



*Guiding You Through the Legal Maze.<sup>SM</sup>*

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**AN ACCOUNTANT'S REPRESENTATION  
OF A FRANCHISOR OR FRANCHISEE CLIENT**

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## **I. OVERVIEW OF FRANCHISE LAWS**

### **A. HISTORICAL BACKGROUND**

1. **Pre-1970.** There were no laws specifically regulating the sale of franchises before 1970. Disgruntled franchisees who sued their franchisors claimed, in addition to other claims, that the sale of a franchise constituted the illegal sale of a security. But the courts consistently ruled that a franchise relationship was not a "security" under the securities laws due to the active involvement of the franchisee in the operation of the business. Due to abuses by a minority of individuals and companies, the need for specific regulation was perceived.

#### **2. The '70s, '80s and '90s.**

(a) In 1970, California enacted its Franchise Investment Law requiring the prior registration and approval of the franchisor by the state, including the creation of a disclosure statement to be given to prospective franchisees before the sale was completed.

(b) In 1975, the Midwest Securities Commissioners Association, in reaction to the inability to regulate franchising using their existing securities laws, developed a franchise disclosure and registration law called the Uniform Franchise Offering Circular ("UFOC"). Eventually, from 1975 through 1980, 15 states adopted the same or similar versions of such a law.

(c) In 1978, the Federal Trade Commission decided that nationwide, federal regulation was necessary. It adopted the FTC Franchise Rule, similar to, but not identical to, the UFOC. Since the UFOC provides for greater disclosure to prospective franchisees it was not preempted by the FTC Franchise Rule, thereby creating dual regulation at the federal and state level.

(d) Since 1980, no other state has adopted a franchise registration law, although legislation has been proposed in some states from time to time. Indiana, Michigan, South Dakota and Wisconsin have since changed from registration and review states to "notice only" states making the registration process less burdensome.

(e) Florida has adopted a "notice only" registration in order to be clearly exempt from Florida's Sale of Business Opportunities Act. (F.S. § 559.802.)

(f) In 1994, the UFOC Guidelines were substantially revised to expand the amount and types of disclosure required by franchisors and for the FOC to be in "plain English." The new UFOC Guidelines became mandatory on January 1, 1995, in the registration states and mandatory everywhere else (including Florida) on January 1, 1996.

(g) On July 1, 2008, a new revised FTC Franchise Rule became mandatory. The new rule expands certain disclosure requirements and changes the name of the disclosure document from a Franchise Offering Circular to a Franchise Disclosure Document ("FDD").

(h) Many states regulate the franchise relationship, even though these states do not have any franchise disclosure and registration laws. Thus, a franchisor may not have to register in a state to sell franchises there, but the relationship between the franchisor and its franchisees in that state

may be subject to a variety of relationship laws, including those which do not permit termination of a franchisee without due cause, regardless of the terms of the franchise agreement. Legislation in the area of franchise relationships is a continuing and active area of franchise laws both at the state level and the federal level.

## **B. CURRENT LEGAL ENVIRONMENT**

### **1. Federal Laws.**

(a) **New FTC Franchise Rule.** This rule is formally titled "Federal Trade Commission Rule Regarding Franchising and Business Opportunity Ventures Disclosure Requirements and Prohibitions" (16 C.F.R. Part 436). It governs the offering for sale of franchises in all 50 states, Puerto Rico and the U.S. Virgin Islands.

#### **(i) Franchise Disclosure Document**

☞ A franchisor must use the new Franchise Disclosure Document format. The prior 2 formats (FTC Disclosure Statement or the Franchise Offering Circular) can no longer be used.

#### **(ii) Delivery of Franchise Disclosure Document to a Prospective Franchisee**

☞ The Franchise Disclosure Document must be given to a prospective franchisee at least 14 days before the franchisee signs any franchise-related agreement or the franchisor receives any money from the franchisee.

☞ The franchisee must also receive a franchise agreement containing all material terms at least 7 days before signing the franchise agreement.

☞ The 14-day and 7-day periods described above can run concurrently.

#### **(iii) Currency of Franchise Disclosure Document**

☞ The information contained in the Franchise Disclosure Document must be current as of the close of the franchisor's most recent fiscal year. The franchisor now has 120 days to prepare an updated Franchise Disclosure Document that includes its audited financial statements for its previous fiscal year.

☞ Any "material" change in the information must be disclosed in a supplement to the FDD at least quarterly (*e.g.*, quarterly financial statements showing material changes, franchise sales and/or terminations showing material changes, etc.).

☞ The Franchise Disclosure Document must be updated annually and the information contained in the quarterly supplements must be included in the body of the Franchise Disclosure Document.

