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The Use & Analysis of Financial Statements

**Joel R. Buckberg,
Of Counsel
Baker, Donelson, Bearman, Caldwell & Berkowitz, PC
Nashville, Tennessee**

and

**Robert M. Einhorn
Zarco Einhorn Salkowski & Brito, P.A.
Miami, FL**

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The Use & Analysis of Financial Statements

I. INTRODUCTION

The authors intend for this paper to be a primary resource for franchise lawyers and legal assistants with little or no background in accounting or financial analysis. The paper is intended to educate the reader about the strengths, nuances and weaknesses of financial information contained in the financial statements of a business, and identify areas where accounting is as much an art as a science. The purpose of accounting is to communicate information about economic entities to interested persons. Financial accounting seeks to report accurately on economic resources known as assets, economic obligations known as liabilities, residual interests known as owners' equity, and economic activity.¹

Notwithstanding the formality and gravity attending audited financial statements, a clever and determined management team, chief financial officer, chief accounting officer or controller can orchestrate an enormous fraud that is based on either falsified general ledger entries at the source, or on intentional mischaracterization and misstatement of legal rights and liabilities that produce a misleading translation of the financial aspects of franchise contracts into financial statements.²

Franchising has a unique place in accounting history. By the early 1960's, the first wave of national expansion for Kentucky Fried Chicken carried the brand into 500 outlets, some of which simply added the original recipe product to their existing menus. In 1963, John Brown and Jack Massey bought the company from Harland Sanders with a hand written contract, a price of \$2 million cash plus a salary of \$40,000 for life. The new owners standardized the franchise program, designed a takeout oriented outlet, revamped the supply chain and created a national advertising program starring Harland Sanders. The monthly contribution to national advertising was set at \$25 and royalties on sales went from five cents a chicken to 3% of gross sales. Other financial arrangements were updated. The company undertook relatively conservative accounting practices and reported initial franchise fee income when stores opened, not when franchisees signed franchise agreements. KFC also pioneered what was later called off balance sheet financing through franchises. Franchises invested their equity and borrowed to develop their stores, in effect providing the financing for the growth of the KFC chain. The company then bought many of the franchised stores back after construction and revenue stabilization. These stores provided a return of 15% on sales, instead of the 3% royalty. The growth of the company after its reoriented franchises hit the market was dramatic. In 1972, KFC was sold to Heublein for \$239 million.

Success spawns imitators, so KFC spawned Minnie Pearl's Fried Chicken. Brothers John Jay and Henry Hooker leveraged their political connections to create a business that imitated KFC in appearance but not in substance. With no restaurant experience and a tiny support staff, they sold stock to those who missed out on the big run up in KFC stock value. The company had one open restaurant, and sold area development transactions in which the developers committed to blocks of 10 unit franchises. Developers paid 10% of the initial fee at

¹ DONALD E. KIESO & JERRY J. WEYGANDT, INTERMEDIATE ACCOUNTING 5-7 (2ND ED. 1977).

² See, e.g., KURT EICHENWALD, CONSPIRACY OF FOOLS (2005).

signing the development agreement, and issued an unsecured promissory note for the balance. The company recorded the entire initial fee as income in the month when the contract was signed. The operations never caught up to the franchise sales, with developers never fulfilling their development obligations. Minnie Pearl's was never able to develop a system that produced consistent unit level profits. Imitators with famous names abounded. The company faltered quickly, and the Securities and Exchange Commission eventually ruled that the financial statements filed with the company's annual reports were false. The restatement turned a reported profit into a loss, assets were sold, the chain closed and a chapter in franchise history ended.³

Franchise lawyers will recognize from this story the abuses of the 1960's that led to the franchise legislation and regulations in the 1970's. The accounting issues of this saga also found their way into the disclosure concepts that underpin Items 19 and 21 of the original 1978 Federal Trade Commission Franchise Rule,⁴ the California Franchise Investment Law of 1970 and the Midwest Securities Commissioners Association Uniform Franchise Offering Circular Guidelines dating back to 1974.

II. ACCOUNTING REGULATION AND THE SOURCES OF FINANCIAL STATEMENT FORMS

A. Accounting Regulatory Bodies

1. State Regulatory Bodies

In the United States, accounting is regulated by state licensure boards like other professions. The National Association of State Boards of Accountancy was formed in 1908 to represent the various licensing boards and to administer the professional certification exam on a uniform national basis. While these boards have admission and disciplinary authority, they do not promulgate substantive accounting rules. For example, the Tennessee Board of Accountancy operates to serve the following legislative intent:

It is the policy of this state, and the purpose of this chapter, to promote the reliability of information that is used for guidance in financial transactions or for accounting for or assessing the financial status or performance of commercial, noncommercial and governmental enterprises. The public interest requires that persons professing special competence in accountancy or offering assurance as to the reliability or fairness of presentation of such information shall have demonstrated their qualifications to do so and that persons who have not demonstrated and maintained such qualifications not be permitted to represent themselves as having such special competence or to offer such assurance, that the conduct of persons licensed as having special competence in accountancy be regulated in all aspects of their professional work, that a public authority competent to prescribe and assess the qualifications and to regulate the conduct of licensees be

³ BILL CAREY, FORTUNES, FIDDLES AND FRIED CHICKEN (2004).

⁴ 16 C.F.R. § 436 (2013).

established, and that the use of titles that have a capacity or tendency to deceive the public as to the status or competence of the persons using such titles be prohibited.⁵

States have enacted ethics rules and regulations as well as continuing professional education requirements similar to continuing legal education requirements. Few reported disciplinary actions are taken against accountants. States regulate the admission, competence, conduct and discipline of the profession but not its actual substantive practices.

2. AICPA

The American Institute of Certified Public Accountants (“AICPA”) has its origins in the American Association of Public Accountants, formed in 1887. The organization fostered the 1917 adoption by the Federal Trade Commission of a pamphlet it authored entitled "Uniform Accounting."⁶ The confluence of the stock exchange growth and interest in the 1920's and the subsequent crash and creation of the Securities and Exchange Commission (“SEC”) produced the potential of conflicting sources of accounting rules. In 1959, the AICPA formed the Accounting Principles Board which issued opinions and statements that served as the profession’s rules for accounting.

3. Financial Accounting Standards Board

The AICPA sponsored the creation of the independent Financial Accounting Standards Board (“FASB”) in 1972, which is now supported through private donations by the Financial Accounting Foundation.⁷ FASB began operation in 1973. Its website provides this description of its role in financial accounting:

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. Those standards are officially recognized as authoritative by the Securities and Exchange Commission (SEC) (Financial Reporting Release No. 1, Section 101, and reaffirmed in its April 2003 Policy Statement) and the American Institute of Certified Public Accountants (Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979). Such standards are important to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information. The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however,

⁵ TENN. CODE ANN. § 62-1-102 (2006).

⁶ J. EDWARD KETZ, ACCOUNTING ETHICS 201 (2006).

⁷ The Foundation solicits donations and provides financial support as a 501(c)(3) charitable organization to the various accounting standards setting organizations, such as FASB and the Government Accounting Standards Board. FIN. ACCOUNTING FOUND., <http://www.accountingfoundation.org/home> (last visited Aug. 21, 2013).

the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.⁸

In 2009, the FASB codified the thousands of standards, policies, announcements, interpretations, technical bulletins, statements and other means of published accounting guidance into the FASB Accounting Standards Codification⁹ (the "Codification") for application to all nongovernmental accounting entities in the United States. The codified rules form the basis for generally accepted accounting principles, commonly referred to as "GAAP" in this paper and elsewhere. Accountants and others with access to this body of literature follow a study system organized around areas, topics and subtopics. The Codification organizes around the concepts of General Principles, Presentation, Assets, Liabilities, Revenue, Equity, Expenses, Broad Transactions and Industry Areas.¹⁰ The Codification was implemented on July 1, 2009 after considerable study and buildup.

