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## **Chapter 2 Franchising**

### **Chapter 2 Content**

The concept of franchising is introduced. Different types of franchises are presented. The pros and cons of owning operating a franchise versus having small business ownership are discussed. The differences that need to be accounted for when franchises are international.

#### Defining Franchising

What are the Types of Franchises?

#### Positive Aspects of Franchises

Start-up Assistance

Instant Recognition

Purchasing Power

Advertising and Emotional Support

Operating Guidelines and Assistance

Record of Success

#### Drawbacks of Buying a Franchise

Constraints on Creativity and Freedom

Costs

Standards and Termination

#### The Structure of the Franchise Industry

Franchising and the Law

Steps for Franchise Selection

Exploring Global Franchising Opportunities

### **LEARNING OBJECTIVES**

**1. Define and describe franchising.**

- 2. Identify the positive and negative aspects of franchising.**
- 3. Understand the structure of the franchise industry.**
- 4. Recognize the legal aspects of franchising.**
- 5. Learn how to research franchise opportunities.**
- 6. Explore international franchising.**

## Chapter 2 Outline

### **Learning Objective 1: Define and describe franchising.**

#### I. Defining **Franchising**:

A **franchise** is a business that markets a product or service developed by the franchisor, typically in the manner specified by the franchisor.

**Franchising** is the system of operating a franchise governed by a legal agreement between a franchisor and franchisee.

**Franchisee** is the second party to the franchise agreement, the owner of the unit or territory rights.

#### A. What Are the Types of Franchises?

1. **Product and trade-name franchising** is the licensing of the product or the production of the product and the use of the trademark, logo, or other identity of the franchise.
2. **Business-format franchising** take place when the franchisee secure the product and trade-name benefits, and the operating, quality assurance, accounting, marketing methods and support of the franchisor.

### **Learning Objective 2: Identify the positive and negative aspects of franchising.**

#### II. Positive Aspects of Franchises

- A. Start-up assistance (+).
- B. Instant Recognition
- C. Purchasing Power
- D. Advertising and promotional support (+)
- E. Operating guidelines and assistance (+)
- F. Record of success (+).

#### III. Drawbacks of Buying a Franchise

- A. Constraints on creativity and freedom (-).
- B. Costs (-).
- C. Standards and termination (-).

### **Learning Objective 3: Understand the structure of the franchise industry.**

#### IV. The Structure of the **Franchise** Industry

- A. Large franchisors control most of the industry.
- B. Types include **Internet franchises**, **conversion franchising**, and **co-branding**.

**Learning Objective 4: Recognize the legal aspects of franchising.**

V. Franchising and the Law

- A. **Franchise Disclosure Document** (FDD) is essential.
- B. State and federal regulations govern franchising.
- C. A **franchise agreement** and other legal documents will be involved.
- D. Use good legal counsel.

**Learning Objective 5: Learn how to research franchise opportunities.**

VI. Steps for **Franchise** Selection

- A. Self-reflection and engagement of core support people.
- B. Industry, type, geography, or brand selection and brand name, or business-format choice.
- C. Research using available resources.
- D. Narrow the list of options.
- E. Make the broker decision.
- F. Visit franchise operator (s).
- G. Contact the franchisor.
- H. Perform due diligence on the specific franchise.
- I. Explore financing options.
- J. Make a decision and negotiate the **franchise agreement** and engage professional counsel.
- K. Make it work!

**Learning Objective 6: Explore international franchising.**

VII. Exploring Global Franchising Opportunities

- A. Opportunities are available worldwide.
- B. Decision is more complex than domestic franchising.

**Teaching Notes**

**Class Discussion Ideas:**

1. Ask the students to list as many companies as they can think of that have locations around town (e.g., McDonald's, Burger King, Wendy's, Taco Bell, and Subway). How do they think one company or one owner could afford to have that many stores?