(iv) **Violation of the FTC Franchise Rule**

☞ Unfair and deceptive act or practice under Section 5 of the Federal Trade Commission Act.

☞ FTC may bring civil penalty action of up to \$10,000 per violation per day.

☞ Also subject to FTC action for damages brought on behalf of injured franchisees.

☞ While there is no private cause of action, violation of FTC Franchise Rule constitutes a violation under a state's "Little FTC" Act (for example, Part II of Chapter 501 of the Florida Statutes) creating liability for a franchisee's damages and attorneys' fees and costs.

2. **State Laws.**

(a) **Franchise Registration/Disclosure Laws**

(i) The FTC Franchise Rule preempts state law only if there is a conflict between the two, and also if the FTC Franchise Rule affords greater protection to a prospective franchisee. Where state law affords greater protection, state law is not preempted and a franchisor must also comply with state law - resulting in dual regulation. Florida does not have a franchise registration/disclosure law.

(ii) Fifteen states have franchise investment laws modeled after or deferring to the FTC Franchise Rule:

California	North Dakota
Hawaii	Oregon (disclosure only)
Illinois	Rhode Island
Indiana (notice only)	South Dakota (notice only)
Maryland	Virginia
Michigan (notice only)	Washington
Minnesota	Wisconsin (notice only)
New York	

(b) **Franchise Relationship Laws**

Twenty-one states have laws which regulate to some extent the relationship between a franchisor and a franchisee in a general franchise relationship:

Arkansas	Michigan
California	Minnesota
Connecticut	Mississippi

Delaware  
Florida (F.S. § 817.416)  
Hawaii  
Illinois  
Indiana  
Kentucky  
Maryland

Missouri  
Nebraska  
New Jersey  
North Dakota  
South Dakota  
Virginia  
Washington  
Wisconsin

**C. FDD DISCLOSURE CATEGORIES**

**1. The Franchisor, and Any Parents, Predecessors and Affiliates** - Identity of the Franchisor, and any Parents, Predecessors, and Affiliates - description of the franchise business, and prior business experience of the franchisor regarding the business to be operated as a franchise.

**2. Business Experience** - identity and business experience of the franchisor's directors and principal officers, and their occupations and employers, within the past 5 years as well as any franchise brokers.

**3. Litigation** - litigation history of the franchisor and its directors, principal officers and franchise brokers during the previous 10 years.

**4. Bankruptcy** - bankruptcy history of the franchisor, its officers and directors during the previous 10 years.

**5. Initial Fee** - the franchisee's initial franchise fee or other initial payments.

**6. Other Fees** - recurring or isolated fees or payments required of the franchisee.

**7. Your Estimated Initial Investment** - initial investment requirements of the franchisee.

**8. Restrictions on Sources of Products and Services** - obligations of the franchisee to purchase or lease from designated sources and purchase or lease in accordance with specifications or from approved suppliers.

**9. Franchisee's Obligations** - a checklist of what the franchisee is obligated to do under the franchise agreement.

**10. Financing** - financing arrangements offered by the franchisor.

**11. Franchisor's Assistance, Advertising, Computer Systems and Training** - a Description of promised assistance, advertising, computer systems and training by the franchisor.

**12. Territory** - a description of any exclusive area or territory granted to the franchisee.

**13. Trademarks** - information about trademarks and other proprietary symbols.

14. **Patents, Copyrights and Proprietary Information** - information about patents and copyrights and proprietary information.
15. **Obligation to Participate in the Actual Operation of the Franchise Business** - requirements for the franchisee, or affiliated person, to participate personally in operating the franchise.
16. **Restrictions on What the Franchisee May Sell** - restrictions on goods or services offered by the franchisee.
17. **Renewal, Termination, Transfer and Dispute Resolution** - renewal, termination, repurchase, modification and assignment of the franchise agreement and related information.
18. **Public Figures** - arrangements with public figure involvement.
19. **Financial Performance Representations** - disclosures regarding the financial performance of existing outlets.
20. **Outlets and Franchisee Information** - information regarding franchises of the franchisor and company outlets.
21. **Financial Statements** - last 3 years audited plus current balance sheet.
22. **Contracts** - copies of franchise agreement and related contracts.
23. **Receipt** - 2 copies of the Receipt.

## **II. REPRESENTING A PROSPECTIVE FRANCHISEE**

### **A. REVIEW FDD TO ASSIST IN PREPARING CLIENT'S BUSINESS PLAN**

#### **1. ITEM 5 - Initial Fees**

In ITEM 5, the franchisor must disclose all fees and payments, whether payable in lump sum or installments, for services or goods received from the franchisor before the franchisee's business opens. These initial fees include:

- (a) Deposits;
- (b) Application Fees;
- (c) Initial Franchise Fee; and
- (d) All other initial fees.

