Franchising earnings claims: To do or not to do

By David L. Cahn, Esq.

The debate continues: Should franchisors include earnings claims (also known as financial performance agreements) in Item 19 of their Uniform Franchise Offering Circular, or should they leave it up to prospective franchisees to research the likelihood of success?

At first blush, you may wonder what this debate has to do with CPAs. But think about your client base.

As an increasing number of business owners evaluate their growth options, franchising is becoming more popular. Undoubtedly, a client who is considering such a growth strategy will seek your advice, which means you will be in a position to suggest how they address Item 19 in their Franchise Offering Circular and in their marketing materials.

Option 1: Negative disclosure

The first option is to provide a negative disclosure, since the FTC Trade Rule on franchise sales and UFOC guidelines (for use in states like Maryland, which require registration) do not require that franchisors make earnings claims.

If stating nothing is the chosen preference, the guidelines require this negative disclosure in Item 19: "(Franchisor) does not furnish or authorize its salesperson to furnish any oral or written information concerning the actual or potential sales, costs, income or profits of (the franchise). Actual results vary from unit to unit and (Franchisor) cannot estimate the results of any particular franchise."

But what does such a statement really accomplish from the franchisor's perspective?

The negative disclosure clearly puts the franchisor's sales staff in a difficult position since they legally cannot provide oral or written information to prospects, yet they are encouraged to excite, inform and recruit new franchisees. Additionally, the prospect who encounters a negative disclosure is often left with a negative impression, wondering, "What are they hiding?" This suspicion is exacerbated when the prospect compares one non-disclosure franchise opportunity with other franchisors who disclose their financial information so that prospects can make informed decisions.

Additionally, financial institutions are reluctant to lend money without reliable data to substantiate the pro forma financial statement and validate the applicant's business plan. Few desirable candidates will purchase a franchise before they obtain a commitment for financing.

Despite the inherent difficulty in selling a franchise without providing earnings data, most franchisors still choose the negative disclosure. For most, they choose this path for fear of lawsuits about misrepresentation. Ironically, most franchisors who are sued for misleading sales figures did not provide written earnings claims. In fact, they are the franchisors with anxious salespeople who, for lack of a stated claim, provided information orally or in an informal manner, as on a cocktail napkin.

Option 2: Stated earnings claims

By contrast, the second and preferred option for most franchisors, in my opinion, for preparing Item 19 is to provide financial data that complies with the FTC rule and UFOC guidelines. If presented correctly, the stated earnings figures can actually help protect a franchisor against fraudulent inducement claims. And the perception of honesty and cooperation is a definite marketing advantage.

It is my understanding that a significant percentage of the franchisors who utilize broker networks to help sell business opportunities provide earnings claims. This is, in part, because brokers encourage it, believing a better match can be made between a franchisor and franchisee when a prospect has as much accurate, company-provided information as possible to complement conversations with franchisees and other due diligence efforts.

Since you, as the CPA, may be involved in preparing or evaluating such earnings claims if your client chooses to disclose figures, you should be aware that the information cannot promise or guarantee any income or profit. The data must "have a reasonable basis at the time the claim is made," and a description of the "factual basis and material assumptions underlying its preparation and presentation" should be provided.

Additionally, the franchisor should also include a clearly-worded disclaimer, which states that each franchisee's performance is likely to differ from the figures provided. This is also a good place to again encourage prospective franchisees to do other first-hand research, including talking to franchisees about financials and other aspects of the company.

CPA-provided assistance

In anticipation of assisting in the preparation of such claims, it is likely that you will want to discuss with the appropriate growth-oriented clients the importance of creating systems that can be replicated and the importance of keeping reliable, standard-format financial records so they can be easily used to compile a proper earnings claim if and when they choose franchising as a growth strategy.

You will also want to help your client determine what figures to provide. There is no set format that prescribes what figures — gross profit, gross revenue, net profit, number of customer visits, etc. — to give prospects or in what format. Some franchisors choose to present data in terms of industry benchmarks, such as meals served or lodging rooms booked.

Others regionalize information if geography has an impact on sales. Some retail franchisors prefer to provide data based on the type of location being considered by the prospect, offering different figures for units in strip centers, malls or free-standing stores. And yet another alternative is to give information based on the age of franchisees — startups versus those that have been operational for five or 10 years or more.

Another note to make is whether the figures are historical or projections. If they are historical, the disclosure must state whether the figures are based on all franchisees or only a certain number, the percent of units that attained or surpassed the reported figures and the dates covered by the data (one year, five years, etc.).

Regardless of the figures you and your client choose to present, the cardinal rule is that the figures be real and defendable. The factual basis and assumptions must be described and the franchisor has to be willing to provide additional documentation if a prospective franchisee requests it. Also consider reviewing the draft of the earnings claims with an attorney experienced in representing franchisees or franchisors in litigation. This may be helpful to avoid future disputes over the data presented.

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