

## Finding Value: The Roles of Accountants in Franchising

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By David Gurnick, Tal Grinblat, Rex Poulsen, Peter Weir

David Gurnick and Tal Grinblat, Lewitt Hackman and Rex Poulsen, CPA, and Peter Weir, CPA, Hutchinson & Bloodgood, LLP

Lawyers typically view the accountant's role in franchising to be mainly auditing the franchisor's financial statements and consenting to their use in the FDD. But accountants can play other valuable roles, from developing franchise programs, to advising on certain items of the FDD, to consulting with franchisors and franchisees on business issues.

The FTC Rule requires that the FDD include three years of audited financial statements. A new franchisor may opt to present unaudited financial statements for its first year or partial year (although in California, if unaudited statements are provided, they must be reviewed by an independent CPA). Either way, every franchisor must have an independent CPA perform an audit or review of its financial statements. In addition, the application to register the FDD in franchise registration states must include the auditor's consent for the franchisor to use the financial statements in the FDD.

Before issuing the required consent, the independent CPA is required by professional auditing standards to read the FDD to identify and resolve any material inconsistencies between the audited or reviewed financial statements and the other information in the disclosure document.

Under the FTC Rule, the Cover Page of the FDD must tell potential franchisees: "If possible, show your contract and this information to an advisor, like a lawyer or an accountant." Thus, an additional role for accountants is to review the FDD and franchise agreement



DAVID GURNICK



TAL GRINBLAT



REX POULSEN



PETER WEIR

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and consult with prospective franchisees on the advisability of investing in a franchise system.

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A prospective franchisor or franchisee should have a business plan, including projections of revenues and expenses, as well as a narrative concerning the business being developed. Accountants can help franchisors or franchisees prepare these business plans.

### **Finding an Optimal Formula**

Key elements of the franchisor's business plan are the amount of the initial franchise fee, rates to be charged for royalties, franchisee contributions to the advertising fund, and other fees and charges. Higher rates and fees generate more revenue for the franchisor but reduce the franchisee's projected results. Lower rates have the opposite effect, generating better franchisee results but reducing the franchisor's revenues. Accountants can test alternative rate structures and compare them to similar franchised businesses to help the franchisor find an overall rate structure that balances competing objectives and achieves an optimal formula for all constituents of the franchise system.

One of the most important parts of the FDD is Item 7, presenting numerically, in a table, a high-low range for each major category of the investment to be made by a new franchisee and a high-low range for the new franchisee's total investment. Franchisors want to make sure the Item 7 table describes the full initial investment cost, but they also may want to keep their estimates as low as possible while still remaining accurate and not misleading. Professional accountants, who frequently advise start-up companies, can offer useful insights on start-up expenses, whether for tax or financial-reporting purposes, for developing projections, or for setting up financial controls. Thus, they can assist in making sure the Item 7 table is accurate and complete.

Another important part of the FDD is Item 19, in which the franchisor is allowed, although not required, to provide information about actual or potential financial performance of its franchised or franchisor-owned units. The information must have a reasonable basis, and the franchisor must have written substantiation. This disclosure must state whether the representation is based on historical results for existing outlets or a subset of the outlets, or is a forecast of a prospective franchisee's future financial performance. Material bases for the representation must be disclosed, as well as the assumptions that underlie any forecast of future performance. Accountants' training and experience can be valuable in preparing a financial performance representation that satisfies the rigorous requirements of Item 19.

Most franchisors establish an advertising fund to which franchisees contribute. These aggregated advertising funds often have substantial amounts of money flowing in and out. Franchisees want to know how their advertising contributions are used, and the

franchise agreement typically promises that the franchisor will provide franchisees with a periodic accounting (sometimes an audited accounting) of contributions to and expenditures from the advertising fund. Preparing this accounting or auditing the financial statements of the advertising fund is another task for accountants.

Item 20 of the FDD presents information on the historical, current, and projected number of franchised and company-owned outlets. This information is presented in five tables, covering: system-wide outlets at the start and end of each of the three prior years; franchisee transfers to new owners for the past three years; the status of franchised outlets for the past three years, including openings, terminations, non-renewals, acquisitions by the franchisor, closings for other reasons, and the number of units at the start and end of each year; company-owned outlets for the past three years, including openings, acquisitions from franchisees, closings, units sold to franchisees, and the number of outlets at the start and end of each year; and projected openings of franchised and company-owned units for the coming year. It is not always clear which category particular franchises or franchise transactions fall into, and it is important that the tables be presented consistently from year to year. Accountants can be helpful in preparing these tables to ensure that they are accurate and consistent.

Royalty payments, central to any franchise system, typically are accompanied by regular reports from the franchisee of transactions on which the royalties are based. The franchise agreement typically reserves a right for the franchisor to audit the franchisee's revenues and records. Accountants can perform these audits to determine whether all revenues were reported and all royalties and advertising fees paid.

Finally, when litigation arises, there may be a need for historical financial evidence or expert opinions about actual or projected damages. Accountants are well suited to provide these services as well.

By taking advantage of these and other services that accountants can provide, lawyers can improve their own services to franchisor and franchisee clients alike.