The Initial Franchise Fee is to be amortized over a 15-year period (I.R.C. § 197). Organizational costs are to be amortized over a 180-month period (I.R.C. §§ 195 and 248).

## **2. ITEM 6 - Other Fees**

In ITEM 6, the franchisor must disclose other recurring or isolated fees or payments that the franchisee must pay to the franchisor or its affiliates or that the franchisor or its affiliates impose or collect in whole or in part on behalf of a third party. These fees include:

- (a) Royalty and Service Fees.
- (b) Advertising Contributions to National or Regional Marketing Fund.
- (c) Lease Negotiation Fees.
- (d) Construction and Remodeling Fees.
- (e) Training Fees and Expenses.
- (f) Fees for Additional Assistance.
- (g) Software Fees.

## **3. ITEM 7 - Your Estimated Initial Investment**

The information contained in ITEMS 5, 6 and 7 will assist you in preparing your client's business plan so that you and your client know what your client's financial obligations will be in purchasing the franchise and in opening and operating the franchised business. These payments to be disclosed in ITEM 7 include:

- (a) Real property, whether purchased or leased. If neither estimable nor describable by a low-high range, describe requirements, such as property type, location and building size.
- (b) Equipment, fixtures, other fixed assets, construction, remodeling, leasehold improvements and decorating costs, whether purchased or leased.
- (c) Inventory required to begin operation.
- (d) Security deposits, utility deposits, business licenses, and other prepaid expenses.
- (e) Additional funds required by the franchisee before operations begin and during the initial phase of the franchise (3-6 months). Many franchisors grossly estimate this amount which I interpret to be working capital.
- (f) Other payments that the franchisee must make to begin operations.

These expenditures must be listed in a table listing preopening expenses first. The franchisor must use footnotes to further comment on the expenditures.

#### **4. ITEM 10 - Financing**

If the franchisor, its agent or affiliate, provides financing of the Initial Franchise Fee or any other item disclosed in ITEM 7, the franchisor must disclose the terms and conditions of the financing arrangement. Financing includes leases, notes and installment contracts, but does not include payments due within 90 days on open account financing. The franchisor may summarize the terms of each financing arrangement in a table, using footnotes to entries in the table to provide additional information that does not fit in the table.

#### **5. ITEM 19 - Financial Performance Representations**

Surprisingly, the FTC Franchise Rule does not require a franchisor to give a financial performance representation (formerly, an "earnings claim"), perhaps the most important information any buyer of a business would require. In fact, most franchisors (approximately 80%) do not make any financial performance representation. A financial performance representation made in connection with the offer of a franchise must be included in full in ITEM 19 of the FDD and must have a reasonable basis at the time it is made. If no representation is made, ITEM 19 must contain a negative disclosure. A financial performance representation must include a description of its factual basis and the material assumptions underlying its preparation and presentation. Many franchisors prepare its financial performance representation through the use of an independent certified public accountant, who prepares a financial forecast or projection in accordance with AICPA standards.

Some of the things you should consider include:

(a) If the FDD you are reading does not include a financial performance representation you and your client will need to do additional homework including analyzing industry statistics and having your client talk to existing franchisees.

(b) Even if a financial performance representation is made, don't blindly assume that your client will achieve the same numbers. These are just estimates. Your client needs to prepare its own financial projection for the business.

(c) If ITEM 19 states that no financial performance representation is made and the franchisor or its broker orally or in a separate writing (the "cocktail napkin") makes a earnings claim - this violates the franchise laws. Make the cocktail napkin an exhibit to the franchise agreement. Get the oral statement in writing.

(d) If a financial performance representation is made, what is the basis of the claim (historical figures or unsubstantiated projections)? Were all outlets included? Are the assumptions reasonable? What do the disclaimers say? Did an independent certified public accountant prepare the earnings claim? If yes, was the earnings claim prepared in accordance with AICPA Standards for Financial Forecasts or Projections?

(e) Don't have your client rely on a multiplication table which provides sales per day times the number of outlets. Your client will overestimate. Get the real numbers.

## 6. **ITEM 21 - Financial Statements**

The franchisor must prepare its financial statements in accordance with GAAP. These financial statements must be audited by an independent certified public accountant. Unaudited statements may be used for interim periods. The following financial statements must be included:

(a) The franchisor's balance sheets for the last 2 fiscal year ends before the application date, as well as statements of operations, of stockholders' equity and of cash flows for each of the franchisor's last 3 fiscal years. If the most recent balance sheet and statement of operations are as of a date more than 90 days before the application date, then the franchisor must submit and include an unaudited balance sheet and statement of operations as of a date within 90 days of the application date.

