Chapter 1

Sole Proprietorships and Franchises

TRUE/FALSE QUESTIONS

B1. In choosing a form of business organization for a new enterprise, important factors include the ability to raise capital.

ANSWER: T PAGES: Introduction
BUSPROG: Reflective AICPA: BB-Critical Thinking

B2. The franchise is not strictly speaking a business organizational form.

ANSWER: T PAGES: Introduction
BUSPROG: Analytic AICPA: BB-Legal

B3. A sole proprietor is free to make any decision he or she wishes concerning the business.

ANSWER: T PAGES: Section 1
BUSPROG: Analytic AICPA: BB-Legal

B4. Any lawsuit against the business or its employees does *not* lead to unlimited personal liability for the owner of a sole proprietorship.

ANSWER: F PAGES: Section 1
BUSPROG: Analytic AICPA: BB-Legal

B5. A sole proprietor does *not* own the entire business.

ANSWER: F PAGES: Section 1
BUSPROG: Analytic AICPA: BB-Legal

B6. A franchisee is generally legally independent of the franchisor.

ANSWER: T PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B7. A franchisee is generally economically independent of the franchisor's integrated business system.

ANSWER: F PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B8. In a manufacturing arrangement, a franchisor transmits to a franchisee the essential ingredients or formula to make a particular product.

ANSWER: T PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Critical Thinking

B9. The laws governing franchising are primarily designed to protect franchisors from dishonest franchisees.

ANSWER: F PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B10. No state requires franchisors to provide presale disclosures to prospective franchisees.

ANSWER: F PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B11. Some states require that a franchisor submit advertising aimed at prospective franchisees to the state for approval.

ANSWER: T PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B12. Some states require the termination of a franchise when there is no “good cause” for it to continue.

ANSWER: F PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B13. If a franchisee is induced to enter into a franchise contract by the franchisor’s fraudulent misrepresentation, the franchisor may be liable for damages.

ANSWER: T PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B14. A franchisee ordinarily does *not* pay a fee for a franchise license (the privilege of being granted a franchise).

ANSWER: F PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B15. The franchisor may require that the business use a particular organizational form and capital structure.

ANSWER: T PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B16. The franchise agreement is not likely to set out standards such as sales quotas and record-keeping requirements.

ANSWER: F PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B17. The duration of a franchise is a matter determined by federal or state statutes.

ANSWER: F PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B18. A franchisor can suggest retail prices for the goods that a franchisee sells but cannot mandate them.

ANSWER: T PAGES: Section 2
BUSPROG: Analytic AICPA: BB-Legal

B19. When a franchise agreement contains a notice-and-cure provision, a franchisee's breach of the duty of honesty and fidelity is *not* enough to allow the franchisor to terminate the franchise.

ANSWER: F PAGES: Section 3
BUSPROG: Analytic AICPA: BB-Legal

B20. If a franchisor's decision to terminate a franchise is made in the normal course of business and reasonable notice is given, it is less likely that the termination will be considered wrongful.

ANSWER: T PAGES: Section 3
BUSPROG: Analytic AICPA: BB-Legal

MULTIPLE CHOICE QUESTIONS

B1. Kari is the sole proprietor of Living Earth Garden Shop. As a sole proprietor, on the business's profits, Kari pays

a. no income taxes.
b. only personal income taxes.
c. only business income taxes.
d. both personal and business income taxes.

ANSWER: B PAGES: Section 1
BUSPROG: Reflective AICPA: BB-Legal

B2. Silvano owns Textbooks Plus, a sole proprietorship that sells textbooks and other school supplies. When Silvano dies, Textbooks Plus will automatically

a. dissolve.
b. pass to Silvano's heirs.
c. pass to the state.
d. be offered for sale to its creditors and competitors.

ANSWER: A PAGES: Section 1
BUSPROG: Reflective AICPA: BB-Legal

B3. Haute Dogs, Inc., sells a franchise to Ilene's Cuisine, a lunch truck. Ilene's Cuisine is

a. a franchisee.
b. a franchisor.
c. an agent.
d. a principal.

ANSWER: A PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B4. Cookie Shops, Inc., sells a franchise to Donuts & Desserts, a mall food-court vendor. Cookie Shops is

a. a franchisee.
b. a franchisor.
c. an agent.
d. a principal.

