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VIA FIRST CLASS MAIL AND EMAIL

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Re: Comments to Proposed Franchise Commentary on Financial Performance Representations

Dear Mr. Cantone:

With this letter, Cheng Cohen LLC submits comments to NASAA’s Franchise and Business Opportunity Project Group’s (the “FPG”) Proposed Commentary on Financial Performance Representations (“Commentary”). We understand and support many of the FPG’s proposals, but hope our comments are constructive and shed light on the challenges faced by franchisors and franchisees alike with respect to this issue. We organized our comments by the order in which they appear in the Commentary.

Definitions.

1. In the definition of "gross profit," the terms "cost of goods sold" and "cost of providing services" should be defined. Whether these items include labor costs, for example, is critical not only to allow the prospective franchisee to have a clear understanding of the “gross profit,” but also from the perspective of consistency from one franchisor’s FDD to the next. For a franchisee that offers services, labor costs are an important component of the “cost of goods/services sold,” but one franchisor might include those costs as part of the cost of providing the services while another franchisor might simply reflect labor costs in the “other expense” category. Without a clearer definition of “gross profit”, comparisons of Item 19 disclosures for competing franchise brands would be unfair if one franchise system used a different definition of "cost of providing services" as a competing franchise system.
2. The definition of "net profit," as written, appears to look at earnings after depreciation but before interest, taxes, and amortization. In our experience, when assessing the value of businesses, most people look at EBITDA; they’re excluding interest, taxes, depreciation and amortization. Depreciation could vary greatly among franchisees and is really meaningless for determining the profitability of a business. Further, franchisees typically do not prepare financial statements according to GAAP; they typically just prepare financial statements using basic categories of income and expenses. In addition, including depreciation is inconsistent with FAQ 19.9, which says that "costs of operation" must exclude depreciation. If we are asking for consistency among franchisors, we would recommend using EBITDA instead of net profits.

FAQ 19.4 – Gross Sales FPR Based on Company-Owned Outlets Alone when Franchisor Has Both Operational Franchises and Company-Owned Outlets.

We recommend revisiting the blanket prohibition on including gross sales FPRs for company-owned outlets without gross sales of operational franchises. Not all franchisors collect financial statements from franchisees, and some – particularly those whose royalty is a flat fee rather than a percentage of revenue – might not even collect gross sales information from franchisees because the information is irrelevant to the royalty calculation. Further, franchisors who do require franchisees to submit gross sales or other financial information often encounter issues with franchisees who refuse to submit the required information. Under FAQ 19.4, as currently drafted, a franchisor with operational franchisees would nevertheless be prohibited from making a gross sales FPR if it doesn’t require financial reports from its franchisees or if it is unable to obtain 100% reporting participation from its franchisees. We suggest that the “Question” be re-written to read: “If a franchisor has operational franchises from whom it collects gross sales information, can the franchisor make a gross sales FPR based on company-owned outlet data alone?”

FAQ 19.6 – FPR Disclosing Gross Profit or Net Profit Based on Company-Owned Outlets When Franchisor Has Operational Franchises.

Requiring a franchisor to adjust its costs to reflect potential material financial and operational differences between company-owned outlets and franchised outlets is the equivalent to requiring the franchisor to make a projection, and most franchisors will likely have insufficient data on which to base such a projection (or to be able to satisfy the requirements applicable to forecasts). The costs and expenses may vary widely among franchised outlets based on a number of factors, such as the franchised outlet’s geographic location, whether a franchisee owns one or multiple franchised outlets, whether the franchisee has other types of businesses which enables it to leverage its infrastructure, and so on. Therefore, to ask a franchisor to adjust its costs, rather than describing those likely differences, to reflect all material differences between company-owned and franchised outlets may be misleading and not truly reflective of what a prospective franchisee can personally expect in terms of gross profit or net profit. Further, the specific example given as to adjustments that should be made when a franchisor provides net profit (“such as the costs of a full time third party manager”) could itself give rise to liability for a franchisor. If a franchisor projects what a franchisee can expect to pay a third party manager, that could be seen as providing employment guidance and could potentially give rise to joint employment issues for a franchisor.
Because the costs can vary so widely from franchised outlet to franchised outlet, it is more appropriate to require the franchisor to describe those differences, as is currently required, than to attempt to speculate as to the actual costs that a particular franchisee might experience. Armed with a description of the differences between the company-owned outlets and what a typical franchisee might experience, prospective franchisees are able to conduct their own due diligence to quantify those differences given their own unique circumstances.