(b) If the franchisor's is part of an affiliated group, the franchisor may include financial statements of its affiliated company, if the affiliated company's financial statements satisfy ITEM 21 and the affiliated company absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement.

(c) When a franchisor owns a direct or beneficial, controlling financial interest in another corporation, its financial statements should reflect the financial condition of the franchisor and its subsidiaries.

(d) If the disclosee is a subfranchisor, the FDD must include separate financial statements for the franchisor and subfranchisor related entity.

(e) Consolidated and separate financial statements must be prepared in accordance with GAAP.

Some of the things you and your client should consider include:

- What is the franchisor's net worth? The FTC Franchise Rule does not require a franchisor to have a certain minimum net worth. However, many of the franchise registration states will require a parent guarantee, surety bond or escrow of the initial fees as a condition to registration. If it is negative or small, will the franchisor be able to continue to operate? Consider an escrow of the initial fees until the franchisee becomes operational if the franchise will be in a non-regisrtation state.

- Look at the accountants' notes contained at the end of the financial statements very carefully. They may say something important that is not otherwise mentioned in the FDD.

## **B. YOUR CLIENT'S DUE DILIGENCE OBLIGATIONS**

### **1. Talk to Existing and Previous Franchisees**

(a) As part of your client's due diligence investigation, the **best** thing you can do is to tell your client to visit and talk to as many existing franchisees as possible to see how they are doing.

They are already down the road your client is thinking of traveling. ITEM 20 of the FDD contains the names, addresses and telephone numbers of all or, at least 100, existing franchises. Are they making money? How long did it take them to break even? Did the franchisor fulfill its promises? If the franchisee could do it all over again, would they still buy the franchise? Are they contemplating buying additional franchises and expanding? The franchisor must also include in its FDD the names, addresses and telephone numbers of every franchisee whose franchise was terminated, canceled, not renewed or ceased doing business during the franchisor's last fiscal year, as well as any franchisee who has not been in communication with the franchisor within the 10-week period before the effective date of the FDD. Your client may want to know what they have to say.

(b) Also, check ITEM 3 of the FDD for pending or past litigation involving the franchisees. Have your client talk to these people. Your client should now have both sides of the story to form his or her own opinion.

(c) It may also be wise for your client to visit the home office or regional office of the franchisor to get a feel for the quality of the operation first hand. Your client should ask to glance over the confidential operating manual and other manuals to determine their thoroughness and completeness.

## **2. Analyze an Industry and a Franchisor**

(a) Franchising is not for everyone. A franchisee needs to be able to follow the system prescribed by the franchisor. If your client is a very independent and entrepreneurial person, franchising may not be right for him or her. On the opposite end of the spectrum, your client must possess good management, organizational and leadership skills to run the business.

(b) Is the industry your client is planning to enter on its way up? Stagnant? On its way down? Analyze what effect technology, changing lifestyles and changing demographics may have on the industry.

(c) Compare the various offerings in an industry. Once your client has targeted an industry, he or she must look at all of the various offerings in the industry to see which opportunity will survive in the long run, if a franchise is available in his or her locality, the cost and the amount of service and support given by the franchisor.

(d) The American Association of Franchisees and Dealers ("AAFD") developed a list of "8 Things To Look For In a Franchise:"

(i) The franchisor is primarily interested in distributing quality goods and services to ultimate consumers.

(ii) The franchisor is dedicated to a franchise system as its *primary* mechanism of product and service distribution.

(iii) The franchisor, in fact, produces and markets quality goods and services for which there is an established market demand.

(iv) The franchisor enjoys a substantial reputation and acceptance (this is frequently identified with favorable trademark recognition).

(v) The franchisor has an established, well-designed marketing and business plan and offers prospective franchisees substantial and complete training.

(vi) The franchisor has developed good relations with its franchisees, and the franchisees have a strong franchisee organization that has negotiating leverage with the franchisor.

(vii) The franchisor has a history of attractive earnings by its franchisees. *Only invest in a franchisor that provides meaningful disclosure of the earnings history and potential of the franchise opportunity being offered.* Anything less is buying a pig in a poke. Like an investment, the franchise opportunity must project sufficient economic benefit to justify the cost of buying the franchise and starting the business. In other words, the economic rewards must justify the price.

(viii) Finally, is the franchisor respectful of certain fundamental rights of business ownership?

### **III. REPRESENTING THE SELLER OR BUYER OF AN EXISTING FRANCHISED OUTLET**

Most newer or sophisticated franchise agreements have provisions giving the franchisor certain rights upon the franchisee's proposed transfer of the franchised business, regardless of whether the franchisee sells his or her assets or sells his or her stock or membership interests in a corporate or limited liability company franchisee. However, the franchise agreement should be thoroughly reviewed because the sale of stock may not be specifically addressed. A thorough review of the franchise agreement should be undertaken before an offer to sell is made or an offer to purchase is accepted.

