NASAA FRANCHISE COMMENTARY
FINANCIAL PERFORMANCE REPRESENTATIONS

INTRODUCTION

The following questions and answers supplement NASAA's Commentary on the 2008 Franchise Registration and Disclosure Guidelines adopted on April 27, 2009 ("2008 Franchise Commentary"). This NASAA Commentary ("FPR Commentary") addresses a number of questions raised by franchisor representatives and state franchise examiners about financial performance representations ("FPRs").

Under the FTC Franchise Rule and applicable state franchise laws, a franchise seller is prohibited from making an FPR unless it has a "reasonable basis" for the representation at the time it is made. What constitutes a reasonable basis, and what information is needed to substantiate an FPR, is fact-specific and varies from case to case, depending on the representation made. In every case, however, written factual information in the seller's possession must reasonably support the representation, as the FPR is likely to be understood by a reasonable prospective franchisee. The FPR must be based on the sort of factual information upon which a prudent businessperson would rely in making an investment decision.[1] This FPR Commentary provides additional guidance for making and substantiating an FPR. It does not address every question that may arise regarding FPRs. Nor does it address issues that may arise when a franchisor makes an FPR outside of a Franchise Disclosure Document.

The effective date of this FPR Commentary is the later of 180 days after the date of adoption by NASAA or 120 days after a franchisor's next fiscal year end, if the franchisor has an effective Franchise Disclosure Document as of the date of adoption by NASAA. This FPR Commentary guidance applies to Franchise Disclosure Documents updated after the effective date.[2]

Date of Adoption by NASAA: May 8, 2017[3]

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[1] *See* FTC Franchise Rule Compliance Guide, p. 135 (May 2008).

[2] This FPR Commentary governs the preparation of FPRs following the effective date. NASAA does not intend that any FPR contained in a Franchise Disclose Document issued before the effective date is necessarily deficient or unlawful.

[3] Adopted by the NASAA Membership at the 2017 NASAA Spring Conference in Washington, D.C.

Excerpt from 2008 NASAA Franchise Commentary[4]

These questions and answers, adopted by NASAA in 2008 as part of a general commentary, are reprinted here for convenience.

19.1 *Item 19 - Exclusion of Costs*

QUESTION: Item 19 no longer includes costs in the definition of a financial performance representation. Can cost information be provided outside of Item 19 in a form that sets forth those expenses as a percentage of revenues?

ANSWER: No. If a franchisor provides information about a prospective franchisee's anticipated operating expenses as a percentage of a stated level of revenue, that information constitutes a financial performance representation, and a franchisor may provide that information only if it complies with the requirements of Item 19.

19.2 *Item 19 – Pro Formas*

QUESTION: Can the franchisor attach a blank "pro forma" to the franchise disclosure document and treat it as a financial performance representation?

ANSWER: No. A blank pro forma that identifies categories of revenue and costs but without corresponding figures is not a financial performance representation and should not be attached or otherwise included in a Franchise Disclosure Document. A blank pro forma, or a pro forma that contains cost information alone, may constitute franchise advertising under state franchise statutes, depending on how the franchisor uses that document.

19.3 *Item 19 – Disclaimers*

QUESTION: Under Item 19, when a franchisor makes a financial performance representation, what is an appropriate "clear and conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation?"

ANSWER: While Item 19 does not require any specific language, franchisors should use one of the following admonitions in a separate paragraph:

> **For historical representations—**
> "Some [outlets] have [sold] [earned] this amount. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much."
>
> **For projections—**
> "These figures are only estimates of what we think you may [sell] [earn]. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much."

In either case, franchisors may not include additional language that serves to disclaim the financial performance representation they have just made or state that a franchisee may not rely on the information presented.

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[4] http://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary_final.pdf.

NASAA FPR COMMENTARY

Definitions

When used in this FPR Commentary, the following terms have the meanings indicated**:**

Average, also known as the "mean," means the sum of all data points in a set, divided by the number of data points in that set.[5]

Company-owned outlet means an outlet owned either directly or indirectly by a franchisor, by an affiliate of the franchisor, or by any person required to be identified in Item 2 of the franchisor's Franchise Disclosure Document, which operates a substantially similar business under the same brand as the business the franchisor offers to franchisees. It also includes any such outlet that: (i) is operated as a joint venture owned in part by a franchisor, by an affiliate of the franchisor, or by a person required to be identified in Item 2; and (ii) is managed by the franchisor, an affiliate of the franchisor, or by a person required to be identified in Item 2.