4. Others

Other organizations have some influence over accounting. Because financial and tax accounting diverge, the Internal Revenue Service has substantial influence over the application of accounting to businesses, particularly when businesses manage to tax objectives instead of managing to financial objectives. The financial statements of public companies are governed by the accounting rules published in Regulation S-X¹¹ of the SEC, and the interpretations of its accounting staff which affect presentation of the financial statements in filed reports.¹² The FASB stated that the Codification was harmonized with SEC accounting rules. Public companies must also comply with the accounting and internal control rules of the Foreign Corrupt Practices Act.¹³

a. Generally Accepted Accounting Standards (GAAS)

Generally Accepted Auditing Standards ("GAAS") are a set of standards against which the quality of audit work is performed and judged. These standards are promulgated by the AICPA's Auditing Standards Board ("ASB"). The AICPA began issuing guidance to accountants and auditors in 1917. This guidance has changed in name and form over the years. Beginning in 1939, the SEC began requiring public accountants to include a representation in their audit opinions of public companies that their audit was conducted in accordance with GAAS. In 1972,

⁷ FIN. ACCOUNTING STANDARDS BD., *Facts About FASB*, <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495> (last visited July 25, 2013).

⁹ FIN. ACCOUNTING STANDARDS BD., *Summary of Statement No. 168*, http://www.fasb.org/cs/ContentServer?pagename=FASB%2FPronouncement_C%2FSummaryPage&cid=1176156308679 (last visited July 25, 2013).

¹⁰ Bruce Pounder, *FASB Learning Guide*, FIN. ACCOUNTING STANDARDS BD. (Mar. 1, 2012), available at https://asc.fasb.org/cs/ContentServer?site=FAF&c=Document_C&sitepfx=FAF&pagename=FAF/Document_C/CodDokumentPage&cid=1175805121281.

¹¹ 17 C.F.R. § 210.1-01 (2012).

¹² 17 C.F.R. §§ 240.13a-13, 249.310 (2013).

¹³ 15 U.S.C. § 78m(b) (2012).

the AICPA implemented significant changes to its standard setting procedures by consolidating all previous pronouncements into a unified set of rules called Statements on Auditing Standards (“SAS”). Finally, in 1978, the AICPA established the ASB which would be the highest authoritative body governing the responsibilities of public accountants performing audit work and the standards by which audits are to be performed in the United States. There are currently 121 SAS outlining the required training, independence, professional care, standards of field work and standards of reporting required by accountants when conducting audits. These SAS are further defined by interpretive publications and technical practice guides issued by the ASB which outline the auditor’s responsibilities in industry and fact-specific situations.

The ASB issued clarified standards in 2012 after a seven year project to bring United States GAAS in line with international standards promulgated by the International Auditing and Assurance Standards Board. The recodified audit standards took effect in 2013, with the first audits using the new standards covering fiscal years ending in 2013.¹⁴ While the new GAAS rules made technical changes to the way audits are conducted, several important changes were made to the audit opinion format to clarify the roles and responsibilities of the management of the audited enterprise and the auditors. A new section of the audit report will describe “management’s responsibility for the preparation and fair presentation of the financial statements and will reference management’s responsibility for the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to error or fraud.”¹⁵ Other changes will detail the auditor’s responsibility for the audit, the basis for issuing any qualified opinion, and differentiate for the reader the report and the opinion, if it is other than unqualified. For those unfamiliar with audit opinions, an unqualified opinion means the auditor found no reason in the financial statements or the audits to believe that the enterprise may not be able to continue as a going concern. A qualified opinion expresses varying degrees of doubt or concern about the ability of the enterprise to continue in business.

b. Public Company Accounting Oversight Board (PCAOB)

Until 2002, the ASB remained the sole authority on auditing standards in the United States. However, in response to the massive number of accounting financial restatements filed with the SEC in the 1990s and the many high-profile accounting scandals which resulted in the bankruptcies of large public companies, most notably Enron and WorldCom, the United States Congress passed the Sarbanes-Oxley Act (“SOX”), which changed the hierarchy of oversight of public accountants performing audits on publicly traded companies. SOX established the Public Company Accounting Oversight Board (“PCAOB”) which is now the authority which oversees audit regulation and public-auditor professional practice standards in connection with audits performed on publicly traded companies.¹⁶ The PCAOB’s mandate is clear:

[T]o oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public

¹⁴ Jan Taylor Morris & C. William Thomas, *Clarified Auditing Standards: The Quiet Revolution*, J. OF ACCT. (June 2011), available at <http://www.journalofaccountancy.com/Issues/2011/Jun/20113792>.

¹⁵ *Id.*

¹⁶ Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7211 (2002).

investors. The Board shall be a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress.

Section 101 of SOX provides that the PCAOB has the power to, among other things, set auditing standards for audits of public companies, require accounting firms that conduct audits on public companies to register with the PCAOB, investigate and inspect registered public accounting firms, conduct disciplinary proceedings of registered public accounting firms and impose fines and sanctions against both registered accounting firms and individual public accountants. In addition, the PCAOB has the authority to regulate non-audit services performed by registrants on publicly traded companies to insure that auditors' independence is not compromised by large fees earned by accounting firms providing both auditing services and other ancillary accounting services for public companies.¹⁷

One of the recent regulations implemented by the PCAOB requires CEOs and CFOs of publicly traded companies to attest to the correctness of their financial statement presentation, thereby exposing CEOs and CFOs to criminal penalties for false financial statement presentation.¹⁸ To date, the PCAOB has promulgated 16 standards which have heightened requirements for ethical practice of registered accountants. They include stricter guidelines for independence, internal control testing and ethical standards and safeguards such as concurring reviews and partner rotation. To date, the PCAOB has not issued any specific rule governing franchise companies or franchising. However, it is still important for attorneys to understand the basic differences in the requirements now mandated on audits of public companies when advising their clients as to the necessary steps to take when they are required to produce financial statements to the public.

c. International Financial Reporting Standards (IFRS)

Accounting for private enterprises has traditionally followed the standards of the home country of the enterprise. Because so many enterprises have operations outside their home country, and constituencies outside their home county that wish to use and review the financial statements of the enterprise, the international accounting community has been working for many years on a global set of accounting standards that will be currency and country neutral, and provide the same financial information to readers regardless of the country where the enterprise or the reader is located. The reader would be absolved from knowing or researching the nuances of home country audit or presentation standards to comprehend the financial condition of the enterprise.

The International Accounting Standards Board ("IASB") was first created to harmonize accounting across the European Union, but the project has expanded to a truly global reach. The AICPA has a convergence plan and task force to implement "International Financial Reporting Standards" or "IFRS." While GAAP has been focused traditionally on historical cost accounting, IFRS adds significant components that measure and adjust asset and liability values for inflation and deflation, currency valuation and other market factors that present a more current financial picture of values. Although the United States lags in the adoption of IFRS, the 2012 Annual Report of the IFRS Foundation reports that more than 100 countries have adopted IFRS, and half of all global Fortune 500 companies report in IFRS instead of

¹⁷ See 15 U.S.C. § 7213 (2012).

¹⁸ 15 U.S.C. § 7241; 18 U.S.C. §§ 1341,1349.

GAAP or another system. Canada adopted IFRS in 2011, and Mexico, Russia and Argentina adopted IFRS in 2012. The SEC has endorsed a memorandum of understanding between FASB and IASB to move toward IFRS that was signed in 2006,¹⁹ and has issued a final staff report in July 2012 that calls for implementation of IFRS after a three year transition period, once the convergence issues with GAAP are resolved.²⁰

Indeed, this paper may be the last one that uses GAAP as the basis of presentation. Future papers will focus on the impact of IFRS on franchisor and franchisee financial statements. The AICPA reports on the key differences between GAAP and IFRS financial statements include the following that may impact financial statements in franchising:

- IFRS does not permit Last In, First Out (“LIFO”) as an inventory costing method.
- IFRS uses a single-step method for impairment write-downs rather than the two-step method used in U.S. GAAP, making write-downs more likely.
- IFRS has a different probability threshold and measurement objective for contingencies.
- IFRS does not permit curing debt covenant violations after year-end.
- IFRS guidance regarding revenue recognition is less extensive than GAAP and contains relatively little industry-specific instruction.
- IFRS provides much less overall detail than US GAAP.²¹

The reader should be aware that the SEC plans to implement IFRS on a voluntary basis as early as 2015. FASB is likely to implement on the same timeline.

