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W-16: YOU NEED TO TALK TO THE ACCOUNTANTS: FINANCIAL STATEMENT REQUIREMENTS AND OPTIONS FOR THE FDD

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YOU NEED TO TALK TO THE ACCOUNTANTS: FINANCIAL STATEMENT REQUIREMENTS AND OPTIONS FOR THE FDD

I. INTRODUCTION

When the Federal Trade Commission ("FTC") originally enacted the Federal Trade Commission Rule ("FTC Rule"),[1] it noted that the purchaser of a franchise needs some assurance of the financial stability of the franchisor and of the franchisor's ultimate ability to meet its obligations to its franchisees.[2] As such the FTC took the position that the disclosure of basic financial information by all franchisors is "essential." The Statement of Basis and Purpose ("SBP")[3] notes that financial disclosures provide prospective franchisees with information to enable them to assess financial trends, rather than just an isolated snap-shot of franchisor's finances. Accordingly, when read with the rest of the franchise disclosure document ("FDD"), the financial statements should serve to inform the prospective franchisee whether the franchise system is one in which the franchisee's hard-earned investment is merited or whether the franchisee should run for cover in the opposite direction. In practice, however, the financial information disclosed by franchisors may not always be sufficient to achieve these goals. For example, under certain circumstances, only the financials of a franchisor's affiliate, rather than of the franchisor itself, needs to be disclosed in the FDD.

Section II of this paper provides a general overview of the financial statement disclosure requirements under federal and state franchise law. Section III describes the import of financial statements and takes a closer look at their various components and the rules and governing bodies that establish the standards for financial statements. Section IV examines state franchise laws and regulations governing the financial statements, the typical issues regulators raise regarding the financial statements and the types of financial assurances, amendments or risk factors that may be required to address financial statement or franchisor net worth risks or deficiencies. Section V summarizes the preparation and disclosure of financial statements and describes the various circumstances under which a franchisor may include different financial statements.

II. GENERAL

A. <u>Financial Statement Requirements in General</u>

Financial statements are disclosed in Item 21 of the FDD and must be compliant with the FTC Rule.[4] The North American Securities Administrators Association ("NASAA") has adopted the disclosure requirements of the FTC Rule and has issued guidance in its NASAA 2008

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[1] 16 C.F.R. § 436.2 (2007).

[2] Original Statement of Basis and Purpose, 43 Fed. Reg. 59,679–59,680 (Dec. 21, 1978).

[3] Disclosure Requirements and Prohibitions Concerning Franchising ("FTC Rule"), 72 Fed. Reg. 15444, 15,509–15,512 (Mar. 30, 2007).

[4] *See* Joel R. Buckberg & Robert M. Einhorn, *The Use & Analysis of Financial Statements*, ABA 36TH ANNUAL FORUM ON FRANCHISING, W-10 at 34 (2013) for a comprehensive treatment of financial statement issues.

Franchise Registration and Disclosure Guidelines (Amended and Restated UFOC Guidelines).[5] Financial statements must be prepared in accordance with generally accepted accounting principles ("GAAP") (including notes), and are an essential component of the FDD. Financial statements enable prospective franchisees to assess financial trends in a franchise system. As such, they frequently receive the attention of state examiners. Incomplete or improperly prepared financial statements are a common reason approvals or renewals of state applications are delayed.[6] Therefore, franchisors should make the timely completion of the audit a priority for both initial registration and renewals. See Section IV.A. below.

B. Updating Requirements

Franchisors are required to update their FDDs on an annual basis. The FTC Rule states, "after the close of each fiscal year, the franchisor shall be given a period not exceeding 90 days to prepare a revised disclosure statement and, following such 90 days, may distribute only the revised prospectus and no other."[7] For an updated FDD to be considered complete, it must include audited financials for the fiscal year that just ended.

C. Changes in Franchisor's Financial Condition

The audited financial requirement is only an annual reporting obligation. Therefore, if a franchisor prepared audited financials as part of its annual update of its FDD, it is not required to disclose any additional audited financial statements with the FDD until it is required to prepare its next annual update. However, if there is a change in the franchisor's financial circumstances during the year, within a reasonable time after the close of each quarter of the fiscal year, the franchisor must prepare revisions to its FDD.[8] In such cases, the franchisor may disclose any unaudited financial statements with its quarterly update if the statements clearly and conspicuously disclose they have not been audited.

D. Predecessor Statements Should Not Be Included

The FTC Rule does not expressly require that a successor-franchisor include financial statements of a predecessor. As noted in an FTC Advisory Opinion, a franchisor should not attach a predecessor's financial statements to its FDD and noted "[i]ndeed, presentation of a predecessor's financials may be irrelevant to a prospective investor of a successor-franchisor or, worse, misleading. It is the financial health of the successor-franchisor, not a predecessor, that is material to a prospective franchisee."[9]

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[5] *North American Securities Administrators Association, Inc. ("NASAA") 2008 Franchise Registration and Disclosure Guidelines* (July 1, 2008).

[6] *See* Leonard D. Vines, Halima Madjid & Dale Cantone, *Best Practices for State Franchise Registration*, ABA 32ND ANNUAL FORUM ON FRANCHISING, W-8 at 16 (2009).

[7] 16 C.F.R. § 436.1(a)(22) (2007).

[8] FTC Informal Staff Advisory Opinion 06-*2*, FED. TRADE COMM'N (Apr, 3, 2006), https://www.ftc.gov/policy/advisory-opinions/informal-staff-advisory-opinion-06-2. Note that FTC Informal Advisory Opinions have not been reviewed, approved, or adopted by the FTC, and they are not binding on the Commission.

[9] FTC Informal Advisory Opinion 05-5, FED. TRADE COMM'N (Oct. 25, 2005), https://www.ftc.gov/policy/advisory-opinions/informal-staff-advisory-opinion-05-5.

E. Coordination with the States

While franchisors must update their FDD within 120 days of the end of their fiscal year to remain compliant with the FTC Rule, franchisors may be required to meet different deadlines to maintain compliance with state franchise disclosure laws. An FTC Advisory Opinion[10] provided guidance on an issue relating to coordination between the FTC and the states when it responded to a question asking whether a franchisor would be in compliance with the FTC Rule if it prepared annual financial statements as permitted by the states. The Opinion noted:

> "State registration requirements are not necessarily tied to a franchisor's fiscal year. For example, a franchisor may register its disclosure document with a state in the middle of its fiscal year. Where a franchisor's fiscal year ends in the middle of its annual registration, the state may require the franchisor to update its registration by filing amended financial statements after the close of its fiscal year.
>
> The Commission permits great latitude to franchisors in order to comply with state law. As noted in the Interpretive Guides, where a franchisor has a currently registered disclosure document in a state, the Commission "will presume the sufficiency, adequacy, and accuracy of the document." The Commission, however, "retains the right to determine whether the UFOC requirements . . . have been met, so that this presumption should not be viewed as deferring to state law enforcement. 43 Fed. Reg. at 49970-971.
>
> In reviewing the states' actions, we focus not on the term of the franchisor's registration – an issue solely within the purview of the states – but on how the states permit a franchisor to report its financial statements…(S)everal states are accommodating Franchisor essentially by permitting Franchisor to use a 15-month fiscal year. That approach is entirely consistent with the approach outlined above and we anticipate no conflict with the Franchise Rule."

F. Foreign Franchisors

Since the FTC Rule permits franchisors to comply with the audited financial statement requirement by looking to principles articulated by the Securities Exchange Commission ("SEC"), foreign franchisors are permitted to use GAAP or to reconcile their financial statements to GAAP, consistent with SEC regulations. SEC permits financial statements using accounting procedures other than GAAP if they are prepared according to a "comprehensive body of accounting principles."[11] The franchisor must also disclose the specific comprehensive body such accounting principles used to prepare the statements and explain material differences between the principles and GAAP and must also be able to reconcile its statements with GAAP.[12] The Compliance Guide states that even if a foreign company reconciles its financials to GAAP, it must audit them

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[10] FTC Informal Advisory Opinion 06-2, *supra* note 8.

[11] FED. TRADE COMM'N, FRANCHISE RULE COMPLIANCE GUIDE 112-116 (May 2008), https://www.ftc.gov/tips-advice/business-center/guidance/franchise-rule-compliance-guide.

[12] *Id.*

according to the GAAS, and the auditor must comply the United States standards for auditor independence.[13]

III. BACKGROUND

A. <u>Why the Financial Statements are Useful and Important</u>

Perhaps unsurprisingly, the financial statements contained in the FDD are often overlooked by prospective franchisees. This appears to be particularly true for prospective franchisees that lack the resources available to more experienced investors in the form of business consultants, accountants, or good lawyers with a knack for numbers. Many entrepreneurs do not learn how to analyze financial statements unless the subject matter is part of a school curriculum or degree program, or until a distinct need arises tor an individual to read and understand them. A first glance at a balance sheet can be daunting to someone who has not been previously exposed to basic financial statements and basic accounting. The good news, however, is that, at least according to the SEC, "if you can read a nutrition label or a baseball box score, you can learn to read basic financial statements. [And] [i]f you can follow a recipe or apply for a loan, you can learn basic accounting."[14] With a little effort practically anyone can learn to read and understand basic financial statements.

One of the underlying principles of GAAP underscores how important it is that financial statements be presented in a form that may be readily understood by the reader. This principle, "understandability," means that financial information should be presented in a manner that a person with "reasonable knowledge of business and economic activities and financial reporting" can readily comprehend it.[15] In order for financial statements to be understandable, they must be complete so as not to miss any important information.[16] They must also be concise, meaning that the financial statements should present adequate information without burdening the reader with too much unnecessary detail.[17] The financial statements must be clear and use a method of presentation that is easy for the reader to follow.[18] Finally, the information must be organized and easily cross-referenced.[19] With this and other fundamental principles underlying GAAP, the governing accounting bodies have sought to achieve the objective that any potential investor, lender or donor is able to access reliable information upon which to assess a company's financial health.[20]

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[13] *Id.*

[14] SEC, *Beginners' Guide to Financial Statement*s, SEC.GOV (Feb. 5, 2007), https://www.sec.gov/reportspubs/investor-publications/investorpubsbegfinstmtguidehtm.html.

[15] Cam Merritt, *The Guiding Principles of GAAP*, CHRON, https://smallbusiness.chron.com/guiding-principles-gaap-42212.html (last visited July 27, 2021).

[16] *Id*.

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id*.

It is imperative that the franchisor's financial statements not be overlooked when a prospective franchisee is determining whether to invest in a franchised business. The financial statements provide information and data that show how the franchisor is doing financially and how it will likely fare in the immediate future. From the franchisor perspective, the financial statements are a critical component of the FDD. They help a franchisor to present a more robust picture of the franchise system to prospective franchisees. Financial statements are also an integral component of the FDD. Setting aside any applicable exemptions or exclusions from the obligation to provide each prospective franchisee with a FDD, a franchisor may not offer or sale franchises in the United States without the inclusion of financial statements in its FDD.[21]

B. Financial Statement

1. Components

Balance sheets, income statements, cash flow statements and statements of shareholders' equity comprise the four basic financial statements that are used to analyze a company's finances.[22] A company's balance sheet reflects what the company owns and owes at a fixed point in time.[23] The income statement shows the company's revenue and costs and expenses over a certain time period.[24] The company's cash flow statement reflects the "exchange of money between the company and the outside world"[25] by summarizing the amount of cash and cash equivalents that enter and leave the company.[26] The statement of shareholders' equity shows changes in shareholders' interests over time.[27] A closer look at these components show how they work together to help the reader understand the financial health of a company.

a. Balance Sheet

A key point regarding the balance sheet is that the company's assets must be equal to (hence the term "balance") the sum of the company's liabilities and shareholders' equity.[28] This is illustrated by the following equation:

Assets = Liabilities + Shareholders' Equity[29]

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[21] *See* 16 C.F.R. § 436.2 (2007). It is an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act for any franchisor to fail to furnish a prospective franchisee with a copy of the franchisor's current disclosure document, as described in subparts C and D of the FTC Rule.

[22] *Beginners' Guide to Financial Statements*, *supra* note 14.

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] Chris Murphy, *Understanding the Cash Flow Statement*, INVESTOPEDIA (Jan. 16, 2021), https://www.investopedia.com/investing/what-is-a-cash-flow-statement/.

[27] *Beginners' Guide to Financial Statements*, *supra* note 14.