Gross profit means gross sales minus cost of goods sold, or minus the cost of providing services for a franchise system that offers services.

Gross sales means the total revenue derived from the sale of goods or services less sales tax, discounts, allowances, and returns.

Managed outlet means any outlet that: (i) is owned by a person that is not a franchisee, the franchisor, an affiliate of the franchisor, or a person required to be identified in Item 2; and (ii) is managed by the franchisor, an affiliate of the franchisor, or by a person required to be identified in Item 2.

Median means the data point that is in the center of all data points used. That number is found by examining the total number of data points and finding the middle number in that set. In the event the number of data points is an odd number, the median will be the center number. If the dataset contains an even number of data points, the median is reached by taking the two numbers in the middle, adding them together, and dividing by two.[6]

Net profit means gross profit minus all ordinary and recurring operating expenses, interest, income taxes, depreciation and amortization.

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[5] For example, if the data points are 13, 13, 14, 19, and 26, the average is 17. This figure is arrived at as follows: Calculate the sum of all data points (that is, 13+13+14+19+26=85). Divide this number by the total number of data points in the set. Here, we get 85 divided by 5 (the number of data points) = 17. Thus the average is 17.

[6] For example, if the data points are the odd numbered sequence of 13, 13, 14, 19, and 26, the median is 14, which is the third number in the five data point set. We have two numbers above this data point, and two below this data point. If our data set was modified by adding a 12 to our set, so that the even numbered sequence we are now using is 12, 13, 13, 14, 19, and 26, we discover that the two numbers in the middle of this dataset are the third and fourth numbers, which are 13 and 14. By adding these together (13+14=27), and dividing by two (27/2), we know the median is 13.5. In this example, we have three data points above this number, and three below this number.

Operational franchise outlet means an outlet operated under a franchise agreement that: (i) is not a company-owned outlet; and (ii) has been fully operational for one full year or, in the case of franchise systems that operate seasonally, for at least one full season. It also includes any such outlet that: (i) is owned by a franchisee; and (ii) is managed by the franchisor, an affiliate of the franchisor, or a person required to be identified in Item 2.

A. Disclosure of FPRs Generally

19.4. *Item 19 – Disclosure of Gross Sales Generally*

QUESTION: Must a franchisor making an FPR disclosing gross sales define how it calculates gross sales?

ANSWER: Yes. A franchisor making an FPR disclosing gross sales (whether characterized as gross sales or a similar term, e.g., "gross revenue") must disclose which items, if any, it is deducting from total revenue, including sales tax, discounts, allowances, and returns.

19.5. *Item 19 – Disclosure of Net Profit Generally*

QUESTION: Must a franchisor making an FPR disclosing net profit define how it calculates net profit?

ANSWER: Yes. A franchisor making an FPR disclosing net profit (whether characterized as net profit or a similar term, e.g., "net income") must disclose which items it is deducting from gross profit, including ordinary and recurring operating expenses, interest, income taxes, depreciation, and amortization.

19.6 *Item 19 – Identifying Source of Data Underlying FPR*

QUESTION: Does a franchisor have an obligation to identify the sources of data it uses to make an FPR?

ANSWER: Yes. A franchisor must clearly identify the sources of all data presented in an FPR. If a franchisor makes an FPR based on both franchise and company-owned outlet data, the two different types of data must be clearly identified. If a franchisor is adjusting or supplementing actual cost data in an FPR, the franchisor must clearly identify which data are actual costs, which data are adjusted or supplemental costs, and the method and rationale for determining the adjusted or supplemental costs.

19.7 *Item 19 – Managed Outlets*

QUESTION: Must a franchisor disclose managed outlets separately from company-owned outlets?