B. Balance Sheets, Statement of Operations, Statement of Cash Flow, Statement of Owner’s Equity

The method of accounting known as the general ledger system of double entry using debits and credits is said to originate with Renaissance era Italy and the business interests of the Medici family.²² Debits represent increases in assets, decreases in liabilities and recognition of expenses. Credits represent decreases in assets, increases in liabilities, and recognition of revenue. All transactions must have a corresponding debit and credit under the double entry system. Contra accounts are used to offset account values to adjust gross values to current values.

¹⁹ INT’L ACCOUNTING STANDARDS COMM. FOUND., IASC ANNUAL REPORT 10 (2006), *available at* <http://www.ifrs.org/The-organisation/Governance-and-accountability/Annual-reports/Documents/IASCFoundationAnnualReportFinal.pdf>.

²⁰ See U.S. SEC. & EXCH. COMM’N, FINAL STAFF REPORT: WORK PLAN FOR THE CONSIDERATION OF INCORPORATING INTERNATIONAL FINANCIAL REPORTING STANDARDS INTO THE FINANCIAL REPORTING SYSTEM FOR U.S. ISSUERS (2012), <http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-final-report.pdf>.

²¹ See AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS): AN AICPA BACKGROUNDER, http://www.ifrs.com/pdf/IFRSUpdate_V8.pdf (last visited July 25, 2013).

²² WIKIPEDIA ENCYCLOPEDIA, http://en.wikipedia.org/wiki/Medici_Bank (last visited July 25, 2013).

The general ledger uses a chart of accounts specific to a particular business, following the parameters set by GAAP. Accounting for the enterprise's economic activity operates under certain basic assumptions that underpin the methodology:

- Economic activity can be identified to a particular economic entity that is distinct from its owners and other economic entities.
- The economic entity will continue as a going concern that will continue in business long enough to fulfill its obligations.
- Monetary units provide an appropriate basis for measuring activity and performing analysis.
- The economic activities of the enterprise can be attributed and divided to artificial time periods.

These assumptions build into a set of principles on which general ledger accounting operates:

- Historical cost - assets and liabilities are determined on the basis of historical cost, because it is definite and determinable.
- Revenue is realized when the earning process is virtually complete and an exchange transaction has occurred.
- Efforts (expenses) must be matched with accomplishments (revenues).
- The economic entity must give the accountable events the same treatment in different time periods.
- Financial statements must present sufficient information to permit the knowledgeable reader to reach an informed decision and avoid any misleading inference.
- Information must be objective and verifiable.

These principles are tempered in their practical application by modifying conventions that connect theory and reality. These are materiality, industry practices and conservatism, which hold that the best solution is the one that is least likely to overstate assets and income.

The building blocks of accounting are these basic elements:

- Assets - rights and resources that have future benefit in use, expressed in monetary terms.
- Liabilities - obligations that must be satisfied through the disbursement of assets or the rendering of services.
- Owners' Equity - ownership claims against the net assets of the enterprise that are residual in nature and do not require eventual liquidation.

- Revenues - increases in net assets arising from services rendered or products sold.
- Expenses - assets costs that expire in an enterprise's attempt to attain revenues.
- Income - excess of revenues over expenses for a given period of time.
- Transactions - changes in assets, liabilities and equities that are recorded, generally financial in nature expressed in money, and generally the result of the transfer of values between parties.²³

Another important concept is recognition - the point where a transaction becomes an event that is recorded on the income statement as revenue or expense or both. Until recognition, the transaction is recorded on the balance sheet as either an asset, representing prepaid expense, or a liability, representing prepaid revenue. At recognition, the general ledger entries cause the transaction to be properly characterized on the income statement.

For example, when an initial franchise fee is received, the cash is debited to cash, and the initial fee is credited to deferred initial fee revenue. As start-up expenses are incurred, prepaid support expenses are debited (if matched to the particular transaction) and cash is credited. At recognition, deferred initial fee revenue is debited on the balance sheet and initial fee revenue is credited on the income statement. Likewise, initial services expenses are debited on the income statement and prepaid support expenses are credited on the balance sheet.

Armed with these principles, conventions and elements, we can now focus on the format of financial statements as they have evolved from the time of the Medicis, through various formulations to the current format under GAAP.

1. **Balance Sheet**

The balance sheet ("Form A") is a presentation of assets, liabilities and owners' equity as of a specific date. Another name is the Statement of Financial Position. The accounting equation that forms the underlying basis for the balance sheet is: Owners' Equity = Assets - Liabilities. Assets are presented on the left side in a specified order of accounts, liabilities and owner's equity on the right side. Assets are presented with the highest liquidity on the top of the asset section, with each account down the page representing less liquidity than the account immediately above it. Liabilities are presented below the assets with the shortest maturity of obligation on the top, with each account down the page representing a longer time to maturity of the obligation. Owners' Equity appears below liabilities. The balance sheet accounts are fixed in the order of presentation under GAAP. Asset values are always reported at their "fair value," which may require some adjustment to the lower of cost or market value, if readily determinable. Historical cost is used where fair value cannot be readily determined by reference to a public marketplace value. For assets used in franchised businesses, like leasehold improvements and furniture, fixtures and equipment, historical cost is used in place of more subjective valuations even if recently observed market prices for similar assets are higher than the corresponding historical cost, Recent changes in GAAP require certain assets to be revalued as impaired if

²³ DONALD E. KIESO ET AL., INTERMEDIATE ACCOUNTING 22-23 (12th Ed. 2007).

the carrying value does not reflect the current economic value of residual cash flows or net realizable value at sale.²⁴

One important aspect of the balance sheet is the definition of current assets and current liabilities. Current means realized assets and expended liabilities within a one year period from the date of the balance sheet.²⁵ Normal inclusions in current assets are cash, cash equivalents, marketable securities, accounts receivable, inventories, and prepaid items that will be expended in one year. Current liabilities include accounts, wages and taxes payable, prepaid collections that will be realized in one year, short term debt and current maturities of long term debt.

Long term assets on the balance sheet include property, plant and equipment, long term investments, noncurrent accounts receivable, tangible assets of a durable nature used in the operations of the business, intangible assets, advances to subsidiaries, and other prepaid items. Long term liabilities are relatively straightforward, but carry significant disclosures in footnotes that bear on the long term financial exposure of the enterprise, its covenants, capital leases and pension obligations. The precursor of liquidity issues are maturities of long term debts that must be paid off or refinanced. Principal reductions are a balance sheet, not an income statement deduction entry. An indicator of cash flow to match debt principal reported as coming due is the amount of depreciation and amortization shown on the Income Statement. These non-cash charges represent cash retained by the entity with which it can pay principal of its indebtedness.

Form A

Assets	Liabilities
Cash and Cash Equivalents (fair value)	Short Term Payables (fair value)
Short Term Investments and Marketable Securities (Fair value)	Borrowings: short term debt; current maturities of long term debt; long term debt (approximate fair value)
Receivables (Quasi Fair Value)	Accrued and estimated liabilities (quasi fair value)
Inventories (lower of cost or market)	Commitments and contingencies
Long Lived Tangible Assets (depreciated historical cost)	Owners' Equity
Recorded Intangible Assets (amortized historical cost)	Preferred Stock
Goodwill (unimpaired historical cost)	Capital Stock - Par Value and Paid-In Capital

²⁴ S.H. Pennam, *Financial Statement Analysis and Security Valuation: Introduction to Financial Statements*, <http://answers.mheducation.com/accounting/financial-statement-analysis-and-security-valuation/introduction-financial-statements#the-balance-sheet-> (last visited July 25, 2013).