#### **A. NO ENCUMBRANCING**

Many franchise agreements provide that neither the franchisee nor any ownership interest in the franchise may be pledged, mortgaged, hypothecated, granted as a security interest for an obligation or in any manner encumbered. If your client is obtaining a loan, make sure the franchisee's interest in the franchise agreement is not collateral without the franchisor's prior written consent.

#### **B. "FOR SALE" RESTRICTIONS**

1. The franchise agreement may provide that in connection with the offer for sale of an existing franchised business, the franchisee is prohibited from putting up a "For Sale" sign at the premises.

2. In addition, the franchise agreement may prohibit the use of the franchisor's trade name and other proprietary marks in connection with the sale and only allow generic advertising (for example, "Restaurant Business For Sale," not "McDonald's For Sale").

### **C. THE FRANCHISOR'S RIGHT OF FIRST REFUSAL**

1. Many franchise agreements provide that the franchisor has the right of first refusal to purchase the franchisee's franchised business on the same terms and conditions as offered by a bona fide unrelated third party purchaser. The franchisor has a period of time (usually 30-60 days) to decide if it wants to match the third party's offer. The reason why the franchisor usually retains this right is to control who may purchase the franchise and also to repurchase franchises and convert them to company outlets.

2. If the right of first refusal exists in the franchise agreement, the following must be done:

(a) There should be a contingency in the sale agreement making the obligations of the seller to sell and the buyer to purchase contingent upon obtaining the waiver of the right of first refusal by the franchisor.

(b) A notice should be given to the franchisor in accordance with the terms of the right of first refusal provision. The notice should include a request for a waiver.

(c) The copy of the third party's offer or the contract must be sent to the franchisor.

(d) The parties should obtain the waiver of right of first refusal in writing.

3. Some franchisees give the franchisor a right of first purchase rather than a right of first refusal. A right of first purchase differs from a right of first refusal. Under this arrangement a franchisee, upon determining that he or she desires to sell the franchised business would approach a franchisor with specific price and terms and offer a franchisor the opportunity to purchase the franchised business. A franchisor would have a 30-day period within which it could accept or reject the proposed purchase at the designated price. If a franchisor rejects the opportunity to purchase, a franchisee would then have the right to offer the franchised business to third persons (either within or outside the franchise system) at or above the designated price. Should a franchisee wish to offer or sell the franchised business at a lower price and/or terms less favorable to him or her within the 120-day period, a franchisee must first give a franchisor a "right of first refusal" to purchase the business at the new price and terms. Upon receiving the new price and terms from a franchisee, a franchisor would be required to accept or reject such offer within 10 days of the date of receipt of the information by notifying a franchisee, in writing, of its decision.

### **D. CONDITIONS PRECEDENT TO THE FRANCHISOR'S CONSENT TO TRANSFER**

1. Most franchise agreements provide that the grant of the franchise to the franchisee is personal and that the franchisee is prohibited from selling the franchised business without the prior written consent of the franchisor. Usually, the franchise agreement details the conditions in which the franchisor will consent to a transfer, including:

- (a) Waiver of the franchisor's right of first refusal.
- (b) Absence of both monetary and non-monetary defaults under the franchise agreement by the franchisee.
- (c) General release of any and all claims from the franchisee to the franchisor.
- (d) Payment of a transfer fee (from nominal to a significant percentage of the initial franchise fee or purchase price) which may or may not include a training fee. This expense should be addressed in the purchase agreement as to who pays--seller or buyer.
- (e) Execution by the transferee of the then-current form of franchise agreement (which may be materially different), rather than assumption of the existing franchise agreement.
- (f) Transferee must meet the requirements of the franchisor including reputation, business skills and financial capacity.
- (g) Completion of training by the transferee and manager.
- (h) Renovation and upgrading of the franchised business which can be substantial dollars.
- (i) Continued occupancy of the business premises.
- (j) No excessive purchase price (franchisor veto power).
- (k) No release of the original franchisee (ongoing guarantee).

2. If the franchise agreement is silent on its assignability, assignment by the franchisee will be presumed.

#### **E. ESTOPPEL LETTER FROM THE FRANCHISOR**

1. Regardless of whether assets or stock is being purchased, it is advisable to obtain a written estoppel letter from the franchisor (similar to an estoppel letter from a landlord) confirming the following:

- (a) Consent to the transfer (if required).
- (b) Waiver of the right of first refusal (if required).
- (c) Acknowledgement there are no defaults by the franchisor or the franchisee under the franchise agreement and related documents.