ANSWER: Not in all cases. If managed outlets are included in an FPR, the franchisor must disclose the existence of managed outlets in the FPR and identify how they are characterized. As long as the results of managed outlets are not materially different from the results of other outlets included in the FPR, a franchisor may characterize a managed outlet as any of the following in an FPR: (i) as a company-owned outlet; (ii) as a franchise outlet; or (iii) in a separate "managed outlet" category. If the results of managed outlets are materially different from the results of other outlets included in the FPR, the franchisor may not include results from managed outlets in the FPR.

B. Use of Data from Company-Owned Outlets

19.8 *Item 19 – Gross Sales FPR Based on Company-Owned Outlets Alone When Franchisor Has Both Operational Franchise Outlets and Company-Owned Outlets*

QUESTION: If a franchisor has operational franchise outlets,[7] can the franchisor make a gross sales FPR based on company-owned outlet data alone?

ANSWER: No. A franchisor with operational franchise outlets has no reasonable basis for making a gross sales FPR based on company-owned outlet data alone.

19.9 *Item 19 – Gross Sales FPR Based on Company-Owned Outlets Alone When Franchisor Has No Operational Franchise Outlets*

QUESTION: If a franchisor has no operational franchise outlets, can the franchisor make a gross sales FPR based on company-owned outlet data alone?

ANSWER: Yes. If a franchisor has no operational franchise outlets, the franchisor can make a gross sales FPR based on company-owned outlet data alone, if the franchisor has a reasonable basis for the FPR and discloses material financial and operational characteristics of the company-owned outlets that are reasonably anticipated to differ materially from future operational franchise outlets.[8]

19.10 *Item 19 – Gross Profit or Net Profit FPR Based on Company-Owned Outlets Alone*

QUESTION: Can a franchisor make an FPR disclosing gross profit or net profit based on company-owned outlet data alone?

ANSWER: Yes. A franchisor can make an FPR disclosing gross profit or net profit based on company-owned data alone if it has a reasonable basis to make the FPR and includes the following information: (a) gross sales data from operational franchise outlets, when the franchisor has operational franchise outlets; (b) actual costs incurred by company-owned outlets; and (c) supplemental disclosure or adjustments to reflect all actual and reasonably expected

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[7] For purposes of this Commentary, the determination about whether a franchisor has operational franchise outlets is made as of the end of the franchisor's last fiscal year.

[8] Although a presentation of cost or expense data alone is not an FPR, a franchisor that makes an FPR disclosing gross sales alone may not separately provide cost or expense data outside of the FPR from which a prospective franchisee could readily calculate average net profits. *See* FTC Franchise Rule Compliance Guide p. 131 (May 2008).

material financial and operational differences between company-owned outlets and operational franchise outlets.[9] These differences consist of fees and other expenditures required by the franchise agreement, disclosed in the Franchise Disclosure Document, or that are otherwise known or reasonably should have been known by the franchisor.

In an FPR disclosing gross or net profit, if franchisees pay more for goods or services than the franchisor, the franchisor must adjust or supplement the FPR to include the costs the franchisee would incur. In an FPR disclosing net profit, the franchisor must adjust or supplement the FPR to include imputed royalties, advertising fund contributions, and other fees not paid by company-owned outlets, such as the costs of a full time third party manager if, for example, multiple company-owned outlets are managed by a single employee.

The disclosure of these differences must be clearly presented and in the same format as the rest of the FPR. For example, if the FPR presents data in a table, the differences must be adjusted within or added to the end of the table.

19.11 *Item 19 – FPR Merging Data from Both Franchise Outlets and Company-Owned Outlets*

QUESTION: If a franchisor makes an FPR that includes data from both franchise outlets and company-owned outlets, can the franchisor merge the data from both types of outlets in the FPR?

ANSWER: No, except as set forth in this answer. Generally, if a franchisor makes an FPR that includes data from both franchise outlets and company-owned outlets, the franchisor must disclose the data from the company-owned outlets and the franchise outlets separately.[10] Once a franchisor separately discloses data from both franchise outlets and company-owned outlets in an FPR, the franchisor may then choose to also present the same data in a combined format.

If, however, a franchisor has such a small number of total franchisees[11] that the identity of franchisee(s) whose data is being reported in Item 19 is discernable, and the franchise and company-owned outlets have gross sales that are not materially different, the franchisor may merge the data in the FPR. In that case, the franchisor must include a representation in Item 19 that there are no material differences in the gross sales of franchise and company-owned outlets.