2. Discuss with the students why \_\_\_\_\_ (choose a franchised fast-food product) is always the same, no matter where they are eating it, anywhere in the world. Establish that the company sets standards for its products and requires all branches—even if they are not directly owned by the parent company—to use the same menu, quality of product, size of portions, etc. It does this to make sure that the quality is consistent so that customers know what to expect, wherever they are.
3. Ask students to brainstorm why it might be a good idea to franchise or license a brand. (Sharing the risks and rewards as well as expanding the brand using capital/investment by others [franchiser/licensor] could be mentioned.) Divide the class into four groups, and have each brainstorm the pros and cons for licensing (pros/licensor, cons/licensor; pros/licensee, cons/licensee). Then have them share their findings with the class. Discuss how franchisers and licensors get paid through fees or royalties (a percentage of sales or profits). Discuss and summarize how franchising and licensing create valuable relationships that help both parties to be more profitable than they would be separately.
4. Ask: When you buy a McDonald's or some other franchise, what exactly are you getting? (Answers include the brand name and its reputation, a business concept that has already proven successful, training, operating and accounting procedures, quality standards, possible incentive programs, a protected market territory into which no other franchisee from this company can do business.) Ask: When you buy a license to make a line of clothing (e.g., from Janet Jackson), what exactly are you getting? (You are buying the brand name and its reputation only.)
5. Pretend: You are a company (e.g., McDonald's) and are considering issuing a franchise to someone in your town. What kinds of things do you need to take into consideration before you issue a franchise? Hint: Think of this like a hiring interview. (Possible answers: Look for the person's commitment to your brand, his/her business experience and track record of success, the amount of money he/she has to invest, any criminal record, etc.).
6. Pretend: You are a celebrity and are considering issuing a license to someone. What kinds of things do you need to take into consideration before you issue it? Hint: Think of this as similar to researching potential manufacturers. (Possible answers: Look for a commitment to your brand, the person's business experience and track record of success, the quality of the product your name will be associated with, etc.) Ask: What can happen if you don't consider these things in advance? (Your brand's reputation can be tarnished.)

### **Lecture Enhancers**

#### **PPT Lecture Slides for Chapter 2**

#### **Outside the Classroom:**

BizBuySell sends email alerts to registered users who might want to buy your business. The site also provides tools you can use to estimate the value of your business.

All About Branding provides extensive resources and opinions on branding, including brand development, management, and communications.

International Franchise Association: Celebrating 50 years of excellence, education and advocacy, the International Franchise Association is the world's oldest and largest organization representing franchising worldwide. On the site, you will find:

Detailed information for over 1,100 franchises  
A complete list of subject matter experts and  
A comprehensive library of franchising information available ranging from basic “how to’s” to advanced regulatory and legal information.

### **Key Terms**

area franchise 36  
business-format franchising 36  
co-branding 43  
conversion franchising 43  
cooperative advertising fee 38  
franchise 35  
franchise agreement 45  
franchise Disclosure Document (FDD) 44  
franchisee 35  
franchising 35  
franchisor 37  
internet franchise 43  
master franchise 36  
multiple-unit franchising 36  
piggybacking 43  
product and trade-name franchising 36

### **Class Activity Ideas and Group Exercises**

1. Divide the class into groups of four. Two students in each group should think of a company and product while the other two figure out ways for franchising or licensing from that company. The two pairs negotiate and write up an agreement. Bring the groups together as a class and let the students evaluate these agreements against the criteria given in the textbook.
2. Ask the students to discuss, in pairs or small groups, the following: You have created and manufactured mascaras in hot colors—like lime green, hot pink, fuchsia, or yellow—under the brand name Eye Love It! They have sold very well to teenage girls. Other businesses have asked you for permission to manufacture and sell the same kind of mascara in return for a fee or a share of their profits. Now you are considering *licensing* your brand (letting others use your company/product name and product formula) to other companies. What would