²⁵ KEISO ET AL., *supra* note 21, at 161.

Other Intangible Assets (amortized historical cost)	Retained Earnings (Loss)
Long Term Debt Securities (fair value)	
Equity Investments (fair value)	

2. Income Statement

The Income Statement ("Form B"), sometimes called the Statement of Operations, reports on how the owners' equity changed as a result of business activity in the period. Revenues are presented first, followed by cost of goods sold, operating expenses charged against revenues, then net interest expense or income, non-cash charges such as depreciation and amortization, taxes, net extraordinary items from non-recurring events, preferred equity distributions and finally net income available to common equity owners. Form B shows the structure of the Statement of Operations.

Form B

Net Revenues
(Cost of Goods Sold)
Gross Margin
(Operating Expenses (Selling, General and Administrative Expenses))
Net Margin (EBITDA)
(Depreciation & Amortization)
(Net Interest Expense/Income)
(Income Taxes)
Net Income After Taxes
Extraordinary Items, Net After Taxes
Preferred Equity Distributions
Net Income Available for Distribution

3. **Statement of Cash Flow**

The cash flow statement describes how the enterprises generated and used cash during the accounting period. Cash flows are divided into three types in the statement: cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities. The statement reports the cash generated from the three activities of the enterprise.

- Cash from operations is cash generated from selling products and services, net of cash expended in doing so. Investing cash flows are cash spent on purchasing assets to be employed in the operating activities less cash received from selling assets.
- Financing cash flows are the cash transactions to raise cash from and disburse cash to the debt and equity claimants of the enterprise.
- The sum of the cash flows from the three activities explains the increase or decrease in the firm's cash at the bottom of the statement.²⁶

4. **Statement of Owners' Equity**

This statement starts with the equity at the beginning of the period, describes changes in owners' equity from capital transactions involving capital inflows and outflows from the purchase and sale of equity by the enterprise, applies the net income or loss, and derives the net end of period owners' equity.

a. **Industry Specific Formats: Uniform System of Accounts for Hotels; Uniform System of Accounts for Restaurants**

Industry conventions modify GAAP to enhance utility and common understanding among enterprises engaged in similar activities and to facilitate comparisons among them. Two leading industry conventions are the Uniform System of Accounts for Hotels and the Uniform System of Accounts for Restaurants. These conventions provide charts of accounts and methods of analysis that improve the ability of ownership and management to make effective use of accounting data.

i. **Hotels**

The original Uniform System of Accounts for Hotels dates back to the 1926 publication by the Hotel Association of New York City. It was adopted by the American Hotel & Lodging Association as the national standard for the lodging industry in 1961. The industry trade association has updated the "Uniform Hotel System" frequently, with the tenth edition as the most recent.²⁷ The Uniform Hotel System puts flesh on the bones of GAAP, as shown in the forms of income statement and summary statement of operations reproduced in Appendix A.

Many hotel franchisors require that franchisees adhere to the Uniform Hotel System, with one major exception. Franchisors typically use gross room revenues as the revenue base

²⁶ *Id.*

²⁷ See Timothy Eaton, UNIFORM SYSTEM OF ACCOUNTS FOR THE LODGING INDUSTRY (9th Ed. 1996).

for calculation of royalties and other variable fees based on revenue of the franchisee. The franchise agreements typically take the amount charged for the room rate on the guest's room folio at checkout as the original entry measure of revenue, and allow few or no deductions. Typical exclusions would be taxes and gratuities if paid over to taxing authorities and employees, respectively. If the guest receives free meals or other benefits such as event tickets or golf rounds as a package, the franchise agreement does not authorize deductions for purposes of revenue and fee calculations. The Uniform Hotel System books room revenues with more detail. If the franchisor requires free breakfast or other services as part of brand service standards, there is no allocation of revenue to any other account. If the package includes non-standard amenities as part of an inclusive price, the Uniform Hotel System allocates room revenue to other accounts to cover the costs, based on the ratio of fair market values of the components.²⁸ For franchisors who disclose gross room revenues and other revenue measures in Item 19 of their Franchise Disclosure Documents, and who require franchisees to adhere to the Uniform Hotel System, explanations of their variations in accounting for gross room revenues will be most helpful to reader understanding.

ii. Restaurants

The National Restaurant Association first created the Uniform System of Accounts for Restaurants (the "Uniform Restaurant System") in 1968, and has updated the system frequently with the latest update published in 2012.²⁹ The system has evolved to help its users understand their controllable and non-controllable expenses, so meaningful information for applying management decisions can be derived from the accounting information. A sample chart of accounts and income statement from the Uniform Restaurant System appears in Appendix B.

Both Uniform Systems create analytical tools and ratios that we will discuss below.

C. Reviewing and Understanding Financial Statements

1. Where to Look

a. Footnotes

Financial statements have extensive footnotes that provide a great deal of detail about the policies, practices and procedures used by the enterprise. Any reading of the audited financial statements must include a careful review of the footnotes.

b. Cash v. Accrual

GAAP requires accrual accounting, which records transactions as they occur. Cash basis accounting records only cash transactions and is used by individuals and by some businesses that elect not to audit their financial records and sell no inventory, operate primarily with cash transactions and have less than \$5 million in sales. Accrual accounting provides more accurate and fulsome information for decisions and analysis.³⁰

²⁸ *Id.*

²⁹ *Id.* at 41.

³⁰ TELESTRAT EDUCATION: ACCOUNTING FOR LAWYERS, www.onedaymba.org (last visited July 25, 2013).

c. Balance Sheet

The balance sheet is a snapshot of the financial health of the enterprise as of its date. The customary presentation compares the balance sheet values to the values from the prior year so the reader can assess instantly the directional changes in the financial health of the enterprise. The balance sheet shows the vital signs of the enterprise - cash, working capital (defined below), liabilities, debt and owner's equity. Movements in a positive direction for assets and equity and a negative direction for liabilities signal a positive change in finances. The converse is also true. Negative movement in assets and equity and positive movement in liabilities and debt signal a worsening of finances.

d. Income Statement

The income statement or statement of operations is a score card for the success or failure of the enterprise over the time period of activity measured - usually monthly, quarterly or annually. The presentation compares the current period to the prior period's results so directional change is evident. Net income or earnings, the payment of distributions and dividends, and the addition to owner's equity demonstrate positive financial performance, as would a reduction in net loss from a larger net loss the prior year.

2. Basic Ratios

Ratio analysis utilizes balance sheet and income statement data to assess the financial health, strength and direction of the business. These snapshots provide an instant picture as of the balance sheet date and the period covered by the income statement, When compared with the same ratios from prior periods, usually one month or one quarter, the entity's directional change can be measured - are its finances getting better or worse or remaining constant? Within an industry or franchise system, the ratios should distribute around a norm, which may vary from a broader sample of similar sized businesses operating in different industries. There are five broad categories of ratio analysis: 1) activity analysis; 2) liquidity analysis; 3) long term debt and solvency analysis; 4) profitability analysis; and 5) market valuation analysis. One key definition is working capital, which represents the excess of current assets over current liabilities. That single measure of liquidity is very important to the sustainability of the enterprise. The ratio of current assets divided by current liabilities is called the Current Ratio. If that fraction is less than 1.00, then the enterprise will quickly face cash flow challenges in most cases.

a. Activity Analysis

These measures assess the relationship between the level of operations and asset base necessary to sustain the operations.

- Inventory Turnover Days = $365 / (\text{Cost of Goods Sold} / \text{Average Inventory})$
- Accounts Receivable Turnover Days = $365 / (\text{Credit Sales} / \text{Average Receivables})$
- Accounts Payable Turnover Days = $365 / (\text{Purchases} / \text{Average Accounts Payable})$ ³¹

³¹ KEISO ET AL., *supra* note 21, at 66.

