Attached are suggested wording revisions to the proposed NASAA FPR Commentary.

19.7

I urge the NASAA Franchise Project Group to change the answer to Question 19.7 from "No" to "Yes." Even if a franchisor does not have operational franchises, it should be permitted to disclose gross profit and/or net profit numbers for its company-owned outlets if it has a reasonable basis to believe that franchisees' costs will be similar to its company-owned outlets' costs. The proposed "No" answer to Question 19.7 will cause valuable information to be withheld from prospective franchisees of new franchise systems.

Respectfully,

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NASAA FRANCHISE COMMENTARY
FINANCIAL PERFORMANCE REPRESENTATIONS

INTRODUCTION

The following questions and answers supplement NASAA's Commentary on the 2008 Franchise Registration and Disclosure Guidelines adopted on April 27, 2009 ("2008 Franchise Commentary"). This NASAA Commentary ("FPR Commentary") addresses a number of questions raised by franchisor representatives and state franchise examiners about financial performance representations ("FPRs"). **The FPR Commentary also includes the three questions and answers related to FPRs that NASAA adopted in the 2008 Franchise Commentary. Those questions and answers are reprinted here for convenience as Items 19.1 through 19.3.**

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

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

Date of Adoption by NASAA: ________________________

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

NASAA FPR COMMENTARY

Definitions

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

Company-owned outlets mean outlets, owned either directly by a franchisor or indirectly by the franchisor's ~~affiliate~~affiliates, operating a substantially similar business under the same brand as the business the franchisor offers to franchisees.

Gross sales means the ~~total~~ amount of total revenue derived from the sale of goods or services, less sales tax, discounts, allowances and returns. A franchisor may vary the items deducted from total ~~revenues~~revenue, but in all events must disclose what it deducts when it refers to gross sales or a similar term.

Operational franchises means franchises that have been fully operational for at least one full year or, in the case of franchise systems that operate seasonally, for at least one full season.

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

Net profit means gross profit ~~minus~~, less all ordinary and recurring operating expenses, including depreciation, but excluding income taxes, interest and amortization. A franchisor may vary the expenses deducted from gross profit, but in all events must disclose what it deducts when it refers to net profit or a similar term.

A. Excerpt (From 2008 Franchise Commentary)[2]

19.1 *Item 19 - Exclusion of Costs*

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

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

19.2 *Item 19 – Pro Formas*

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

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

19.3 *Item 19 – Disclaimers*

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

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

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

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

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

B. Use of Data from Company-Owned Outlets

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

QUESTION: If a franchisor has operational franchises, can the franchisor make a **gross sales** FPR based on company-owned outlet data alone?

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

19.5 *Item 19 – Gross Sales FPR Based on Company-Owned Outlets Alone When Franchisor has No Operational Franchises*

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

ANSWER: Yes. If a franchisor has no operational franchises, the franchisor can make a gross sales FPR based on company-owned outlet data alone, if the franchisor has a reasonable basis for the FPR and discloses material financial and operational characteristics of the company-owned outlets that may differ from franchised outlets.

19.6 *Item 19 — FPR Disclosing Gross Profit or Net Profit Based on Company-Owned Outlets When Franchisor Has Operational Franchises*

QUESTION: If a franchisor has operational franchises, can the franchisor make an FPR disclosing **gross profit** or **net profit** based on company-owned outlet cost data alone?

ANSWER: Yes. A franchisor with operational franchises can make an FPR disclosing gross profit or net profit based on company-owned outlet cost data alone if it has a reasonable basis to make the FPR and includes the following information: (a) gross sales data from operational franchises and; (b) actual costs[3] incurred by company-owned outlets that are adjusted to reflect potential material financial and operational differences between company-owned outlets and franchised outlets. These differences must include those that are material in the aggregate.

At a minimum, in an FPR disclosing gross profit, if franchisees pay more for goods or services than the franchisor, the franchisor must adjust its results (and explain the adjustment) to reflect the costs the franchisee would incur. In an FPR disclosing net profit, the franchisor must adjust the FPR (and explain the adjustment) to include imputed royalties, advertising fund contributions, and other fees not paid by company-owned outlets and any other costs unique to franchised outlets, such as the costs of a full time third party manager if, for example, multiple company-owned outlets are managed by a single employee. Simply stating that there may be differences between the costs that a franchisee may incur and the costs disclosed for company-owned outlets, or indicating the types of costs unique to franchisees, is not sufficient.