[28] *Id.*

A franchisor's balance sheet contains information about the franchisors: (i) assets, which are the things of value that the franchisor owns; (ii) liabilities, which are the monies that the franchisor owes to others; and (iii) shareholders' equity, which is the money that would be leftover if the franchisor sold all of its assets and paid all of its liabilities.[30] Shareholders' equity is often referred to as a company's net worth.[31] Another point of note about the balance sheet is that it captures a snapshot of these three critical pieces of information as of the end of a financial reporting period.[32]

The format of the balance sheet reflects the equation above. Typically, a company's assets are listed on the left side of the balance sheet in the order of how quickly the assets will be converted into cash.[33] Assets can be subdivided into current assets, which are those assets a company expects to liquidate within the span of a year, and noncurrent assets, which are those assets which a company does not anticipate liquidating within a year.[34] A company's liabilities and shareholders' equity are typically listed on the right side of the balance sheet.[35] Occasionally a balance sheet will show assets at the top and liabilities and shareholders' equity at the middle and bottom of the balance sheet respectively.[36] Liabilities are generally listed based on when they become due and are subdivided into current or long-term liabilities.[37] Current liabilities are liabilities which a company expects to pay within a year.[38] Long-term liabilities are liabilities that will become due in the longer term.[39]

b. <u>Income Statement</u>

A franchisor's income statement will show whether the franchisor made a profit over a given reporting period.[40] It reflects three main components: revenues, expenses, and net

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[29] *Id.*

[30] *Id.* Examples of assets include cash, company investments, physical property and intellectual property. Common examples of liabilities in the franchise system context include payroll, rent, supplier payments, bank loans and taxes.

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] Tim Stobierski, *How to Read and Understand an Income Statement*, HARV. BUS. SCH. ONLINE (May 28, 2020), https://online.hbs.edu/blog/post/income-statement-analysis.

income.[41] These components are reflected in the following income statement equation, which is made up of three interrelated formulas:[42]

Income Statement Formula
Gross Profit = Revenues – Cost of Goods Sold
Operating Income = Gross Profit – Operating Expenses
Net Income = Operating Income + Non-Operating Items

The income statement shows the proverbial "bottom line," which is how much a company earned or lost over a specific time period.[43] To get there however, the reader should start at the top line of the income statement which reflects the company's gross revenues and then work its way down the statement for a detailed itemization of the company's income and expenses over the relevant reporting period. Specifically, after the company's gross revenue is presented, what follows is a detailed breakdown of any cost of goods sold, followed by any operating expenses charged against revenues, net interest expense or income, non-cash charges (e.g., depreciation and amortization), taxes, net extraordinary items from non-recurring events, any applicable distributions and net income.[44] The chart below lists income statement items and provides a brief description of the item:[45]

Revenue: The amount of money generated by the company during a reporting period
Expenses: The amount of money a company spends during a reporting period
Costs of goods sold (COGS): As applicable, the cost of component parts to make what the business sells

[41] *Id.*

[42] Madhuri Thackur, *Income Statement Formula*, WALLSTREETMOJO, https://www.wallstreetmojo.com/income-statement-formula/ (last visited July 27, 2021).

[43] Buckberg & Einhorn, *supra* note 4, at 16.

[44] *See*, *e.g.*, Stobierski, *supra* note 40.

[45] *Id.*

Gross profit: Total revenue less COGS **Operating income**: Gross profit less operating expenses **Income before taxes**: Operating income less non-operating expenses **Net income**: Income before taxes less taxes **Earnings per share (EPS)**: Division of net income by the total number of outstanding shares **Depreciation**: The extent to which assets (for example, aging equipment) have lost value over time **EBITDA**: Earnings before interest, depreciation, taxes, and amortization *Available at https://online.hbs.edu/blog/post/income-statement-analysis*

Depending on the level of specificity of the income statement, these items may be broken down further into other line items.[46] Financial experts look to the income statement to determine a company's performance relative to expectations.[47] EBITDA is used to assess a company's operating and financial performance and valuation.[48]

EBITDA = Net Income + Interest + Taxes+ Depreciation + Amortization

EBITDA = Operating Profit + Depreciation + Amortization[49]

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[46] *Id.*

[47] Matt Whittaker and Paulina Likos, *Everything You Need to Know About EBITDA*, US News, https://money.usnews.com/investing/investing-101/articles/everything-you-need-to-know-about-ebitda (last visited July 27, 2021). EBITDA can be a useful measure to compare the valuation of companies in the same industry.

[48] *Id.*

[49] *Id.*

The income statement is vital because it provides a detailed breakdown of the subject company's expenses and income during the reporting period.[50]

c. Cash Flow Statement

The cash flow statement shows how a company generates and uses cash and cash equivalent during the underlying accounting period.[51] It measures how well the company has "managed its cash position," which is how the company takes the cash it generates, funds its operating expenses and pays its debts.[52] The cash flow statement's main components are: (i) cash from operating activities; (ii) cash from investing activities; and (iii) cash from financing activities.[53] Cash from operating activities shows cash generated from the products or services offered by the company.[54] Changes in cash, accounts receivable, depreciation, inventory and accounts payable are typically reflected in this category and may include receipts from the sale of goods and services, interest payments, income tax payments, supplier payments, salaries and wage payments to a company's employees, rent and other operating expenses.[55] Cash from investing activities shows the cash flow from the company's purchase and/or sale of assets such as real estate, cars, and non-tangible property like intellectual property.[56] Cash from financing activities shows the cash flow from debt and equity financing.[57]

There are two methods of calculating cash flow: (i) the direct method; and (ii) the indirect method.[58] The direct method involves taking the cash from operating activities and subtracting all cash disbursements from that figure.[59] With the indirect method, the company's net income is converted to cash flow through "de-accruing" it, which means that non-cash expenses are identified for the underlying period.[60] This is done via "depreciation", which is how an asset reduces in value over time and "amortization," which is where payments are spread over several periods.[61]

The cash flow statement is critical to help evaluate how well a company is doing and whether it is on solid financial ground. Potential investors and creditors may use the cash flow

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[50] *Id.*

[51] Buckberg & Einhorn, *supra* note 4, at 17.

[52] Tim Stobierski, *How to Read and Understand a Cash Flow Statement*, HARV. BUS. SCH. ONLINE (Apr. 30, 2020), https://online.hbs.edu/blog/post/how-to-read-a-cash-flow-statement.

[53] *Id*.

[54] *Id.;* Buckberg & Einhorn, *supra* note 4, at 17.

[55] *Id*.

[56] *Id*.

[57] *Id*.

[58] *Id*.

[59] *Id*.

[60] Stobierski, *supra* note 40.

[61] *Id*.

statement for financial modeling and to conduct financial analysis to ascertain whether and how much cash is available or "liquid" for the company to fund its operating expenses and pay any debts.[62] For example, "working capital," which equals a company's current assets less its current liabilities, shows what liquid assets are available after liabilities have been paid off in the short term.[63] Positive working capital is an indicator of a company's short-term financial health short term. Positive working capital is an indicator of a company's short-term financial health while negative working capital is a sign that the company could have a liquidity crisis.[64] The cash flow coverage ratio is used to calculate when a company can pay its obligations on its total debt including debt with a one year maturity.[65] A company is not likely in the warning zone for default if the cash flow coverage ratio is greater than 1.0.[66] The turnover ratio shows how much assets are used to generate sales.

d. <u>Statement of Shareholders' Equity</u>

The statement of shareholders' (or owners') equity, a section in the balance sheet, shows the changes in the owners' equity over the reporting period.[67] These changes include earned profits, dividends, inflow of equity, withdrawal of equity, and net loss.[68] In sum, the statement shows the difference between a company's total assets and total liabilities.[69] If the statement shows an equity increase it is an indicator that the company's business activities are paying off.[70] These increases happen where the business profits improve, the company sells more products or services, the company has increased its margins through cutting costs or the owner's invest more capital into the business.[71]

Together, these financial statements are useful to analyze the financial viability of a company and provide a picture of the company's value. The statements are meant to complement each other in a way that is transparent and consistent and when prepared properly should achieve that objective.

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[62] *Id*.

[63] *Id.;* CFI, *Working Capital Formula*, https://corporatefinanceinstitute.com/resources/knowledge/modeling/working-capital-formula/.

[64] *Id*.

[65] Rosemary Carlson, *How to Calculate the Solvency, Liquidity and Viability of your Firm*, THE BALANCE SMALL BUSINESS (Apr. 23, 2021), https://www.thebalancesmb.com/ratios-for-cash-flow-analysis-393116.

[66] *Id*.

[67] *What is an Equity Statement*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/accounting/equity-statement/ (last visited July 27, 2021).

[68] *Id.*

[69] *Id.*

[70] *Id.*

[71] *Id.*

C. GAAP

GAAP are the set of accounting standards that companies must follow to prepare the financial statements. GAAP's ultimate purpose is to safeguard transparency and consistency in financial statements across the board for companies that report their financials.[72] These standards evolved in large part as reform mechanisms to help address divergent and sometimes "murky" financial reporting by companies that historically manipulated their financial reports to misrepresent the true value of the companies.[73] By using GAAP, the accounting regulatory bodies hoped to facilitate consistency in financial reporting, which in turn would allow a more apples to apples comparison of financial information reported by different companies.[74]

D. FASB

Established in 1972, the Financial Accounting Standards Board ("FASB") was created to be the designated organization for independent, private-sector and non-profit companies to establish financial accounting and reporting standards that govern the preparation of their financial reports according to GAAP.[75] The SEC recognizes FASB as the designated accounting standard bearer for public companies and the FASB standards are deemed authoritative by accounting organizations including the American Institute of Certified Public Accountants ("AICPA") and state accounting boards.[76] FASB codified thousands of accounting standards into one uniform FASB Accounting Standards Codification ("Codification") for its constituents in the United States in 2009.[77] The Codification is organized around several financial preparation and reporting concepts including General Principles, Presentation, Assets, Liabilities, Revenue, Equity, Expenses, Broad Transactions and Industry Areas.[78] It is this Codification that forms the basis for GAAP. The Public Company Accounting Oversight Board ("PCAOB") was established under the Sarbanes-Oxley Act to oversee the regulation of audits and the professional practice standards of public auditors for audits of publicly-traded companies.

E. How GAAP and IFRS Differ

As discussed above, the GAAP standards referred to in this paper is the set of US accounting standards. Foreign franchisors whose statements are not audited in accordance with GAAP must disclose the accounting principles used to prepare the financials, explain the material differences between the foreign principles and GAAP and also reconcile, via the notes to the

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[72] Vijay Govindarajan, Anup Srivastava & Rong Zhao, *Mind the GAAP*, HARV. BUS. REV. (May 4, 2021), https://hbr.org/2021/05/mind-the-gaap ("GAAP is a fancy term for accounting rules and regulations.").

[73] H. David Sherman & S. David Young, *Where Financial Reporting Still Falls Short*, HARV. BUS. REV. (July-Aug. 2016), https://hbr.org/2016/07/where-financial-reporting-still-falls-short.

[74] *See* James Kroeker, Christa LaBrosse & Lee Plave, *The New FASB Rules,* ABA 41ST ANNUAL FORUM ON FRANCHISING at 3 (2018).

[75] *About the FASB*, FIN. ACCT. STANDARDS BD. (FASB) (July 2020), https://www.fasb.org/facts/.

[76] *Id.*

[77] Buckberg & Einhorn, *supra* note 4, at 9.

[78] *Id.*

financial statements, the income statement and balance sheet so they are presented in accordance with GAAP.[79] After the major financial scandals of the 1990s, there was a push to revolutionize the accounting world by creating a single set of international accounting standards to unite GAAP with the International Financial Reporting Standards ("IFRS") used by European countries.[80] This reconciliation never materialized.[81] As of 2016, at least 110 countries used either GAAP or IFRS.

While GAAP is determined by FASB, IFRS are developed through international due process procedures involving accountants, financial analysts, and the business community at large.[82] Most notably, GAAP is more ruled-based and provides more detailed rules than IFRS which is principle-based.[83] IFRS has fewer guidelines for industry-specific financial reporting, which is challenging historically given the differences in revenue recognition and measurement requirements related to transactions or events common to certain industries but not pertaining to others.[84] Another difference is that how IFRS regulations are applied varies widely from one country to the other.[85] Efforts are ongoing to converge the differences between GAAP and IFRS. This is important because without more unification the analysis of investment targets, acquisitions, or competitors may continue to require comparing financial statements under two distinct accounting standards.[86] To be compliant under the federal and state franchise laws, financial statements prepared according to IFRS must be reconciled to GAAP.

F. FASB Revenue Recognition Rule ASC 606

This and other convergence challenges helped to explain why FASB issued Accounting Standards Codification 606 ("ASC 606") in 2014, which impacts how all business entities recognize revenue and report revenue recognition in their financial statements.[87] ASC 606 supersedes previous industry-specific guidance for franchisors and provides a five-step analysis that all companies must adhere to.[88] Also notable is that ASC 606 is less of a traditional rules-based standard consistent with historical GAAP standards and more akin to a principles-based standard characteristic of the IFRS standards in that it requires companies to make more

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[79] FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 11, at 113; *see also* Buckberg & Einhorn, *supra* note 4, at 34.

