

UNDERSTANDING THE FDD



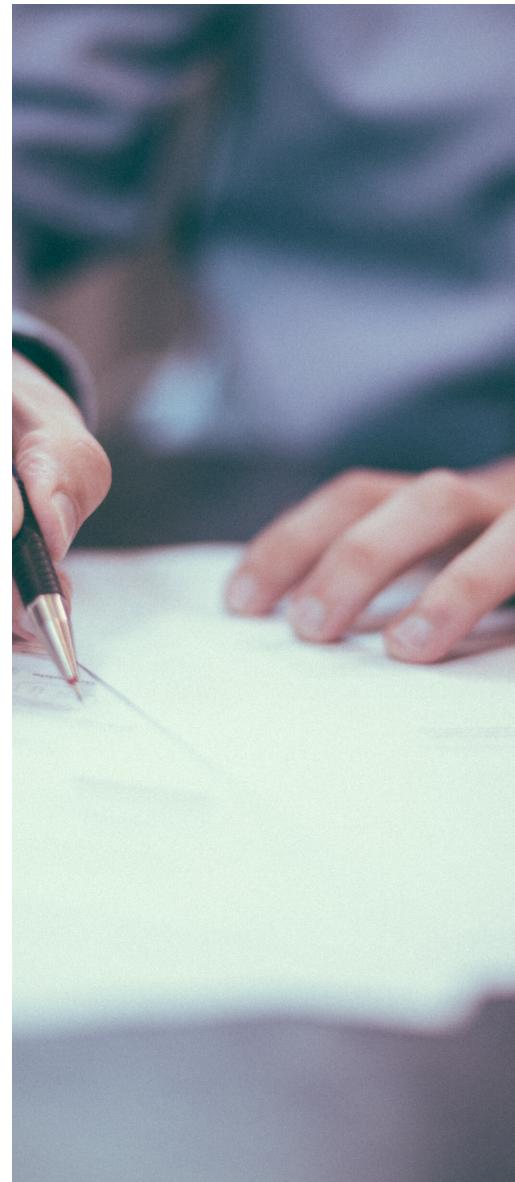
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FRANCHISE DISCLOSURE DOCUMENT (FDD)

The franchise disclosure document (FDD) is a legal disclosure document that must be given to individuals interested in buying a U.S. franchise as part of the pre-sale due diligence process. It contains information essential to potential franchisees about to make a significant investment

Under the Franchise Rule enforced by the FTC, you must receive the document at least 14 days before you are asked to sign any contract or pay any money to the franchisor or an affiliate of the franchisor. You have the right to ask for — and get — a copy of the FDD once the franchisor has received your application and agreed to consider it.



ITEMS YOUR FRANCHISE DISCLOSURE DOCUMENT MUST INCLUDE

The FDD is drafted in a prescribed format to provide your prospective franchisee with the information they need to make an informed decision. And while the quality and contents of these documents vary, each FDD is required to contain the following sections in this order:

Franchisor's Background (FDD Item 1)

Item 1 tells you how long the franchisor has been in business and its likely competition. It also lets you know if there are any legal requirements unique to the franchised business, like a requirement that you get a special license or permit. This will help you understand the costs and risks you will take on if you purchase and operate the franchise.

Business Background (FDD Item 2)

Item 2 identifies the executives of the franchise system and describes their experience. Pay attention to their general business backgrounds, their experience in managing a franchise system and how long they've been with the franchisor.

Litigation History (FDD Item 3)

Item 3 lists important information about prior litigation – whether the franchisor or any of its executive officers have been convicted of felonies involving fraud, violations of franchise law, or unfair or deceptive practices law, or are subject to any state or federal injunctions involving similar misconduct. This item will tell you whether the franchisor or any of its executives have been held liable for – or settled civil actions involving – the franchise relationship. If there have been many claims against the franchisor, it may mean the franchisor has not performed according to its agreements. Or it could show that franchisees are dissatisfied with its performance.

Item 3 also should say whether the franchisor has sued any of its franchisees during the last year. That disclosure may indicate common types of problems in the franchise system. For example, if a franchisor sued franchisees for failing to pay royalties, it could be because franchisees weren't successful, and weren't willing or able to make their royalty payments.

Bankruptcy (FDD Item 4)

Item 4 discloses whether the franchisor or its predecessor, affiliates or any of its executives have been involved in a recent bankruptcy. If the franchisor or its predecessor or affiliate has declared bankruptcy, carefully review the franchisor's financial statements in Item 21 of the FDD to see if the franchisor is financially capable of delivering the support services it promises. Consider having an accountant review the required financial statements too.