ANSWER: B PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B5. Paradise Footwear buys a franchise from Quadrangle Athletic Shoes, Inc. This relationship, like *all* other franchise relationships, is governed by

a. contract law.
b. no law.
c. the Franchise Disclosure Document, or FDD.
d. Article 2 of the Uniform Commercial Code.

ANSWER: A PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B6. Instead of setting up a business to market her own products, Rita considers entering into a distributorship franchise with Sports Equipment Corporation. This involves the transfer of

a. a license.
b. a trade name.
c. the formula to make a certain product.
d. the ownership of the business.

ANSWER: A PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Critical Thinking

B7. Sauces n' Syrups, Inc., and Thad's Sweet & Spicy Bottling Plant have a manufacturing franchise arrangement. This involves the transfer of

a. a license.
b. a trade name.
c. the formula to make a certain product.
d. the ownership of the business.

ANSWER: C PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Critical Thinking

B8. Ralph is interested in buying a franchise from Sparkle Beverages Inc. For Ralph to make an informed decision concerning this purchase, Sparkle Beverages must disclose in writing or online

a. general estimates of costs and sales, but not the basis for them.
b. material facts such as the basis of projected earnings figures.
c. no information.
d. start-up requirements, but not renewal conditions.

ANSWER: B PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B9. Eudora is interested in buying a franchise from First Home Realty Company. In this transaction, the Federal Trade Commission's Franchise Rule

a. does not apply.
b. enables Eudora to weigh the deal's risks and benefits.
c. enables First Home to weigh the deal's risks and benefits.
d. prohibits certain types of anticompetitive agreements.

ANSWER: B PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

Fact Pattern 1-1B (Questions B10–B11 apply)
Jumbo Juice Inc. offers entrepreneurs the opportunity to operate a franchise under the Jumbo Juice trade name as a member of a select group of dealers that engage in retail juice sales.

B10. Refer to Fact Pattern 1-1B. To potential investors, Jumbo Juice must provide

a. actual earnings figures.
b. hypothetical earnings figures.
c. projected earnings figures.
d. none of the choices.

ANSWER: D PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B11. Refer to Fact Pattern 1-1B. Jumbo Juice makes earnings claims to potential investors. For those claims, the franchisor

a. can have a hypothetical basis.
b. must have a reasonable basis.
c. must have an actual basis.
d. can have any or no basis.

ANSWER: B PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B12. Level Fencing Company wants to present information in “disclosure documents” via the Internet to prospective franchisees. Among other legal requirements with which Level Fencing must comply, prospective franchisees must

a. agree to settle any lawsuits that may arise over the documents.
b. be able to download or save all electronic documents.
c. provide e-mail addresses for Level Fencing to verify users’ authenticity.
d. register with the Federal Trade Commission via Level Fencing’s Web site.

ANSWER: B PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B13. FreezE Yogurt Corporation provides its prospective franchisees with projected earnings figures based on actual data. FreezE Yogurt must also disclose

a. the number and percentage of franchisees that achieved the figures.
b. hypothetical examples of potential earnings.
c. an answer to the entrepreneur’s question, “How much will I make?”
d. none of the choices.

ANSWER: A PAGES: Section 2
BUSPROG: Communication AICPA: BB-Legal

B14. Sasha contracts to buy a franchise from TrustMe Financial Consultants, Inc. The contract is silent on the issue of territorial rights. When TrustMe allows a competing franchise to be established near Sasha’s office, she suffers a significant loss in profits. This is most likely a violation of

a. no law.
b. the ban on certain types of anticompetitive agreements.
c. the Federal Trade Commission’s Franchise Rule.
d. the implied covenant of good faith and fair dealing.

ANSWER: D PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B15. George buys from Haul-U Corporation the exclusive right to use the Haul-U trademark and sell and lease Haul-U-brand products in a certain area. Their franchise agreement requires George to pay certain administrative expenses. Their agreement may also require George to pay a percentage of the franchisor's

a. advertising costs.
b. personal expenses.
c. retirement income.
d. none of the choices.