[80] Kroeker et al., *supra* note 74, at 4.

[81] *Id.*

[82] *Id.*

[83] *Id.*

[84] *Id.*

[85] Sherman & Young, *supra* note 73.

[86] *Id.*

[87] *FASB Accounting Standards Update (ASU) No. 2014-09: Revenue from Contracts with Customers (Topic 606)*, FASB § 606-10-50-1 *et seq.* (Disclosure) (May 2014).

[88] Kroeker et al., *supra* note 74, at 9.

individual judgment calls about how to determine the timing and matter of revenue recognition.[89] What this means in the franchise context for example, is that companies must make judgment calls about how to recognize certain franchise fees, including initial fees.[90] Too much unilateral judgment is not always a good thing and the confusion that ensued within the franchise industry after ASC 606 was issued reflected this challenge.

The most significant impact to franchisors concerned the impact on the recognition of revenue for initial franchise fees. Under the original standard, franchisors could recognize initial franchise fee revenue at the time (or shortly thereafter) that the franchisor performed its material pre-opening and opening obligations to a new franchisee.[91] Under ASC 606, the franchisor may be required to defer recognition of some or all of the initial franchise fee depending on when the specific obligation for which the franchisee has paid the fee has been performed by the franchisor.[92] In sum, revenue is no longer recognized when the franchisee opens for busines and the franchisor is now required to defer the initial franchise fee over the term of the franchise agreement unless the practical expedient is utilized.[93]

G. <u>Practical Expedient</u>

In January 2021 FASB issued ASU 2021-02. This so-called "practical expedient" allows non-public business entity franchisors to treat certain preopening services provided to their franchisees as distinct from the license of the franchise.[94] FASB intended the practical expedient to reduce the cost and complexity of applying ASC 606 to preopening services associated with initial franchise fees. The pre-opening services to which the practical expedient applies are the following:

- Assistance in the selection of a site.
- Assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural, and engineering services, and lease negotiation.
- Training of the franchisee's personnel or the franchisee.
- Preparation and distribution of manuals and similar material concerning operations, administration, and record keeping.

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89 *Id.*

90 *Id.*

91 *Summary of Statement No. 45: Accounting for Franchise Fee Revenue*, FASB (Mar. 1981), https://www.fasb.org/summary/stsum45.shtml#:~:text=It%20requires%20that%20franchise%20fee,or%20satisfied%20by%20the%20franchisor.

92 *ASU No. 2014-09*, *supra* note 87.

93 *Id*.

94 *FASB Accounting Standards Update (ASU) No. 2021-02—Franchisors—Revenue from Contracts With Customers (Subtopic 952-606): Practical Expedient*, FASB (Jan. 2021).

- Bookkeeping, information technology, and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate, and other taxes or about regulations affecting the franchisee's business.
- Inspection, testing, and other quality control programs.[95]

If a private-company franchisor applies the practical expedient, it must disclose that fact.[96] If a company does not apply the practical expedient, it must still comply with the other requirements under ASC 606 including the five step analysis of revenue recognition: (1) identifying other performance obligations; (2) determining the stand-alone selling prices of the performance obligations; (3) allocating the transaction price to the performance obligations; and (4) determining the timing of revenue recognition. ASC 606 is effective to all financial statements prepared after December 15, 2020.[97]

IV. STATE FRANCHISE REGULATOR REVIEW OF FINANCIAL STATEMENTS

A. <u>State Review of Financial Statements</u>

The FTC Rule allows individual states to provide additional protections for their residents. There are ten registration states,[98] nine notice filing states,[99] six states that require registration or notice filing for franchisors without registered trademarks[100] and, 25 states that do not regulate franchising.[101] All the registration filing states and one notice filing state (South Dakota) review financial statements.

The registration states, consistent with the FTC Rule, require franchisors with three or more years of operating history to submit three years of audited financial statements. The FTC Rule and the NASAA Franchise Guidelines permit start-up franchisors to submit phase-in of audited financial statements. However, seven registration states offer more protections for their residents. Maryland, North Dakota, and Rhode Island require either a fee deferral or escrow to

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95 *Id*.

96 *Id*.

97 *Id*.

98 CAL. CORP. CODE § 31000 *et. seq*., HAW. REV. STAT. § 482E-1 *et. seq*., ILL. COMP. STAT. § 705/1 *et. seq*., MD. CODE ANN. BUS. REG. § 14-201 *et. seq.*, MINN. STAT. § 80C.01 *et. seq.*, ND. CENT. CODE § 51-19-01 *et. seq.*, NY. GEN. BUS. LAW § 680.1 *et. seq.*, R.I. Gen. Laws § 19-28.1-1 *et. seq.*, VA. CODE § 13.1-557 *et. seq.* and WASH. REV. CODE § 19.100.010 *et. seq.*

99 FLA. STAT § 559.802 *et. seq.*, Ind. Code § 23-2-2.5-1 *et. seq.*, KY. REV. STAT. § 367.801 *et. seq.*, MICH. COMP. LAWS § 445.1501 *et. seq.*, NEB. REV. STAT. § 591701 *et. seq.*, S.D. CODIFIED LAWS § 37.5A-1 *et. seq.*, TEX. BUS. & COM. CODE, § 51.001 *et. seq.*, UTAH CODE § 13-15-1 *et. seq.* and WIS. STAT. § 553.01 *et. seq.*

100 CONN. GEN. STAT. § 36b-60 *et. seq.,* O.C.G.A. § 10-1-410 *et. seq.*, LA. REV. STAT. § 51:1821 *et. seq.*, ME. REV. STAT. TIT. 32 § 4691 *et. seq.*, N.C. GEN. STAT. § 66-94 *et. seq.* and S.C. CODE § 39-57-10 *et. seq.*

101 AK, AL, AR, AZ, CO, DE, IA, ID, KS, MA, MO, MS, MT, NH, NJ, NM, NV, OH, OK, OR, PA, TN, VT, WV, and WY.

accompany a phase-in audit. California allows the use of reviewed financial statements in limited situations[102] and Minnesota, New York and Virginia do not permit the use of a phase-in audit.[103]

Interim financial statements are required to be submitted with the audited financial statements in California and Hawaii if the franchise submits its filing more than 90 days after the fiscal year.[104] Maryland, Virginia and Washington require the interim financial statements if the franchisor submits is filing more than 120 days after the fiscal year.[105]

B. <u>Franchisor Cash Flow and Working Capital</u>

The U.S. Small Business Administration reports that about half of all small businesses fail within the first five years.[106] According to Investopedia the four most common reasons why small businesses fail are lack of sufficient capital, poor management, inadequate business planning and, overspending on marketing budgets.[107] All of these involve cash flow problems. Capital and cash flow play a large role determining a franchisor's failure or success.

In the course of reviewing applications for franchise registrations and exemptions from franchisors, state franchise regulators normally review each franchisors' working capital closely because it is a critical data point for franchisors of any size but especially for new franchisors. The working capital is computed by subtracting the franchisor's current liabilities from its current assets. It measures whether the franchisor has the ability to pay its short-term expenses.

If a franchisor has negative working capital, meaning it does not have enough cash on hand to meet its current expenses, it should expect state regulators to require a financial assurance. A financial assurance is a condition of registration that requires the franchisor to demonstrate that it can meet is performance obligations. Types of financial assurances are discussed in paragraph E below.

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[102] *DFPI § 310-111: State of California Guidelines for Franchise Registration*, DEP'T OF FIN. PROT. AND INNOVATION at 7 ¶ 5, https://dfpi.ca.gov/wp-content/uploads/sites/337/forms/franchise/DFPI-310.111.pdf. A Reviewed financial statement may be used if the franchisor is submitting its first registration application in California; has no prior audited statements; the balance sheet is as of a date within 90 days of the application filing date, the statement includes profit and loss statements for the last 3 years or from the inception of the franchisor's business, a cash flow statement, and appropriate footnotes; and the Reviewed financial statement complies with AICPA standards.

[103] *See* MINN. STAT. § 80C.04(g); N.Y. GEN. BUS. LAW § 683(g) (McKinney 1982); 21 VA. ADMIN. CODE § 5-110-30(A)(7) (2013).

[104] CAL. CODE REGS. Tit. 10, § 310.111.2(b) (1982); HAW. REV. STAT. § 482E-3(7)(2013); HAW. RULE 16-37-3(b).

[105] MD. CODE REGS. § 02.02.08.13C(2) (1994) requires 90 days but Maryland Securities Commissioner issued a no action position allowing franchisors to extend to 120 days of application. *See* Interpretive Opinion/No Action Position Allowing Franchisor Financial Statements to be Current within 120 Days of a Franchise Application, MD. ATT'Y GEN. (Nov. 1, 2013)*; see also* 21 VA ADMIN. CODE § 5-110-30(E).

[106] *U.S. Age NAICS at Table 7: Survival of Private Sector Establishments by Opening Year,* U.S. BUREAU OF LAB. STAT. EMP. DYNAMICS, https://www.bls.gov/bdm/us_age_naics_00_table7.txt (last visited July 28, 2021). Data shows that of the small businesses that opened in March of 2012, 50.2% made it to March of 2017.

[107] Melissa Horton, *The 4 Most Common Reasons a Small Business Fails*, INVESTOPEDIA (Mar. 31, 2021), https://www.investopedia.com/articles/personal-finance/120815/4-most-common-reasons-small-business-fails.asp#citation-1.

C. Consistent Disclosures in the FDD and Audit

The auditor's notes provide important disclosures that explain the assumptions used to prepare the financial statements. Franchisors or their counsel should review the auditor's notes to make sure they are consistent with the FDD disclosures. For example, if the auditor's notes disclose an open franchise outlet and the Item 20 tables show no outlets for an initial franchise registration, it is possible the regulator will conduct an independent investigation to determine whether there was an unregistered franchise sale.

A common error is for the auditor's notes and FDD Item 1 to disclose a different formation date for the franchisor. This may look like a harmless error but for regulators this calls into question the effectiveness of internal controls and reliability of the financial reporting. Some regulators will even check to see if the auditor has an active license.

Another red flag would be the inclusion of a subsequent event that calls into question whether the franchisor has a reasonable basis to include a financial performance representation ("FPR").[108] A general disclosure about COVID-19 may not be problematic but a more specific disclosure discussing the number of outlet closures, whether permanent or temporary, could raise doubt about whether the franchisor had a reasonable basis to make an FPR. Also, the inclusion of revenue from Payment Protection Program loan ("PPP loan") in Item 19 could be materially misleading if not separately identified.[109]

In addition, it is possible that disclosures in the FDD will require the auditor to make certain disclosures. For instance, pending litigation in Item 3, may require a contingent liability disclosure if it is either probable or reasonably possible that litigation claims, or assessments will result in a material loss of revenue. If the auditor fails to include this disclosure, it may result in a comment letter by the regulator asking for an explanation.

D. Typical Issues Regulators See in Financial Statement Disclosures

Regulators are primarily reviewing franchisor's financial statements to determine whether the franchisor has the necessary capitalization to meet its obligations to its franchisees. However, typographical or formatting errors or missing disclosures will raise doubt about the reliability of the financial reporting or even the qualifications of the franchisor's certified public accountant ("CPA"). On occasion, a regulator has discovered that a CPA was not licensed or licensed as a CPA but not yet eligible to complete an audit. The FTC Rule require Franchisor's financial statements be audited by an independent CPA using US GAAP standards.[110]

Common typographical errors usually involve wrong formation data for the franchisor or reference the wrong franchisor entity. Formatting errors include submitting: (a) an audit that is not US GAAP or reconciled to US GAAP; (b) an Accountant's Consent Form without the firm's letterhead; (c) an Accountant's Consent Form not manually signed; (d) an Accountant's Consent Form dated after the issuance date on the FDD Cover Page; and (e) financial statements in a single format column instead of two columns that compare the last two fiscal years.

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[108] See FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 11, at 135.

[109] *See Disclosing Financial Performance Representations in the Time of COVID-19,* NASAA (June 17, 2020), https://www.nasaa.org/wp-content/uploads/2020/06/FPRs-in-the-time-of-COVID-19.pdf.

[110] 16 C.F.R. § 436.5(u).

The auditor's notes provide critical context as to whether the franchisor is adequately capitalized to meet its pre and post opening obligations to all franchisees in the franchise system. If all of the franchisor's assets have been used as collateral to secure a parent's or affiliate's loan, then it is likely this leveraged position will cause the regulator to scrutinize the financial stability of the franchise system. Likewise, if a member or shareholder holds a note that is due on demand, and that if called will materially diminish the franchisor's working capital, it will raise doubt about whether the franchisor is adequately capitalized to fund operations. In addition, if there are revolving credit arrangements or a line of credit then the debt load and available credit will be reviewed and considered accordingly for its potential impact on the financial condition during the franchise registration period. Some franchise systems use a parent or affiliate to act in a treasury capacity and upstream franchisor revenue so the parent or affiliate can manage cash flow. These are just some of the factors that will have an impact on how regulators understand a franchisor's overall financial stability.