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ITEMS YOUR FRANCHISE DISCLOSURE DOCUMENT MUST INCLUDE

Initial and Ongoing Costs (FDD Items 5-7)

These items describe some of the costs involved in starting and operating a franchise, including deposits or franchise fees that may be non-refundable, and costs for initial inventory, signs, equipment, leases or rentals. It also explains ongoing costs, like royalties and advertising fees. In addition, ask or find out about:

- grand opening or other initial business promotions
- business and operating licenses
- product or service supply costs
- real estate and leasehold improvements
- required equipment, such as a computer system or a security system
- training
- business insurance
- compliance with local ordinances, such as zoning, waste removal, and fire and other safety codes
- employee salaries

You'll need to investigate other initial and ongoing costs that aren't described in Items 5-7, such as the cost of accounting and legal help.

It may take several months to start your business, and it may take more than a year to break even. Some franchises never break even. Estimate your operating expenses for the first year and your personal living expenses for up to two years. Compare your cost estimates for the franchise with what other franchisees in this system and competing systems have paid. An accountant can help you evaluate this information. You may be able to do better with another franchisor.

Supplier, Territory and Customer Restrictions (FDD Items 8 and 12)

These items tell you whether the franchisor limits:

- suppliers from whom you may purchase goods
- the goods or services you may offer for sale
- where and to whom you can sell goods or services
- your use of the internet to sell goods or services to customers within and outside your territory
- the right of the franchisor (or other franchisees) to use the internet to solicit customers or to sell in your territory

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ITEMS YOUR FRANCHISE DISCLOSURE DOCUMENT MUST INCLUDE

Supplier, Territory and Customer Restrictions (FDD Items 8 and 12) CONT..

These kinds of restrictions may limit your ability to exercise your own business judgment in operating your outlet. If the franchisor does not limit the territory where each franchisee can sell, the franchisor and other franchisees may compete with you for the same customers by establishing their own outlets or selling through the internet, catalogs or telemarketing.

Franchisor's Advertising and Training (FDD Item 11)

The FDD includes important summaries of the franchise system's advertising programs and the initial and ongoing training the franchisor will provide. Talk to the franchisor and current franchisees to get answers to your questions.

Advertising

Franchisees are often required to contribute a percentage of their sales to one or more national, regional or local advertising funds. Ask the franchisor what advertising it has done and what is being planned.

Ask whether franchisees have any control over how advertising dollars are spent, and if all franchisees and company outlets contribute equally to the advertising funds. Find out if the franchisor gets a commission or rebate when it places ads. If there is a rebate, who benefits — you or the franchisor?

See what percentage of the fund is spent on:

- administrative costs
- national advertising
- advertising in your area
- selling more franchises
- other expenses

Read Item 11 to learn whether franchisees need the franchisor's consent to develop and buy their own advertising. If they buy their own advertising, do they get a rebate or discount on their Advertising contribution?

SOURCE FTC.GOV

ITEMS YOUR FRANCHISE DISCLOSURE DOCUMENT MUST INCLUDE

Training

New franchisees typically count on the franchisor to provide all the business and operational training needed to run a successful franchise. The training you need depends on your business experience and knowledge of the franchisor's goods and services. Check Item 11 for information about:

- the trainers and their qualifications
- who is eligible for training
- the cost of training new employees and who pays
- the length of training sessions
- the amount of time spent on technical training, business management training and marketing
- whether the franchisor offers ongoing training and at what cost
- whether support staff are available for trouble-shooting in your area and how many franchisees they are responsible for
- whether on-site individual assistance is available and at what cost

Be sure to talk with recent franchisees about the quality of training the franchisor provides. If – after you read the information in Item 11 and talk with franchisees – you still aren't sure you'll get the training you need, ask the franchisor if you can review the training materials. If the franchisor won't provide them, even if you volunteer to sign a confidentiality agreement, consider a different franchise opportunity.

Renewal, Termination, Transfer and Dispute Resolution (FDD Item 17)

Item 17 covers important topics. First, it states whether you can renew your franchise at the end of the term, and, if you can renew:

- what you must do to qualify for renewal
- whether fees and other contract terms may change

Item 17 also explains what your obligations would be to the franchisor after termination. For example, after termination, restrictions in the contract typically will stop you from operating a business that would compete with your prior franchise, if the new business is within a specified distance of your prior outlet. The restrictions may also prevent you from operating a new business within a specified distance of any other outlets of the franchise. The restrictions may last as long as three years.

