

## **FRANCHISING - AN ADVANCEMENT FORM OF ENTERPRISES' ECONOMIC EFFICIENCY<sup>1</sup>**

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**Abstract.** *The current trend of globalization of world trade is linked with existence of companies, including those in franchising. Franchising is very useful for "pouring" financial and intellectual capital across the borders of countries. In the last decade we were witnesses of great removal of political and technological barriers. Nowadays franchising is present in virtually all countries of the world. It is mostly spread in the most developed economies. Franchising system supports and develops small and medium sized companies and medium business class. It helps companies to withstand the market, which is more and more affected by big and strong players. A great opportunity is to use the macroeconomic advantages of franchising in the field of privatization of communal or municipal companies.*

### 1. INTRODUCE

Nowadays franchising is a very popular form of investing. It is mostly spread in the most developed economies, such as USA, Canada, Great Britain, Germany. In the last ten years franchising has become one of the most successful methods for small and medium-sized enterprises. This situation is one of characteristics of the foreign expansion of supranational, infiltrated post-communist countries. In these countries over foreign capital franchising participated in forming their economies in tranzition.

Co-operation with economies in tranzition in the form of franchising still represents very interesting possibilities for foreign investors with successful business concept. The current trend of the globalization of world trade is connected with existence of supranational companies, including the companies in form of franchising. The foreigners have developed international franchising systems. This is the way of removing the political, administrative, but also technological and economical barriers. Franchising expansion has been particularly developing in the last decade. It is a chance for the countries in tranzition and their small and medium-sized companies.

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Nowadays, franchising in countries in transition is somewhat different from the Western concept. There are several reasons for this. One of these could be that franchising, widely used in the developed countries, is just beginning to emerge in Eastern and Central European countries. Also, the countries in transition are transforming their economies into a market economy. And last but not least, a legal framework for franchising appeared only a year ago.

## 2. LEGAL DEFINITIONS OF FRANCHISING

International franchising is increasingly regulated by home and host legislation, including regional groups. On one hand, we can see the European Union. In 1986 the European Court of Justice issued its first major opinion on the legality of franchise agreements under EU competition law. On the other, in the third world countries, for example Latin America, technologies transfer laws aimed principally at international patent and know-how licensing. Local laws sometimes answer to the cultural impact of foreign franchises. In India and Mexico, for example, nationalist feelings have produced laws intended to remove hostile usage. It is sure that, being of great importance, franchising has to be regulated. Also, antitrust and tax law are important in international franchising.

Having taken into account previous facts, several definitions of franchising can be noted. Some authors distinguish legal and commercial definitions. However, perhaps the first answer at the question: "What franchising is", could be - franchising is a method of marketing goods and services. Franchising includes the need for successful business to grow and the ability to achieve that growth by linking up with others who possess the capital and manpower to do so [1].

There are no many legal definitions. The first formal legal definition is in the Financial Services Act: franchise is an arrangement under which a person earns profit or income by exploiting a right conferred by the arrangements to use a trade name or design or other intellectual property or the goodwill attached to it [2]. Franchising is an important sector in the United States economy. Thousands of franchisors have created and administer franchise systems throughout the nation. Franchising is a business technique that permits rapid and flexible penetration of markets, growth and capital development [3, p. 437]. Franchise means a contract or agreement between two or more persons by which, inter alia, the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trade mark, service mark, trade name, logo type, advertising or other commercial symbol designating or its affiliate [4].

From European countries point of view, particular countries in transition (including Yugoslavia), the most important is the definition of franchising of European Union [5]. Franchise means a package of industrial or intellectual property rights relating to trade marks, trade names, shop signs, utility models, designs, copyrights, know-how or patents, to be exploited for the resale of goods or the provision of services to the end users. Franchise as defined in this regulation normally improves the distribution of goods and/or the provision of services as they give franchisors the possibility of establishing uniform network with limited investments, which may assist the entry of new competitors on the market, particularly in the case of the small and medium-sized companies. They also allow

independent traders to set up outlets more rapidly and with higher chance of success than if they had to do so without the franchisor's experience and assistance.

