An Introduction to Franchising

IFA EDUCATIONAL FOUNDATION

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An Introduction to Franchising

IFA EDUCATIONAL FOUNDATION

By Barbara Beshel

CHAPTER 1

An Introduction to Franchising

1. What is a franchise?
2. What are common franchise terms?
3. What are the alternatives to franchising?
4. What are the advantages and disadvantages of owning a franchise?
5. 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

FRANCHISE AGREEMENT

FRANCHISOR	FRANCHISEE
Owns trademark or trade name	Uses trademark or trade name
Provides support: • (sometimes) financing • advertising and marketing • training	Expands business with franchisors support
Receives Fees	Pays Fees

TYPES OF FRANCHISES

PRODUCT DISTRIBUTION

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 drinks, automobiles and gasoline.

Some familiar product distribution franchises include:

- Coca-Cola
- Goodyear Tires
- 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 FRANCHISE

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

Some popular business format franchises include:

Fast Food
Wendy's
McDonald's
Hardee's

Retail
Athlete's Foot
Blockbuster Video
Play It Again Sports

Lodging
Comfort Inn
Embassy Suites
Quality Inn

Health & Beauty
Jenny Craig Weight Loss
Great Clips
Pearle Vision, Inc.

Business Services
H & R Block
Signs By Tomorrow
UPS Store

Maintenance
Roto-Rooter
Stanley Steemer
ServiceMaster

Auto
AAMCO
Midas
Budget Rent-A-Car

Education
Sylvan Learning
Huntington
New Horizons

Restaurants
Blimpie
Dairy Queen
Outback Steakhouse

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.

SINGLE-UNIT (DIRECT-UNIT) FRANCHISE

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.

MULTI-UNIT FRANCHISE

- area development
- master franchise (sub-franchising)

A multi-unit franchise is an agreement where the franchisor grants a franchisee the rights to open and operate more than one unit.

AREA DEVELOPMENT 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. The franchisor grants the franchisee exclusive rights for the development of that territory.

MASTER FRANCHISE

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.

Another hybrid-type of multi-unit franchise is an area representative franchise. In this model, the area representative buys a territorial franchise to sell and service unit franchisees in the territory. The area representative does not contract with the unit franchisees (who sign agreements directly with the franchisor), but does receive a portion of the initial fees and ongoing fees paid by the unit franchisee to the franchisor.

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 FDD, or Franchise Disclosure Document, the disclosure document provides information about the franchisor and franchise system

FDD

the Franchise Disclosure Document, FDD, is the format for the disclosure document which provides information about the franchisor and franchise system to the franchisee

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 franchisee

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 marks, brand name and logo that identify a franchisor which is licensed to the 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:

DISTRIBUTORSHIP

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

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

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF OWNING A FRANCHISE?

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 may already enjoy widespread brand-name recognition. This gives the franchisee the benefits of a pre-sold customer base which would ordinarily takes 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
  - 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

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 franchisee 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 DISCLOSURE DOCUMENT (also known as the FDD)

The purpose of the FDD 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 FDD 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 FDD 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 sell a franchise until the franchisor has presented the prospective franchisee with a Disclosure Document. In fact, 14 states require franchisors to register their FDDs with the state or to notify them that they will offer franchises before they begin to conduct any franchising activity in the state.

The FDD 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

WHAT ARE THE LEGAL ISSUES OF FRANCHISING? (continued)

Receipt of the FDD is governed by the "14-day rule." This is a cooling-off period in which franchisors must give prospective franchisees 14 days to think about their decision before they are allowed to sign the franchise agreement.

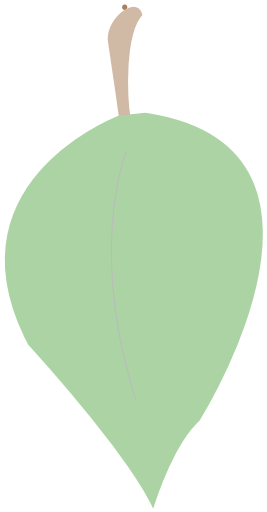
THE FRANCHISE AGREEMENT

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

The franchise agreement includes information 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. A prospective franchisee should closely review the franchise agreement and consult with a professional advisor, like an attorney or an accountant, before making a final decision.