E. Financial Assurances

Financial assurances are extremely important in the franchise sales process. The state franchise laws require the regulators to act as a gatekeeper, verifying that the franchisor is adequately capitalized to keep the promises it makes to franchisees in its state. Accordingly, state regulators may require that franchisors provide adequate financial assurances before making a franchise registration effective in their state.

For example, in California, it is the intent of the Franchise Investment Law to prohibit the sale of franchises where the sale would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled.[111] One of the tools to achieve this mandate is to condition a state registration on a financial assurance if the regulator determines that the franchisor is not adequately capitalized or cannot fund operations without relying on the franchisee's initial franchise fee.[112] If a franchisor would like to avoid the challenges of complying with a financial assurance in a registration state it can do so by adequately capitalizing the business before the audit is performed. Otherwise, a poorly capitalized franchisor should recognize it will undergo scrutiny in the registration states. Virginia focuses on whether a franchisor is insolvent or in danger of becoming insolvent.[113] Washington, in contrast, requires a financial assurance for all new franchisors.[114] And although New York has the authority to require financial assurances, it generally chooses to use risk factors.[115]

There is no set formula or a single factor that determines whether a franchisor will be deemed adequately capitalized. It is a multifactorial financial risk analysis that generally includes reviewing: (a) working capital; (b) net worth; (c) profit/loss; (d) ability to meet debt obligations as they mature; (e) franchisor's experience or track record; (f) economic conditions; (g) proportion of

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[111] CAL. CORP. CODE § 31001 (West 1971).

[112] *Id*. at § 31203.

[113] VA CODE ANN. § 13.1-562 (West 1972).

[114] WASH. REV. CODE § 19.100.050 (2011).

[115] N.Y. GEN. BUS. § 685 (McKinney 1981); N.Y. COMP. CODES R. & REGS. tit. 13 § 200.6 (1980) (New York examiners may require escrows or surety bonds).

intangible assets; (h) quality of receivables; and (i) going-concern disclosure in the auditor's notes. And some regulators may use financial ratios (current ratio, quick ratio, debt/equity ratio) to inform their decision. The analysis involves the exercise of regulator discretion and may result in different states or regulators arriving at different conclusions. This does not mean there is no comprehensive explanation of the criteria used by regulators to make the determination, only that it is not strictly formulaic because it is complex and fact-specific.

Once a regulator imposes a financial assurance as a condition of franchise registration, the franchisor should not unilaterally remove or alter that assurance during the registration period or while the condition is required to be in effect under state law. The condition remains for the duration required by state law or until lifted by the regulator. In California, franchisor may request that the condition be removed and explain how the financial condition has materially improved either in a Post-Effective Amendment or Registration filing. In Illinois, a surety bond must be posted for four years. When franchisors unilaterally remove or alter a financial assurance in a subsequent filing, they often find the regulator imposes the condition again - or worse; if the franchisor does not maintain the condition throughout the required period, it may face an enforcement action for failing to maintain a condition of registration.[116]

F. Types of Financial Assurance

1. Escrow (Impound) Initial Franchise Fees

One common type of financial assurance is an escrow, sometimes called an 'impound'.[117] The franchisor may be required to escrow initial franchise fees and other fees required to be paid by a franchisee until the franchisor's obligations under the franchise offering have been satisfied. This covers all fees from the date that the franchisee signs until the time when the franchise opens for business.

The terms of the escrow agreement vary among the states, and some states will negotiate specific terms of the agreement. California, Maryland, Minnesota, and Virginia require that the funds collected from the franchisee be placed in a separate trust account with a bank or trust company located in the registration state; however, other registration states permit the funds to be deposited into accounts that may be located out of the state.[118] As a practical matter, some franchisors may find it difficult to find an out-of-state bank to serve as escrow agent.

In most cases the franchisor must also file an original signed copy of the escrow agreement in a form required by the state. The escrow agreement must include the name and address of the depository and the account number of the escrow account. All checks collected must be made payable to the depository. For example, in California, the money must be deposited within 48 hours of receipt.[119] When the franchisor has satisfied its pre-opening obligations, and the franchisee is able to open for business, the franchisor may then apply to the state for authority to direct the escrow agent to release the escrowed funds. To do this, in some

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[116] *See* CAL. CORP. CODE § 31203 (West 1971).

[117] CAL. CODE REGS. Tit. 10, § 310.113.1 (1982).

[118] *See infra* Appendix B.

[119] CAL. CODE REGS. tit. 10, § 310.113.1 (1982).

states the franchisee must sign a statement authorizing the release of funds. For example, California specifically requires the franchisor must show that it has performed its pre-opening obligations and the franchisee must sign a statement that the information is correct. The regulator has broad authority to require such other information as may be needed in a particular case.[120]

2. Deferral of Initial Franchise Fees

A second common type of financial assurance is a fee deferral. Under this requirement, the franchisor must defer the collection of the initial franchise fee and any other fees required to be paid to the franchisor or an affiliate (as disclosed in FDD Item 5) until the franchisor has performed its pre-opening obligations under the franchise agreement (as disclosed in FDD Item 11) and each franchise outlet is open for business. If the franchisor is selling Area Development opportunities, it is a best practice to confirm with the regulator whether the fee deferral applies to each outlet opened under the Area Development Agreement.[121]

3. Guaranty of Performance

A third type of financial assurance is a guaranty. A parent or affiliate may agree to provide a guaranty of performance of the franchisor's obligations owed to the franchisee under the franchise agreement, and state regulators may accept this under certain conditions. Some states may also permit a non-affiliated party to provide a guaranty. In order to provide this type of assurance, the guarantor must submit as part of the franchisor's registration application: (a) audited financial statements that demonstrate an ability to successfully perform franchisor's obligations; (b) Consent of Accountant form; (c) provide a signed guaranty of performance that shows the guaranty is irrevocable and remains in effect during the entire term of any franchise agreement signed; (d) Certification form; (e) Consent to Service of Process form; and (f) Corporate Acknowledgement or other notarization as required by the state.

4. Financial Risk Factors on the NASAA State Cover Sheets

All registration states may ask franchisors to add financial related risk factors to the NASAA State Cover Sheets.[122] New York in particular favors risk factors when a franchisor's financial statements cause concern. This is because the requirements to require other financial assurances may be cumbersome and strict.

5. Surety Bond

If accepted by the state regulators, the franchisor may opt to post a surety bond. A surety bond is a promise by a surety to pay a franchisee up to the amount specified if the franchisor fails to perform as promised. These types of bonds ordinarily are obtained from insurance companies that specialize in commercial bonding, which underwrite them based on information about the

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[120] *Id*. at § 310.113.4.

[121] *See Multi-Unit Commentary*, NASAA (September 16, 2014), https://www.nasaa.org/wp-content/uploads/2011/08/Franchise-Multi-Unit-Commentary-effective-Adopted-Sept.-16-2014.pdf. An Area Development arrangement is one where the franchisor grants the right to open and operate multiple unit franchises, usually in a delineated geographic area.

[122] *See New Franchise State Cover Sheets Instructions*, NASAA (May 19, 2019), https://www.nasaa.org/wp-content/uploads/2019/06/New-Frachise-State-Cover-Sheets-Instructions.pdf.

franchisor, its principals, credit scores and financial information.[123] Assuming good credit, the bond premium is normally about 1% of the amount of the bond.[124] If the surety uses the bond proceeds, the surety will require the franchisor or its principals who provided a guaranty for the bond to reimburse them.

Typically, surety bonds last one year from the date of issuance and then must be renewed. The franchisor should be diligent in making sure the surety bond covers the required duration under state law. In some states it is the registration period, but it could be longer. For example, in Illinois it is four years and in if the franchisor sells more franchises than originally projected then the franchisor must obtain another bond for each new sale.[125] Maryland requires the bond to stay in effect until the later of the registration period or when the franchise outlet covered by the surety bond is opened.[126]

The franchisor should work with the state regulator to verify the amount and duration of the bond. In California, Hawaii, Rhode Island, South Dakota, and Wisconsin the amount of the bond is left to the discretion of the regulator.[127] In Washington the bond is $100,000.[128] Illinois, Maryland, Minnesota, and North Dakota use a formula that includes initial franchise fees (franchisor should verify whether this includes total fees in FDD Item 5) multiplied by number of projected openings in the state that registration year (FDD Item 20, Table 5).

6. Other (Capital Infusion, Certificate of Deposit, Undertaking)

Some states, like California, have broad discretion to craft financial assurances that protect investors and provide franchisors flexibility. An example of this is allowing the franchisor to improve its equity position with an infusion of capital. In that instance the franchisor would be required to provide a redacted bank statement showing the capital infusion. This option is often paired with a written undertaking[129] by the franchisor to maintain a designated minimum working capital amount in the franchise business during the registration period. Failure to do so would be a violation of the condition of registration.

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[123] Surety companies typically are authorized and qualified to do business by the state insurance commissioner where they are domiciled and in the jurisdiction where the bond is issued. The state departments of insurance regulate surety companies, which must meet minimum capital requirements, file periodic financial reports in those jurisdictions where they are authorized to do business, and are subject to market conduct investigations, among other regulatory requirements and actions. *See* National Association of Surety Bond Producers (NASBP), *What are Bond Producers*?, https://www.nasbp.org/getabond/about-surety/what-surety-companies (last visited July 27, 2021).

[124] C. Christian Thompson, Kara K. Martin, Nate Whitaker & Heidi Coccimiglio, *Bonding: What It Is and How to Do It*; The Franchise Lawyer (Fall 2017) at 12-14.

[125] 815 ILL. COMP. STAT. 705/15 (2009); ILL. ADMIN. CODE tit. 14, § 200.500 (1999); ILL. ADMIN. CODE tit. 14, § 200.505 (1988).

[126] MD. CODE ANN., BUS. REG. § 14-217 (West 1992); MD. CODE REGS. § 02.02.08.08.F(2)(b).

[127] CAL. CODE REGS. Tit. 10, § 310.113.5 (1982).; HAW. REV. STAT. § 482E-8(e) (1984); 1993 R.I. PUB. LAWS 19-28.1-9(b); S.D. CODIFIED LAWS § 37-5B-5 (2017); WIS. STAT. § 553.27(2) (2008); WIS. ADMIN. CODE DFI-SEC § 32.09 (1996).

[128] WASH. REV. CODE § 19.100.050 (2011); WASH. ADMIN. CODE § 460-80-460 (2009).

[129] Undertaking is a written promise offered by the franchisor as security for the performance of a particular act and required as a condition of registration.

An undertaking may be paired with other financial assurances or singularly imposed where the franchisor has a promissory note due on demand to a parent, affiliate, third party or principal. For instance, California will require the franchisor to provide a written undertaking (whether or not there is another financial assurance provided) to not call the note (including any portion of that note) during the registration period to preserve the franchisor's working capital to fund operations.

Illinois allows a franchisor to post a Certificate of Deposit as a financial assurance.[130]

G. Other Financial Statement Issues

1. Amendments to State Addenda to FDD and Franchise Agreement

If a state regulator requires a financial assurance as a condition of registration the condition should be disclosed both in the state addenda to the FDD and Franchise Agreement. Failure to do so could result in violations of state franchise law that could result in costly franchise enforcement actions.[131]

2. Required Risk Factors/ NASAA State Cover Sheets

Although the federal and state franchise laws were based on the securities law, the FTC staff is more circumspect about how risk factors should be used. The FTC Staff policy concern is that risk factors may incorrectly signal which risk factors are most important or repeat what franchisors must already disclose.[132] State regulators who are mindful of this policy carefully use their discretion to add risk factors on the State Cover Sheets.

To better help franchisees understand the FDD, NASAA adopted the State Cover Sheets May 2019, and the State Cover Sheets became effective January 1, 2020, replacing the State Cover Page in the FDD.[133] The third cover sheet is where a franchisor now discloses risk factors required by state regulators. State regulators will provide uniform risk factor language to the franchisor. The NASAA uniform risk factors are written in plain English and will be used thoughtfully by regulators to make the risks used on this page both effective and meaningful.

Several of the uniform risk factors are financially related and may be required in the regulator's discretion if there is: (a) going concern paragraph in the auditor's notes; (b) a working capital deficit; (c) negative net worth; (d) substantial intangible assets; and (e) a significant amount of money owed to or due from affiliate or parent.

3. ASC 606 Disclosure

As discussed above in Section III, ASC 606 is a recent change in the accounting principles for revenue recognition. It is triggered when any business enters into contract to transfer goods

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[130] ILL. ADMIN. CODE tit. 14, § 200.506 (1988).