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ITEMS YOUR FRANCHISE DISCLOSURE DOCUMENT MUST INCLUDE

Renewal, Termination, Transfer and Dispute Resolution (FDD Item 17) CONT..

Additionally, Item 17 describes what you must do to get the franchisor's approval if you want to sell your franchise. Lastly, it states whether you have the right to go to court if you have a dispute with the franchisor, or must use arbitration instead.

Financial Performance Representations (FDD Item 19)

Item 19 contains claims the franchisor chooses to make about the sales or earnings of its franchises for which there is a reasonable factual basis. The Franchise Rule doesn't require a franchisor to provide sales or earnings information, but most do.

Any claims the franchisor makes about sales, income or profits must be in Item 19. No other spoken or written financial performance claim may be made if it doesn't appear in Item 19. There are two exceptions to this:

1. The franchisor may provide the actual records of an existing outlet you're thinking of buying.
2. The franchisor may add to the information in Item 19. For example, the franchisor may provide information about possible performance at a particular location or under particular circumstances.

Franchisee and Franchise System Information (FDD Item 20)

Item 20 provides charts showing growth and owner turnover in the franchisor's system. If the charts show more than a few franchised outlets in your area have closed, transferred to new owners, or transferred to the franchisor, it could be due to problems with the franchisor's support or because franchises aren't profitable.

Current and Former Franchisees

Look for the required disclosure of contact information for current franchisees and franchisees who have left the system during the franchisor's last fiscal year. Talking to these people may be the most reliable way to verify the franchisor's claims. Visit or phone as many of them as possible to chat about their experiences. Some current franchisees may be reluctant to talk to you if they're having problems. If that's the case, try contacting others on the list.

Some franchisors may give you a separate reference list of franchisees to contact. To ensure you get the full picture, you may want to contact a number of franchisees listed in the disclosure document and some on the separate list.

SOURCE FTC.GOV

ITEMS YOUR FRANCHISE DISCLOSURE DOCUMENT MUST INCLUDE

Current and Former Franchisees and Franchise System Information (FDD Item 20) CONT..

Talk to several franchisees who have been in business just over one year. They're in the best position to tell you:

- their total investment
- whether they were able to open their outlet in a reasonable time
- whether they were satisfied with the franchisor's training, opening assistance and advertising
- whether the franchisor provided ongoing help and assistance
- whether they have been able to break even

It's also a good idea to talk to several franchisees who have been in business for five years.

Ask:

- how long it took them to break even, earn a reasonable income and recoup their investment 11
- whether the franchisor is providing the services and assistance it promised and fulfilling its contractual obligations
- what problems, if any, they are having with the franchisor
- whether they would invest in another outlet
- whether they're satisfied with the advertising program
- whether they are satisfied with the cost, delivery and quality of goods or services they must buy from the franchisor, its affiliates or sole approved suppliers

It's worth tracking down former franchisees (using contact information from Item 20), although some of them may have signed confidentiality agreements that prevent them from talking with you. Prior owners can tell you:

- the problems they had with their outlet
- whether they broke even or made a profit
- when and for how long they operated the outlet
- their business background
- why they left the franchise system

Some franchisors may buy back failed outlets and list them as company-owned outlets. If you're thinking about buying an existing outlet that the franchisor acquired from a prior franchisee, ask to see the financials showing the outlet's actual operating results. The franchisor must tell you who owned and operated the outlet for the last five years. If a franchise has had several owners in a short time, perhaps the location isn't profitable or the franchisor hasn't supported that outlet as promised. Contact as many of the previous owners as possible to learn about their experience operating the outlet that failed.