[3] Including costs stated as a percentage of sales, when applicable.

19.7 *Item 19 — FPR Disclosing Gross Profit or Net Profit of Company-Owned Outlets When Franchisor Has No Operational Franchises.*

QUESTION: If a franchisor has no operational franchises, can the franchisor make an FPR disclosing **gross profit** or **net profit** based on company-owned outlet data alone?

ANSWER: No. A franchisor with no operational franchises cannot make an FPR disclosing gross profit or net profit based on company-owned outlet data alone.

This situation differs from the answer in FPR Commentary Item 19.5 because an FPR disclosing gross sales is not comparable to an FPR that combines gross sales and costs. There are fewer potential material differences between the gross sales of company-owned outlets and those of franchised outlets.

As indicated in the answer to FPR Commentary Item 19.6, when an FPR includes cost data, the costs used to prepare the FPR must be based on data from franchised outlets, or at least on franchisee experience. A franchisor's company-owned outlets may have lower costs than franchised outlets for a variety of reasons, both financial and operational, including volume discounts, bargaining power, and business experience. A franchisor with operational ~~franchisees~~franchises has some experience with costs that franchised outlets actually incur, and that experience can establish a reasonable basis for a franchisor to adjust its company-owned outlet cost data to reflect the costs that franchisees may incur. A franchisor with no operational franchises, however, has no experience, and thus no reasonable basis, for adjusting its company-owned outlet costs (or gross profit or net profit) so that they would be representative of the actual costs that franchised outlets would incur or the profit they would achieve.

19.8 *Item 19 — FPR Merging Data from Both Franchised Outlets and Company-Owned Outlets*

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

ANSWER: No, except as set forth below. Generally, if a franchisor makes an FPR that includes data from both franchised outlets and company-owned outlets, the franchisor must disclose the data from the company-owned outlets and the franchised outlets separately.[4] If, however, a franchisor has such a small total number of ~~total~~operational franchises[5] that the identity of franchisee(s) whose data is being reported in Item 19 is discernable, and the franchisor can demonstrate that the franchised and company-owned outlets have gross sales that are not materially different, the franchisor may merge the data in the FPR. In that case, the franchisor must include a representation in Item 19 that there are no material differences in the gross sales of franchised and company-owned outlets. Once a franchisor separately discloses data from both

[4] See FTC Franchise Rule Compliance Guide, p. 137 (May 2008). A franchisor that discloses gross sales data from operational franchisees and adjusted actual cost data based on company-owned outlets as described in Commentary Item 19.6 is not "merging data" for purposes of this Item.

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

franchised outlets and company-owned outlets in an FPR, the franchisor may then choose to also present the same data in a combined format.

19.9. *Item 19 — Disclosure of Net Profit Generally*

QUESTION: May a franchisor make an FPR disclosing net profit, whether for franchised outlets or company-owned outlets, without including all costs?

ANSWER: Yes. So long as the franchisor clearly discloses whether the net profit figures reflect all costs of operation, it may make an FPR disclosing net profit, whether for franchised outlets or company-owned outlets. The costs of operation that the franchisor discloses must include interest, taxes, depreciation and amortization or, if any of these are excluded, the franchisor must state which items are excluded.

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

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

ANSWER: Yes. A franchisor must clearly identify the sources of all data presented in an FPR. If a franchisor makes an FPR based on both franchised and company-owned outlet data, the two different types of data must be clearly identified (in addition to being presented separately). If a franchisor is adjusting actual cost data in an FPR, the franchisor must clearly identify which data are actual costs, which data are adjusted costs, and the method and rationale for making the adjustments.