- you want to make sure happened after you licensed your product? (The name and quality should be kept the same as your original; even if you agreed to let others use it, you will continue to own the name and formula.) What types of products or services would be good candidates for licensing? (Answers include food, clothing, sports equipment, hotels, hair styling, dry cleaning, real estate sales, etc.) What types of products would be a bad idea to license to others to make and sell? Why?
3. Contact the community relations person for a local McDonald's (or another franchise) and ask if your class might tour the restaurant to see the operation. The purpose of this visit would be to show students standardized procedures. Have class prepare questions beforehand.
  4. Have students research various articles and discussions on the success rate of franchises versus independent business start-ups. Be sure to look at different size franchises. What is the logic to the numbers?
  5. Are there particular franchises that have been known for "churning"? How can you find this information?
  6. Research: What is one of the largest franchise organizations? What is a typical cost to buy a franchise belonging to a large organization? What is an example cost to buy a franchise for a small organization? Provide several findings.

### **Suggested Answers for Critical Thinking Exercises 2-1 - 2-4**

1. What are four positive aspects of franchising for a business startup? Why are they important?  
**Start-up assistance, advertising and promotional support, operating guidelines and assistance, record of success. They are important because they take away some of the risk of starting a business from the ground up. (Learning Objective 2 – AACSB –Application of knowledge)**
2. What are some challenges faced by franchisees?  
**They face constraints on creativity and freedom. Initial costs are preset and can be higher than a traditional business structure. If standards are not met, franchisees can face termination and/or penalties and fees. (Learning Objective 2 – AACSB –Application of knowledge)**
3. Describe the type of franchise that you might want to open.  
**Answers will vary but be sure to have the students support why they choose a particular franchise over another. (Learning Objective 3, 5– AACSB – Application of knowledge)**
4. Franchisees agree to pay a variety of fees to franchisors initially and in an ongoing manner. Describe these fees and why understanding their impact on profitability and cash flow is important to franchisees.

**There are initial franchise fees and ongoing fees. Some ongoing fees are royalties paid on top-line revenues and some are fees paid for cooperative advertising, and required capital equipment maintenance for example. Note that top-line revenue is not the same as profit. These fees and the other required fees are not concerned with profitability or cash flow. Franchisees should be wary of franchisors that practice “churning”. (Learning Objective 4 – AACSB –Application of knowledge)**

### **Suggested Answers for Key Concepts Questions 2-5 - 2-7**

5. Compare and contrast product and trade-name franchising and business-format franchising.

**Product and trade-name franchising is the licensing of the product, or the production of the product, and the use of the trademark, logo, or other identity of the franchise. It is essentially a supplier-dealer relationship with some level of exclusivity. Business-format franchising is a much broader and more extensive form of operation. The franchisee secures the product and tradename benefits but also the operating, quality assurance, accounting, marketing methods, and support of the franchisor. (Learning Objective 5 – AACSB –Application of knowledge)**

6. Explain why the Franchise Disclosure Document is critical to analyzing a franchise opportunity.

**The FDD must be in a common format so that the prospective franchisees can compare franchise opportunities. The FDD discloses the terms of the franchise relationship and any pertinent financial and legal issues affecting the franchisor. (Learning Objective 4 – AACSB –Application of knowledge)**

7. What, if any, trends in franchising suggest continued expansion of the industry? Contradiction?

**Internet, conversion and co-branding are all growing franchise trends. With an increase in populations and an increase in small businesses, there are likely to be increases in the number and types of franchises. Co-branding is a way to get additional advertising and exposure from another business and possibly work opposites. While one business may do well in a particular season, another may do well in another season. Co-branding can help to keep the business filled with customers. (Learning Objective 5 – AACSB – Application of knowledge)**

### **Suggested Answers for Application Exercises 2-8**

Identify an industry or type of business that interests you. Select a community where you would like to locate such an organization (select a business that would have a physical presence). Find two competitors already in that market space and one franchisor that is not. Would it or would it not make sense to open a franchise in the community?

