the franchises available and evaluating the strength of the franchisors.

Find out what franchises are available:

- ✓ Read directories:
 - *The Franchise Opportunities Guide*
 - *The Executives' Guide to Franchise Opportunities*
 - *Bond's Franchise Guide*
 - *The Franchise Annual*
 - *Franchise Handbook*
 - *How Much Can I Make?*

- ✓ Read articles and ads in business publications:
 - *Inc.*: www.inc.com
 - *Entrepreneur*: www.entrepreneurmag.com
 - *Franchise Times*: www.franchisetimes.com
 - *Franchising World*: www.franchise.org
 - *Franchise Update*: www.franchise-update.com
 - *The Wall Street Journal*: www.wsj.com
 - *USA Today*: www.usatoday.com
 - *The New York Times*: www.nytimes.com



✓ Attend trade shows and expositions:

- IFE (International Franchise Expo) is sponsored by the International Franchise Association (IFA: 202-628-8000 or www.franchise.org) and is the world's largest gathering of franchise companies.
- The U.S. Small Business Administration and Small Business Development Centers (SBA: www.sbaonline.sba.gov/sbdc/)

✓ Conduct research on the internet:

- Federal Trade Commission — www.ftc.gov/bcp/menu-fran.htm
- Small Business Administration — www.sba.gov
- International Franchise Association — www.franchise.org
- *Entrepreneur Magazine* — www.entrepreneurmag.com
- *Franchise Update Magazine* — www.franchise-update.com
- *IFA Franchise Opportunities Guide* — www.franchise.org
- *Franchise Handbook* — www.franchise1.com
- Source Book Publications — www.worldfranchising.com



Evaluate the strength of the franchisor:

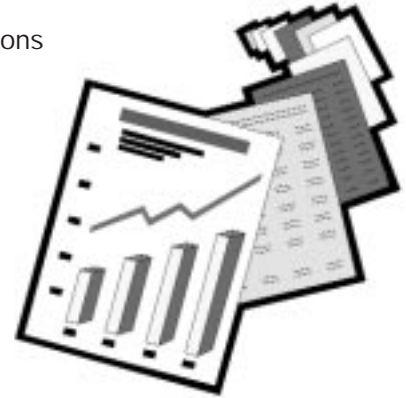
✓ Investigate the franchisor's history:

- How long has the franchisor been in business?
- How many current franchisees are there?
- What is the failure rate of the franchisees?
- Are there any pending or past lawsuits and what have they been for?
- Does the franchisor have a reputation for quality products or services?
- What is the franchisor's financial health (get its Dun & Bradstreet rating)
 - credit rating
 - profitability
 - reputation
- What are the earnings claims and profit projections?
 - On what are they based?
 - Are the projections based on franchisor or franchisee-run units?
 - How long have the units used for projections been in business?
- What is the background of the principals/management?
 - What is their business experience?
 - Have they personally had any bankruptcies?
 - Have they personally had any recent litigation?



✓ Carefully study and obtain professional advice concerning the franchisor's UFOC and franchise agreement, paying special attention to:

- costs
- term (duration of) agreement and renewal provisions and conditions
- termination clauses
- franchise territory
- procedures and restrictions
- training and assistance
- earnings potential - gross sales, net profit
- expansion plans
 - How fast do they plan to grow?
 - Where do they plan to grow?
 - Do they have a business plan for your area of location?
 - What is their analysis of the competition in your area?
 - How many units are being planned for your area? Why that many?
 - How much is going to be spent in regional advertising in your area?



✓ Visit and talk with existing franchisees, emphasizing the:

- level of training
- quality of products or service
- level and promptness of support
- operations and quality of the operations manuals
- earnings potential/claims
- any problems or difficulties with the franchisor

✓ Visit/talk with franchisees who have left the system and find out why they left.

✓ Visit the franchisor's headquarters:

- meet the support team
- review the operations manuals and see if you can sit in on a training class

✓ Go to work in an existing franchise for a couple of weeks and really get to know the:

- system
- manuals
- training program
- support
- earnings potential

✓ Seek the advice of an attorney and accountant who specialize in franchises.



WHAT ARE THE CRITERIA FOR SELECTING A FRANCHISE?