- Working Capital Turnover = Sales/Average Working Capital

These day counts are then used to determine if the business has sufficient liquidity using the cash conversion cycle (“CCC”): Accounts Receivable Days + Inventory Days - Accounts Payable Days = CCC Days. If Working Capital Turnover is less than CCC days, then liquidity is an issue.

b. Liquidity Analysis

Activity analysis determines how much liquidity is needed to sustain the enterprise. The liquidity of the enterprise is measured by specific ratios that assess the ability to respond to cash needs. As we mentioned above, the most significant is the current ratio:

- Current Ratio = Current Assets (Cash & Cash Equivalents, Short Term Marketable Securities, Accounts Receivable, Inventory) / Current Liabilities (Accounts Payable, Current Maturities of Long Term Debt)
- Quick Ratio = (Cash + Marketable Securities + Accounts Receivable) / Current Liabilities
- Cash Ratio = (Cash + Marketable Securities) / Current Liabilities.
- Cash Flow from Operations Ratio = Cash Flow from Operations (“CFO”) / Current Liabilities

c. Debt and Solvency Analysis

These ratios evaluate the overall risk to the enterprise from its capital structure, including long term debt relative to owner’s equity, and the use of leverage from debt to fund the enterprise. For these ratios, Total Debt is the sum of short term debt (borrowings with maturities of less than one year) plus long term debt (borrowings with maturities of one year or more). Total Equity is the sum of capital stock value, paid in capital and retained earnings or undistributed prior profits.

- Debt to Total Capital = Total Debt / Total Debt + Total Equity
- Debt to Equity = Total Debt / Total Equity
- Interest Coverage = Earnings Before Interest and Taxes / Interest Expense
- Capital Expenditure Ratio = CFO / Capital Expenditures
- CFO/Debt = CFO / Total Debt

In the franchise world, Interest Coverage is very important for highly levered businesses like hotels and restaurants where the Debt to Total Capital ratio is high, usually over 65%. Covenants in loan and debt agreements frequently require coverage of at least 1.5 or cash flow traps may be invoked. A cash flow trap is a lockbox or depository arrangement where all cash

flow from business activity and asset sales is deposited into a separate account from the general checking account of the entity, The cash accumulates until the month's debt service payments are covered, then the cash is released for use in the business. Funds to support payroll, sales taxes and employment taxes are also often released to meet legal obligations,

d. Profitability Analysis

This category breaks down into two subcategories. Return on Sales measures the enterprise's ability to generate and improve profits and control costs associated with its productive process. These ratios are:

- $\text{Gross Margin} = \text{Gross Profit} / \text{Sales}$. Gross Profit is Sales less Cost of Goods Sold.
- $\text{Operating Margin} = \text{Operating Income} / \text{Sales}$.
- $\text{Pretax Margin} = \text{Earnings Before Taxes} / \text{Sales}$
- $\text{Profit Margin} = \text{Net Income} / \text{Sales}$

The second ratio category measures return on investment and the relationship between the level of investment and the net income it produces.

- $\text{Return on Assets} = \text{Net Income} / \text{Average Total Assets}$
- $\text{Return on Total Capital} = \text{Net Income} / \text{Average (Total Debt + Owner's Equity)}$
- $\text{Return on Equity} = \text{Net Income} / \text{Average Owner's Equity}$

e. Market Valuation Analysis

Market value analysis presupposes a market for the equity of the enterprise. With public companies that have their equity traded on exchanges, the market value analysis is relatively easy. Private companies are more difficult to value but there are some recognized measures of enterprise value. One key factor is the book value per share of the enterprise. Book value divides the owner's equity by the number of shares outstanding. Public companies are valued on the basis of earnings per share. The price earnings ratio is found by dividing the market price by earnings per share.

For private entities that are tax pass through entities like limited liability companies, limited partnerships and S-corporations, traditional market value analysis tools are not meaningful. Surrogate measures use multiples of Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") or capitalization rates as valuation indices. A capitalization rate divides net operating income ("NOI") or EBITDA (cash flow) to produce a value of the enterprise. The higher the rate, the lower the value.

- $\text{Capitalization Rate} = \text{NOI} / \text{Value}$
- $\text{Value} = \text{NOI} / \text{Capitalization Rate}$

f. Industry Metrics

Each industry group has its own measures or metrics that provide information to the reader on the same topics - activity, liquidity, solvency, profitability, and market value. The Uniform Hotel System has focused on several key metrics that appear in hotel franchisor Item 19 financial performance representations:

- Average Daily Room Rate = Gross Room Revenues / Rooms Occupied
- Occupancy Percentage = Rooms Occupied / Rooms Available for Rent
- Revenue Per Available Room ("REVPAR") = Gross Room Revenue / Rooms Available for Rent

The Uniform Restaurant System introduced new comparative ratios and analysis in the 2012 edition. The most significant concept is called "Prime Cost," which is defined as the total cost of sales plus total labor cost. The benefit of Prime Cost is as an indicator of the restaurant management's effectiveness in controlling the variable costs of a restaurant. These formulas are relevant:

- Cost of Sales = Beginning Inventory + Purchases - Ending Inventory
- Labor Cost = Management Compensation + Hourly Compensation + Employee Benefit Costs
- Prime Cost = Cost of Sales + Labor Cost

The ratio of Prime Cost to total sales creates a benchmark for comparative purposes that operate as a predictor of financial performance. The text gives examples of Prime Costs of 65% for full service restaurants and 60% for limited service restaurants as levels above which the restaurants may not be able to meet their other expenses and return a "reasonable net income margin."³² The Uniform Restaurant System has several other useful "Rules of Thumb" for restaurants in Appendix C.

D. FAS 45 and ASC 952

One of the consequences of the KFC/Minnie Pearl experience was the promulgation of FAS 45 in March 1981 by FASB. Under this Statement of Financial Accounting Standards, guidance was provided for accounting treatment of initial fee revenue under franchise agreements. From 1970 until 1981, an AICPA Guide established the convention of recognizing initial fee income when all material pre-opening services were provided. FAS 45 codified this convention:

Franchise fee revenue from an individual franchise sale ordinarily shall be recognized, with an appropriate provision for estimated uncollectible amounts, when all material services or conditions relating to the sale have been substantially performed or satisfied

³² NAT'L REST. ASS'N, UNIFORM SYSTEM OF ACCOUNTS FOR RESTAURANTS 5 (Jim Laube & Barry K. Shuster eds., 8th ed. 2012).

by the franchisor. Substantial performance for the franchisor means that (a) the franchisor has no remaining obligation or intent—by agreement, trade practice, or law—to refund any cash received or forgive any unpaid notes or receivables; (b) substantially all of the initial services of the franchisor required by the franchise agreement have been performed; and (c) no other material conditions or obligations related to the determination of substantial performance exist.

Area development fees are treated the same way. If a franchise terminates prior to the completion of material services, the franchisor may recognize a collected initial franchise fee that does not require a refund to the franchisee.

FAS 45 created a curious cash flow whirlpool for franchisors. When a franchise is sold, the franchisor records and pays various pre-opening expenses that may span several accounting periods until the franchise either opens or terminates. Costs associated with the franchise may be deferred until income recognition only to a limited degree:

Direct (incremental) costs relating to franchise sales for which revenue has not been recognized ordinarily shall be deferred (held on the balance sheet) until the related revenue is recognized (on the income statement); however, the deferred costs shall not exceed anticipated revenue less estimated additional related costs. Indirect costs of a regular and recurring nature that are incurred irrespective of the level of sales, such as general, selling, and administrative costs, shall be expensed as incurred. Costs yet to be incurred shall be accrued (on the balance sheet) and charged against income no later than the period in which the related revenue is recognized.

As a result, the franchisor's balance sheet may worsen from the acceleration of expense recognition and the deferral of revenue recognition. The franchisor expends its cash to pay expenses but has no revenue to offset the expenses while its cash depletes.