ANSWER: A PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B16. Rooster Red, LLC, grants a franchise to Qiana to open and operate a Rooster Red restaurant. Rooster Red will likely charge Qiana

a. an initial fee or lump sum price for the franchise license.
b. a percentage of Qiana's weekly payroll expense.
c. an amount of Qiana's monthly overhead savings, if any.
d. none of the choices.

ANSWER: A PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B17. Shop n' Pay Convenience Stores, Inc., is a franchisor. Tonya operates a Shop n' Pay franchise. Ulysses is one of Tonya's employees. As a franchisor, if Shop n' Pay controls the day-to-day operations of the business to a significant degree, it may be liable for tortious acts by

a. no one.
b. Shop n' Pay only.
c. Shop n' Pay and Tonya, but not Ulysses.
d. Shop n' Pay, Tonya, or Ulysses.

ANSWER: D PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B18. Fletcher buys a Great Big Burgers, Inc., franchise. Great Big Burgers requires that its franchisees buy its products exclusively for every phase of their operations. Because Fletcher wishes to buy less expensive products, he challenges the requirement. His best argument is probably that the requirement violates

a. the implied covenant of good faith and fair dealing.
b. the Federal Trade Commission's Franchise Rule.
c. federal antitrust laws.
d. Great Big Burgers's marketing image.

ANSWER: C PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Legal

B19. Mix n' Match Clothing Corporation gives notice to Neely that Mix n' Match is terminating their franchise arrangement. Winding up the business requires

a. a new franchise agreement.
b. nothing more than closing immediately.
c. Neely's death, disability, or insolvency.
d. the return of Mix n' Match's property.

ANSWER: D PAGES: Section 3
BUSPROG: Reflective AICPA: BB-Legal

B20. A franchise agreement between Grid Tools Company and Hometown Hardware, Inc., is silent on a time for termination of the franchise. Grid Tools may

a. never terminate.
b. terminate at any time.
c. terminate on reasonable notice.
d. terminate on three days notice.

ANSWER: C PAGES: Section 3
BUSPROG: Reflective AICPA: BB-Legal

ESSAY QUESTIONS

B1. Rini, the owner of Simply Sushi, is a sole proprietor. What are the chief characteristics, advantages, and disadvantages of this form of business organization? Rini wants to obtain additional capital to expand Simply Sushi, but she does not want to lose control of the firm. As a sole proprietor, what is her best option to attain these goals?

ANSWER: A sole proprietorship is the simplest form of business organization. In a sole proprietorship, the owner and the business are the same. Anyone who creates a business without designating a specific form for its organization is doing business as a sole proprietorship. An advantage of the sole proprietorship is its greater flexibility over other forms of business organization. The owner makes all of the decisions and can operate the enterprise without any formalities.

A significant disadvantage of this form of organization, however, is that unlike most other forms of business organization, there are no limits on the liability of the owner for the debts and obligations of the firm. Another disadvantage of the sole proprietorship form of doing business is indicated by Rini's dilemma in this question. The ability of a sole proprietor to raise capital while maintaining control, and retaining the same form, is limited chiefly to borrowing funds. Bringing in partners would convert the business to a partnership. Issuing stock would require incorporating or establishing another form of business. Selling the business would sacrifice all control. The only way to obtain additional business capital without accumulating it through business profit is by borrowing funds.

PAGES: Section 1
BUSPROG: Reflective AICPA: BB-Decision Modeling

B2. Mucho Tacos, Inc., sells franchises. Mucho Tacos imposes on its franchisees standards of operation and personnel training methods. What is the potential pitfall to Mucho Tacos if it exercises too much control over its franchisees?

ANSWER: A provision in a franchise agreement permitting the franchisor to establish and enforce certain quality standards is valid and unquestionable. A franchisor has a legitimate interest in maintaining the quality of its products or services to protect its name and reputation.

But too much control over the operations of its franchisees risks potential liability. For example, under the doctrine of *respondeat superior*, the exercise of too much control may result in the franchisor's liability for the torts of a franchisee's employees. That is, if the franchisor has a right to control the franchisee's operations and exercises this right to a significant degree, and an employee under this control acts in a tortious or criminal manner that results in an injury to another, the franchisor may be held vicariously liable.

PAGES: Section 2
BUSPROG: Reflective AICPA: BB-Decision Modeling