(d) That there are no addenda, riders or modification of the franchise agreement or oral or "side" agreements.

2. This would also be an appropriate time to try to "renegotiate" the franchise agreement on behalf of the buyer, but usually the franchisor will insist on the execution of its then-current franchise agreement without negotiation.

#### **IV. REPRESENTING A FRANCHISOR**

##### **A. FINANCIAL STATEMENT REQUIREMENTS**

###### **1. Preparation of Financial Statements**

(a) Must be prepared in accordance with GAAP.

(b) Must be prepared by an independent CPA or, if permitted by the franchise law of a particular state, by an independent public accountant.

(c) Unaudited statements may be used for interim periods.

###### **2. Types of Statements**

(a) The franchisor's balance sheets for the last 2 fiscal year ends before the application date, as well as statements of operations, of stockholders' equity and of cash flows for each of the franchisor's last 3 fiscal years. If the most recent balance sheet and statement of operations are as of a date more than 90 days before the application date, then the franchisor must submit and include an unaudited balance sheet and statement of operations as of a date within 90 days of the application date.

(b) If the franchisor's is part of an affiliated group, the franchisor may include financial statements of its affiliated company, if the affiliated company's financial statements satisfy ITEM 21 and the affiliated company absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement.

(c) When a franchisor owns a direct or beneficial, controlling financial interest in another corporation, its financial statements should reflect the financial condition of the franchisor and its subsidiaries.

(d) If the disclosee is a subfranchisor, the offering circular must include separate financial statements for the franchisor and subfranchisor related entity.

(e) Consolidated and separate financial statements must be prepared in accordance with GAAP.

(f) Unaudited statements for prior years may be used. Such use is limited only to the extent that audited statements have not been made, and provided such statements are accompanied

by a clear and conspicuous disclaimer that they are unaudited. Audited financial statements will be required for future years.

### **3. Controlling Company Statements**

In lieu of the franchisor's audited statements, complete audited financial statements of a controlling company may be included in the FDD, but only if the controlling company guarantees to assume the debts and obligations of the franchisor under the franchise agreement should the franchisor become unable to perform its duties and obligations.

### **4. Consolidated and Separate Statements**

(a) Where the franchisor owns, directly or beneficially, a controlling financial interest in any other corporation, the financial statements required to be filed should normally reflect, on a consolidated basis, the financial condition of the franchisor and each of its subsidiaries.

(b) A separate financial statement will normally be required for each substantial franchisor or subfranchisor related entity.

(c) A company controlling 80% or more of a franchisor should normally be required to file its financial statements.

(d) Consolidated and separate financial statements must be prepared in accordance with GAAP.

(e) If the statements described in 4(b) or 4(c) are required to be included, the franchisor should include a clear and conspicuous disclosure that the other company whose statements are included is not responsible for or liable on the franchise agreement and is not a guarantor of the performance of the franchisor or any of the franchisor's obligations.

## **B. CONSENT OF ACCOUNTANT**

### **1. Manually Signed Consent**

Under the 2008 Franchise Registration and Disclosure Guidelines a "Consent of Accountant" signed by the accountant whose audited financial statements for the last fiscal year are disclosed in the FDD must be provided with each initial or renewal filing application. The form of Consent of Accountant is set forth as Form F to the Guidelines.

### **2. Public Document**

The financial statements become a public document when a FDD is registered in a franchise registration state. Florida is not a franchise registration state.

### **C. FINANCIAL PERFORMANCE REPRESENTATIONS**

Franchisors are permitted to disclose to prospective franchisees expense or cost information without it being considered a financial performance representation. Also, a franchisor may disclose financial performance information limited to a subset of company outlets or franchised outlets. A financial performance representation claim does not include mere puffery.

### **D. ITEM 19 OF THE FDD**

ITEM 19 of the FDD sets forth the standards under which any financial performance representations (FPR) may be made to a prospective franchisee in connection with an offer of a franchise. If the franchisor makes any FPR to prospective franchisees, the franchisor must have a reasonable basis and written substantiation for the FPR at the time the representation is made and must state the FPR in the ITEM 19 disclosure. The franchisor must also disclose the following:

(a) Whether the FPR is an historic financial performance representation about the franchise system's existing outlets, or a subset of those outlets, or is a forecast of the prospective franchisee's future financial performance.

(b) If the FPR relates to past performance of the franchise system's existing outlets, the material bases for the representation, including:

(i) Whether the FPR relates to the performance of all of the franchise system's existing outlets or only to a subset of outlets that share a particular set of characteristics (for example, geographic location, type of location (such as free standing vs. shopping center), degree of competition, length of time the outlets have operated, services or goods sold, services supplied by the franchisor, and whether the outlets are franchised or franchisor-owned or operated).