CHAPTER 2

Beginning Your Search

1. What are your options when you begin your business?
2. How do you investigate your options?
3. How do you investigate a franchise?
4. What are your criteria for selecting a franchise?

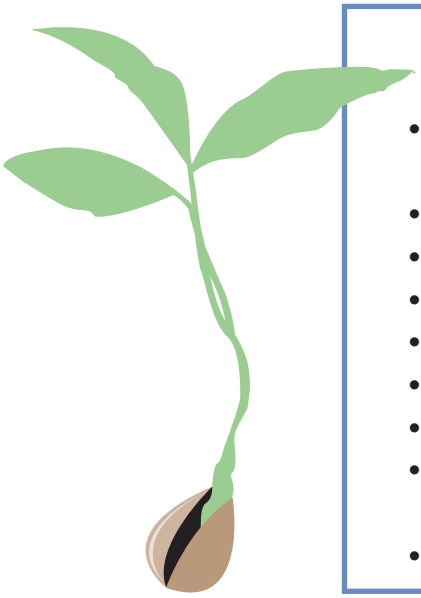
WHAT ARE YOUR OPTIONS WHEN YOU BEGIN YOUR BUSINESS?

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.

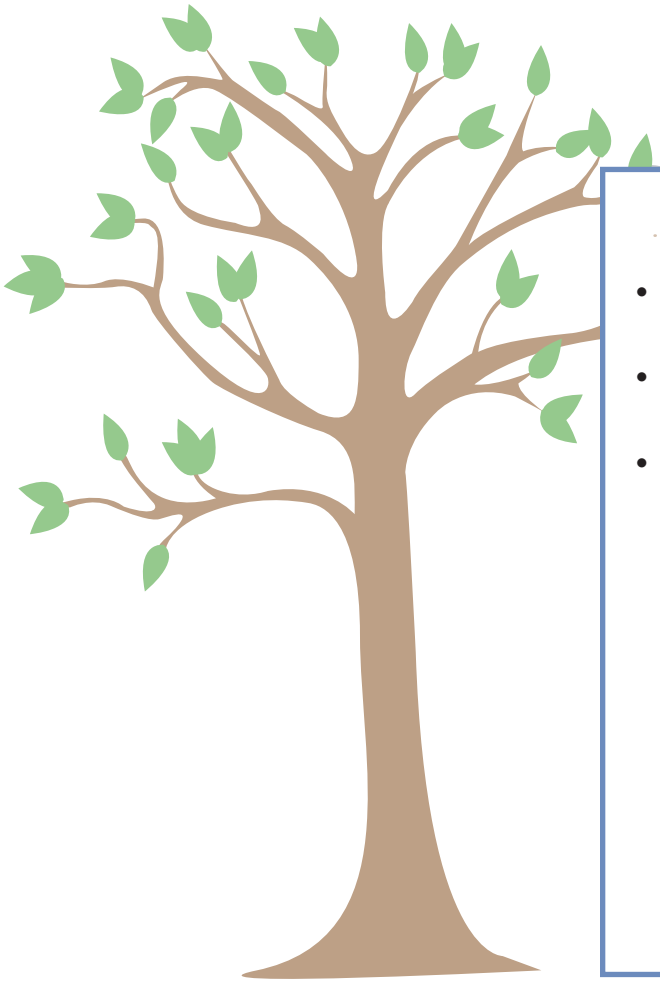
STARTING A NEW BUSINESS

Advantages	Disadvantages
• usually lower start-up cost • independence and creative freedom • freedom with location and procedures • no inherited problems from an existing business	• requires more time and energy • higher risk of failure • takes longer to become profitable • financing may be more difficult to obtain

BUYING A NEW FRANCHISE



Advantages	Disadvantages
• reduced risk of failure over an independent business • 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	• 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	Disadvantages
• the business is already up and running • risk and uncertainty are reduced • the basic infrastructure is in place: - established location - exisiting customers and reputation - employees - vendors - policies and procedures - cash flow - no start-up period– quicker profitability - easier to obtain financing	• 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 remain 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 FRANCHISE

What business?

Is there a market?

Can you afford it?

Can you make enough money to make it worthwhile?

WHAT BUSINESS SHOULD YOU START?

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.)
- 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?

"Find something you love to do and you'll never have to work a day in your life."