Before buying any business, you must carefully consider many factors that are critical to your success:

- ✓ costs
- ✓ your abilities
- ✓ demand and competition
- ✓ training and support
- ✓ franchisor's experience
- ✓ expansion plans

Costs:

- ✓ How much money will this franchise cost before it becomes profitable?
- ✓ Can I afford to buy this franchise?
- ✓ Can I make enough money to make the investment worth my time and energy?

Your Abilities:

- ✓ Do you have the technical skills or experience to manage the franchise?
- ✓ Do you have the business skills to manage the franchise?

Demand:

- ✓ Is there enough demand in your area for the franchisor's products or services?
- ✓ Is the demand year-long or seasonal?
- ✓ Will the demand grow in the future?
- ✓ Does the product or service generate repeat business?

Competition:

- ✓ How much competition do you have, including other franchisees?
- ✓ Are the competing companies/franchises well established?
- ✓ Do they offer the same products and services at the same or lower prices?
- ✓ Is there a specialty or niche you can capture?

Brand Name:

- ✓ How well known is the franchise name?
- ✓ Does it have a reputation for quality?
- ✓ Have any consumers filed complaints with the local Better Business Bureau?

Training and Support:

- ✓ What kind and how much training and support does the franchisor provide?
- ✓ Do existing franchisees find this level of training and support adequate?

Franchisor's Experience:

- ✓ Has the franchisor been in business long enough to have established the type of business strength you are seeking?

Expansion Plans:

- ✓ Is the franchisor planning to grow at a rate that is sustainable?

Chapter 3:

Navigating the Paper Trail

What are the key subjects in the franchise agreement?

What are the key items in the Disclosure Document (UFOC)?

What do you have to know about financial statements?

Where can I get help?

WHAT ARE THE KEY SUBJECTS IN THE FRANCHISE AGREEMENT?

The franchise agreement is more specific than the UFOC about the terms of the relationship between the franchisor and franchisee.

- ✓ **Use of trademarks.** One of the main benefits you receive when purchasing a franchise is the use of well-known trademarks. This section lists the trademarks, service marks or logos the franchisee is entitled to use.
 - Has the trademark been in operation for a significant amount of time and is it well known?
 - Are there any restrictions on its use by the franchisor or franchisee?
- ✓ **Location of the franchise.** This section describes the exclusive area or territory granted to the franchisee.
 - Do you have exclusive rights in a certain territory?
- ✓ **Term of the franchise.** In this section, the duration of the agreement is specified.
 - How long does the agreement last?
 - Can the franchisor purchase the franchise before the agreement expires?
 - Do you have the right to renew the agreement?
- ✓ **Franchisee's fees and other payments.** In this section, all the mandatory fees are described:
 - initial fee and what the franchisee receives for that fee
 - royalty payment, what it is based on and when it is due



-
- ✓ **Obligations and duties of the franchisor.** This section describes, in detail, all the services which the franchisor will provide:
 - training
 - operations support
 - advertising

 - ✓ **Obligations and duties of the franchisee.** This section describes the franchisee's responsibilities:
 - requirements for training
 - requirements for participation in the business
 - requirements for keeping and submitting adequate records

 - ✓ **Restriction on goods and services offered.** This section describes any restrictions placed on the goods or services offered, including:
 - required quality standards
 - approved suppliers
 - approved advertising
 - hours of operation
 - pricing

 - ✓ **Renewal, termination and transfer of franchise agreement.** This section includes:
 - the rights and obligations of a franchisee upon termination
 - descriptions about the transfer of the franchise agreement
 - descriptions about the renewal of the franchise agreement

**Make sure you hire an experienced
franchise attorney to review the agreement!**



WHAT INFORMATION IS FOUND IN THE DISCLOSURE DOCUMENT (UFOC)?

The purpose of the UFOC is to provide prospective franchisees with information about the franchisor, the franchise system and the agreements they will need to sign so that they can make an informed decision.

The Disclosure Document (UFOC)

- ✓ **Item 1: The franchisor, its predecessor and affiliate.** This section provides a description of the company.