From a pragmatism point of view franchising could be often called business under someone else's name, business fully furnished generally brings the franchisee a significant lowering of business risk and faster success, or along the formula of success [6].

### 3. INTERNATIONAL REGULATION OF FRANCHISING

In the European Union countries there is not yet any legal regulation of franchising contract. The first act perhaps is the European Codex of Franchising Ethics issued by the European Franchise Federation in 1972. But, we are the witnesses of wide judicature of the European Court. In some countries that are not member of EU, the franchising system is regulated. In USA and Canada, for example, there are special laws regulating franchising. These rules cover the obligatory contents of a franchise contract, the franchisor's obligation to inform the franchisee or his obligation to register at their franchise union. Similar regulations we can see in the Czech Republic where is the Czech Association of Franchising. This association issued an Ethical Code for the members. This codex also contains the principles of honest behavior and treatment for the participants of a franchise. Chapter 54 of the Russian Civil Code is dedicated to franchising, or, "commercial concession." Article 1027 defines "an agreement of commercial concession as a contract by which the franchisor is obliged to present the franchisee with a compensation of a complex of exclusive rights belonging to the franchisor, including the firm name and/or the commercial mark of the franchisor, protected commercial information as well as of the other franchisor's exclusive rights, such as the trademark, the service marks," etc.

### 4. FRANCHISING AGREEMENTS

The basic presumption of the franchising co-operation between the franchisor and the franchisee is suitable franchise contract. The contract is a type of combined contract that contains elements of various contracts. Franchising agreement touches many legal areas. It is completely sure that franchising comprises the elements of license contract, know-how contract, and contract of leasing or business representation.

At the first step it is helpful to identify the various types of agreements and their uses. The position of contract parties is the next task. There are many attempts to define all types of franchising agreements and differences among them. One of the most complete is noted in Lexicon of terms Used in International Franchising [7].

**A franchise agreement** is the basic contract for the franchising unit (it means, "franchising business"). The person who participates is a *franchisor* (person who grants the franchise rights) and *franchisee* (person who operates the franchised unit). From our point of view, Yugoslav small and medium-sized companies should take the role of the franchisee.

The franchise agreement or "franchise" means the operation of the franchised business, and contains the full range of provisions, which are relevant for this purpose [1]. This kind of franchise agreements may contain the provisions about basic elements of franchise or may be agreements which are supplemental to the franchise agreement (for

example, lease or rental equipment which is used by the franchisee in the franchising business, a software license, etc.)

*A master franchise agreement* is an agreement granting rights to exploit a territory, invariably by a combination of company-owned and sub-franchised franchise units. We have to mention that a master franchise agreement involves sub-franchising. The contract parties in master franchising agreements are "sub-franchisor", the person to whom the rights are granted. The company with ownership of the rights should be in this position. On the other side, the person who is giving the rights is called the "franchisor". In fact, this person is the operator of the franchised unit and always is called the franchisee.

And on the other hand, *a development agreement* or area development is one under which the franchisor, as the first person in this model of contract, grants rights to a developer as another person. The developer has opened and operated an agreed number of franchise units in a given area within an agreed time frame.

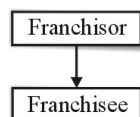
Obligations of the participants could be different. They seem to be more burdensome for the franchisor than for franchisee. The franchisor is bound: to transfer to the franchisee technical and commercial documentation and to present other information necessary for the franchisee to fulfil the rights granted by the agreement; to instruct the franchisee and employees on issues relating to the realisation of the franchisee's contractual rights; and to issue to the franchisee, according to established procedures, licenses that are stipulated by the franchise agreement. The franchisor is also bound, if otherwise not stipulated, to secure the registration of the franchise agreement, responsible for the quality of goods or services provided by the franchisee.