When FASB issued its codification, FAS 45 was reissued as Accounting Standards Codification 952 effective July 1, 2009. This standard largely continued the principles of FAS 45, but addressed the cash flow trap with authority to defer recognition of start-up and sales related expenses until initial fee revenue.

For initial fees, the codification now provides that initial franchise fee revenue, less any estimated uncollectible amount, is to be recognized when all material services and conditions have been substantially performed or satisfied by the franchisor. Substantial performance means there is no obligation or intent to refund the initial fee, substantially all of the initial services have been performed by the franchisor, and no other material conditions or obligations related to determination of performance exist. If no legal obligation to perform services exists, but there is a voluntary practice to perform services under the circumstances, the initial franchise fee cannot be recognized until the franchisee opens its franchise, unless the franchisor can demonstrate that it has substantially performed all of its obligations. If the franchisor receives a large initial franchise fee and its continuing fees will not cover its cost of

continuing performance, then it must reserve a portion of the initial fee sufficient to cover the cost of its continuing services, and apply the reserve to cover the costs over time.³³

Franchisors are permitted to defer recognition of expenses directly or incrementally related to franchise sales until the related revenue is recognized, so long as the deferred costs do not exceed the anticipated related revenue.³⁴ This allows franchisors to match the franchise sales and development revenue and expenses in the same accounting period, so net income for financial accounting and tax accounting is truly representative of the economics of the transaction.

Continuing fees are recognized when they become receivable, with appropriate reserves for uncollectible amounts based on historical experience.³⁵ Costs related to continuing franchise fees are expensed as incurred.³⁶ Also expensed as incurred are indirect costs of a regular and recurring nature, such as selling, general and administrative expenses.³⁷

1. Franchise Relationship Issues

One underappreciated element of ASC 952 is the admonition that a franchisee can become an affiliate of the franchisor, and thus require affiliate accounting of the two enterprises, if the franchisor guarantees the borrowings of the franchisee, has a creditor interest in the franchisee, or controls the franchisee's operations by sales or other agreements to such an extent that the franchisee is not a separate economic enterprise.³⁸ While there is limited guidance in ASC 952 as to where the line is drawn, the level of independence and dependence created by the franchise agreement and practices of the franchise system will be heavily scrutinized by the auditors of a franchisor if these three elements are observed in a franchise relationship. In the structure of a franchise program, a franchisor must be mindful of these limitations and assure franchisee financial independence and separateness to avoid affiliate accounting. Once the franchise relationship crosses that line, the franchisor is a minority investor in the franchisee, whether or not there is a formally documented legal relationship.

2. Advertising Funds, ASC 952 and FIN 46

Many franchisors separate advertising, marketing or brand fund contributions in their franchise agreements and FDDs from other continuing fees, assigning to such contributions and the accounts into which they are deposited a status of untethered to the funds and accounts of

³³ See FRANCHISORS REVENUE RECOGNITION, Statement of Fin. Accounting Standards No. 952-605, §§ 25-1–25-17 (Fin. Accounting Standards Bd. 2010).

³⁴ FRANCHISORS OTHER ASSETS AND DEFERRED COSTS, Statement of Fin. Accounting Standards No. 952-340, § 25-1–2 (Fin. Accounting Standards Bd. 2010).

³⁵ FRANCHISORS REVENUE RECOGNITION: CONTINUING FRANCHISE FEES, Statement of Fin. Accounting Standards No. 952-605, § 25-12 (Fin. Accounting Standards Bd. 2010).

³⁶ FRANCHISORS OTHER EXPENSES: RECOGNITION OF COSTS, Statement of Fin. Accounting Standards No. 952-720, § 25-2 (Fin. Accounting Standards Bd. 2010).

³⁷ *Id.*

³⁸ FRANCHISORS REVENUE RECOGNITION: RELATIONSHIP BETWEEN FRANCHISOR AND FRANCHISEE, Statement of Fin. Accounting Standards No. 952-605, § 25-8 (Fin. Accounting Standards Bd. 2010).

the franchisor. For many years, franchisors considered these funds not to be revenues of the franchisor held in a contractually defined, non-fiduciary capacity and thought to be off balance sheet funds that were accounted for separately and not consolidated with the funds of the franchisor. Under ASC 952, the portion of continuing fees designated for a particular purpose is not recognized as revenue until earned and receivable. If the franchise is an agency relationship for a designated fund, the designated portion of the fee is required to be segregated and is recorded as a liability until the specified costs are charged against the amount.

Prior to the adoption of ASC 952, a more significant change in accounting rules was adopted. FASB issued FIN 46 in January 2003, then FIN 46R in December 2003, to provide guidance on consolidation of variable interest entities, largely as a result of the Enron scandals. FASB incorporated these principles in ASC 810. 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 of the variable entity, based on factors such as the power to direct the activities of the variable entity.³⁹ While a complete discussion of the impact of these accounting rules on advertising and marketing funds is beyond the scope of this paper, franchisor financial statements are significantly affected by this issue.

E. Auditors' Opinions

Auditors must satisfy 10 standards under GAAS:⁴⁰

General Standards:

- The auditor must have adequate technical training and proficiency to perform the audit.
- The auditor must maintain independence (in fact and appearance) in mental attitude in all matters related to the audit.
- The auditor must exercise due professional care during the performance of the audit and the preparation of the report. The auditor must diligently perform the audit and report any misleading statements in the report.

Standards of Field Work:

- The auditor must adequately plan the work and must properly supervise any assistants.
- The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the

³⁹ See FRANCHISORS CONSOLIDATION, Statement of Fin. Accounting Standards No. 952-810 (Fin. Accounting Standards Bd. 2010).

⁴⁰ CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards § 150 (Am. Inst. of Certified Pub. Accountants 2003).

financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

- The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting:

- The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles.
- The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
- When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.
- The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.

SAS 122 and SAS 123 changed the format of audit opinions from the prior format for fiscal years ending after December 15, 2012. The new format includes the following segments:

- The address of the recipient, usually the reporting entity;
- An introduction that states the name of the reporting entity, explains what year is audited, what the financial statements include, and a statement that the auditor has performed the audit.
- A description of management's responsibility for the financial statements, for internal controls, and "and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error."
- A description of the auditor's responsibility for the audit and to "plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement." Although the auditors evaluate the appropriateness of significant accounting policies and the reasonableness of estimates, they express no opinion on the effectiveness of the internal controls of the

reporting entity, which requires additional work and procedures beyond the scope of the audit engagement.⁴¹

- The opinion or withholding of the opinion and any qualifications to the opinion.
- The auditor's signature and the date of the last field work of the audit.

At the inception of the audit, management of the reporting entity issues a representation letter to the auditors in which the entity makes important representations about the facts underlying the financial statements, the company's internal controls and accounting policies and procedures, and any disclosures about fraud or other irregularities discovered by the company.⁴² These letters take on enormous significance for the officers of public companies, and serve as the basis for claims of fraud if they are materially inaccurate.⁴³

1. Clean or Unqualified Opinion and Its Limitations

A clean or unqualified opinion means that the standards of reporting are satisfied and the auditor expresses the opinion that the financial statements are prepared and presented in accordance with GAAP, present fairly the financial condition and results of operations of the reporting company, comply with applicable laws and regulations, there is adequate disclosure of all material matters relevant to the financial information in the statements, and any changes in the application of accounting standards has been appropriate. Note from the material presented above that the audit does not express any opinion on the effectiveness of internal controls, and places responsibility on management for fraud or intentional errors. The audit procedures are designed to verify the representations in the management representation letter, but even the best audit cannot be assured to uncover a systemic or deliberate attempt to perpetrate a fraud.

2. Qualified Opinion

A qualified opinion may issue in one of two circumstances: (1) one area or more of presentation does not conform to GAAP, but such non-conformance does not affect the rest of the presentation of the financial condition or results of operations of the reporting entity, taken as a whole; or (2) the scope of the audit was limited such that one or more areas were not audited, but the rest of the financial statements conformed to GAAP and can be the subject of an unqualified opinion.