-Harvey Mackay

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 in the industry

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

(refer to pages 51 to 55 in *Franchising for Dummies*)

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/)

Research the Internet

- www.franchise.org
- www.franchise.com
- www.franchising.org
- www.aafd.org
- www.franchiseopportunities.com
- www.everyfranchise.com
- www.franchiseamerica.com
- www.franchiseconnections.com
- www.ownyourownfranchise.com
- www.topfranchises.com
- www.worldfranchising.com
- www.franchisedoc.com
- www.franchiseregistry.com
- startup.wsj.com
- www.bison.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 financial performance representations?
  - On what are they based?
  - Are the projections based on franchisor or franchisee-run centers?
  - How long have the centers 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?

Obtain Professional Advice Concerning the Franchisor's FDD and Franchise Agreement

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

Paying special attention to:

- costs
- agreement life and renewal provisions and conditions
- termination clauses
- franchise territory (if any)
- procedures and restrictions
- training and assistance
- financial performance 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 or location?
  - What is their analysis of the competition in your area?
  - How many units are being planned for your area?
  - How much is going to be spent in regional advertising in your area?

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
- financial performance history/claims
- any problems or difficulties with the franchisor

Visit with Existing Franchisees

- 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

Work in an Existing Franchise

Get to know the system, manuals, training program, support, earning potential, etc.

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

- 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 & 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

1. What are the key subjects in the franchise agreement?
2. What information is found in the Disclosure Document (FDD)?
3. What are the key items in the Disclosure Document (FDD)?
4. What do you have to know about financial statements?
5. Where can I get help?

WHAT ARE THE KEY SUBJECTS IN THE FRANCHISE AGREEMENT?

The franchise agreement is more specific than the FDD 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 the franchisee's responsibilities:

- requirements for training
- requirements for participation in the business
- requirements for keeping and submitting adequate records

Make sure you hire an experienced franchise attorney ro review the agreement.

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

WHAT INFORMATION IS FOUND IN THE FDD?

The purpose of the FDD 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. (Refer to pages 83 to 91 in *Franchising for Dummies*.)

THE DISCLOSURE DOCUMENT (FDD)

Item 1: **The franchisor** and any parents, predecessors and affiliates. This section provides a description of the company and its history.

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 fees.** 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.** This item describes the terms and conditions of any financing arrangements offered by the franchisor.

Item 11: **Franchisor's Assistance, Advertising, Computer Systems and Training.** 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: **Obligation 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.

Item 16: **Restrictions on what the franchisee may sell.** This sections deals with any restrictions on the goods and services that the franchisee may offer its customers.

Item 17: **Renewal, termination, transfer 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: **Financial Performance Representations.** Here the franchisor is allowed, but not required, to provide information on unit financial performance.

Item 20: **Outlets and Franchisee Information.** 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: **Receipts.** Prospective franchisees are required to sign a receipt that they received the FDD.

WHAT ARE THE KEY ITEMS IN THE FDD?

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

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, transfer 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:

Financial performance representations.

Only 30 to 40 percent of all franchisors provide prospective franchisees with information about financial performance. The next best thing to do is to talk to existing franchisees about sales and 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:

Outlets and franchisee information.

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 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 FDD—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 FDD 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:

Stockholder's Equity = Assets – Liabilities = Net Worth

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

Sample Balance Sheet

ABC Sleepwear
Balance Sheet
January, 2010

ASSETS	
Current Assets	$6,900
Cash	$4,900
Accounts Receivable	$8,000
Inventory	$200
Prepaid Expenses	
Total Current Assets	$20,000
Fixed Assets	$8,500
Machinery	$1,000
Computer/Printer	$4,500
Furniture	
Total Fixed Assets	$14,000
Total Assets	**$34,000**
LIABILITIES AND EQUITY	
Current Liabilities	$6,500
Accounts Payable	$1,200
Current Long-Term Due	$1,800
Accrued Expenses	
Total Current Liabilites	$9,500
Long-Term Liabilities – Note	$12,500
Stockholder's Equity	$12,000
Total Liabilities and Equity	**$34,000**

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

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 three years of financial data (unless the franchisor has less than 3 years of operating history).