FAQ 19.7 – FPR Disclosing Gross Profit or Net Profit of Company-Owned Outlets When Franchisor Has No Operational Franchises.

The FDD is intended to protect prospective franchisees by aiding in their investigation of whether to purchase the franchise. Precluding a franchisor with no operational franchises from disclosing gross profit or net profit will actually disadvantage the prospective franchisee and make it impossible to conduct critical due diligence. For a franchise system with no operational franchises, there are, by definition, no franchisees with whom the prospective franchisee can discuss the financial experience of other similarly situated business owners. If the franchisor is unable, in this situation, to disclose anything except gross sales (which is the effect of the FAQs), the prospective franchisee is left with no viable resource from which to obtain information on which to build its own pro forma financial statements and business plan. In this situation, the franchisor is already required to describe the differences between its company-owned outlets and what a franchisee might experience. Those disclosures should appropriately alert and inform the prospective franchisee as it builds its pro forma.

Accordingly, we believe it would be beneficial to both prospective franchisees and franchisors to apply the same requirements on a franchisor seeking to disclose gross profit or net profit, whether or not they have operational franchises.

FAQ 19.8 – FPR Merging Data from Both Franchised Outlets and Company-Owned Outlets.

On the whole, we agree with the Commentary with respect to its comments on Section 19.8, but the proposed answer to this FAQ raises a couple of issues that should be clarified:

a. The FPG writes “If, however, a franchisor has such a small number of total franchises that the identity of franchisee(s) whose data is reported in Item 19 is discernable, and the franchisor can demonstrate that the franchised and company-owned outlets have gross sales that are not materially different, the franchisor may merge the data in the FPR.” To whom must a franchisor demonstrate that it is entitled to merge the data? If the determination may be made by each state examiner, doesn’t this proposed answer make each franchisor subject to different interpretations from state to state and, thus, make it impossible for franchisors to have a single FPR that is given to all prospective franchisees?

b. In footnote 5, the Commentary states “A franchisor with 10 or more operational franchisees, however, will be presumed to have a sufficient number of franchisees to require data from franchised outlets and company-owned outlets to be disclosed separately.” Often franchisors will sell company-owned outlets to franchisees. The Commentary should address how to classify a location when it switches ownership in this manner in the middle of the year. For example, if a location operates as a franchisee for 6 months or more out of the year, it will count toward the minimum quota of 10.
FAQ 19.9 – Disclosure of Net Profit Generally

The requirement to include interest, taxes, depreciation and amortization in the calculation of the costs of operation appears inconsistent with the definition of “net profit” which requires that those items be excluded from “net profit.”

FAQ 19.15 – Averages

The requirement to include the median when the FPR includes averages is intended to address outliers. However, outliers impact the median as well as the average, so including the median, without discussing the outliers can also be misleading. For example, consider the following example:

Consider a franchisor with 5 units whose sales were $1,000, $5,000, $5,000, $5,000, and $10,000. Here, there were two outliers – one on the low end, and one on the high end. The average is $5,200, and the median is $5,000. Disclosing the median does nothing to explain that the data set ranged from $1,000 to $10,000. Consider another franchisor whose 5 units had sales of $5,000, $5,000, $5,000, $5,000, and $5,000. Here, the average and median are both $5,000, and the units were consistent with each other.

While the averages for the two franchisors were close, and the medians were identical, the data for each franchisor – and the stories told by the data – are very different. Disclosure of the median did nothing to tell the appropriate stories and, in fact, contributed to the perception that the financial results of the systems were more alike than they were different. Therefore, we would recommend against imposing this requirement.

FAQ 19.16 – Disclosure of Outlets that Opened and Closed during First Year of Operation.

FAQ 19.16 addresses outlets opening and closing within the same disclosure year (i.e. opening in January 2015 and closing in June 2015), but does not address outlets opening in prior years and closing during the applicable disclosure year (i.e. opening September 2014 and closing in February 2015). For the second class of outlets, it is possible that the outlet might only have been operating one to two months into the applicable disclosure year. Unless a franchisor annualizes the numbers for such units (a process which may create unrealistic results if the unit was, for example, only operating for one month in that year) including such data may produce unintended results. We would propose that franchisors have the right to exclude any outlet that closed during the course of the applicable disclosure year, regardless of when such outlet opened. If not, we would need guidance on how to calculate data for such units.
We appreciate being provided the opportunity to submit our comments. If you would like additional clarifications or explanations of our comments, please feel free to contact Amy Cheng or Michael Daigle at 312.243.1701.

Very truly yours,

CHENG COHEN LLC

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