SOURCE FTC.GOV

ITEMS YOUR FRANCHISE DISCLOSURE DOCUMENT MUST INCLUDE

Franchisee Associations

Associations of a franchisor's franchisees are an important source of information. Franchisors are required to list in the FDD the associations they sponsor or endorse and independent associations that ask to be listed. An association, whether it's sponsored, endorsed or independent, can provide information about the relationship between the franchisor and its franchisees. You may want to ask members of a franchisee association about:

- the kinds of system problems or issues they discuss
- system problems they successfully resolved
- any problems franchisees face in the operation of their outlets
- any problems franchisees have with the franchisor

Financial Statements (FDD Item 21)

Item 21 provides the franchisor's three most recent audited annual financial statements. If you know how to read financial statements, this information will give you a good understanding of the franchisor's financial health. If you don't, it's a good idea to hire an accountant to review the statements and explain them to you. Investing in a financially unstable franchisor is a significant risk; the franchisor may go out of business or into bankruptcy after you have invested your money. An accountant can help you understand whether the franchisor:

- has steady growth
- has a growth plan
- makes more of its income from royalty payments from successful existing franchisees or from the sale of franchises
- devotes sufficient funds to support its franchise system



You may want to know how much money you can make if you invest in a particular franchise. A franchisor isn't required to disclose information about potential income or sales. If it does, the law requires it to have a reasonable basis for the claim when it's made and to include the claim in Item 19 of the FDD. If a franchisor makes a claim that has a reasonable basis, the FDD also must disclose:

- the source and limitations of data that support the claim
- any important assumptions on which the claim is based

Be sure to ask the franchisor for written substantiation that supports the claim. The franchisor is required to provide substantiation if you ask. An accountant can help you determine whether the claims are reasonable, and if they apply to how you plan to operate your business. When you review earnings claims, consider:

IS THE EARNINGS CLAIM TYPICAL FOR A FRANCHISE IN THIS SYSTEM?

Suppose a franchisor claims that franchisees in its system earned \$50,000 last year. The claim may be deceptive if it doesn't represent the typical earnings of franchisees. The FDD should tell you how many franchises the franchisor has, how many it surveyed to get that figure, and the number and percentage of franchisees who reported earnings at the level claimed.

GROSS SALES

Some franchisors provide figures for their franchisees' gross sales. These figures don't really tell about the franchisees' actual costs or profits. An outlet with high gross sales on paper might be losing money because of high overhead, rent and other expenses.

AVERAGE INCOME

If a franchisor claims that its franchisees earn an average income of \$75,000 a year, that tells you very little about how individual franchises performed. Using an average figure may make a franchise system look more successful than it really is, because the high incomes of just a few very successful franchises can inflate the average for all franchisees.

NET PROFITS

Franchisors often don't have data about their franchisees' net profits. If you get profit information, ask if it's based on information from company-owned outlets. Company-owned outlets often have lower costs because they can buy equipment, inventory and other items in larger quantities at lower prices or may own, rather than lease, their property

GEOGRAPHIC RELEVANCE

Earnings may vary with geography. If a franchisor provides franchisee sales or income figures, ask if any of the supporting data came from franchisees in your area. The FDD should state whether there are geographic differences between the franchisees whose earnings are reported and your likely location.

FRANCHISEES' BACKGROUNDS

Keep in mind that franchisees have different skill sets and educational backgrounds. The success of some franchisees doesn't guarantee success for all.

FRANCHISEES' BACKGROUNDS

Franchisors may ask you to sign a statement — sometimes presented as a written interview or questionnaire — that asks whether you received any earnings or financial performance representations during the course of buying a franchise. If they told or gave you any information about how much your franchise may earn, report it fully on the questionnaire or other statement. If you don't, you may be waiving any right to contest the earnings representations that were made to you and that you used to make your decision to buy.

FDD CHECK OFF SHEET

This is a contract and you want to understand it. You also want to read it as if you have been in business for two years. You will be surprised how that will change your perspective. This will help you do exactly that.

QUESTIONS PERTAINING TO THE FRANCHISE COST TERMS

- What are the payment terms: amount, time of payment, lump sum or installment, financing arrangements, etc.?
- Does the franchisor offer any financing, or offer help in finding financing?
- Does it include an ``opening" inventory of products and supplies?
- What does the initial franchise fee purchase?
- Are there any deferred balances? If so, who finances and at what interest?
- Is any part of the initial fee refundable? Does the contract clearly distinguish between ``total cost" and ``initial fee," ``initial cash required," or ``initial costs," etc.?
- Do you understand the differences?
- Are there periodic royalties? If so, how much are they and how are they determined?
- How and when are sales and royalties reported, and how are royalties paid?
- If royalty payments are in whole or part payment for services by the franchisor, what services will be provided?
- Are accounting/bookkeeping services included or available?
- How are advertising and promotion costs divided?
- Is a specified amount of working capital required of the franchisee to cover operating costs until profits can be made?
- Must premises be purchased or rented, and are there further conditions on either of these (from franchisor, selected site, etc.)?
- How and by whom will the building be financed, if purchased?
- Does the franchisee have to make a down payment for construction and/or equipment?