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

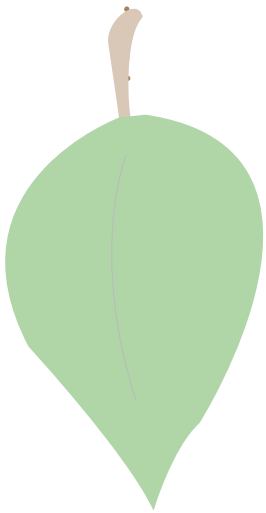
Sample Income Statement

ABC Sleepwear
Income Statement
January, 2010

SALES/REVENUE	$2,600
COST OF GOODS	$1,776
Merchandise	$1,155
Purchases	$610
Freight	$11
GROSS PROFIT	$824
OPERATING COSTS AND EXPENSES	$544
Fixed	
Insurance	$26
Rent	$100
Salaries	$310
Utilities	$42
Variable	
Advertising	$24
Dues	$4
Telephone	$24
Office Supplies	$14
PROFIT (INCOME) BEFORE TAXES	$280
TAXES (30%)	$84
NET PROFIT (NET INCOME) ("The Bottom Line")	**$196**

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
- Directory of Franchise Attorneys, www.franchise-update.com
- IFA's Council of Franchise Suppliers (CFS) publishes a list of firms that specialize in franchising law, www.franchising.org
- recommendations from other franchisees



CHAPTER 4

Evaluating a Franchise-Interviewing Both Sides

1. What should I ask the franchisor?
2. What should I ask the franchisees?
3. What questions should I ask myself before buying a franchise?
4. What are the keys to franchise success?

WHAT SHOULD I ASK THE FRANCHISOR?

ABOUT THE FRANCHISOR:

- Who owns the trademarks, service marks, etc., and are they federally registered?
- Are there any disputes pending or threatened against the trademarks?
- Has the franchisor complied with the FTC and state disclosure laws?
- Are any senior management or key personnel leaving the system?
- Does this company compete with the franchisees in the marketplace?
- Will the franchisor finance any of the costs?
- Is the franchisor willing to negotiate the terms of the franchise?
- Does the franchisor staff attend seminars on franchising and management?
- Do field consultants offer help and guidance or merely act in a regulatory role?
- How many franchises are expected to be added each year?
- Where will they be located?
- What is the success rate of existing franchises?
- What method is used to protect franchisees from poorly performing franchises?
- Is there a franchise owners association?
- Is there a franchise advisory council?

ABOUT COSTS:

What is the total investment required to own a franchise?

- franchise fee
- furniture, fixtures and equipment
- leasehold improvements
- lease deposits
- other deposits
- franchise training
- travel expense
- supplies
- advertising and brochures
- grand-opening advertising
- inventory
- pre-opening staff costs
- working capital until breakeven
- working capital – living expenses
- other

What are the continued financial costs, the basis used for calculation, method of payment and frequency of payment?:

- royalties
- advertising

Must the franchisee purchase products or services from the franchisor?:

- Does the franchisor earn income on purchases?
- How much does the franchisor earn?
- How are the products distributed?
- How long does it take for the orders to be filled?
- What other initial or continuing services does the franchisor provide? What do these cost?

ABOUT CONSUMER RESEARCH AND MARKETING:

- What type of consumer research has the company conducted?
- What were the results?
- Has the franchisor conducted any market studies on the territory to ensure that it can support a franchise?
- What are the demographics required to support a franchise?
- What are the traffic counts required to support a franchise?

ABOUT TRAINING:

- What are the location, duration and additional costs of initial training?
- Who must attend the training?
- What is the cost of additional staff attending training?
- What is the training curriculum?
- Who conducts the training and what are their backgrounds?
- Who pays for transportation, room and living expenses?
- Does the franchisor provide training materials for training new staff in addition to the operations manuals?
- Does the franchisor provide hands-on assistance during the pre-opening, grand opening and initial period? Of what type, duration and cost?

ABOUT PRODUCTS AND SERVICES:

- Are there any new products or services under consideration for addition to the franchise?
- When are they going to be introduced?
- What is the estimated additional cost for adding the new products or services?
- Are there any restrictions on the distribution or sale of the product?
- Is there a guarantee or warranty program? How is it administered and what is the cost?
- Is there a minimum that must be purchased?