[131] See https://dfpi.ca.gov/wp-content/uploads/sites/337/2021/08/Great-Greek-Franchising-LLC-Consent-Order.pdf

[132] FTC Rule, *supra* note 3 at 15,444, 15448, 15452, 15473.

[133] *New Franchise State Cover Sheets Instructions*, *supra* note 122.

or services. In addition to the change in how franchisors may recognize revenue, ASC 606 requires the auditor's notes to make disclosure that enable the users of the financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.[134] This includes the use of any practical expedients.[135]

ASC 606 addresses revenue from contracts and identifies performance and licensing obligations. ASC 606 disclosures should be detailed and demonstrate both an understanding of and compliance with the requirements. Disclosures should include (a) the method of adoption, (b) any catch-up adjustments to retained earnings which should be presented in a table format, (c) an analysis that includes the five steps to revenue recognition, and (d) whether the practical expedient was relied upon.

Regulators will also be looking to see that unrecognized initial fees are separated into current deferred revenue and long term deferred revenue. Deficiencies that regulators may comment on include but are not limited to: (a) conclusory disclosure that omits the required detailed ASC 606 analysis; (b) use of GAAP Legacy disclosure language which creates doubt about reliability of the financial statements and whether the auditor is familiar with ASC 606; and (c) failure to separate current and long-term deferred revenues as described above.

V. PREPARATION AND DISCLOSURE OF FINANCIAL STATEMENTS

A. Audited Financial Statements

As noted in the SBP, the primary purpose of an FDD is to provide prospective franchisees with material information in a clear and conspicuous manner. Therefore, that the information must be presented in a format that is meaningful to both franchisees and their financial advisors.[136]

The FTC Rule defers to other policymakers in regard to what constitutes compliance with GAAP. Under the FTC Rule, financial statements prepared by an independent certified public accountant according to GAAP, as revised by any future United States government mandated accounting principles, or as permitted by the Securities Exchange Commission.[137] Therefore, the FTC Rule recognizes that GAAP may be changed by federal government oversight and allows for flexibility by permitting accounting standards recognized by the Securities and Exchange Commission.

Audited financial statements prepared in accordance to GAAP must be included in Item 21 and attached to the FDD, except where the franchisor is a start-up that does not have audited financials. The audited financial statements must be presented in a tabular form that compares at least two fiscal years, and must include:

(i) The franchisor's balance sheet (statement of financial position) for the previous two fiscal year-ends before the disclosure document issuance date.

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[134] *ASU 2014-09*, *supra* note 87.

[135] *ASU 2021-02, supra* note 94 ("if an entity elects to use the practical expedient …, the entity shall disclose that fact").

[136] FTC Rule, *supra* note 3 at 15,444, 15,509–15,512.

[137] 16 C.F.R. § 436.5(u).

(ii) Statements of operations, stockholders' equity, and cash flows for each of the franchisor's previous three fiscal years.

(iii) Instead of the financials required by (i) and (ii) above, the franchisor may include financial statements of its affiliates under circumstances as more fully described in Section IV.D. below.

(iv) Financial statements should reflect the financial condition of the franchisor and its subsidiary, when the franchisor owns a direct or beneficial controlling financial interest in a subsidiary (see Section IV.C below).

(v) As more fully described below, separate financial statements for the franchisor and any subfranchisor (see Sec. IV.E. below) and for any parent that commits to perform post-sale obligations for the franchisor or guarantees the franchisor's obligations (see Section IV.B below) should be included.

As an alternative to the financial disclosures described in (i) and (ii) above, the franchisor may include financial statements of any of its affiliates provided that certain conditions are satisfied (see Section IV.D. below).

B. Parent Company Financial Statements

In addition to its own financial statements, a franchisor must disclose a parent company's financial information when the parent commits to perform post-sale obligations for the franchisor or guarantees the franchisor's obligations. According to the SBP, under such circumstances the financial stability of the parent becomes a material fact that must be disclosed.[138] The Compliance Guide notes that under such circumstances, prospective franchisees may reasonably consider the parent's financial status in their investment decision-making.[139] If the parent is guaranteeing the franchisor's obligations, a copy of the guarantee must be disclosed in Item 22 so that the franchisee can assess the extent of any performance or financial guarantees. Appendix A is a Guarantee of Performance Form with instructions.[140]

In its response to the FTC's Frequently Asked Questions ("FAQ"), the FTC staff stated that if a parent happens to supply goods or services to franchisees where there is no underlying obligation to do so, its financials need not be disclosed. In those cases, the parent is no different than a third-party supplier. However, if the franchisor (a) is obligated to provide goods and services and the parent assumes that responsibility, or (b) arranges for the parent to provide goods or services directly to franchisee on its behalf, the parent's financials must be disclosed.[141]

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[138] FTC Rule, *supra* note 3 at 15,444, 15,511.

[139] FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 11.

[140] *NASAA 2008 Franchise Registration and Disclosure Guidelines, supra* note 5, at 18 (Form E – Guarantee of Performance).

[141] *Amended Franchise Rule FAQ's*, FED. TRADE COMM'N, https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs#4.

The obligation to disclose a parent's financial statements in FDD Item 21 is intended to cover formal arrangements between the parent and the franchisor for the benefit of franchisees, or formal arrangements directly between the parent and franchisees. As such, the performance of post-sale obligations by a parent's employee for the benefit of franchisees does not trigger the obligation unless there is a formal commitment to perform or a guarantee to perform made by the parent.[142]

The definition of the term "parent" varies under the FTC Rule. Under section 1(m), a "parent" is defined as "an entity that controls another entity directly or indirectly through one or more subsidiaries. This definition focuses on "control," not mere ownership. Accordingly, a parent that merely owns, but does not control, a franchise system – for example, a parent that does not shape the franchisor's policies or control franchise sales or operations – is not a "parent" for purposes of any disclosure item.[143] FAQ 16 notes that the definition focuses on 'control", not mere ownership.

However, the disclosure of parent financial information is only required when the parent commits to perform post-sale obligations for the direct benefit of franchisees. Therefore, even if the parent exercises control over the franchisor entity, it may need to be included in the Item 1 disclosures, but it would not need to disclose its financials if it has only agreed to provide administrative and other services (i.e., "back office services" or bookkeeping and accounting services) for the franchisor.

In addition, performance of a single or isolated obligation alone is not sufficient to trigger the obligation to disclose a parent's financial statements. However, there is no specific guidance that explains the level to which a parent must commit to perform post-sale obligations to trigger the requirement that its audited financials be included in the FDD. The FTC Rule does not establish a threshold standard, such as "substantial obligations" or "preponderance of obligations" for this obligation. Therefore, according to the FTC, a parent should disclose its financials if it commits or guarantees to perform more than an isolated obligation to franchisees on behalf of the franchisor.[144]

While a parent's financials do not need to be disclosed if the parent is one of a number of approved suppliers, the obligation to disclose the parent's financials is triggered if the parent is the sole supplier of a good or services without which a franchise cannot be operated.[145] According to the SBP,"[146] [t]o the extent that a prospective franchisee is asked to rely on a parent to perform post-sale contractual obligations or relies on a parent's guarantee, the financial stability of the parent becomes a material fact that should be disclosed." Therefore, even if the franchise agreement does not contain an express commitment for the parent to provide a good or service, if the good or service is so essential to the franchisee's business that the business could not be

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[142] *Id.* at ¶ 16(D).

[143] 16 C.F.R. § 436.1(m); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 11; *Amended Franchise Rule FAQ's, supra* note 141, at ¶ 16.

[144] *Amended Franchise Rule FAQ's*, *supra* note 141.

[145] *Id.*

[146] FTC Rule, *supra* note 3 at 15,444, 15,511.

conducted without it, the obligation is implicit, and the parent's financial statements would have to be disclosed.

C. Subsidiary Financial Statements

1. Franchisor Owns Interest in Subsidiary

As noted above, financial statements should reflect the financial condition of the franchisor and its subsidiary, when the franchisor owns a direct or beneficial controlling financial interest in a subsidiary.[147]

2. Consolidated Financial Statements

Sometimes the franchisor will not have to disclose audited versions of its own financial statements when its parent's audited financial statements are provided in Item 21. Where a franchisor is a subsidiary of another corporation which is permitted under generally accepted accounting principles to prepare financial statements on a consolidated or combined statement basis, the parent's audited financial information may be the only financial disclosed if (a) the corresponding unaudited financial statements of the franchisor are also provided, and (b) the parent absolutely and irrevocably has agreed to guarantee all obligations of the franchisor subsidiary.[148]

D. Affiliate Financial Statements

A franchisor may choose to (but is not required to) substitute the financial statements of an affiliate for its own in Item 21 if the affiliate's financial statements satisfy the requirements of the FTC Rule and the affiliate absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement.[149] The affiliate's guarantee must cover all of franchisor's obligations to the franchisee. However, it does not have to guarantee the franchisor's obligations to third parties. A copy of the guarantee must be attached to the disclosure document in Item 22 of the FDD. A sample form Guarantee of Performance with instructions is in Appendix A of this paper.

If an affiliate commits to perform post-sale obligations for the franchisor, an affiliate is not required to disclose financials unless it qualifies as a "parent" and commits to perform or guarantee the franchisor's post-sale obligations.

E. Subfranchisor Financial Statements

In addition to the franchisor's audited financial statements, the FTC Rule requires the franchisor to disclose separate audited financial statements for any subfranchisor.[150] Again, the SBP notes that prospective franchisees should be provided an opportunity to assess an entity's

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[147] 16 C.F.R. § 436.5(u).

[148] *Id.* at § 436.1(a)(20)(i); FTC Informal Staff Advisory Opinion 06-2, *supra* note 8.

[149] FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 11.

[150] 16 C.F.R. § 436.5(u)(iv).

financial stability before risking their own investment. The Compliance Guide notes that the financial information of a subfranchisor becomes material because it gives prospective franchisees an opportunity to assess the subfranchisor's financial condition.

A "subfranchisor" is a person "who functions as a franchisor" by use of the qualifying phrases "grants a franchise" and "participates in the franchise relationship". A subfranchisor is one who steps into the shoes of the franchisor by selling franchises and performing post-sale obligations.[151] A party is considered a "subfranchisor" under the FTC Rule if it has (1) the authority to enter into a franchise agreement, or other agreement relating to the franchise, and (2) as a result of entering into such an agreement it is obligated to perform after the purchase of the franchise.

Brokers, even if they call themselves "subfranchisors," are distinguished from subfranchisors because they are not typically a party to the franchise agreement and do not have post-sale contractual obligations. Therefore, financial statements of brokers are not to be disclosed in the FDD. As an example of how one state defines a franchise broker is "any person engaged in the business of representing a franchisor in offering for sale or selling a franchise and is not a franchisor, an affiliate of a franchisor or an officer, director or employee of a franchisor or an affiliate of a franchisor with respect to such franchise."[152]

Likewise, with respect to area representation arrangements the financial statements of **"**development agents," "area developers," or "regional developers," and other similar parties (regardless of what they are called) that perform post-sale obligations, but are not parties to the franchise agreement or other agreement involved in the franchise, should not be disclosed.[153]

F. Phase-In of Audited Financial Statements for Start-Up Franchisors

1. FTC Rule

Under the FTC Rule, a start-up franchisor that does not yet have audited financial statements may phase-in the use of audited financial statements over the course of three years, as more fully outlined in the chart below.[154]

FTC RULE	REQUIREMENT
First partial or full fiscal year selling franchises.	An unaudited opening balance sheet. FAQ 11 notes that the opening balance sheet does not have be prepared by an accountant and it can be internally prepared, but it should be in the format of a

[151] FTC Rule, *supra* note 3 at 15,444, 15,511.

[152] Franchise Disclosure Act of 1987, 815 ILL. COMP. STAT. 705/3(21) (2009).

[153] *See Multi-Unit Commentary*, *supra* note 121 and *Amended Franchise Rule FAQ's*, *supra* note 141.

[154] 16 C.F.R. § 436.5(u).

	typical balance sheet prepared under GAAP with explanatory notes, where warranted, to ensure that it is clear and accurate. The balance sheet must be in a format that conforms as closely as possible to audited statements prepared under GAAP. Furthermore, the franchisor must clearly and conspicuously note that the balance sheet is unaudited.
Second fiscal year selling franchises	Audited balance sheet opinion on its financial condition based on its opening balance sheet and a balance sheet as of the end of the first partial or full fiscal year selling franchises. The SBP notes that the FTC will look to the close of the franchisor's first fiscal year after selling franchises, regardless of whether that time period was a partial or full year.
Third fiscal year and thereafter	All required financial statements for the previous year, plus any previously disclosed audited statements that still must be disclosed according to paragraph (1)(i) and (ii) of Item 21.

A start-up franchisor may phase-in the disclosure of audited financial statements if the franchisor:

(a) Prepares audited financial statements as soon as practicable.

At a minimum, the statements for its first full fiscal year must be prepared by an independent public accountant, and financial statements for the following year must be fully audited.