On the other side, the franchisee is bound to use the firm name or commercial marks of the franchisor in the manner defined by the contract; to ensure the quality of goods or services produced by the franchisee, in accordance with the quality of goods produced by the franchisor; to observe the franchisor's instructions and directions meant to ensure that the franchise rights are used in the same manner and on the same conditions as the franchise rights would be used by the franchisor, to include instructions regarding exterior and interior appearance of such of the franchisee's commercial premises that are used to carry on activities under the franchise agreement; to perform all such additional services for the consumer as if the product was provided directly by the franchisor; to maintain confidentiality of the trade information supplied by the franchisor; to issue the sub-franchises as stipulated by the franchise agreement; to maintain appropriately the firm name, commercial mark, trade mark, service mark or identification of the franchisor, according to the franchise agreement.

## 5. MODELS OF FRANCHISING SYSTEM

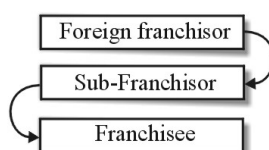
Franchise system, particular in developed country regulations, is very popular. For example, we can see numerous possibilities of relationships between the participants.

Case No 1:



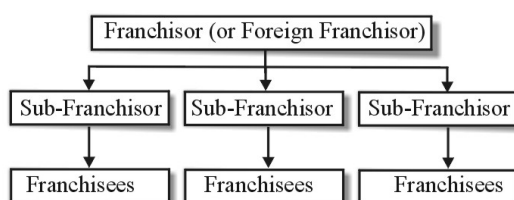
This presents no difficulties.

Case No 2:



This situation is permitted and applied.

Case No 3:



From Yugoslavia point of view the international franchising would be one of the best solutions for foreign investments using the small and medium-sized companies. A franchisor that intends to expand into foreign territories has a number of strategic business decisions to make or to choose. Whichever model of action is chosen, one or more of the models will be appropriate. When we say models, it means company-owned operation, direct franchising, master franchising, area developments or joint ventures.

Company-owned operations include the possibility of establish own operations and units of foreign potential franchisor. The franchisor also can enter into a direct franchise agreement with each individual franchisee. This model sometimes makes the problems to franchisor to recognize the differences between the territory in which the business originated and the target territory. The area development can solve a problem, because it keeps the numbers of franchisees with whom they have to deal. The target of the master franchising usually is to provide for the exclusive right for a sub-franchisor in a country to open his own outlets and to sub-franchise. In joint venture business parties (the franchisor and co-venturer) have to negotiate what shares to take up. Also their basic task is to make a decision how to finance the venture.

On the basis of knowledge a foreign franchisor should decide on a suitable method of opening an establishment. He can choose to open an actual establishment (a branch), ter-

ritorial branch or daughter companies assisting the franchisees or a direct franchise to local companies or joint ventures (with the franchisor's participation).

## 6. FRANCHISING SYSTEM AND DIFFERENT FORMS OF ENTERPRISES

It is widely accepted that franchising is an effective development strategy for small and medium-sized businesses both nationally and internationally. It is not surprising that there is growing interest among those who might be considering involvement in franchising particularly in the countries in transition. In recent years we have seen fundamental economic and political changes there. Franchising is used most often in services, in areas such as restaurant type fast food, hotel business, retail shops, especially supermarkets, consulting agencies, copy and photocopy services, delivery and transporting services, petrol stations and cleaners. Few years ago in many countries in transition there were local companies which decided to distribute their products or services using the method of franchising. In Czech Republic the first franchising business was McDonald's and Yves Rosher. Franchising started and made boom in business world in these countries in the third year of the economic transition. At the end of 2001 there were over fifty franchising systems present in Czech Republic. Foreign franchising brings an influx of foreign capital. Also, the import of a foreign package of services and know-how passed to local entrepreneurs. This is the way of prospect of further continuous development.