ABOUT OPERATIONS:

- What are the roles and responsibilities of the field staff?
- How many locations does each franchise consultant work?
- What is the background of the franchise consultant I will be working with? Can I meet that person before purchasing the franchise?
- How often does the field staff visit a franchisee's location?
- What is the additional cost of field services if the franchisee requires it?
- Exactly what kind of assistance is given?
- What kind of supervision or quality control is there?
- What, if any, is the charge for assistance?
- What kind of business management systems are provided to boost sales and profits?

ABOUT ADVERTISING AND MARKETING:

- What type of consumer advertising does the company recommend?
- What types of cooperative advertising programs are being used?
- What percentage of sales is recommended or required for advertising or marketing?
- How do the franchisees obtain their sales leads or customers?
- What is the franchisor's national/regional advertising program and budget?
- What portion of the national/regional advertising contribution is used for administrative/corporate/agency expenses and fees?
- What are the primary advertising/marketing vehicles?
- What is the grand opening advertising program and cost?

WHAT SHOULD I ASK THE FRANCHISEES?

ABOUT THE FRANCHISOR:

- How much support do you get?
- Are you satisfied with the franchisor?
- Is the franchisor fair and easy to work with?
- Does the franchisor listen to your concerns and accept input from the franchisees?
- Have you had any disputes and, if so, were you able to settle them?
- Do you know of any trouble the franchisor has had with other franchises, competitors or the government?
- Has the franchisor kept its promises?

ABOUT COSTS:

- Is your franchise profitable?
- What are your gross revenues?
- What have your pre-tax profits been for the past three years?
- What is your salary?
- How is your cash flow?
- Were the franchisor's start-up costs and working capital requirements accurate?
- Were the franchisor's profit projections and earnings claims accurate?
- How long did it take you to break-even?
- Have you made the profit you expected to make?

ABOUT TRAINING:

- Was the training by the franchisor adequate?
- Was the training by the franchisor effective?

ABOUT PRODUCTS AND SERVICES:

- Is the product or service you sell of good quality?
- Is delivery of goods from the franchisor adequate?
- Are you getting supplies cheaper from the franchisor than you could on your own?
- What does the franchisor supply?

ABOUT ADVERTISING AND MARKETING:

- How much do you spend on advertising a month?
- How effective is the regional or national advertising?
- Do you think you are getting good value for your advertising dollars?
- Are you satisfied with the marketing and promotional assistance the franchisor has provided?

ABOUT OPERATIONS

- How effective are the operational procedures?
- Have the operations manuals helped you?
- What do you think of the manuals?
- Are the manuals updated on a regular basis?
- What did you do before you bought the franchise?
- Describe your day.
- How many hours a day do you work?
- How many hours a week do you work?
- How much freedom do you have to make decisions?
- Are you happy with your investment?
- Are you disappointed in any aspect of the business?
- Is there anything about the business you do not like?
- What do you like most about the business?
- What kind of problems do you encounter?
- What do you like least about the business?
- Would you do it again?
- Would you recommend I buy a franchise?

WHAT QUESTIONS SHOULD I ASK MYSELF BEFORE BUYING A FRANCHISE?

There are three main sets of questions you should ask yourself:

Do I have what it takes to start my own business/be an entrepreneur?

Do I have what it takes to be a franchisee?

Do I have all the answers I need about the franchise I am considering buying?

DO I HAVE WHAT IT TAKES TO START MY OWN BUSINESS/BE AN ENTREPRENEUR?

So you want to be an entrepreneur? You're not alone! Consider these statistics:

- 55% of all Americans want to be their own boss.
- 37% of all households are involved in small business.
- 70% of all high schools students want to start a business.
- 1 out of every 25 adults is currently starting a business.
- 5 million people started a business in 1995.
- By 2000, there will be 200 million home-based businesses.

An entrepreneur is defined as:

- "One who pursues opportunity beyond the resources currently controlled."
- "A person who sees an opportunity and creates an organization to pursue it."
- "A dreamer who attempts to turn an idea into a profitable reality."
- "Anyone who assumes the risk and responsibility for starting and managing a business."
- "Anyone who takes the risk of starting a business for the purpose of making a profit."