(b) Prepares unaudited statements in a format that conforms as closely as possible to audited statements.

(c) Includes one or more years of unaudited financial statements, as available, or clearly and conspicuously discloses that the franchisor has not been in business for three years or more and cannot include all financial statements as required for Item 21. An example of such disclosure is:

> **FRANCHISOR HAS NOT BEEN IN BUSINESS FOR THREE YEARS OR MORE AND CANNOT INCLUDE ALL FINANCIAL STATEMENTS REQUIRED BY THE FTC RULE. THE BALANCE SHEET IS UNAUDITED.**

The exception for start-up franchisors may result in franchisors having three fiscal years to phase in audited financial statements. For example, if a franchisor begins to sell franchises – and thus first begins to comply with the Rule – in fiscal year 2005, then the franchisor may use unaudited financials during 2005, as well as 2006 (its first full fiscal year selling franchises). In fiscal year 2007 – the year after the franchisor has completed one fiscal year selling franchises – it must provide a balance sheet opinion. Thereafter, starting with fiscal year 2008, the franchisor must prepare fully audited financial statements.[155]

It is important to note that the phase-in only applies to companies that are new to franchising and who do not yet have audited financials. The phase-in cannot be used for spin-offs, affiliates, or subsidiaries of existing franchisors that have been engaged in franchising or had prepared audited statements for any other purposes in the past.[156] The Compliance Guide specifically states that an existing franchise system cannot avoid the obligation to provide full audited financial statements by forming a spin-off company. The SBP further states that the term "start-up" should be read narrowly and that the phase-in is not intended to apply to any non-franchise company that is new to franchising if it had prepared audited financials in the ordinary course of business.[157]

Merger and acquisition transactions impact the audited financials included in the FDD and some state regulators, such as those in California and Washington will be scrutinizing compliance for both franchise and securities laws. If the transaction results in the sale of the direct or indirect equity ownership interest in the franchisor there typically would be no change in audited financials used for the FDD. The new owners of the franchisor simply continue using the audited financials of the franchisor. Of course, if a parent or affiliate's audited financial statements were used before the sale and that is no longer the franchisor's parent/affiliate, there would be a change.

An FTC Advisory Opinion addressed questions regarding an asset sale by franchisor noted that a successor-franchisor should not include financial statements of a predecessor where the acquiring company is financially separate and distinct from the predecessor. However, the opinion stated that the opinion could be different if the relationship between a predecessor and successor-franchisor is so close as to warrant attributing the financials of the predecessor to the successor, particularly "in the case of an asset sale designed to circumvent the (FTC) Rule's financial disclosure requirements. For example, the franchisor cannot prolong the phase-in of audited financials indefinitely by continually spinning-off successor corporations every two years…where it appears In circumstances, based upon all of the facts taken together, that a franchisor is intentionally attempting to avoid audited financial disclosures or otherwise fraudulently taking advantage of the phase-in of audited financial statements, we will deem the successor-franchisor as stepping into the shoes of the predecessor, affording both a single phase-in. If a predecessor is in the second year of the phase-in, an attempt to avoid audited financials by spinning off a successor will result in the successor having only one additional year to phase-in audited financials. If the franchisor attempts to spin-off yet another successor, we will deem the phase-in exhausted and the successor-franchisor must prepare audited financials before selling franchises."[158]

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[155] *See* Interpretive Guides, 44 Fed. Reg. 49954, 49981 (Aug. 24, 1979); FTC Informal Advisory Opinion 05-2, *supra* note 8.

[156] FTC Rule, *supra* note 3 at 15,444, 15,512.

[157] *See* Interpretive Guides, 44 Fed. Reg. 49954, 49981 (Aug. 24, 1979).

[158] FTC Informal Advisory Opinion 05-5, *supra* note 9.

While not required, there are advantages to a start-up having audited financial statements from the beginning, such as: (a) some states require it; (b) it is generally easier and less expensive for an auditor to audit financials for subsequent years if prior years have already been audited; (c) they may help the franchise avoid having to comply with state financial assurance requirements in some registration states; and (d) audited financials may give the franchisor more credibility with potential franchisees. Indeed, many franchisor attorneys urge their clients to have audited statements prepared once they commence franchise activities.

2. Registration States

Some registration states do not follow the FTC Rule phase-in exception for start-ups. Illinois, Indiana, Maryland, Michigan, North Dakota, South Dakota, Washington, and Wisconsin permit the phase-in of audited financials as allowed by the FTC Rule.[159] However, Minnesota, New York, and Virginia require start-ups to provide an audited opening balance sheet.[160] Hawaii permits start-ups to provide a current verified financial statement and California requires audited or reviewed, if eligible, financial statement.[161] Appendix C provides a summary of the registration states' phase-in requirements. Due to the nuances of each state's approach, it is important to review the applicable state statutes.

G. Interim Financial Statements

Neither the FTC Rule nor the Compliance Guide mention interim financial statements. An FTC Advisory Opinion[162] noted that audited financials are an exclusively annual reporting obligation. Therefore, the opinion states that franchisors need not prepare any additional audited financial statements during the course of their fiscal year. However, in the event of changes in financial circumstances during a fiscal year, franchisors may use unaudited financials, until such time as their next annual update.

As more fully described on Appendix D, some of the registration states require franchisors to include unaudited interim financial statements as part of Item 21 if the issuance date of the FDD is more than 90 or 120 days after the close of the franchisor's fiscal year.

In most cases the financial statements are not required to include a disclosure that the financial statements are unaudited; however, Maryland and Minnesota regulations require the following legend:[163]

> **These Financial Statements Have Been Prepared Without An Audit. Prospective Franchisees or Sellers of Franchises Should Be Advised That**

[159] *See* Appendix C.

[160] *Id.*

[161] *Id.*

[162] FTC Informal Advisory Opinion 06-2, *supra* note 8.

[163] MD. CODE REGS. § 02.02.08.13; MINN. RULE § 2860.1400. This disclosure must appear on, or in a cover page to, the unaudited financial statements and is meant to alert the reader that the unaudited financial statements do not have the same protections and explanations as the audited financial statements.

No Certified Public Accountant Has Audited These Figures or Expressed An Opinion With Regard to Their Content or Form.

If the interim financial statement is only added to comply with state law, it is not a material change per se. However, if there has been a material change to the franchisor's financial condition then it should be disclosed in all states per the FTC Rule.

H. <u>Variable Interest Entities</u>

Franchisors may not use financial statements to comply with Item 21 if an auditor issues a qualified opinion because the statements do not comply with FIN 46R issued by FASB. FIN 46R has modified GAAP to require than an entity provide consolidated financial statements that include a "variable interest entity", which is any other entity in which it has interest, as the primary beneficiary, that may increase or decrease in value.[164]

Variable interest entities have one or both of the following characteristics:

1. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity.

2. The equity investors lack one or more of the following essential characteristics of a controlling financial interest:

    a. The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights;

    b. The obligation to absorb the expected losses of the entity if they occur, which makes it possible for the entity to finance its activities;

    c. The right to receive the expected residual returns of the entity if they occur, which is the compensation for the risk of absorbing the expected losses.[165]

As a result of the Enron scandals, FASB issued FIN 46 and FIN 46R to provide guidance on consolidation of variable interest entities. These rules can have a significant impact on a franchisor's financial statements. FASB has stated that "[a] variable interest entity must have its financial statements consolidated into a reporting entity's statements if the reporting entity is the primary beneficiary of the activities of the variable interest entity. A primary beneficiary absorbs a majority of the variable entity's losses and receives a majority of the variable entity's expected residual returns. The reporting entity is a primary beneficiary if it has a controlling financial interest in the variable entity, based on factor such as the power to direct the activities of the variable entity."[166]

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[164] *Amended Franchise Rule FAQ's*, *supra* note 141.

[165] *Summary of Interpretation No. 46: Consolidation of Variable Interest Entities – An Interpretation of ARB No. 51*, FASB, https://www.fasb.org/summary/finsum46.shtml.

[166] Buckberg & Einhorn, *supra* note 4, at 25. *See* FRANCHISORS CONSOLIDATION, Statement of Fin. Accounting Standards No. 952-810 (Fin. Accounting Standards Bd. 2010). *FASB Accounting Standards Update (ASU) No. 2009-17:*

I. General Tips

The following are some tips for counsel representing franchisors based on the information provided in this paper.

1. Talk to the client's accountants *early* and avoid last minute surprises;

2. Review states statutes, including state regulations for registration states;

3. Review notes to the client's financial statements;

4. If the franchisor has a parent entity, whose financial statements have not been audited, structure the franchisor's relationship with its parent entity in a way that limits the parent's post-sale obligations;

5. Determine if variable interest entity issues will come into play;

6. Alert accountants of the need for audited financials, and the applicable deadlines, well in advance of renewal season; and

7. Even if your client is eligible to take advantage of the phase-in policy for start-up franchisors, consider having the client obtain audited financials anyway, as there may be practical benefits to having an audit conducted.

J. U.S. In-Bound Franchisors

As noted above in Section II, international franchisors seeking to offer and sell their franchises in the United States must disclose the accounting principles used to prepare their financial statements if such financial statements are not prepared according to US GAAP.[167] They must also have the notes to the financial statements, the income statement and balance sheet reconciled so they are presented in accordance with GAAP. This can be and has been a challenge for in-bound franchisors, particularly with respect to timing and costs to reconcile the financial statements. For large sophisticated international brands with consolidated financial statements that have been prepared under IFRS or other similar standards, it is important that the franchisor be advised of this particular challenge at the onset or early enough in the preparation of the US form of FDD so that the in-bound franchisor's expectations regarding timing to "go-live" in the US are better managed in the event no applicable exemptions from registration or disclosure are available to the franchisor.

VI. SYSTEM CHANGES AND CHALLENGES

The auditor's notes are a critical area to look to identify any system challenges and changes being faced by the franchisor and the franchise system whether those challenges involve a material adverse change in the franchisor's financial condition, overall structure or recent

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Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities (Consolidations Topic 810), FASB § 810-10-25-38 (Dec. 2009).

167 *See also* Buckberg & Einhorn, *supra* note 4, at 34.

mergers and acquisitions. If the audit is prepared properly according to GAAP, key items to look for to identify any issues in the notes including any qualified or adverse and disclaimed opinions, going concern disclosures, which means that the auditor does not believe that the company will be able to support itself over the next year. Sometimes companies will delay issuing their audits instead of providing one with a going concern disclosure since it is a giveaway that the company is experiencing financial distress. It is also important to review the management letter which describes whether there are any issued with respect to preparing the audit. If a company has failed to adhere to certain internal controls or accounting policies and procedures, this will be disclosed in the management letter that accompanies the financial statements.

VII. CONCLUSION

If these authors have met the objective of this paper, by the time the reader has reached this conclusion the reader will have learned the basics about financial statements and franchise disclosure obligations for the financial statements. The reader will have also concluded that properly prepared and properly disclosed financial statements read in conjunction with the FDD can be a useful tool to try to ascertain the viability of a franchise system, but sometimes they are not enough. The title of this program is appropriate –- you really do need to talk to the accountants! Financial issues relating to franchising can be complex. Therefore, it is important for franchise attorneys to educate their client's accountants and work closely with them in addressing the intricacies of both the FTC Rule and the statutes and regulations of the franchise registration states.

APPENDIX A

NASAA FORM FOR GUARANTEE OF PERFORMANCE

For value received, (name of guarantor_) , a (state of formation and form of entity) (the "Guarantor"), located at (address) , absolutely and unconditionally guarantees to assume the duties and obligations of (name of Franchisor) , located at (address) (the "Franchisor"), under its franchise registration in each state where the franchise is registered, and under its Franchise Agreement identified in its (year) Franchise Disclosure Document, as it may be amended, and as that Franchise Agreement may be entered into with franchisees and amended, modified or extended from time to time. This guarantee continues until all such obligations of the Franchisor under its franchise registrations and the Franchise Agreement are satisfied or until the liability of Franchisor to its franchisees under the Franchise Agreement has been completely discharged, whichever first occurs. The Guarantor is not discharged from liability if a claim by a franchisee against the Franchisor remains outstanding. Notice of acceptance is waived. The Guarantor does not waive receipt of notice of default on the part of the Franchisor.

This guarantee is binding on the Guarantor and its successors and assigns. The Guarantor signs this guarantee at ____________,___________ on the ____ day of ______.

Guarantor:

____

By:_________________________

Name: ______________________

Title:________________________

NASAA Instructions for Preparing Guarantee of Performance

The Guarantee of Performance form must be used if the franchisor's parent or affiliate will be guaranteeing the franchisor's performance under the Franchise Agreement. Personal guarantees of individuals are not acceptable.

1. In the opening lines, insert the correct legal name of the guarantor, its state of formation and form of the entity (*e.g.*, a Delaware corporation), and its principal business address.

