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Buying a Franchise





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What is it?

If you would like to work for yourself but would rather not start your own business, then purchasing a franchise might be a solution. Though far from simple, franchising permits you, the franchisee, to own a business with both a proven method of operation and a familiar name and trademark. That is, broadly, the definition of a franchise. The following discussion explores the advantages and disadvantages of franchise ownership, the preselection process, and the method by which you might select the franchise that's right for you.

Advantages of franchise ownership

Is franchise ownership right for you? To answer this question you'll need to know, among other things, what franchise ownership offers and what it does not. Remember, however, that the decision of whether the advantages of franchise ownership outweigh the disadvantages is a personal one.

Managerial assistance provided

Most franchisors offer managerial assistance to franchisees. Their general business knowledge can be an invaluable source for franchisees. This expertise, indispensable to inexperienced entrepreneurs, can sometimes mean the life or death of the business. Therefore, with help from your franchisor, you will likely make fewer mistakes than if you had started your own business. As a result, your chances for success will likely increase. Indeed, franchisees often fare much better than entrepreneurs who start a business from scratch.

Business "goodwill" and a trusted product or service

Most franchisors have been in business for some time. Their product or service has been tested in the marketplace and has succeeded. Local, regional, or national consumers are familiar with it. Suppliers, employees, lenders, and others (upon whom survival of the company may depend) respect it.

Greater purchasing power

Franchisors usually restrict franchisees from buying supplies from anyone else. Franchisors can therefore employ group purchasing power to buy lower-cost items. Usually, this savings is passed on to you, the franchisee.

Proven operating system

Especially attractive are the proven operating systems of a franchise. Ideally, these systems have been established and refined over the years. The more franchises that are operating, the more highly refined the franchisor's operating systems are likely to be.

Professional advertising

As a franchisee, you will typically pay a small percentage of your gross income for advertising expenses. The franchisor combines this money with contributions from other franchisees to conduct professional advertising campaigns, usually on a national or regional level. In addition, the franchisor is available for advice should you wish to advertise locally.

Financial assistance

Some franchisors will assist you in obtaining financing for your franchise. The franchisor will likely have established relationships with lending institutions, which may, because of that relationship, be inclined to lend money to you. Though you will ultimately be responsible for repaying the debt, the franchisor's involvement may facilitate the lending process.

Disadvantages of franchise ownership

Fees



In exchange for your franchise, the franchisor may require you to pay the following fees:

- **Franchise fee.** A franchise fee is a one-time, nonrefundable payment to the franchisor. The fee charged depends on the franchisor, and can range from a few thousand dollars to several hundred thousand dollars or more. In addition, you might have to dole out funds to rent, build, renovate, or equip your franchise, as well as to acquire your initial inventory, licenses, and insurance.
- **Royalty fees.** This fee, usually a percentage of your weekly or monthly gross income, represents your continued payments for the use of the franchise name. Keep in mind that royalty fees must be paid regardless of how meager your income, and notwithstanding that the franchisor may have failed to provide promised services.
- **Advertising fees.** You will likely be required to contribute to an advertising pool. As a franchisee, you should inquire as to the allocation of these funds. How much is spent on administrative costs? Will you and other franchisees exercise any control over how advertising dollars are spent? How much is spent in your area, on national advertising, on regional advertising, or on selling more franchises?

Control by franchisor

For the sake of uniformity among all outlets, franchisors often exercise significant control over franchisees. The extent of such control varies, but it usually includes the following:

- **Appearance.** The franchisor may dictate how your outlet should appear, both internally and externally. Some may even require occasional modifications. Keeping pace with standards of appearance can therefore be a significant expense.
- **Restrictions on goods/services sold.** The franchisor will likely restrict the goods or services you can sell. This restriction will disallow any product or service additions regardless of the potential for profit.
- **Operational restrictions.** The franchisor will have an established method of operation from which you will not be permitted to deviate. The franchisor may require that you purchase supplies from a particular supplier, hire employees in accordance with its hiring policies, operate your outlet during specified hours, hang only preapproved signs, or issue your employees standard uniforms. These restrictions may restrain you from operating your franchise as you see fit.
- **Selling restrictions.** The franchisor may prohibit sales beyond a specified territory. These restrictions usually ensure that other outlets will not compete with yours, but they prohibit expansion — not a good thing if your territory is minimally profitable.
- **Business location.** The franchisor may reserve the right to disapprove of the site you choose for your franchise, or may pick the location outright.

Renewal of franchise

Franchise contracts are for a limited time only. Because there is no guarantee that the contract will be renewed, you may be denied renewal once that time has expired. This is not a very pleasant thought, especially if your outlet has become very profitable. Even if your contract is renewed, your franchisor can impose higher fees or more severe restrictions.