Entrepreneurs have a different way of looking at life:

Opportunity	INSTEAD OF	Security
Results	INSTEAD OF	Routine
Profit	INSTEAD OF	A Paycheck
Trying New Ideas	INSTEAD OF	Avoiding Mistakes
Vision	INSTEAD OF	Short-Term Gain

The advantages of being an entrepreneur:

- freedom and independence
- control over a major aspect of your life
- an outlet for creativity
- excitement

- satisfaction and sense of achievement
- self-esteem
- status and recognition
- flexibility
- job security—you cannot be fired or laid off
- unlimited income potential
- growth of initial monetary investment

The disadvantages of being an entrepreneur:

- risk
- responsibility and pressure
- fear of failure
- obstacles and frustration
- loneliness
- more work
- longer hours
- less time or energy to spend with friends and family
- less financial security
- fewer job benefits
- risk of losing investment
- income fluctuation
- you are responsible for your own portion of taxes and FICA

Entrepreneurial self-assessment:

Starting a successful business takes a tremendous amount of energy and certain personal characteristics. Read each of the characteristics below and circle the number that most accurately describes your entrepreneurial potential on a scale of one to ten. (1 is low, 10 is high)

Characteristic	Description	Your Tendency (low to high)
Motivation	drive, energy to succeed	1 2 3 4 5 6 7 8 9 10
Enthusiasm	excited involvement	1 2 3 4 5 6 7 8 9 10
Risk-taker	willing to take chances	1 2 3 4 5 6 7 8 9 10
Confidence	sure of your own abilities	1 2 3 4 5 6 7 8 9 10
Competitiveness	wanting to win	1 2 3 4 5 6 7 8 9 10
Perseverance	refusal to quit a task	1 2 3 4 5 6 7 8 9 10
Creativity	imaginative thinking	1 2 3 4 5 6 7 8 9 10
Organization	keeping things in order	1 2 3 4 5 6 7 8 9 10
Vision/leadership	knowing where you want to be	1 2 3 4 5 6 7 8 9 10
Persuasiveness	ability to convince others	1 2 3 4 5 6 7 8 9 10
Honesty	truthfulness	1 2 3 4 5 6 7 8 9 10
Adaptability	can handle new situations	1 2 3 4 5 6 7 8 9 10
Understanding	can sense peoples' feelings	1 2 3 4 5 6 7 8 9 10
Self-discipline	sticking to a plan or schedule	1 2 3 4 5 6 7 8 9 10
Independence	belief in oneself	1 2 3 4 5 6 7 8 9 10
Purposefulness	doing things for a reason	1 2 3 4 5 6 7 8 9 10
Goal-oriented	work steadfastly toward a goal	1 2 3 4 5 6 7 8 9 10
Problem-solver	think of solutions to problems	1 2 3 4 5 6 7 8 9 10
Drive	desire to work hard	1 2 3 4 5 6 7 8 9 10
Optimism	positive attitude	1 2 3 4 5 6 7 8 9 10

Date_____ Total Score_____

Your score is an indication of the extent to which you possess personal characteristics similar to those of successful entrepreneurs.

The Probability of Your Entrepreneurial Success

A Score of 160-200

You possess very strong entrepreneurial characteristics. You will probably find entrepreneurship a very desirable, exciting and fulfilling way of life.

A Score of 120-159

You are mildly entrepreneurial. You may find entrepreneurship desirable and stimulating, but may have to develop your entrepreneurial abilities through training.

A Score of 120 and Below

You will probably find entrepreneurship undesirable and difficult. You will probably be more successful working for someone else, although you can still develop your entrepreneurial abilities. So, if you are determined to start your own business, don't give up!

Making a decision to start your own business isn't just about numbers. It's about you…your lifestyle, family, likes and dislikes, work habits, values, ethics and dreams. You need to honestly define who you are and what you want—your future depends on it!

Questions to ask yourself:

- Do you have the personal drive to be a successful entrepreneur?
- Are you willing to work whatever hours it takes to make your business a success?
- Are you willing to give up the perks of being an employee to invest and run your own business?
- Are you self-reliant?
- Can you work without support?
- Are you healthy?
- Do you have the physical ability to meet the needs of operating on your own?
- Can you handle stress?
- Do you have the mental ability to meet the everyday needs of operating your own business?
- Can you handle crisis situations and deadlines?
- Do you like people?
- Do you listen well?
- Do you have patience when working and interacting with others?
- Do you communicate well?
- Can you be a leader and a trainer for your staff as well as a front person for your business?
- Can you maintain a positive relationship with the people who work for you?
- Can you meet the needs of your customers?
- Do you have the ability to sell—yourself and your products and services?
- Can you afford to start your own business?
- Do you have the support of your family and friends?