2. Insert the correct legal name of the franchisor and its principal business address.

3. Insert the year corresponding to the issuance date of the Franchise Disclosure Document.

4. Insert the city and state where the Guarantee of Performance is executed and date of execution.

5. In the signature block, insert the correct legal name of the guarantor and print or type the name and title of the authorized signer. The authorized signer should sign in the “By:” line.

6. Attach a copy of the signed Guarantee of Performance to the financial statement exhibit of the Franchise Disclosure Document.

APPENDIX B

SUMMARY OF FINANCIAL ASSURANCE OPTIONS

FOR REGISTRATION STATES

	Financial Assurance								
State	**Fee Deferral**	**Escrow**	**Escrow + State Bank**	**Guaranty**	**Risk Factor**	**Surety Bond**	**Capital Infusion**	**Certificate of Deposit**	**Undertaking**
CA	√	√	√	√	√	√	√		√
HI	√	*		√	√	*			
IL	√	√		√	√	√		√	
MD	√	√	√	√	√	√			
MN	√	√	√	√	√	√			
ND	√	√		√	√	√			
NY	*	*	*	*	√	*			
RI	√	√		√	√	√			
SD	√	√		√	√	√			
VA	√	√	√	√	√				
WA	√	√		√	√	√			

* allowed but in practice not used because of cumbersome and strict requirements

APPENDIX C

PHASE-IN REQUIREMENTS OF REGISTRATION STATES

STATE	SUMMARY OF STATE LAW	STATUTE/REGULATION
CALIFORNIA		
Audited, or reviewed, in limited situations	Financial Statements required to be filed by these rules or by any official form of the Department shall be prepared in accordance with generally accepted accounting principles. Financial statements should be audited by either an independent certified public accountant or independent public accountant, except where the particular form or this Section permits the use of unaudited statements for interim periods or generally.	Cal. Code Regs. tit. 10, § 310.111.2(a)
	The Department may accept a "Review" report balance sheet if the following conditions are met: (i) it is the franchisor's first registration application in California and the franchisor has no prior audited financial statements; (ii) the "Review" report balance sheet is as of a date within 90 days of the application filing date; (iii) the financials include profit and loss statements covering the prior three years, or from inception of the business; a statement of cash flow, and appropriate footnotes; and (iv) the "Review" report conforms to American Institute of Certified Public Accountants standards.	See Department of Financial Protection & Innovation, Franchises – Frequently Asked Questions and Answers, available at https://dfpi.ca.gov/franchise-investment-law/franchises-frequently-asked-questions-and-answers/#b38.
HAWAII		
Verified financial statement	Financial statements. (1) Financial statements required to be filed in connection with an offering circular shall be prepared in accordance with generally accepted accounting principles. Such financial statements shall be audited and certified by a certified public accountant, except where the particular form or this section permits the use of unaudited statements… (2) A balance sheet of the franchisor at the close of the franchisor's last fiscal year preceding the date of filing of the offering circular and a profit and loss statement and analysis of surplus for the fiscal year ended at the date of the balance sheet, together with a balance sheet of the franchisor as of a date within 90 days prior to the date of filing of the offering circular and a statement of profit and loss for the period from the close of the last preceding fiscal year to the date of the balance	Hawaii Rule 16-37-3(b)

STATE	SUMMARY OF STATE LAW	STATUTE/REGULATION
	sheet, both verified by a duly authorized officer of the franchisor, if the franchisor has been in existence for less than one year, a balance sheet of the franchisor as of a date within ninety days prior to the date of filing and a statement of profit and loss for the period from the franchisor's organization to the date of the balance sheet shall be filed together with the offering circular… (4) In certain cases the director may waive the requirement for audited statements if the statements have been prepared by an independent certified public accountant or independent public accountant and the director is otherwise satisfied as to the reliability of such statements and as to the ability of the franchisor to perform future commitments. Such waiver shall ordinarily be granted only upon a showing that the franchisor has not had prior audited statements; that the close of the most recent or current fiscal year is so near the time of filing of the offering circular that it would be unreasonably costly or impractical to provide audited statements with the application; and that audited statements will be furnished within a reasonable time after the end of the most recent or current fiscal year. In such cases the director may impose an impoundment and such other conditions and restrictions as in his discretion may be appropriate. In every case where an unaudited statement is to be filed, the person requesting approval shall submit to the director, in writing, his reasons therefore and obtain the prior written approval of the director. (5) The use of unaudited financial statements as provided herein shall not relieve the applicant or any person from any liability for false and misleading statements contained in such financial statements.	
ILLINOIS		
FTC Rule phase-in allowed	Phase In Of Audit Requirement: Franchisors who have never had audited financial statements and are filing their first application with the Administrator may request a phase in of the audit requirement. All unaudited statements must be prepared by an independent CPA in accordance with GAAP. Initial registration will be granted using the unaudited statements which cover the time periods set forth in UFOC Item 21. The franchisor must notify its CPA to count the opening inventory at the beginning of	4 Admin. Code tit. 14, §200.602(c)

STATE	SUMMARY OF STATE LAW	STATUTE/REGULATION
	the franchisor’s fiscal year which commences after the registration has been filed. At the end of that fiscal year, the balance sheet must be audited. The remainder of the financial statements for that fiscal year may be unaudited but must independently be prepared in accordance with GAAP. Financial statements for the following fiscal year must be fully audited.	
INDIANA		
FTC Rule phase-in allowed	The disclosure statement shall be in a form prescribed by the commissioner or in a form permitted under 16 CFR 436, as amended.	Ind. Code §23-2-2.5-13
MARYLAND		
FTC Rule phase-in allowed	The following financial statements shall be prepared in accordance with this regulation: (1) A financial statement required by the Maryland Franchise Law; (2) A financial statement required by any regulation adopted under the Maryland Franchise Law, including the MFOC; and (3) A financial statement used by or on behalf of a franchisor in connection with an offer, sale, or purchase of a franchise in Maryland. B. Standards. (1) A financial statement specified in § A of this regulation shall be prepared in accordance with generally accepted accounting principles. (2) Financial statements of a franchise offering, for which registration is required under the Maryland Franchise Law, shall be audited and certified by an independent certified public accountant, except that this requirement: (a) Does not apply to interim financial statements unless otherwise required by the Commissioner in a particular case; and (b) May be waived by the Commissioner for good cause shown when a waiver would not be inconsistent with the purposes of the Maryland Franchise Law or contrary to the public interest or the protection of prospective franchisees. C. Content of Financial Statements. (1) The financial statements that accompany an application for initial or renewal registration shall include comparative: (a) Balance sheets as of the end of the franchisor's last 2 fiscal years before the application date; and	Md. Admin. Code tit. 02.02.08.13 (A) – (C), (D)

STATE	SUMMARY OF STATE LAW	STATUTE/REGULATION
	(b) Statements of operations, or owners' equity, and of cash flows for the last 3 fiscal years before the application date. (2) If the date of the most recent audited financial statements precedes the date of the application by more than 90 days, the franchisor shall also include: (a) An interim balance sheet as of a date within 90 days of the date of the application; and (b) Statements of operations for the period from the date of the most recent audited statement to the date of the interim balance sheet. D. Disclosure. A presentation of unaudited financial statements shall be accompanied by the following written disclosure, immediately adjacent to the financial statements: These Financial Statements Have Been Prepared Without An Audit. Prospective Franchisees Or Sellers of Franchises Should Be Advised That No Independent Certified Public Accountant Has Audited These Figures Or Expressed An Opinion with Regard to their Content Or Form.	
MICHIGAN		
FTC Rule phase-in allowed	The disclosure statement required in subsection (1) may be in the form of a disclosure statement required by a federal or state government agency, or a disclosure statement approved by an association of state regulatory agencies, which the department determines by rule or order to encompass disclosure requirements similar to those in this subsection, or may be a disclosure statement that shall contain… (g) A recent financial statement of the franchisor, together with a statement of material changes in the financial condition of the franchisor from the date thereof. The department may prescribe the form and content of financial statements required under this act and the circumstances under which consolidated financial statements shall be filed. If a financial statement audited by independent certified public accountants is available, that audited financial statement shall be a part of the disclosure statement.	Mich. Comp. Laws, Ann. 445.1508(2)(g)
MINNESOTA		

STATE	SUMMARY OF STATE LAW	STATUTE/REGULATION
Audited financials required	Subpart 1. PREPARATION. All financial statements required by these rules shall be prepared in accordance with generally accepted accounting principles. Financial statements shall be audited by an independent certified public accountant who shall express an opinion thereon, except where these rules permit the use of unaudited statements for interim periods or otherwise. Any financial statement prepared in accordance with the rules and requirements of the Securities and Exchange Commission shall satisfy the requirements of this part; provided, however, that the statements are audited by an independent certified public accountant who expresses an opinion thereon.	Minn. Rule §2860.1400(1)
	Subpart 2. TYPE OF STATEMENT REQUIRED. Whenever in these rules financial statements of a franchisor or other person are required without further description, such requirement refers to a balance sheet as of the end of the franchisor's most recent fiscal year, as well as an income statement and a statement of changes in financial position for the 12-month period preceding the date of the balance sheet. If the fiscal year end of the franchisor is in excess of 90 days prior to the date of filing the application, the financial statements shall also contain a balance sheet, income statement, and statement of changes in financial position as of a date within 90 days of the date of filing the application; provided, however, that such interim statements need not be audited.	Minn. Rule §2860.1400(2)
NEW YORK		
Audited financials required	The most recent financial statement of the franchisor, together with a statement of any material changes in the financial condition of the franchisor from the date thereof. The department of law may by rule or order prescribe (1) the form and content of financial statements required under this article, (2) the circumstances under which consolidated financial statements shall be required, and (3) the circumstances under which financial statements shall be audited by independent certified public accountants.	N.Y. Gen. Bus. §683(2)(g)

STATE	SUMMARY OF STATE LAW	STATUTE/REGULATION
	Prepare financial statements in accordance with generally accepted accounting principles. These financial statements must be audited by an independent certified public accountant. Unaudited statements may be used for interim periods. Include the following financial statements: A. The franchisor's balance sheets for the last two full fiscal years before the application date. In addition, include statements of operations (profit and loss statements), of stockholders equity and of cash flows for each of the franchisor's last three fiscal years. If the most recent balance sheet and statement of operations are as of a date more than 90 days before the application date, also submit an unaudited balance sheet and statement of operations as of a date within 90 days of the application date.	N.Y. Comp. Codes R. & Regs. tit. 13, § 200.2 (c)(21)
NORTH DAKOTA		
FTC Rule phase-in allowed	A recent financial statement of the franchisor, together with a statement of any material changes in the financial condition of the franchisor from the date thereof. The commissioner may by rule or order prescribe the form and content of financial statements required under this chapter, the circumstances under which consolidated financial statements must be filed, and the circumstances under which financial statements must be audited by independent certified public accountants or public accountants.	N.D.C.C. § 51-19-06(7)
	The commissioner may accept, in lieu of the prospectus meeting the requirements set forth in this chapter, a prospectus which complies with the requirements of any federal law or administrative rule or with the law of any other state requiring substantially the same disclosure of information as is required under this chapter.	N.D.C.C. 51-19-08(5)
RHODE ISLAND		
FTC Rule phase-in allowed	The director may require the filing of audited financial statements examined and reported upon by an independent certified public accountant and prepared in accordance with generally accepted accounting principles and of additional documents or disclosures.	R.I. Gen. Laws § Sec. 19-28.1-9(a)
SOUTH DAKOTA		

STATE	SUMMARY OF STATE LAW	STATUTE/REGULATION
FTC Rule phase-in allowed	Start-up franchise system to disclose certain audited financial statements. For the purposes of § 37-5B-7, a start-up franchise system that does not yet have audited financial statements, may phase-in the use of audited financial statements by providing, at a minimum, the following statements in the times indicated below: (1) The franchisor's first partial or full fiscal year selling franchises: an unaudited opening balance sheet; (2) The franchisor's second fiscal year selling franchises: audited balance sheet opinion as of the end of the first partial or full fiscal year selling franchises; and (3) The franchisor's third and subsequent fiscal years selling franchises: all required financial statements for the previous fiscal year, plus any previously disclosed audited statements that still must be disclosed such as the franchisor's balance sheet for the previous two fiscal year-ends before the disclosure document issuance date and statements of operations, stockholders equity, and cash flows for each of the franchisor's previous three fiscal years.	S.D. St. § 37-5B-8
	For the purposes of § 37-5B-7, a start-up franchisor may phase-in the disclosure of audited financial statements, if the franchisor: (1) Prepares audited financial statements as soon as practicable; (2) Prepares unaudited statements in a format that conforms as closely as possible to audited statements; and (3) Includes one or more years of unaudited financial statements or clearly and conspicuously discloses in the disclosure document that the franchisor has not been in business for three years or more, and cannot include all of the financial statements required in the disclosure document such as the franchisor's balance sheet for the previous two fiscal year-ends before the disclosure document issuance date and statements of operations, stockholders equity, and cash flows for each of the franchisor's previous three fiscal years.	S.D. St. § 37-5B-9