- ✓ **Item 2: Business experience.** This section provides biographical and professional information about the franchisors and its officers, directors and executives.
- ✓ **Item 3: Litigation.** This section provides relevant current and past criminal and civil litigation for the franchisor and its management.
- ✓ **Item 4: Bankruptcy.** This section provides information about the franchisor and any management who have gone through a bankruptcy.
- ✓ **Item 5: Initial franchise fee.** This section provides information about the initial fees and the range and factors that determine the amount of the fees.
- ✓ **Item 6: Other fees.** This item provides a description of all other recurring fees or payments that must be made.
- ✓ **Item 7: Initial investment.** This item is presented in table format and includes all the expenditures required by the franchisee to make to establish the franchise.
- ✓ **Item 8: Restriction on sources of products and services.** This section includes the restrictions that franchisor has established regarding the source of products or services.
- ✓ **Item 9: Franchisee's obligations.** This item provides a reference table that indicates where in the franchise agreement franchisees can find the obligations they have agreed to.
- ✓ **Item 10: Financing Available.** This item describes the terms and conditions of any financing arrangements offered by the franchisor.
- ✓ **Item 11: Franchisor's Obligations.** This section describes the services that the franchisor will provide to the franchisee.
- ✓ **Item 12: Territory.** This section provides the description of any exclusive territory and whether territories will be modified.
- ✓ **Item 13: Trademarks.** This section provides information about the franchisor's trademarks, service marks and trade names.
- ✓ **Item 14: Patents, copyrights and proprietary information.** This section gives information about how the patents and copyrights can be used by the franchisee.
- ✓ **Item 15: Obligations to participate in the actual operation of the franchise business.** This section describes the obligation of the franchisee to participate in the actual operation of the business.

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- ✓ **Item 16: Restrictions on what the franchisee may sell.** This section deals with any restrictions on the goods and services that the franchisee may offer its customers.
 - ✓ **Item 17: Renewal, termination, transfers and dispute resolution.** This section tells you when and whether your franchise can be renewed or terminated and what your rights and restrictions are when you have disagreements with your franchisor.
 - ✓ **Item 18: Public Figures.** If the franchisor uses public figures (celebrities or public persons), the amount the person is paid is revealed in this section.
 - ✓ **Item 19: Earnings claims.** Here the franchisor provides information that a franchisee can use to estimate what can be earned from the business.
 - ✓ **Item 20: List of franchise outlets.** This section provides locations and contact information of existing franchises.
 - ✓ **Item 21: Financial statements.** Audited financial statements for the past three years are included in this section.
 - ✓ **Item 22: Contracts.** This item provides of all the agreements that the franchisee will be required to sign.
 - ✓ **Item 23: Receipt.** Prospective franchisees are required to sign a receipt that they received the UFOC.

WHAT ARE THE KEY ITEMS IN THE DISCLOSURE DOCUMENT?

Item 7: Initial investment.

- ✓ Some of these costs are averages or estimates and may vary in your area.
- ✓ Talk to other franchisees who have been in the system for a year or more to see:
 - how much money they needed in the beginning until they became profitable
 - how much they were able to draw from the business to support themselves

Item 11: Franchisor's obligations.

- ✓ Be sure you understand the services you will get before you open:
 - site selection
 - training
 - development assistance



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- ✓ Be sure you know what services you will receive for your grand opening:
 - marketing
 - advertising
 - field support

 - ✓ Be sure you know what services you will receive after you begin operating your business:
 - training
 - advertising
 - operations

 - ✓ Pay particular attention to those services the franchisor is **obligated to provide** and the services they **may provide**.

Item 17: Renewal, termination, transfers and dispute resolution.

- ✓ Take your time to understand what rights you will have and what rights you are giving up.

- ✓ Pay particular attention to any non-compete provisions and your obligations when the franchise relationship ends.

Item 19: Earnings Claims.

- ✓ Only 20 to 25 percent of all franchisors provide prospective franchisees with information about earnings claims. The next best thing to do is to talk to existing franchisees about earnings potential.

- ✓ Another good source of information is *How Much Can I Make?* by Robert Bond. (800-841-0873 or www.worldfranchising.com).

Item 20: List of franchise outlets.

- ✓ Examine how many units the franchisor has taken back and resold. If this number is high, this could indicate churning (when the franchisor takes back failed locations and remarkets them over and over.)

- ✓ Pay attention to the contact information of the franchisees who have left the system. These are people you definitely want to talk to.

Item 21: Financial statements.

- ✓ Financial statements are the track record of the franchisor. You should be given copies of the franchisor's last two or three years financial statements. Take them to an accountant who specializes in franchising to evaluate.
- ✓ Remember that the financial condition of the franchisor not only affects its ability to run a financially successful operation in the future, but it also determines whether it may go under and you will be left "holding the bag."
- ✓ The two key financial statements to focus on are the balance sheet and the income statement. Make sure they are audited.