DO I HAVE WHAT IT TAKES TO BE A FRANCHISEE?

Once you have determined that you have the abilities, skills and desire to start you own business, you have to further determine if you have the requisite traits to become a franchisee.

- Can you follow someone else's rules, even when you think you have a better way?
- Are you prepared to accept coaching and advice on how to run your business from a franchisor's field and headquarter's staff?
- If the franchisor turns down your great idea for changing the system, can you live with that?
- Can you trust that a franchisor is working for the benefit of the entire system—even when their decisions do not necessarily go your way?
- Are you willing to share financial information and prepare required reports each month?
- Are you willing, able and eager to learn new skills?
- Can you set aside old habits and beliefs to follow a franchise system?

DO I HAVE ALL THE ANSWERS I NEED ABOUT THE FRANCHISE I AM CONSIDERING BUYING?

Do you know the franchisor?
Have you spent enough time finding out about the franchisor from:

- other franchisees?
- the International Franchise Association?
- the franchisee's owners association
- the franchise advisory council

Can you afford a franchise?

- How much do you have to invest?
- How much can you risk losing?
- How much do you need to live on?
- What is the total investment required for getting into the franchise?
- What portion of the investment can be financed?
- Can you find anyone willing to invest in you and your future?
- How much can you earn as a franchisee?
- How long will it take to breakeven?
- What return can you get on your investment?
- Can you get a better return from another investment?
- Are the risks equal?
- Is your research thorough? (Have you researched the industry, the franchisor, the disclosure documents, and talked with current and former franchisees?)
- Have you gotten the assistance of professional advisors who are familiar with franchising?
- Have you made a slow and detailed evaluation of the opportunity to determine if it will meet your personal and financial goals?

Do you understand the terms of the contract?

- Have you thoroughly read the FDD and the franchise agreement?
- Have you had all your questions satisfactorily answered?
- Have the promises which the franchisor made during your discussions been included in the agreement?
- Have you had a qualified, experienced franchise attorney review the documents?
- Have you had a qualified, experienced accountant, familiar with franchising, review the documents?

Are the other franchisees happy with their investments?

- Have you talked with and visited other franchisees?
- Have you worked at a franchise location to get a better feeling if this is the right decision?
- Have you contacted the franchise owners association and talked with the president?
- Have you talked with the director of the franchise advisory council?

Does the franchisor have a history of litigation?

- Are other franchisees constantly bringing lawsuits against the franchisor?
- Is there anything about the franchisor's litigation history that causes you concern?
- Have you discussed these concerns with the franchsior's management and the leadership of the franchisee owners association or franchisee advisory council?

Can you make enough money with this franchise? Ask other franchisees:

- Are you making money with the franchise investment?
- How long did it take you to breakeven?
- How long before you started to make money?
- Was the investment estimate the franchisor gave you accurate? If not, how much more money did you need?
- Was the estimated working capital accurate? How much did you need to have and how long before you could take money out of the business to live on?
- Are there any mistake you made in starting up the franchise that cost you money? How can I avoid the same problem?

Is the franchisor making money and where is the money coming from?

- If the franchisor has been in business awhile, is their business being supported by continuing royalties or is it coming mostly from initial franchise fees?
- Is the franchisor profitable?
- Is the franchisor on firm financial ground?

Does the franchisor understand franchising?

- Does the franchisor have adequate staff, resources and trained personnel to meet its commitment to you?
- Do you feel the franchisor has the appropriate temperament to operate a franchise system?
- Does the franchisor staff attend seminars on franchising and management? Do they know about the latest changes in the industry? Are they active in trade associations for their specific industry and are they active in the International Franchise Association?
- Has the franchise been growing? Are new locations being added on a regular basis? How many locations closed in the last year? Why did they close?
- Are the sales within individual stores increasing?
- Does the franchisor have an active research and development department that introduces new products and services?
- Do the field staff act as consultants and advisors or do they act as police personnel (inspecting franchises and writing up violations, but not offering help and guidance?)