(ii) The dates when the reported level of financial performance was achieved.

(iii) The total number of outlets that existed in the relevant period and, if different, the number of outlets that had the described characteristics.

(iv) The number of outlets with the described characteristics whose actual financial performance data were used in arriving at the representation.

(v) Of those outlets whose data were used in arriving at the representation, the number and percent that actually attained or surpassed the stated results.

(vi) Characteristics of the included outlets that may differ materially from those of the outlet that may be offered to a prospective franchisee.

(c) If the FPR is a forecast of future financial performance, state the material bases and assumptions on which the projection is based. The material assumptions underlying a forecast include significant factors upon which a franchisee's future results are expected to depend. These

factors include, for example, economic or market conditions that are basic to a franchisee's operation, and encompass matters affecting, among other things, a franchisee's sales, the cost of goods or services sold, and operating expenses.

(d) A clear and conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the FPR.

(e) A statement that written substantiation for the FPR will be made available to the prospective franchisee upon reasonable request.

(f) If a franchisor wishes to disclose only the actual operating results for a specific outlet being offered for sale, it need not comply with this section, provided the information is given only to potential purchasers of that outlet.

(g) If a franchisor furnishes financial performance information according to this section, the franchisor may deliver to a prospective franchisee a supplemental financial performance representation about a particular location or variation, apart from the disclosure document. The supplemental representation must:

- (i) Be in writing.
- (ii) Explain the departure from the financial performance representation in the FDD.
- (iii) Be prepared in accordance with the FTC Franchise Rule requirements.
- (iv) Be furnished to the prospective franchisee.

FPRs are subject to the anti-fraud provisions under state law.

#### **E. EXCEPTION FOR DISCLOSURE AS TO A SPECIFIC OUTLET**

A franchisor may disseminate financial performance information, and not be subject to the requirements of ITEM 19 of the FDD if the FPR is limited solely to the actual operating results of a specific outlet being offered for sale and if the representations are given only to potential purchasers of that outlet. The franchisor must include disclosure of the name and last known address of each owner of the outlet for the prior 3 years.

#### **F. SUPPLEMENTAL PERFORMANCE REPRESENTATIONS**

If the franchisor has included a FPR disclosure in ITEM 19 of the FDD and wants to make additional disclosure as to a specific location or circumstance outside of the FDD, the franchisor is permitted to do so provided the franchisor issues a written "supplemental performance representation" prepared in accordance with ITEM 19, explains the departure from the financial performance disclosure contained in the FDD and leaves the supplemental financial performance disclosure with the prospective franchisee. It is a useful means to provide more comprehensive earnings claims information than in the FDD to address specific informational requests of any

prospective franchisee. Note that some initial earnings claims, however basic, must still be provided in the FDD before a supplemental financial performance disclosure outside the FDD may be made.

## **V. FASB-45 (ACCOUNTING FOR FRANCHISE FEE REVENUE)**

### **A. PURPOSE**

FASB-45 (Accounting for Franchise Fee Revenue) establishes accounting and reporting standards for franchisors, particularly the timing of recognizing revenue from initial franchise fees. It became effective for fiscal years beginning after June 15, 1981. Its predecessor was an AICPA industry accounting guide by the same name.

### **B. STANDARDS OF FINANCIAL ACCOUNTINGS AND REPORTS**

Conventional accounting practices and methods, including GAAP, should be used in accounting for franchise revenue. However, unique accounting problems exist, particularly as to the timing and classification of such revenues. FASB-45 attempts to give guidance as to these situations.

#### **1. Individual Franchise Sales (Single-Outlet)**

(a) Initial franchise fees will ordinarily be recognized when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor with an appropriate provision for estimated uncollected amounts. This may be several months after the franchise agreement is executed when all contingencies (*e.g.*, acceptance of the contract by the franchisor at its principal office, site selection approval and successful initial training of the franchisee and/or its manager) have been satisfied and the franchisor has performed its initial services to the franchisee. Substantial performance also means when the franchisor has no remaining obligations or intent to provide a refund. The earliest that substantial performance is presumed to have occurred is when the franchisee commences operation, unless the franchisor can demonstrate otherwise.

(b) Where a franchisor receives a large initial franchise fee and continuing franchise or royalty fees are small in relationship to the franchisor's costs of providing continuing services, then a portion of the initial franchise fee should be deferred and amortized over the term of the franchise agreement if the franchisor's costs of providing the continuing services and a reasonable profit margin will exceed the continuing franchise fee revenue. The portion deferred shall be an amount sufficient to cover the excess costs plus a reasonable profit.