3. Adverse and Disclaimed Opinions

An adverse opinion issues when the financial statements do not conform to GAAP, cannot be relied upon, may be inaccurate, and may not present fairly the financial condition of the reporting company. A scope limitation alerts the reader to the areas where the non-

⁴¹ OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS, Statement on Auditing Standards No. 122, § 200.07 (Am. Inst. of Certified Pub. Accountants 2012).

⁴² See MANAGEMENT REPRESENTATIONS, Statement on Auditing Standards Nos. 85; 89; 99; & 112, § 333 (Am. Inst. of Certified Pub. Accountants 2012).

⁴³ See REPORTS ON AUDITED FINANCIAL STATEMENTS, Statement on Auditing Standards Nos. 58; 64; 79; 85; 93; & 98, § 508 (Am. Inst. of Certified Pub. Accountants 1989).

conformity with GAAP was discovered. A disclaimed opinion occurs when no opinion can be expressed because the audited party withheld information or limited access to the records needed to perform the audit, or the records were incapable of being audited because of their poor quality, accuracy, incompleteness or other infirmity.

4. Going Concern Disclosure

If the auditor does not believe that the reporting entity will be able to sustain itself over the next twelve months, a going concern disclosure is included after the opinion. The typical language expresses doubt as to the ability of the reporting entity to continue as a going concern. The usual causes are recurring losses and a capital insufficiency. Some disclosure about the need for additional capital or to revalue assets to liquidation value may be included. As these opinions are often a self-fulfilling prophecy, a reporting company may delay issuance of the audit instead of completing an audit that will result in a going concern disclosure.

5. Reviews & Compilations

Accountants may prepare compilations of financial statements using a preprinted or prepared form but the compilations are not audited, and are essentially just a presentation for a specific audience in its prescribed format. "The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements."⁴⁴ The AICPA defines the compilation as:

A compilation is a service, the objective of which is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. Although a compilation is not an assurance engagement, it is an attest engagement.⁴⁵

A compilation engagement does not involve any analytic procedures, assessment of internal controls, assessment of fraud risk, testing and confirmation procedures normally associated with an audit. An attest engagement means only that the accountant meets the test of independence from the reporting entity, nothing more.

A review is an engagement to provide limited assurance that the financial statements contain no material misstatements. "A review is a service, the objective of which is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework."⁴⁶ It is an assurance engagement that allows the accountant to issue a report that

⁴⁴ See COMPILATION REPORTS ON FINANCIAL STATEMENTS INCLUDED IN CERTAIN PRESCRIBED FORMS, Statement on Standards for Accounting and Review Services Nos. 3; 5; 7; 15; & 17, § 300 (Am. Inst. of Certified Pub. Accountants 1981).

⁴⁵ FRAMEWORK FOR PERFORMING AND REPORTING ON COMPILATION AND REVIEW ENGAGEMENTS, Statement on Standards for Accounting and Review Services No. 19, § 60.05 (Am. Inst. of Certified Pub. Accountants 2009).

⁴⁶ *Id.* at § 60.07.

may be relied upon by third parties to assure them that the reporting entity's financial statements met externally designated reporting criteria. Like a compilation, the review does not involve the testing, verification and assessment procedures of an audit that focus on internal controls, verification and fraud detection. It only provides reasonable assurance that no material modifications should be made to meet an applicable reporting framework.

6. The Management Letter

Also called the letter of recommendation, the auditor's letter to the reporting entity's management describes any deficiencies noted in the audit, particularly in the area of internal controls, accounting policies and procedures, and operating procedures that deserve management's attention and improvement before the next audit. The management letter is a key delivery of the audit and a precursor of issues that will arise and potentially affect the ability of the reporting company to complete its next audit.

7. Independence

The recent case of an auditor resigning when it determined that it no longer met the standards for independence reminds of one of the keystones of auditing. In the case of two public companies, it arose because of insider trading with information learned during the course of performing the audit.⁴⁷ Auditors must have three kinds of independence:

- programming independence to allow the auditor to select the most appropriate methods and procedures to perform the audit, without hindrance by the reporting company;
- investigative independence to allow the auditor to have unlimited, unrestricted access to all information of the reporting company, and to implement the auditing program methodology it selects without any interference by the reporting company; and
- reporting independence to allow the auditor to issue its audit report in the form and with the disclosures it believes are appropriate and relevant.

Independence also is defined in SOX legislation, as described below. Independence also encompasses the concept of perceived independence, in which the auditor must avoid the appearance of not being independent and objective.

F. State Franchise Regulators' Analysis of Franchisor Financial Statements

1. Cash Flow Financing and Working Capital

Merit review states have in their regulatory authorization statutes some direction to assure franchise investors that registered franchisors have the financial wherewithal to perform their pre-opening obligations. For example, the California Franchise Investment Law provides at Section 31113:

⁴⁷ Matt Egan, *KPMG Resigns as Herbalife, Skechers Auditor After Insider-Trading Scandal*, Fox Business, Apr. 9, 2013, <http://www.foxbusiness.com/industries/2013/04/09/kpmg-resigns-as-herbalife-auditor>.

If the commissioner finds that it is necessary and appropriate for the protection of prospective franchisees or subfranchisors because the applicant has failed to demonstrate that adequate financial arrangements have been made to fulfill the franchisor's obligations to provide real estate, improvements, equipment, inventory, training, or other items included in the offering, the commissioner may by rule or order require the escrow or impound of franchisee fees and other funds paid by the franchisee or subfranchisor until such obligations have been satisfied. At the option of the franchisor, the franchisor may furnish a surety bond as provided by rule of the commissioner.⁴⁸

California's related regulation provides little insight or guidance as how this discretion shall be applied:

In a case where the applicant has failed to demonstrate that adequate financial arrangements have been made to fulfill obligations to provide real estate, improvements, equipment, inventory, training or other items included in the offering, the Commissioner may impose as a condition to the registration of a franchise offering an impoundment of the franchise fees and other funds paid by the franchisee or subfranchisor until such obligations have been satisfied.⁴⁹

Illinois has similar language that puts the onus on the franchisor to demonstrate adequate capital and liquidity to support its preopening obligations:

If the Administrator finds that a franchisor has failed to demonstrate that adequate financial arrangements have been made to fulfill obligations to provide real estate, improvements, equipment, inventory, training, or other items to be included in the establishment and opening of the franchise business being offered, the Administrator may by rule or order require the escrow or impoundment of franchise fees and other funds paid by the franchisee until such obligations have been fulfilled, or, at the option of the franchisor, the furnishing of a surety bond as provided by rule of the Administrator, if he finds that such requirement is necessary and appropriate to protect prospective franchisees, or, at the option of the franchisor, the deferral of payment of the initial fee until the opening of the franchise business.⁵⁰

Maryland's statute speaks to the question of whether the franchisor has made adequate financial arrangements to fulfill the franchisor's obligations under an offering.⁵¹ Its related

⁴⁸ CAL. BUS. & PROF. CODE § 31113 (2012).

⁴⁹ CAL. ADMIN. CODE § 310.113.

⁵⁰ ILL. REV. STAT. § 705/15 (2012).