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[9] Representations based on data from company-owned outlets must take into account "differences between company-owned and franchised outlets, imputing, where appropriate, differences in costs (*e.g.*, royalty payments) and economies of scale." *See* FTC Franchise Rule Compliance Guide, p. 137 (May 2008).

[10] *See Id.* ("If a financial performance is based on both franchise and company-owned outlets "the data for each type ordinarily should be separated to avoid potential misrepresentation".) A franchisor that discloses gross sales data from franchise outlets and actual cost data based on company-owned outlets as described in Commentary Item 19.10 is not "merging data" for purposes of this Item.

[11] What constitutes a small enough number of franchisees to allow the franchisor to combine this data varies depending on the franchise. A franchisor with 10 or more franchisees, however, will be presumed to have a sufficient number of franchisees to require data from franchise outlets and company-owned outlets to be disclosed separately.

C. Use of Subsets

19.12 *Item 19 – Subsets Generally*

QUESTION: Item 19 allows a franchisor to make an FPR based on a subset of outlets that share a particular set of characteristics. Are there any general limitations on a franchisor's ability to make an FPR based on a subset of outlets?

ANSWER: Yes. In general, a franchisor may make an FPR based on a subset of outlets but only if the FPR based on the subset (a) has a reasonable basis, (b) is accurate, and (c) is not misleading.

19.13 *Item 19 – Best Performing Outlets*

QUESTION: May a franchisor make an FPR based solely on the performance of a subset of its best performing outlets?

ANSWER: No. An FPR that is based solely on the performance of a subset of the franchisor's best performing outlets is likely to be misleading and have no reasonable basis. For that reason, an FPR based solely on the performance of a subset of a franchisor's best performing outlets must also include the results of one or more corresponding subsets of its lowest performing outlets. For example, if a franchisor prepares an FPR subset showing the average and median sales of the highest grossing 10% of outlets in its franchise system, the franchisor also must show the average and median sales of the lowest grossing 10% of outlets in its franchise system. Even if a franchisor presents system-wide performance information, it may not include a subset of its best performing outlets without including the corresponding results of its lowest performing outlets.

19.14 *Item 19 – Small Number of Company Owned Outlets and Franchise Outlets*

QUESTION: May a franchisor with a relatively small number of substantially similar company-owned outlets and franchise outlets as of the end of the franchisor's last fiscal year base an FPR on a subset of those outlets?

ANSWER: No. A franchisor with fewer than 10 substantially similar company-owned outlets and franchise outlets as of the end of the franchisor's last fiscal year will be presumed to have too few outlets to base an FPR on a subset of those outlets.[12]

19.15 *Item 19 – Geographic Subsets*

QUESTION: If a franchisor uses a subset based on a geographic area in its FPR, must the franchisor describe why that geographic subset was selected?

ANSWER: Yes. The franchisor must describe why and how that geographic subset was selected. The franchisor may not present information for a geographic subset if that information

[12] This answer does not mean that a franchisor cannot make an FPR based on data from 10 outlets or less, when the franchisor has a reasonable basis for doing so.

is misleading.

D. Averages and Medians

19.16 ***Item 19 – Average***

QUESTION: Are there any statistical requirements that a franchisor must include when disclosing an “average” in an FPR?

ANSWER: Yes. Whenever a franchisor discloses an average of numbers in an FPR, it also must disclose the median of those numbers because the existence of outliers may skew an average, thereby making it misleading (even if the calculation is accurate). Whenever the franchisor discloses the average of gross sales, the franchisor also must disclose the highest and lowest numbers in the range.

19.17 ***Item 19 – Median***

QUESTION: Are there any statistical requirements that a franchisor must include when disclosing a “median” in an FPR?

ANSWER: Yes. Whenever a franchisor discloses a median of a range of numbers in an FPR, it also must disclose the average of those numbers because disclosure of the median alone may be misleading (even if the calculation is accurate). Whenever the franchisor discloses the median of gross sales, the franchisor also must disclose the highest and lowest numbers in the range.

19.18 ***Item 19 – Omission of Outlets that Have Closed***

QUESTION: If a franchisor makes an FPR that includes an average or median, may the franchisor, in calculating that average or median, exclude data from any company-owned outlets or franchise outlets that closed during the time period covered in the FPR?

