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Proposed Financial Performance Representation Commentary

Dear Mr. Cantone and Mr. Staley:

We are pleased to provide comments to NASAA's proposed commentary on Financial Performance Representations ("Commentary"). The focus of our comments is to (1) request clarification as to when a start-up franchisor must begin to include the gross sales of its operational franchises in the franchisor's company-owned outlet gross sales FPR, (2) identify practical issues and request additional guidance related to those aspects of the Commentary which require the adjustment of the franchisor's company-owned outlet cost data included in a gross profit or net profit FPR to "reflect the costs that franchisees may incur," (3) request clarification as to how the Commentary might apply to an FPR for a conversion franchise, and (4) request clarification of certain defined terms.

1. <u>Gross Sales FPR Based on Company-Owned Outlets Alone</u>

Section 19.4 of the Commentary states that if a franchisor has "operational franchises", it has no reasonable basis for making a gross sales FPR based on company-owned outlet data alone. By definition, an operational franchise is one that has been fully operational for one full year (or at least one full season in the case of a seasonal franchise). Assume a start-up franchisor that issues its initial FDD on March 30, 2015. It includes an FPR based on the gross sales of its existing company-owned outlets alone, as permitted under Section 19.5 of the Commentary (since, by definition, there are no franchised outlets at the time the franchisor issues its initial FDD). Further assume that on April 30, 2016, when the franchisor is required by law to first update its FDD, it has two franchised outlets open, but one of those outlets has been open for only 4 months and the other open for only 6 months. It appears clear under Section 19.4 of the Commentary that the franchisor is not required to include the gross sales of either franchised outlet in its FPR at the time of its first annual update *and* can continue to make a gross sales FPR based solely on the data from its company-owned outlets since neither franchised outlet has been open one full year. However, both franchised outlets will become operational franchises under the definition included in the Commentary during the franchisor's 2016 fiscal year. Must the franchisor amend its FDD during the 2016 fiscal year to include the gross sales of the franchised outlets as they become operational franchises? If so, when should the franchisor amend? Alternatively, may the franchisor wait to include the gross sales data of its operational franchises at its next annual update as of the end of the fiscal year in which those outlets become operational franchises?

2. Cost Adjustments for Gross Profits and Net Profits FPRs

Section 19.6 of the Commentary allows a franchisor that has operational franchises to make an FPR disclosing gross profits or net profits based on company-owned cost data alone, but only if certain conditions are met, including that the franchisor must (i) in a net profits FPR, impute "royalties, advertising fund contributions, and other fees not paid by company-owned outlets", and (ii) in both a gross profits and net profits FPR, adjust the "actual costs incurred by the company-owned outlets [. . .] to reflect the potential material financial and operational differences between company-owned outlets and franchised outlets." Examples given in the Commentary include: (a) a required adjustment to the cost of goods or services in a gross profits FPR to reflect the costs a franchisee would incur if franchisees pay more for such goods or services than the franchisor, and (b) required adjustments in a net profits FPR for any costs "unique to franchised outlets", including, for example, labor costs if franchised outlets require additional full time managers not needed in company-owned outlets.

It is not clear to us what process a franchisor should use to make the required cost adjustments. For cost of goods, and assuming that the franchisor supplies certain products to the system or negotiates vendor pricing for such products, it may be possible for the franchisor to adjust for known price differences, if any. However, for products that franchisees source independently, must a franchisor assume that franchisees uniformly pay market price and cannot independently negotiate discounts that may be available to company-owned outlets based on volume purchases, bargaining power or other criteria? If the franchisor must adjust its cost of goods to reflect market pricing, what prices should be used where there are regional, seasonal or other pricing differences? Similar questions arise when adjusting for differences in labor, rent and other common costs. For example, even assuming a franchisor knows that a franchised outlet will require additional labor, what benchmark should be used when adjusting for the additional labor costs given regional and other differences in such costs?

Section 19.7 of the Commentary suggests that a franchisor will be able to make the required cost adjustments based on its direct experience with the "costs that [operational] franchised outlets actually incur". In our experience, franchisors not only do not obtain cost information from franchised outlets in sufficient detail to make the adjustments required by the Commentary, but franchisees are both reluctant to provide detailed cost information and do not categorize costs uniformly, making any numbers that are obtained inherently unreliable. Further, extrapolating numbers from franchised operations and adjusting company-owned financial information creates a financial picture that is not truly representative of either company-owned or franchised outlet operations.

We fully support the goal of providing to prospective franchisees the most relevant financial information possible, including relevant and reliable cost information. However, we are concerned that requiring the adjustment of company-owned outlet cost data to reflect franchisee costs, without providing a clear mechanism that minimizes the risk to franchisors of inadvertently reporting unreliable or potentially misleading information, will have the unintended consequence of removing valuable information from the FDD and from regulatory review. Cost information is not, in itself, a financial performance representation under the FTC Rule (unless expressed as a percentage of sales). If, in order to include cost information in the FDD, a franchisor is required to adjust its actual costs without clear guidelines to follow in making such adjustments, we fear that many franchisors will determine the risk of including cost information in the FDD outweighs the benefit and may elect to provide that information only outside the FDD.

Therefore, we suggest that the cost adjustment requirement either be removed or that additional guidance for implementation be provided.

3. Conversion Franchises.

The Commentary does not specifically address conversion franchises. However, in the context of projections, Section 19.19 states that an FPR must be based on the "historic results of the brand offered to the prospective franchisee" and may not be based on, among other things, "the results of similar or competitive brands operated by others".

In the case of conversion franchises, it is useful and relevant for a prospective franchisee to have information about the contribution of the brand being offered to gross sales. A franchisor may demonstrate that contribution by comparing the historic gross sales information of outlets that have converted to the brand for a certain time period before conversion and the historic gross sales information of the same outlets for a corresponding time period following conversion.

We seek clarification that the Commentary is not intended to prohibit an FPR that makes such a comparison.

4. Definitions.

A. Company-owned outlets. As defined in the Commentary, a "company-owned outlet" is one that is "owned either directly by a franchisor or by the franchisor's affiliate". In our experience, a franchisor may at times own some, but not all, of the equity interests in an entity operating an outlet under the brand. Often, these joint-ventured outlets are operated under a franchise agreement. Would such outlets be considered company-owned outlets or franchised outlets for purposes of the Commentary? Would the characterization differ where the franchisor owns a majority or minority interest in the operating entity?

B. Operational franchises. As defined, unless the franchise system is seasonal, an operational franchise is one that has "been fully operational for one full year". In a number of franchise systems, outlets are not considered to be mature until they have been open for longer than one year. The definition of "operational franchises" appears to preclude franchise systems from taking into account system-specific ramp up periods. We note that the definitions of "Gross sales" and "Net profit" allow a franchisor to vary how the definition is applied in the franchise system as long as the differences are disclosed. We request that you consider incorporating similar flexibility into the definition of "operational franchises" in order to account for differences in ramp up periods.

Thank you for the opportunity to provide our comments on the Commentary, and we hope that our perspective is helpful.

Sincerely,

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