The preselection process

Before choosing a franchise, consider your interests, experience, knowledge, and personality. Though your franchisor will likely offer managerial support and training, you will likely be more successful if you have an interest in, or experience with, the business in which your chosen franchise operates. For example, a former restaurant manager would likely be more successful if he or she acquired a fast-food restaurant rather than, perhaps, a muffler shop.

Available opportunities

According to the U.S. Census Bureau, in 2012, there were more than 500,000 franchise businesses in the U.S.¹ For information on franchise opportunities, contact these sources:

- The International Franchise Association (www.franchise.org)
- The Small Business Administration (www.sba.gov/content/franchise-businesses)
- The U.S. Census Bureau (www.census.gov/econ/census/resources/organization_media_resources/data.html)

Selecting a franchise



When you have chosen one or more franchises in which you are particularly interested, you'll need to examine each more closely. Your examination should include a careful review of the franchisor's Uniform Franchise Offering Circular (UFOC) — a document containing information that the franchisor is required by law to provide to you before you sign a contract. In addition, you should investigate the franchisor's credibility by contacting other franchisees and any consumer agency that compiles information that can help in this regard (e.g., the Better Business Bureau). Last but not least, you should assemble a team of professionals (e.g., a lawyer and an accountant) to assist you each step of the way. The following checklists are provided as a guide.

Request a copy of each franchisor's Uniform Franchise Offering Circular (UFOC)

This document contains information that the franchisor is required by law to deliver to potential franchisees prior to the signing of a franchise contract. (Some franchisors may require, however, that they conduct an initial review of your qualifications prior to providing you with a UFOC.) The UFOC should:

- Name the franchisor and his or her affiliates, as well as the franchisor's key employees (directors, officers, managers)
- Describe the business experience, as well as any litigation history and bankruptcies, of the franchisor and his or her key employees
- Provide the financial statements of the franchisor
- Specify the costs (franchise fee, royalty fees, costs for licenses, advertising, insurance, employee benefits, etc.)
- Spell out the restrictions to which you will be subjected as franchisee (e.g., territorial restrictions, or restrictions on the types of goods sold and from whom purchased), as well as the extent to which you are required to participate in franchise operations
- Detail any financial, managerial, training, building construction, or site-location assistance offered by the franchisor
- Identify the conditions under which the franchise can be terminated, modified, renewed, or transferred to a third party
- Note the number of franchises that currently operate, are projected for the future, have been terminated, have not been renewed, and have been purchased back by the franchisor
- Substantiate any claims regarding the expected earnings as a franchisee that the franchisor may have made to you
- Include the names and addresses of other franchisees

Examine the UFOC and consider

- The experience of the franchisor and his or her key employees
- The demand for the franchisor's product or service
- The number of franchises operating versus those no longer in operation
- The level of competition from other companies, fellow franchisees, and franchisor-owned outlets
- How long the franchisor has been operating
- The franchisor's financial stability
- The extent and quality of training, and any managerial, financial, site-location, and building construction assistance offered
- Any projected operating losses of the franchise
- Potential profits of the franchise
- The reputation of the franchisor among franchisees
- The franchisor's ability to continue to support its franchisees as they grow

Contact other franchisees and ask

- What did they do prior to acquiring the franchise?
- How long have they operated the franchise?
- What was their total investment?
- Were all of the costs and fees disclosed up front?
- How long did it take to realize a profit?
- Are they completely satisfied with the goods or service they sell?
- What do they think about the training and other assistance offered by the franchisor? Was it adequate?



- Does the franchisor continue to support them? How?
- Are they satisfied with the advertising campaigns conducted by the franchisor?
- Has the franchisor ever reneged on a promise or breached a contractual provision?
- If they could start over, would they still purchase this franchise? What would they do differently?
- In light of your personal goals, interests, and experience, would they recommend this franchise to you?

Investigate the credibility and reliability of the franchisor

Contact your local Better Business Bureau and Dun & Bradstreet at (800) 234-3867. Ask them to provide any information they have on the franchisor you are examining.

Solicit the advice of professionals

- Consult an attorney. Have him or her review the franchise agreement (your contract with the franchisor). Are there any problems with the contract? Does it include all of the verbal promises made by the franchisor? Keep in mind that, especially with larger franchisors, deviation from the standard form of franchise agreement is often not an option — in such cases, your attorney will be able to explain the ramifications of all the provisions of the agreement.
- Consult an accountant. Have him or her examine the company's financial statement included in the UFOC and give a written opinion on the financial potential of the business. Are the franchise, royalty, and other fees reasonable? What will your financial position be during the first four years? Is the investment risk reasonable?
- Consult a banker. Have him or her review the franchise, its financial performance, and your financial position. Would the banker consider giving you a loan? Does the banker think the franchisor is credible? What does he or she think are the franchisor's strengths and weaknesses?

¹ U.S. Census Bureau, *2012 Survey of Business Owners*, released February 2016

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