Item 22: Contracts.

- ✓ Make sure that all the agreements listed are attached to the UFOC—and read every one of them.

WHAT DO YOU HAVE TO KNOW ABOUT FINANCIAL STATEMENTS?

Financial statements are the track record of the franchise. They are provided for you in the UFOC and contain important information about the franchisor's financial status and strength.



The two most important financial statements you need to review:

- ✓ balance sheet
- ✓ income statement

The Balance Sheet

A balance sheet is a snapshot summary of how much a company is worth on any given day. It reports the financial condition (solvency) of the franchisor.

Balance sheet categories include:

- ◆ assets – what a company owns: current, fixed and intangible assets
- ◆ liabilities – what a company owes: current and long-term debt
- ◆ stockholders' equity – the company's net worth; it is the money the company has taken in from the sale of stock plus any accumulated profits:

$$\text{Stockholders' Equity} = \text{Assets} - \text{Liabilities} = \text{Net Worth}$$

SAMPLE BALANCE SHEET

ABC SLEEPWEAR
Balance Sheet
January, 2000

ASSETS

Current Assets	\$ 6,000
Cash	4,900
Accts. Receivable	8,000
Inventory	200
Prepaid Expenses	
Total Current Assets	\$19,100
Fixed Assets	8,500
Machinery	1,000
Computer/Printer	4,500
Furniture	
Total Fixed Assets	\$14,000
Total Assets	\$33,100

LIABILITIES AND EQUITY

Current Liabilities	\$6,500
Accounts Payable	1,200
Current Long-term Due	1,800
Accrued Expenses	
Total Current Liabilities	\$9,500
Long-Term Liabilities – Note	\$12,500
Stockholders' Equity	\$20,600
TOTAL LIABILITIES AND EQUITY	\$33,100



Things you want to see on a franchisor's balance sheet:

- ◆ increasing assets
- ◆ increasing stockholders' equity
- ◆ more cash than debt
- ◆ amount of current debt < (less than) 1/2 of the total assets
- ◆ amount of current debt < 1/3 of the stockholders' equity

The Income Statement

An income statement reports a company's profit or loss. It shows a company's income, expense and net income—also known as the “bottom line” or earnings.

Other names for an income statement include:

- ◆ Profit and Loss Statement
- ◆ Statement of Income
- ◆ Statement of Operation
- ◆ Statement of Earnings
- ◆ Results of Operations
- ◆ Statement of Consolidated Income

Income statement categories include:

- ◆ revenues
- ◆ costs and expenses: cost of sales, selling, general administrative, interest expenses
- ◆ income before taxes
- ◆ provision for income taxes
- ◆ net income (earnings)
- ◆ net income (earnings) per share

SAMPLE INCOME STATEMENT

ABC SLEEPWEAR
Income Statement
January, 2000

SALES/REVENUES		\$2,670
		1,776
COST OF GOODS		
Merchandise	1,155	
Purchases	610	
Freight	11	
		894
GROSS PROFIT		544
OPERATING COSTS & EXPENSES		
Fixed		
Insurance	26	
Rent	100	
Salaries	310	
Utilities	42	
Variable		
Advertising	24	
Dues	4	
Telephone	24	
Office Supplies	14	
		350
PROFIT (INCOME) Before Taxes		105
TAXES (30%)		\$245
NET PROFIT (NET INCOME) ("The Bottom Line")		

Things you want to see on a franchisor's income statement:

- ◆ increasing profit
- ◆ more revenue derived from royalties and system income than from selling franchises
- ◆ increasing revenue trends, usually > 15%
- ◆ increasing net income trends, usually > 15%
- ◆ increasing net income per share trend, usually > 15%
- ◆ a profitable franchisor!

What you should know about these financial statements:

- ◆ The financial statements should be audited financial statements.
- ◆ The statements should contain two to three years of financial data.

**You should take these to an accountant
experienced in franchising for evaluation!**



WHERE CAN I GET HELP?

- ✓ International Franchise Association (IFA), 202-628-8000, www.franchise.org
- ✓ American Bar Association's Forum on Franchising, www.abanet.org ☞ forums ☞ franchising
- ✓ IFA's Supplier Forum publishes a list of firms that specialize in franchising law, www.franchise.org
- ✓ recommendations from other franchisees