Not only in Czech, has a foreign business concept used franchising. In all countries in transition big and well-known brand names have appeared: McDonald's, Pizza Cut, Holiday Inn, Hilton, and Hugo Boss. Very important fact is that many local companies and traders have decided to distribute their products or services using the method of franchising. In Russia, for example, small businesses are in private hands. A vast majority of large enterprises have been privatized in Russia since 1991. New private corporations have emerged. In 1994, few franchisee candidates had the necessary commercial experience. In 1995, we saw potential franchisees with the right kind of commercial experience but limited access to the required capital. Now, in 1996, potential franchisees often represent successful commercial businesses, with focused management, and sufficient financing in place. According to estimates of local franchise experts, there are currently over 250,000 potential franchisees in Russia. These business people are ready to invest over \$100,000 in a foreign trademark. This includes both small businesses and large firms interested in diversifying their operations.<sup>2</sup>

Franchising has supported and developed small and medium-sized companies. In any case, this part of every economy is considered the main motor of development in modern

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<sup>2</sup> In Russia, a small business is defined as a self-employed group of individuals or an individual, organized into an entity, in which the authorised capital of public sector bodies, charities or businesses does not exceed 25 percent of shares, and the average number of employees does not exceed the following limits: 100 manufacturers and construction companies; 80 for agricultural firms; 60 for scientific and technical firms; 50 for wholesale traders; 30 for retail sellers and domestic services; and 50 for other sectors. According to GKRP, as of January 1997, there were 877,300 small businesses registered in Russia. Small businesses employ about 9 million people, which are almost 15 percent of the working population. Russian small businesses contribute 12 percent of the GDP and generate 20 percent of Russian exports. Small business profits constitute 35 percent of total Russian industry profits. Small businesses constitute 60 percent of all enterprises in Russia. See [8].

economics. Because of that, franchising is universally an asset for the development of the economies in transition. Its task is to help with withstanding the market, which is increasingly becoming affected by big and strong players. In these circumstances small and medium-sized enterprises within the franchising system can have the effect of a stabilizing counter-balance of the large companies. The basic considerations which could be named are: first of all, the development of the concept, after that structuring the franchising package, marketing the franchising package, opening the business and the long term relationships. All of them contribute healthy competition in the market. It is very important especially today when the small and medium-sized enterprises have to keep to terms with the current trend of business.

The importance of the *development of franchising* is that the main intellectual property rights come into play. The concept is developed by means of a pilot operation, which should be, for example: establish business, provide evidence of success to enable the franchisor to sell the "successful" business concept to franchisees. The both parties in franchising system should choose a viable franchising concept, concept with the elements for a marketable commodity. Another asset of franchising is in *the structural and marketing packages*. Their value is the intensive consulting support of the franchisee, which cultivates the level of management of the small and medium-sized companies of the franchisees to a level comparable with large companies. In this case the state can only support the programs of franchising business. It means that the state hasn't spent money or efforts for that. A great opportunity is to use the macroeconomic advantages of franchising in the field of privatization, particular communal or municipal companies. This task could be realized by franchising, which *opens the door for business*. There are various transport institutions, libraries, organizations of street markets, for example, which would be one of parties in the franchising business. Thanks to entry of new technologies and approaches to the customers, franchising can represent an interesting way of keeping the privatized companies, run in accordance with public interest. The parties hope that *a long-term relationship* has started. The franchisor will want to ensure that the franchisee performs and its system is protected in operation and from unfair competition.

### 7. CASE STUDY<sup>3</sup>

WSI Internet has been rated as the "First Fastest Growing Business Services Franchise", and the "4th Fastest Growing Franchise in the world". It has literally made franchise history by establishing over 700 franchises in 87 countries worldwide.

Franchising is the way to help the small and medium sized companies within community to put their business on-line and profit from the Internet. Nowadays, more and more business is interested to go on-line. Web site simply not enough. Example for this could be the Lifecycle™ System (patent pending). Through this, company's client's Internet solution is custom tailored to increase their revenues as well as reduce their business overhead. The "Internet Solution" for client is then developed at one of WSI Internet's Global Production Centers. These Centers are located in low cost, high tech regions such as India and Australia so that your client gets a result oriented, technologically advanced

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<sup>3</sup> Source: <http://www.msn> - franchising in small and medium sized enterprises

Internet Solution at an economical cost. Further, with unique Client Support System TM, everyone generate an ongoing stream of re-occurring revenue from all clients.

This system offers one of the most thorough and comprehensive Training and Certification Programs available to franchise companies today. It is not required to have computer, Internet or specific business experience to become franchise. WSI INTERNET provides a dynamic Support Program that is customized for each individual franchise.