ANSWER: Yes. A franchisor making an FPR that includes an average or median may exclude data from company-owned outlets and franchise outlets that closed during the time period covered in the FPR, provided the franchisor discloses in the FPR: (i) the number of company-owned outlets that closed during the time period, if the FPR includes company-owned outlets; (ii) the number of franchise outlets that closed during the time period, if the FPR includes franchised outlets; and (iii) the number of excluded outlets that closed during the same time period after being open less than 12 months. This disclosure should cover each year or other period of time covered in the FPR.

E. Use of Forecasts and Projections

19.19 ***Item 19 – FPR Presenting Forecasts (Projections)***

QUESTION: Must forecasts (projections) be based on historical data?

ANSWER: Yes. Projections cannot be based on mere hypothetical situations or expectations. Historical results may be adjusted or supplemented based on changes in the market (for example, when current rents are higher or lower than historic rents), but the projections still must be based on historical data from outlets substantially similar to the type of outlet offered in the Franchise Disclosure Document.

19.20 *Item 19 – FPR Presenting Projections Not Based on Franchisor's Brand Data*

QUESTION: Must the historical data on which projections are based be data from the brand being offered?

ANSWER: Yes. A projection must be based on a reasonable sample of the historic results of the brand offered to the prospective franchisee. The historic results must be from outlets substantially similar to the type of outlet offered in the Franchise Disclosure Document. A projection may not be based on the results of other brands operated or licensed by the franchisor or its affiliates, or on the results of similar or competitive brands operated by others, or on industry reports.

F. Disclaimers

19.21 *Item 19 – Clear and Conspicuous Admonition (Substance)*

QUESTION: May a franchisor vary the language of the admonition provided in FPR Commentary Item 19.3, advising that a new franchisee's individual financial results may differ from the results stated in an FPR?

ANSWER: No. A franchisor may not vary the language of the admonition provided in FPR Commentary Item 19.3, unless the franchisor makes a type of FPR that does not fit the situation for the language provided. FPR Commentary Item 19.3 states that a franchisor should use one of two forms of conspicuous admonition, one for an historical representation and one for a projection. The language of both types of admonition stated in Commentary Item 19.3 applies to an FPR based on sales or earnings. A franchisor that makes an FPR based on outlet sales or earnings must use the applicable language stated in Commentary Item 19.3, without any variation, and without adding any additional disclaimer language. When a franchisor makes an FPR based on something other than outlet sales or earnings (for example, hotel occupancy rates), it may change the language of the sample admonition, but only to the extent necessary to fit the FPR made.

19.22 *Item 19 – Clear and Conspicuous Admonition (Form)*

QUESTION: Are there any limitations on the form of the admonition a franchisor must include in Item 19 when the franchisor makes an FPR?

ANSWER: Yes. Item 19 requires that the admonition a franchisor must include when it makes an FPR must be "clear and conspicuous." Clear and conspicuous means that the admonition must be easily noticeable and easily understandable by a prospective franchisee. The admonition required in FPR Commentary Item 19.3, therefore, must be presented in a separate paragraph from the rest of the FPR and in bold type, for example:

"**Some outlets have earned this amount. Your individual results may differ. There is no assurance that you'll earn as much**."

The language may not be in capital letters or underlined or in larger type than the rest of the FPR.

19.23 *Item 19 – Disclaimers In Addition to Clear and Conspicuous Admonition*

QUESTION: May a franchisor include in Item 19 disclaimers in addition to the admonition required in FPR Commentary Item 19.3?

ANSWER: No. The admonition required in FPR Commentary Item 19.3 is intended to inform a prospective franchisee. It is not intended to allow a franchisor to disclaim responsibility for the FPR or advise a franchisee that it may not rely on the FPR. Under the FTC Franchise Rule, a franchisor is prohibited from disclaiming or requiring a prospective franchisee to waive reliance on any representation made in the Franchise Disclosure Document. A franchisor, therefore, may not include in Item 19 or elsewhere in a Franchise Disclosure Document any disclaimers that contradict, mitigate, or are inconsistent with the admonition prescribed in FPR Commentary Item 19.3.