

ACCOUNTING TODAY

Clients keen on franchising need lots of planning help

by Steven Martini
and Barry Kurtz

Life gets complicated for entrepreneurs who become franchisors, and many fail for lack of planning. They must exercise special care in forecasting revenues, which can take time to appear, much less mature. They must have a robust back-office infrastructure in place early on, with or without the revenue to support it. They must present audited financials to franchisees and follow detailed procedures in reporting to investors, if any.

In short, becoming a franchisor takes doing, and CPAs must understand the process and its risks if they are to help their clients make a go of it.

In general, the jump from entrepreneur to franchisor is a matter of formalizing the business enterprise according to generally accepted accounting practices - meaning rules not followed by many entrepreneurs. Because these seek to make the business comprehensible to outsiders, many entrepreneurs must adopt new ways of operating, and understand that they no longer act alone.

Instead, they take on partners in the form of investors and franchisees and an overseer in the form of government which assumes that between franchisor and franchisee, it is the former who needs policing.

The costs of this transformation only

begin with audited financials and legal fees, which can approach \$100,000. There are additional costs of advertising and marketing, salaries commissions, taxes and the like, plus back-office costs, including hardware and software.

The costs of raising capital from lenders or investors, including finder's fees,

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investment banker's fees, legal fees and the like, can reach 10 percent of the total raised. Last but not least, due diligence on prospective franchisees, who are key to the success of the whole idea, also costs money.

There is also the problem of time. It can take months to do market research on the franchise business model and to draft a franchise offering circular. It takes 60 to

90 days to register the offering with state authorities and get their approval, and another 90 days will probably pass before the first franchisee signs up and pays a franchise fee. More time will pass before the first franchisee actually opens up for business and starts paying royalties.

All in all, it can take a full year, and sometimes longer, for significant revenues to show up on the books of any franchisor, and the launch costs will long since have come due. Thus careful planning is key, and the accountant who accepts such an assignment must take special care to help the client develop realistic projections that reflect the realities of the opportunity.

There are no hard-and-fast rules for doing this; it is one thing to say that a would-be franchisor must exercise caution in forecasting revenues and another to know exactly what that means. Some help is available in statistics collected by government and trade and

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industry groups (see "Franchising guides," at right). But in the end, it won't matter what statistics say; what matters is the discipline, fortitude and good fortune of the individual franchisor.

Franchisors face big hurdles in the details of state and federal franchise law, too. A number of states impose registration burdens on would-be franchisors much like those facing companies seeking to sell securities to the public. These can include filing a detailed registration application, including a Uniform Franchise Offering Circular, along with sample advertising and promotional materials, and detailed supplemental information, among other requirements.

Typically, the offering circular must detail the franchisor's intended business operations and disclose the business experience of the franchisor, its affiliates and predecessor companies. It must also detail:

- Franchise fees, royalties, and other costs imposed on franchisees;
- The initial investment necessary for the franchisee to commence business operations;
- The terms and conditions of any financing arrangements offered directly or indirectly by franchisors to franchisees including lease arrangements and installment contracts;
- The use of trademarks, trade names, copyrights and proprietary information, including proprietary computer software;
- The requirements for the purchase of goods and services; and,

♦ The franchisee's obligation to participate personally in the direct operation of the franchise business.

Franchisors must specify what products and services they will offer franchisees, including advertising and training services, and what equipment they will require franchisees to

have - for example, computerized point-of-sale cash registers. Franchisors must disclose territory rights and the extent to which they may compete through non-franchise outlets - for example, discount retailers near franchise outlets.

Franchisors must also disclose the fees and conditions that they may impose on franchisees in order to renew the franchise agreement, and any rights that they reserve to modify the agreement in the future. Franchisors must proceed with special caution when discussing earnings. These are not required, as a rule, but when offered, franchisors must disclose the material assumptions underlying any such claims, stating whether the claims are based on the actual experience of franchised units.

In no way is this all that franchisors must do to satisfy the law, and in any case, because the manner in which government oversees franchisors depends in great measure on the skill and experience of the individual

official actually doing the work, the process has its surprises. Thus the bottom line is simple for the accountant: Step carefully - and don't hesitate to seek help from peers who have been there and done that in the past.

Franchising guides

Most books on franchising target would-be franchisees, not franchisors, and they cover such basics as the importance of location in any franchise operation.

Exceptions are *Franchising and Licensing: Two Powerful Ways to Grow Your Business*, by Andrew Sherman (Amacom Books), which contains chapters on strategic planning, capital formation and financial issues, and *Franchising: Pathway to Wealth Creation*, by Stephen Spinelli (Prentice Hall), which covers royalties and fees, risk management, capital formation, financial analysis, franchisee selection and monitoring, and service delivery.

For technical guidance, FASB Statement No.45 (www.fasb.org/pdf/fas45.pdf) establishes accounting and reporting standards for franchisors. Guidelines for compiling a Uniform Franchise Offering Circular are available from the North American Securities Administrators Association (http://nasaa.org/nasaa/scripts/fu_display_list.asp?ptid=34).

Other sources include the American Bar Association's Forum on Franchising (www.abanet.org/forums/franchising/home.html); Franchise Times (www.franchise-times.com); and the American Association of Franchisees and Dealers (www.aafd.org/).