**Help the students get started thinking about this by giving an example from the**



**community of fast food chains or clothing shops. Discuss the advantages of adding another chain or shop, i.e. increased competition, more reason for customers to come to an area, etc. and the disadvantages, i.e. increased competition, saturation, etc.. (Learning Objective 5 – AACSB –Application of knowledge)**

**Exploring Online 2-9 – 2-10 (Learning Objective 2– AACSB –Application of knowledge and Information technology)**

- 9 Visit the Wahoo Fish Taco Web site at. What are the advantages of a Wahoo Fish Taco franchise according to the site? What franchise opportunities are available?

**“You’re not just franchising a restaurant, you’re franchising a way of life.”  
Wahoo’s Fish Taco Franchises are available now in: California, Arizona,  
Texas, Florida, S. Carolina, N. Carolina, Virginia, and Georgia.**

- 10 Visit the International Franchise Association Web site at Find a franchise organization that is unfamiliar to you. Find the following information about the franchisor:

**Under the toolbar Franchise Opportunities, students can start a search or be directed by a choice industry.**

- a. When did it begin offering franchises?
- b. How many company-owned units does it have?
- c. What are its initial financial requirements (start-up fee, net worth, liquid resources)?
- d. What type of franchisor is it (product or trade name or business format)?

If the information is not available on the International Franchise Association (IFA) Web site, try others from the list in **Exhibit 2-3**.

and find the most recent list of the top 10 franchises. Compare it with the list included in the text. What, if anything, has changed? Why do you think the change has occurred?

**The world and its economies are constantly changing and the need for different businesses is also changing. Business owners should always be alert to their business and new trends and adapting their businesses to them.**

**Suggested Answers for Chapter 2 Case Studies 2-11 - 14**

**Case Study Analysis : SarahCare of Snellville—A Franchise Opportunity in Adult Day Care (Learning Objectives 2, 3, 4– AACSB Analytical and Reflective thinking, Application of knowledge)**

- 11 What type of franchise is SarahCare?

**Sarah Care is a business-format franchise since the franchisee secures the product and trade-name benefits, and the operating, quality assurance, accounting, marketing methods, and support of the franchisor.**

- 12 Using the Web sites listed under Case Sources or others that you can find, identify each of the following for a SarahCare franchise: franchise fee, net worth requirement, total initial investment, and ongoing royalty fee.

**The student will be able to answer this question after visiting SarahCare’s website.**

- 13 What are some of the distinctive advantages that would lead a franchisee to select a SarahCare franchise?

**Per the case: State of the Art Operational System, Site Selection Assistance, Space Design, Adult Day Care Business Plan Template, SarahCare Marketing System, Advertising and Promotional Materials, 5-Day Operations Training, Ongoing Support and Training by Experienced Professionals.**

- 14 What might be some potential concerns about buying a SarahCare franchise?

**SarahCare does not require its franchisees to have a health care background so they have to hire an executive director which adds to the expense and with no healthcare background, some owners may have a steep learning curve. Additionally, one benefit that SarahCare promotes “is that center hours are from 7:00 a.m. to 6:00 p.m. on Monday through Friday, leaving time for family.” The reality is to operate a successful business requires a significant investment of time.**

**Case Study Analysis 2-15 – 18 (Learning Objectives 2, 3, 4– AACSB Analytical and Reflective thinking, Application of knowledge)**

15. Why did the Pietsches decide to purchase a Wahoo’s Fish Taco franchise rather than start a restaurant on their own?

**They liked the support system and the idea of systems already in place.**

16. Name something the Pietsches could have done better to make their business startup go more smoothly.

**Prepared for the demand. Pay more attention to the troubled labor market in Hawaii and compensate for it.**

17. What does the Pietsch-owned franchise do on an ongoing basis to maintain and grow success?

**Run two side businesses with little overhead (beach sales and catering).  
Donate to charities.**

18. What type of a franchise is Wahoo's Fish Taco? What makes this true?

**Business-format franchise. The purchase of the franchise is the purchase of an entire business model and system.**