What are the keys to franchise success?

Making any business reach its full potential takes talent. If you've selected your franchise well, your franchisor will be able to help you avoid many of the mistakes new, independent start-up businesses make. Here are some keys for franchisee success.

Make sure you have enough money.

- Determine how much you have to invest, how much you're willing to risk and how much you will need to live on for at least 12 months.
- Make sure you understand the initial investment required.
- Make a careful and rational decision about buying the franchise. Listen to your attorney and accountant and do not be pressured by the franchise salesperson.

Follow the system.

- Franchisees often get their business up and running and then begin to change, add or modify existing products, advertising, hours, services and even the quality and consistency they are licensed to deliver. This violates the franchise agreement and puts you in jeopardy of having your franchise terminated!
- By following the system, you:
  - preserve the brand
  - protect your investment and that of your fellow franchisees

Don't neglect your family and friends.

- Be prepared to work long hours, but also make sure to budget time for your family and friends.
- Don't forget to acknowledge the sacrifices your family makes.
- Allow your family and friends to share in your new life.

Be an enthusiastic franchisee.

- The success of any business is linked to the level of enthusiasm you bring to the job.
- Enthusiasm brings a level of excitement and energy to the operation that everyone can feel—including your customers and staff.
- Let your staff in on the fun. Acknowledge their good work with recognition or a raise.

Recruit the best and treat them with respect.

- Good help is hard to find—great help is essential.
- To keep the good staff you've hired:
  - Rotate routine and boring jobs.
  - Be fair. Don't show favoritism.
  - Work with your staff to develop the schedule.
  - Treat your employees with respect. Don't allow employees to be disrespectful to any other employee.
  - Keep employees informed of new marketing and other promotions.
  - Remove hassles—ask employees which procedures are working and which aren't.
  - Make their workdays challenging.
  - Provide timely performance reviews and wage or salary increases.

Teach your employees.

- In franchising, training should be continuous. Employees are your front line.
- Training classes are a good way to show your employees that they matter to you.
- Get all the training you can from the franchisor.
- Regularly train and retrain all your employees.
- Hold refresher and advanced classes on a regular basis.
- Alert your franchisor when you need additional training.
- Take advantage of every training opportunity, whether it's offered by the franchisor or by local schools, trade associations and other sources.

Give customers great service.

- The most important thing you can do is to get everyone to smile!
- Let the customer know you're happy they chose your business.

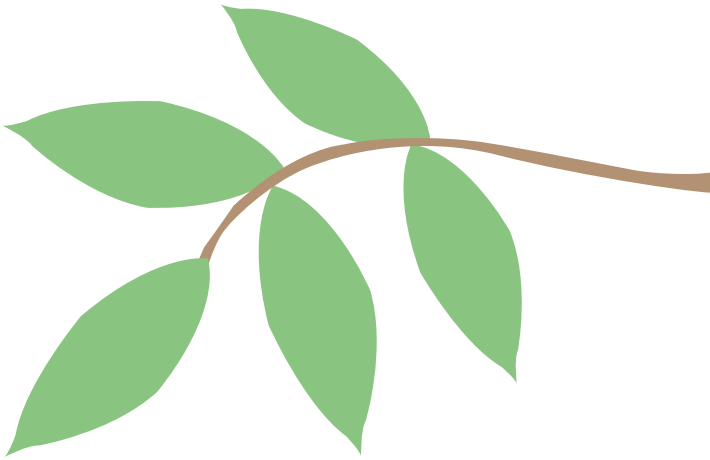
Get involved with the community.

Customers like to shop in places that support them:

- sponsor Little League team
- support a civic or youth group
- give tours of your business for school groups
- set up a kiosk at community events

Stay in touch with your franchisor and other franchisees:

- Stay in communication with the franchisor: letters, newsletters, emails, phone calls, faxes, training classes, regional meetings, conferences and conventions
- Communicate with other franchisees by participating in the franchise owners association.

Watch the details.

- Success is in the pennies! If you watch your pennies, the dollars will take care of themselves.
- Minimize costs and maximize sales.
- Watch out for shrinkage (merchandise that is missing or unaccounted for).
- Work hard every day. Choose your time away from the franchise wisely.