## 8. FINANCIAL ASPECTS OF FRANCHISING

The USA definition of franchising, for example, includes the following essential elements:

- franchising should be made as contract,
- there must be a system,
- there must be branding (a trade mark, trade name, etc.),
- there must be a grant of rights, and
- must be payment of money.

There are different financial aspects of franchise arrangement. The cost to the franchisee of joining the business is one of the financial aspects. Sometimes, the element of franchising is a continuing cost. This is the kind of cost, which is paid by membership of the network. It includes the provision of the franchisor's goods and/or services. The financial aspects of franchising arrangement are very important for all participants in this business. There are the sources of finance, such as banks, finance houses, leasing companies or franchisors. The number of sources of financial assistance has grown. There are a great number of banks and other financial institutions. Financial assistance can come from the franchisor, but not so often.

*Initial fees* are the element that is important for all participants in franchising business. The franchisees have to be able to generate sufficient profitable activity. Because of that, these activities would make the profits, which the franchisees expect. The nature of the revenue sources depends on the type of franchise. The franchisor would have little prospect of receiving sufficient gross revenue to cover its expenses. The franchisor would provide a range of services, which will enable the franchisee to prepare him and open for business. Fee, which is provided on this way, covers the cost of the services and training.

*Continuing fees* are one of the possibilities of franchising cost. These fees sometimes described as a royalty. The continuing fee is paid to the franchisor for more than the use of an asset. It is a payment to the franchisor that enables him to finance activities in providing a wide range of services.

## 9. CONCLUSION

Every developing country should see the importance of franchising for its economy development. It is very clear for European Union also. Because of the usefulness of franchising organs both in home country and EU must support it. It should be offered to entrepreneurs of small and medium-sized companies various interesting programs. In most countries in tranzition we can see that the situation at the moment is gradually being en-



hanced. Some large bank institutions with foreign participation have started to provide loans more willingly to individuals with vetted business plans, whose guarantee is a well-known and strong franchisor.

Franchising assists and supports the development in any case in the countries in transition. But, all of them have to change their connections and positions with developed countries, especially the European Union members. For every entrepreneur who wants to run a franchising business is important a political stability in region and all countries. The development of the legal system protecting the functioning of franchising should also be on a good level. It is gradually being harmonized with European Union regulations.

For successful franchising system it is essential to judge the maturity of the laws protecting the functioning of the system. At this moment franchising system couldn't be separated of small and medium-sized companies. Both of them should be two parts of the same business. One of the most important conditions for development of small and medium-sized entrepreneurs is modern legal system including tax and customs regulations (the level of taxing at source, the level of VAT, tax relief for small entrepreneurs or for some fields of activity, conditions of double taxation agreements). It would keep in mind also the regulations concerning competition rights, labor legislation and customer protection.

After all, an idea is becoming very clear. Small and medium-sized companies through the franchising system are essential component of economy development, particularly in transition countries. Franchising is a useful model for crossing financial and intellectual capital across the borders not only the countries but continents.

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## **FRANŠIZING - USPEŠAN OBLIK EKONOMSKE EFIKASNOSTI PREDUZEĆA**

**Dragana Radenković Jocić**

*Trend globalizacije svetske trgovine nesumnjivo je povezan sa egzistencijom preduzeća, uključujući i franšizing. Franšizing je veoma uspešan način organizovanja za "nadolazeći" finansijski i intelektualni kapital van granica zemlje korisnika. U prethodnoj dekadi bili smo svedoci velikog pomeranja političkih i tehnoloških barijera. Danas franšizing jeste forma prisutna u praksi svih zemalja. Posebno je karakterističan za mnoge razvijene ekonomije. Franšizing sistem podržava i doprinosi razvoju malih i srednjih preduzeća i takozvanoj srednjoj poslovnoj klasi. On*

*pomaže kompanijama da se odupru zahtevima tržišta, koji su nametnuti od strane velikih i jakih učesnika-igrača. Veliku prednost franšizing ima, u odnosu na druge forme, u procesu privatizacije komunalnih i drugih preduzeća čiji je osnivač lokalna samouprava.*