C. Use of Subsets

19.11 *Item 19—Subsets Generally*

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

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

19.12 *Item 19 – Best Performing Outlets*

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

ANSWER: No. An FPR that is based solely on the performance of a subset of a franchisor's best performing outlets is likely to be misleading and has no reasonable basis. For that reason, an FPR that includes the results of a subset of top performing outlets must also include the corresponding results of one or more subsets of the lowest performing outlets. For example, if a franchisor prepares an FPR subset showing the average and median sales of the highest grossing 10% of outlets in its franchise system, the franchisor also must show the average and median sales of the lowest grossing 10% of outlets in its franchise system.

19.13 ***Item 19 — Small Number of Company Owned Outlets and Franchised Outlets***

QUESTION: May a franchisor with a relatively small number of substantially similar company-owned outlets and franchised outlets that have been operational for at least one full year base an FPR solely on the performance of a subset of those outlets?

ANSWER: No. A franchisor with fewer than 10 substantially similar company-owned outlets and franchised outlets that have been operational for at least one year will be presumed to have too few outlets to base an FPR solely on a subset of those outlets.

19.14 ***Item 19 — Geographic Subsets***

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

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

D. Averages and Outliers

19.15 ***Item 19 — Averages***

QUESTION: Are there any statistical requirements that must be included when using an "average" in an FPR?

ANSWER: Yes. Whenever an average (also known as a "mean") of numbers is disclosed in an FPR, the median of those numbers also must be disclosed because the existence of outliers may skew an average, thereby making it misleading (even if the calculation is accurate).[6]

[6] The average, or **mean** is defined as the sum of all data points in a set, divided by the number of data points in that set. For example, if the data points are 13, 13, 14, 19, and 26, the mean is 17. [This is arrived at as follows: Calculate the sum of all data points (that is, 13+13+14+19+26=85). Divide this number by the total number of data points in the set. Here, we get 85 divided by 5 (the number of data points) = 17. Thus the mean is 17.]
The **median** is defined as the data point that is in the center of all data points being used. That number is found by examining the total number of data points and finding the middle number in that set. In the event the number of data points is an odd number, the median will be the center number. Here, in our example, the median is the third number in the five data point set, or 14. (that is, 13, 13, 14, 19, and 26). We have two numbers above this point, and two below this point. In this example, the median is 14. If the dataset contains an even number of data points, the median is reached by taking the two numbers in the middle, adding them together, and dividing by two. [E.g., if our data set was modified by adding a 12 to our set, so that the set we're now using is 12, 13, 13, 14, 19, and 26, we discover that the two numbers in the middle of this dataset are the third and fourth numbers, 13 and 14. By adding these together (13+14=27), and dividing by two (27/2), we know the median is 13.5.] In this example, we have three data points above this number, and three below this number. The median is 13.5.

19.16 ***Item 19 — Disclosure of Outlets that Opened and Closed during First Year of Operation***

QUESTION: If a franchisor makes an FPR that includes an average, may the franchisor exclude data from any of its company-owned outlets or franchised outlets that opened and closed within their first year of operation?

ANSWER: Yes. A franchisor making an FPR that includes an average may exclude data from company-owned outlets and franchised outlets that opened and closed during their first year of operation, provided the franchisor discloses in Item 19 the number of company-owned outlets and franchised outlets that both opened and closed during their first year of operation. This disclosure should cover each year or other period of time covered in the FPR.

19.17 ***Item 19 — Outliers***

QUESTION: May a franchisor present a subset in which data used to create the subset have a material number of results from unusually successful company-owned or franchised outlets?

ANSWER: No. An FPR does not have a reasonable basis if it is created using a material number of atypical results from company-owned outlets or franchised outlets that are not representative of the other company-owned outlets or franchised outlets.

E. Use of Forecasts and Projections

19.18 ***Item 19 — FPR Presenting Forecasts (Projections)***

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

ANSWER: Yes. Projections cannot be based on mere hypothetical situations or expectations. Historical results may be adjusted based on changes in the market (for example, when current rents are higher or lower than historic rents), but the projections still must be based on historical data.

19.19 ***Item 19 — FPR Presenting Projections Not Based on Franchisor's Brand Data***

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

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

F. Disclaimers

19.20 ***Item 19 — Clear and Conspicuous Admonition (Substance)***

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

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

19.21 ***Item 19 — Disclaimers In Addition to Clear and Conspicuous Admonition***

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

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

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

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

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

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

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

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