**Ask questions,
it is your right
to know.**

FDD CHECK OFF SHEET

QUESTIONS PERTAINING TO THE FRANCHISE LOCATION TERMS

- Does the franchise apply to a specific geographical area? If so, are the boundaries clearly defined?
- Who has the right to select the site?
- Will other franchisees be permitted to compete in the same area, now or later?
- Is the territory an exclusive one, and is it permanent or subject to reduction or modification under certain conditions?
- Does the franchisee have a first refusal option as to any additional franchises in the original territory if it is not exclusive?
- Does the franchisee have a contractual right to the franchisor's latest products or innovations? If so, at what cost?
- Will the franchisee have the right to use his own property and/or buildings? If not, will the franchisor sell or lease his property to the franchisee?
- Who is responsible for obtaining zoning variances, if required

Learn your potential business by digging into the contract.

FDD CHECK OFF SHEET

QUESTIONS PERTAINING TO THE BUILDINGS, EQUIPMENT AND SUPPLIES

- Are plans and specifications of the building determined by the franchisor? If so, does this control extend to selection of contractor and supervision of construction?
- Are there any restrictions on remodeling or redecorating?
- Must equipment or supplies be purchased from the franchisor or approved supplier, or is the franchisee free to make his own purchases?
- When the franchisee must buy from the franchisor, are sales considered on consignment? Or will they be financed and, if so, under what terms?
- Does the agreement provide for continuing supply and payment of inventory (by whom, under what terms, etc.)?
- Does the franchise agreement bind the franchisee to a minimum purchase quota?
- What controls are spelled out concerning facility appearance, equipment, fixture and furnishings, and maintenance or replacement of the same? Is there any limitation on expenditures involved in any of these?
- Does the franchisor have a group insurance plan? If not, what coverage will be required, at what costs?

**Post-buy surprises
do not happen to
informed buyers**

FDD CHECK OFF SHEET

QUESTIONS PERTAINING TO THE OPERATING PRACTICES TERMS

- Must the franchisee participate personally in conducting the business? If the answer is yes, then ask to what extent, and under what specific conditions.
- What degree of control does the franchisor have over franchise operations, particularly in maintaining franchise identity and product quality?
- What continuing management aid, training and assistance will be provided by the franchisor, and which of these the service or royalty fee covers?
- Will advertising be local or national? What is the cost-sharing arrangement, if any, in either case?
- If local advertising is left to the franchisee, does the franchisor exercise any control over such campaigns or share any costs?
- Does the franchisor provide various promotional materials point-of-purchase, mail programs, etc. and at what cost? Similarly, what are bookkeeping, accounting and reporting requirements, if any?
- Are sales or service quotas established? If so, what are the penalties for not meeting them?
- Are operating hours and days set forth in the franchise contract? Are there any limits as to what is or can be sold?
- Does the franchisor arrange for mass purchasing and is it mandatory for the franchisee to be a participant buyer?
- Who establishes hiring procedures initially and through the franchise term?

You will find that using the checklist will also make you more familiar with your business model.

FDD CHECK OFF SHEET

QUESTIONS PERTAINING TO TERMINATION AND RENEWAL TERMS

- Does the franchisor have absolute privilege of terminating the franchise agreement if certain conditions have not been met, either during the term or at the end?
- Does the franchise agreement spell out the terms under which the franchisor may repurchase the business?
- Does the franchisor have an option or duty to buy any or all of the franchisee's equipment, furnishings, inventory, or other assets in the event either party terminates the franchise for good cause?
- If the preceding situation occurs, how are purchase terms determined?
- Is there provision for independent appraisal? Is any weight given to good will or franchisee equity in the business?
- Under what conditions (illness, etc.) can the franchisee terminate the franchise? In such cases, do termination obligations differ?
- Is the franchisee restricted from engaging in a similar business after termination? If so, for how many years?
- If there is a lease, does it coincide with the franchise term?
- Does the contract provide enough time for amortization of capital payments?

Even if some factors are not relevant today, they may be tomorrow.

HIRE AN EXPERT



FRANCHISE ATTORNEY

ASK ME FOR REFERRALS



CPA

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DISCLAIMER

Before moving forward on any major buying decision, consult an expert.

CONTACT ME



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