STATE	SUMMARY OF STATE LAW	STATUTE/REGULATION
VIRGINIA		
Audited financials required	Notwithstanding §436.5(u)(2) of the Federal Trade Commission Franchise Rule (16 CFR §436.5), a start-up franchisor in its first partial or full fiscal year selling franchises shall provide an opening balance sheet that has been audited by an independent certified public accountant using generally accepted United States auditing standards.	21 Va. Admin. Code § 5-110-55(B)
	Include the following financial statements prepared according to United States generally accepted accounting principles, as revised by any future United States government mandated accounting principles, or as permitted by the Securities and Exchange Commission. Except as provided in subdivision b of this item, these financial statements must be audited by an independent certified public accountant using generally accepted United States auditing standards. Present the required financial statements in a tabular form that compares at least two fiscal years. (1) The franchisor's balance sheet for the previous two fiscal year-ends before the disclosure document issuance date. (2) Statements of operations, stockholders equity, and cash flows for each of the franchisor's previous three fiscal years. b. A start-up franchise system may phase-in the use of the financial statements specified in subdivisions a (1) and (2) of this item by providing, at a minimum, the following statements at the indicated times: (1) The franchisor's first partial or full fiscal year selling franchises. An audited opening balance sheet. (2) The franchisor's second fiscal year selling franchises. Audited balance sheet opinion as of the end of the first partial or full fiscal year selling franchises.	21 Va. Admin. Code § 5-110-95(B)(21)

STATE	SUMMARY OF STATE LAW	STATUTE/REGULATION
	(3) The franchisor's third and subsequent fiscal years selling franchises. All required financial statements for the previous fiscal year, plus any previously disclosed audited statements that still must be disclosed according to subdivisions a (1) and (2) of this item. (4) Start-up franchisors may phase-in the disclosure of all financial statements required in subdivisions a (1) and (2) of this item, provided the franchisor: (a) Prepares audited statements of operations, stockholders equity, and cash flows as soon as practicable. (b) Prepares all unaudited statements in a format that conforms as closely as possible to audited statements. (c) Includes one or more years of unaudited statements of operations or clearly and conspicuously discloses in this section that the franchisor has not been in business for three years or more, and cannot include all financial statements required in subdivisions a (1) and (2) of this item.	
WASHINGTON		
FTC Rule phase-in allowed	The application for registration of the offer, signed by the franchisor, subfranchisor, or by any person on whose behalf the offering is to be made, must be filed with the director and shall contain: (a) A copy of the franchisor's or subfranchisor's disclosure document which shall be prepared in compliance with guidelines adopted by rule of the director. The director shall be guided in adopting such rule by the guidelines for the preparation of the disclosure document adopted by the federal trade commission or the North American Securities Administrators Association, Inc., or its successor, as such guidelines may be revised from time to time;	RCW 19.100.040(1)

STATE	SUMMARY OF STATE LAW	STATUTE/REGULATION
	The director may require the filing of financial statements of the franchisor or subfranchisor audited by an independent certified public accountant and prepared in accordance with generally accepted accounting principles. When the person filing the application for registration is a subfranchisor, the application shall also include the same information concerning the subfranchisor as is required from the franchisor pursuant to this section.	RCW 19.100.040 (2)
WISCONSIN		
FTC Rule phase-in allowed	The offering circular may be in a form that the division requires by rule, in a form permitted under 16 CFR §436 or in a form permitted by a successor to that regulation.	Wis. Stat. §553.27(4)

NOTE: Maryland, North Dakota, and Rhode Island require either a fee deferral or escrow to accompany a phase-in audit.

APPENDIX D

INTERIM FINANCIAL STATEMENT REQUIREMENTS FOR REGISTRATION STATES

STATE	REQUIREMENT	STATUTE/REGULATION
California	The financial statements required to be filed by a franchisor refer to a balance sheet as of a date within 90 days prior to the date of the application, and profit and loss statements for each of the three fiscal years preceding the date of the balance sheet and for the period, if any, between the close of the last fiscal year and the date of the balance sheet. The balance sheet as of a date within 90 days prior to the date of the application need not be audited. However, if this balance sheet is not audited, there shall be filed in addition an audited balance sheet as of the end of the franchisor's last fiscal year unless such last fiscal year ended within 90 days of the date of the application in which case there shall be filed an audited balance sheet as of the end of the franchisor's next preceding fiscal year. The profit and loss statements shall be audited up to the date of the last audited balance sheet filed, if any.	Cal. Code Regs. tit. 10, § 310.111.2
Hawaii	Director has the right to set requirements for financial statements, including (i) the form and content of the financial statements, (ii) the circumstances under which consolidated financial statements may be filed; and (iii) the circumstances under which financial statements must be audited by independent, certified public accountants. See also Hawaii Rule 16-37-3(b).	Sec. 482E-3(7); Hawaii Rule 16-37-3(b)
Illinois	If the required audited financial documents are not current within 120 days after the anniversary date, interim financials in a format consistent with	Ill. Admin. Code tit. 14, § 200.603(a)(2)

STATE	REQUIREMENT	STATUTE/REGULATION
	GAAP, including a balance sheet and corresponding income statement for the period between the close of the franchisor's most recent fiscal year and the date of the balance sheet must be submitted.	
Indiana	No express requirement for interim financial statements. The disclosure statement shall be in a form prescribed by the commissioner or in a form permitted under 16 CFR 436, as amended.	Ind. Code §23-2-2.5-13
Maryland	If the date of the most recent audited financial statements precedes the date of the application by more than 90 days, the franchisor shall also include: (a) An interim balance sheet as of a date within 90 days of the date of the application; and (b) Statements of operations for the period from the date of the most recent audited statement to the date of the interim balance sheet.	Md. Admin. Code tit. 02.02.08.13 (C)(2)
Michigan	The disclosure statement required in subsection (1) may be in the form of a disclosure statement required by a federal or state government agency, or a disclosure statement approved by an association of state regulatory agencies, which the department determines by rule or order to encompass disclosure requirements similar to those in this subsection, or may be a disclosure statement that shall contain … (g) A recent financial statement of the franchisor, together with a statement of material changes in the financial condition of the franchisor from the date thereof. The department may prescribe the form and content of financial statements required under this act and	Mich. Comp. Laws, Ann. 445.1508(2)(g)

STATE	REQUIREMENT	STATUTE/REGULATION
	the circumstances under which consolidated financial statements shall be filed. If a financial statement audited by independent certified public accountants is available, that audited financial statement shall be a part of the disclosure statement.	
Minnesota	[I]f the fiscal year-end of the franchisor is in excess of 90 days prior to the date of filing the application, a balance sheet and income statement, which may be unaudited, as of a date within 90 days of the date of the application [must be filed]. The commissioner may by rule or order prescribe the form and content of financial statements required under this clause and the circumstances under which consolidated financial statements may or shall be filed and may waive the requirement of audited financial statements.	Minn. Stat. Ann. § 80C.04
New York	Unaudited statements may be used for interim periods. If the most recent balance sheet and statement of operations are as of a date more than 90 days before the application date, also submit an unaudited balance sheet and statement of operations as of a date within 90 days of the application date.	N.Y. Comp. Codes R. & Regs. tit. 13, § 200.2 (c)(21)
North Dakota	No express requirement for interim financial statements. A recent financial statement of the franchisor, together with a statement of any material changes in the financial condition of the franchisor from the date thereof. The commissioner may by rule or order prescribe the form and content of financial statements required under this chapter, the circumstances under which consolidated financial statements	N.D.C.C. § 51-19-06(7)

STATE	REQUIREMENT	STATUTE/REGULATION
	must be filed, and the circumstances under which financial statements must be audited by independent certified public accountants or public accountants.	
Rhode Island	No express requirement for interim financial statements.	R.I. Gen. Laws § Sec. 19-28.1-9(a)
South Dakota	Information that must be audited pursuant to the disclosure requirements need not be audited for quarterly revisions if the franchisor states in immediate conjunction with the information that the information was not audited.	S.D. St. § 37-5B-7(5)
Virginia	If the date of the most recent audited financial statements in the Franchise Disclosure Document precedes the date of the application by more than 120 days, the Franchise Disclosure Document shall also include the following financial statements prepared in accordance with generally accepted accounting principles: 1. An unaudited interim balance sheet as of a date within 120 days of the date of the application; and 2. An unaudited interim statement of income or operations for the period from the most recent audited financial statements to the date of the interim balance sheet.	21 Va. Admin. Code § 5-110-30(E) 21 Va. Admin. Code § 5-110-50F
Washington	No express requirement for interim financial statements. The Franchise Disclosure Document must include financial statements that comply with the instructions for Item 21 of the Franchise Disclosure Document, 16 CFR § 465.5(u).	Wash. Admin. Code § 460-80-140
Wisconsin	If the offering circular contains unaudited updated stub period	Franchise Bulletin

STATE	REQUIREMENT	STATUTE/REGULATION
	financials, the legend required by section SEC 35.05(2) must be affixed. In addition, a separate letter should always be filed with this Office from the preparer of such financials, that the financials have been prepared in accordance with generally accepted accounting principles applied on a consistent basis.	

THERESA LEETS

Theresa Leets is the Assistant Chief Counsel in the California Department of Financial Protection and Innovation's Legal Division. She is responsible for supervising the Department's programs under the Corporate Securities Law of 1968 and the Franchise Investment Law. Last year the Department regulated over $520 billion dollars in securities and franchise transactions. The Department processed over 36,000 exemption notice filings, 2,400 applications and collected $25.6 million dollars in fee revenue.

Theresa speaks frequently on topics related to both franchise and securities law. She is a member of the North American Securities Administrators Association (NASAA) Corporate Finance's Franchise and Business Opportunities Project Group. Theresa is currently serving as a Trustee for the Los Angeles County Bar Association. She is also a licensed California real estate broker with an inactive Mortgage Loan Origination (MLO) endorsement. She is the first franchise regulator to earn a Certified Franchise Executive (CFE) designation from the International Franchise Association (IFA). Theresa received her B.A. degree from the University of California at Santa Barbara and her J.D. degree from the University of California at Davis.

DIANA VILMENAY

Diana Vilmenay is a shareholder at Polsinelli, P.C. She partners with clients to develop and expand their franchise systems in the U.S. and internationally. With more than a decade of experience in franchising, Diana counsels clients on a variety of franchise matters, including assisting new franchisors to launch their franchise concepts in the U.S., working with existing franchisors on negotiating international deals and navigating local laws governing franchising to grow their franchise systems in various markets globally, advising buyers and sellers as special franchise counsel on merger and acquisition transactions and advising franchisors on different compliance and franchise relationship issues.

In addition to managing day-to-day deal work, Diana prepares franchise disclosure documents and manages domestic and foreign franchise filing and registrations. She also prepares and negotiates domestic and international license and distribution agreements. She draws on her previous experience as a commercial litigator and an in-house intern for one of the largest global hospitality chains to review, prepare and negotiate all forms of commercial agreements with an eye towards protecting her clients' best interests.

Diana writes and speaks regularly on legal and business topics governing franchising, particularly in the area of international franchising. She served as an editor for the "Franchising In" international series, published by the LexNoir Foundation. Her experience also includes the review and preparation of country chapters for the second edition of International Franchise Sales Laws, published by the ABA Forum on Franchising.

LEONARD D. VINES

Leonard D. Vines is an officer in the St. Louis law firm of Greensfelder, Hemker & Gale, P.C. He concentrates his practice in franchise and distribution. Mr. Vines has been selected for inclusion in several directories, such as Chambers USA (Nationwide), Best Lawyers of America, International Who's Who of Franchise Lawyers, and Franchise Times "Legal Eagles".

Mr. Vines is a former member of the Governing Committee of the American Bar Association Forum on Franchising and is a member of the Franchise Project Group of the North American Securities Administrators Association (NASAA) since 2007. He is a frequent lecturer on franchise topics for various organizations and has spoken at programs sponsored by, among others, the ABA Forum Committee on Franchising and International Franchise Association. He served as editor of the ABA publications, Mergers and Acquisitions of Franchise Companies, First Edition, co-editor of the Second Edition, and co-authored a chapter for all editions of The FTC Franchise Rule. Mr. Vines has also written articles for various legal publications such as the ABA Journal, The Franchise Lawyer, Journal of the Missouri Bar, St. Louis Bar Journal, LJM's Franchising Business and Law Alert, and Franchise Law Journal.

Mr. Vines graduated from the University of Illinois with a B.S. in accounting with honors and from Washington University School of Law, St. Louis.