#### **2. Area Franchise Sales (Multi-Outlet)**

Development fees or other initial fees for an area development agreement, subfranchisor agreement, regional representative agreement or other multi-outletfranchise agreement are treated in the same manner as the initial franchise fee for a single-outletfranchise (*i.e.*, when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor). If the franchisor's substantial services depend on the number of individual franchises to be opened, area franchise fees must be recognized in proportion to the initial mandatory services

provided based on the number of outlets to be opened (*e.g.*, area development agreement). If the franchisor's substantial services are not affected significantly by the number of outlets to be opened in an area (*e.g.*, subfranchise agreement), the area franchise fee will be treated similarly to a single-outlet initial franchise fee. Revenue that may have to be refunded is not to be recognized until the franchisee has no right to receive a refund.

### **3. Relationships between the Franchisor and the Franchisee**

A franchisor may guarantee the borrowings of a franchisee, have a creditor interest in the franchisee (secured or unsecured) or control a franchisee's operations by sales or other agreements. A franchise agreement may give the franchisor an option to purchase the franchisee's business. If such an option exists, the likelihood of the franchisor acquiring the outlet must be considered in accounting for the initial franchise fee.

### **4. Commingled Revenue**

Where the initial franchise fee includes tangible property such as signs, equipment, inventory, and land and building, the portion of the initial franchise fee applicable to the tangible property must be based on the fair value of such property and may be recognized before or after recognizing the portions applicable to the initial services, usually when title to the property passes to the franchisee. As to initial services, the initial franchise fee must not be allocated among the different services as a means of recognizing any part of the fee for services as revenue before all the services have been substantially performed unless actual transaction prices are available for individual prices.

### **5. Continuing Franchise Fees (Royalties)**

Continuing franchise or royalty fees must be reported as revenue as the fees are actually earned and become a receivable from the franchisee. Costs relating to continuing franchise fees must be expensed as incurred.

### **6. Contingency Product Sales**

Bargain purchases of equipment or supplies by the franchisee from the franchisor require a portion of the initial franchise fee to be deferred and accounted for as an adjustment of the selling price when the franchisee purchases the equipment or supplies. The portion deferred is either: (a) the difference between the selling price to other customers and the bargain purchase price; or (b) an amount sufficient to cover any cost in excess of the bargain purchase price and provide a reasonable profit on the sale, as appropriate.

### **7. Agency Sales**

Where the franchisor acts as a sales agent for the franchisee's inventory and equipment purchases, the franchisor should not account for these transactions as revenue.

## **8. Franchising Costs**

Direct (incremental) costs relating to franchise sales where revenue has not been recognized ordinarily must be deferred until the related revenue is recognized; however, the deferred costs must not exceed anticipated revenue less anticipated additional related costs. Indirect regular and recurring costs such as G&A must be expensed as incurred. Costs yet to be incurred shall be accrued and charged against income no later than the period in which the related revenue is recognized.

## **9. Prepossessed Franchises**

If the franchisee fails to open the franchised outlet and receives a refund of the consideration received, the transaction must be treated as a sale cancellation and the revenue previously recognized must be accounted for as a reduction in revenue in the period the franchise is repossessed. If no refund is made: (a) the transaction must not be regarded as a sale cancellation; (b) no adjustment must be made to any previously recognized revenue; (c) any estimated uncollectible amounts resulting from unpaid receivables must be provided for; and (d) any consideration retained for which revenue was not previously recognized must be reported as revenue.

## **10. Disclosures in the Financial Statements**

(a) The nature of all significant commitments and obligations of the franchisor under the franchise agreements, including a description of services the franchisor has agreed to provide that have not yet been substantially performed shall be disclosed in the financial statements.

(b) If no basis for estimating the collectibility of specific franchise fees exists, the notes to the financial statements must disclose whether the installment or cost recovery method is being used to account for the related franchise fee revenue. Furthermore, the sales price of such franchises, the revenue and related costs deferred (both currently and on a cumulative basis), and the periods in which such fees become payable by the franchisee must be disclosed. Any amounts originally deferred but later recognized because uncertainties regarding the collectibility of franchise fees are resolved also must be disclosed.

(c) Initial franchise fees must be segregated from other franchise fee revenue if they are significant. If it is probable that initial franchise fee revenue will decline in the future because sales predictably reach a saturation point, disclosure of that fact is desirable. Disclosure of the relative contribution to net income of initial franchise fees also is desirable if not apparent from the relative amounts of revenue.

(d) Revenue and costs related to company outlets must be distinguished from revenue and costs related to franchised outlets when practicable. That may be done by segregating revenue and costs related to franchised outlets. If there are significant changes in company outlets or franchised outlets during the period, the number of: (i) franchises sold; (ii) franchises purchased during the period; (iii) franchised outlets in operation; and (iv) company outlets in operation must be disclosed.

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