⁵¹ MD. CODE ANN. § 14-217 (1957).

regulation also offers no guidance as to how a franchisor's financial statements are evaluated, imposing on the Attorney General only a requirement to make an administrative finding that an escrow, surety bond or deferral is "necessary and appropriate for the protection of prospective franchisees or subfranchisors."⁵²

Other merit review states have similarly vague language that delivers maximum regulatory discretion to determine whether a franchisor's financial condition will sustain registration with or without investor protection.⁵³ Practitioners learn these standards in some respects by trial, error and experience. Recent insight from senior state examiners offers the view that examiners are most concerned about demonstrating solvency and sufficient liquidity to meet pre-opening obligations to franchisees.⁵⁴

The application to register a franchise under the 2008 UFOC Guidelines issued by the North America Securities Administrators Association ("NASAA") includes important financial disclosures and a projection of franchise sales. The first financial disclosure is Form B of the application, in which the franchisor must set out a detailed budget for "total costs for performing its pre-opening obligations to provide goods or services in connection with establishing each franchised business, including real estate, improvements, equipment, inventory, training and other items." The applicant must then disclose the source of the capital needed to support the budgeted expenses.⁵⁵

The Franchise Disclosure Document filed with the application includes two other important elements of financial information. The first is the projection of franchise sales that forms Table 5 of Item 20. This table lists the states where the franchisor projects it will sell franchises and the total number of franchises projected to be sold and opened during the fiscal year of the FDD. The document also includes the franchisor's audited financial statements required under Item 21, which are three years of statements of operation, cash flow and owner's equity, and two years of balance sheets.⁵⁶

These three elements are tied together by examiners as part of their review. The cost of services disclosed in Form B is multiplied by the number of franchises projected to be opened in column 3 of the Item 20, Table 5. The product of that multiplication is then compared to the working capital disclosed on the financial statements. If the working capital is insufficient to meet the cash needs of the franchisor determined by the calculation, the examiner is likely to request some form of credit support, or require an escrow, initial fee deferral or surety bond. The experience of the authors is that projected revenue recognition from initial franchise fees will be heavily discounted or ignored, and the cash from initial fees will not be viewed as a valid source of financing for these working capital needs.

⁵² MD. CODE REGS. § 02.02.08.08 (2013).

⁵³ See MINN. STAT. ANN. § 80C.05(3) (2000); N.D. CENT. CODE § 51-19-07(2) (2003); R.I. GEN. LAWS § 19-28-1.9; VA. CODE ANN. §§ 13.1-561(B), 562(A2); WASH. REV. CODE § 19.100.050.

⁵⁴ Dale Cantone ET AL., *Registration: Understanding the State Franchise Registration Framework* 15-16, International Franchise Association 45th Annual Legal Symposium (May 2013).

⁵⁵ See N. AM. SEC. ADM' ASS'N, 2008 Franchise Registration and Disclosure Guidelines Part V, Form B (2008).

⁵⁶ 16 C.F.R. § 436.5(u)(1) (2007).

a. Relationship to FDD Items 3 and 20

Financial statements that are part of the Item 21 disclosure must relate to certain other disclosures in Item 3 (Litigation) and the census of franchises in Item 20. The disclosure of material litigation in Item 3 may also include a list of collection suits routinely brought by the franchisor. This information should match the financial statement disclosure about loss contingencies, most likely in the footnotes for the other liabilities, and the transactional information that permeates the census data. The footnotes will likely reveal the number of open and operating franchises, the backlog of signed but unopened franchises that supports the account line item liability of deferred franchise fees, and non-recurring revenue realized from franchise terminations. If there is incongruence between these disclosure text items and the financial statements, the franchisor will need to provide an explanation.

b. The Back Door Financial Performance Representation

Franchisor statements of operations usually display an account line for royalty revenue for the fiscal year. If the franchisor does not provide franchise outlet financial performance representations in Item 19 of its FDD, the financial statements and Item 20 can be used to allow the reader to estimate the average unit volume of the franchise system. The FDD in Item 6 will disclose the current royalty rate of the franchise system. As this rate may be historically different from the rate disclosed in the current FDD, the financial statements may disclose the actual rate realized by the franchisor during the fiscal year. The reported amount of royalty revenue will be divided by the royalty rate to yield the gross system sales revenue. This amount can then be divided by the average number of franchised outlets reported as open during the fiscal year in Item 20. This result produces the average gross sales of the system outlets for the year. Such information may not be as accurate or as detailed as an Item 19 disclosure, but it does provide a well-supported estimate of average unit volume in the franchise system. The same method can be used to estimate average gross sales for company store units if the gross sales from company stores are reported in the financial statements of the franchisor.

G. Assessing Franchisee Financial Statements in Franchise Applications

1. Liquidity and Net Worth

Franchise applicants usually provide personal financial statements that are prepared on the cash basis of accounting. Perhaps they are compiled by their accountants, but they are mostly not audited or reviewed by an accountant. Methods of valuation of assets vary from historical cost to appraised value to “fair market value” as the franchisee understands the market.

Franchise applicants demonstrate liquidity by access to personal accounts with cash and marketable securities that can be sold or pledged for short term borrowing. Bank and financial institution account statements should support claims of available cash for investment in the business and to provide working capital. Personal lines of credit and home equity loans may also provide liquidity to the business as needed. However, unencumbered equity is preferable to borrowed funds as the latter may be subject to repayment or cause the loss of personal assets to support the business capital needs. Analysis of the source of the cash and the obligations to repay the cash if borrowed should be performed.

Net worth of an individual is similar to owner’s equity; subtract liabilities from assets to derive net worth. The character of the assets and their method of valuation are critical to

assessing what net assets can support the business. The personal balance sheet with emphasis on market values in excess of historical asset costs, or with emphasis on the net value of long term investments in business ownership that has no ready market, is a higher risk than a balance sheet with more emphasis on cash, marketable securities and other higher liquidity assets.

The maturities and monthly payments associated with debt owed by the individual are also a key to evaluating net worth. Short term debts and current maturities of long term debt for an individual place great pressure on the individual to focus on debt management, rather than business management.

a. Debt and Cash Flow

Personal financial statements should list monthly debt obligations, including the projected debt service from any loans to support the franchise investment. Evaluation of continuing income and projected cash needs on a monthly basis are critical to understanding whether the leverage will overwhelm the cash flow. The interest rates are also a concern, as variable debt rates must be matched against variable income rates in order to assure negative arbitrage does not occur. If variable interest rates on debt are paid with fixed levels of cash income that do not move with interest rates, the franchisee might be squeezed out of capital by a financial condition called disintermediation.

b. Incongruity & Spotting the Hidden Investor

The franchise application of most franchisors requires complete disclosure of all beneficial owners of the enterprise, at the direct and indirect ownership levels, for a privately owned business. The financial picture of a franchise application should present logically with regard to assets, income and liabilities. What if the applicant has a modest income at a relatively young age but a disproportionately large cash or securities balance? The diligence required under both common sense and concern about money laundering dictates that further inquiry is needed as to the source of the cash. If the response is vague, or no reasonable explanation exists, the enterprise may have one or more hidden investors who are “off the books” and the disclosure is incomplete. The notion of a silent partner who is a passive investor may be taken one step farther to the undisclosed or secret equity partner/investor. For many reasons, particularly the requirements of the USA Patriot Act and various executive orders relating to anti-terrorism and anti-money laundering⁵⁷, secret equity investors whose presence is felt but not seen cannot be tolerated. If the franchise typically has a significant cash component of its sales pattern, the likelihood of persons interested in money laundering is enhanced.

c. Compare to FDD Items 5 and 7

Since most franchises involving stores or physical locations are financed with debt, the question for early analysis is how the franchisee will finance the franchise start-up costs, as the FDD shows in Item 5, for initial fees, and in Item 7, the initial investment. Franchisors usually monitor or require disclosure of external financing, so an understanding of minimum equity required and the maximum debt to total capital lenders will permit should be easily developed. That knowledge is then communicated, either in entry or review criteria, or as part of the franchise application analysis process. Does the franchisee have the cash for the initial

⁵⁷ See USA Patriot Act, Pub. L. No. 107-56, 115 Stat. 272 (2001); 31 C.F.R. § 500 (2003).

franchise fee, the equity required for the initial investment, and the ability to finance the non-equity portion of the initial investment? If not, who or what is the source of the investment funding? If the applicant is confident about financing, what does the applicant know that he or she has not shared? Is there a silent or secret money partner?

III. Audited Financial Statements

A. The Requirements of Audited Financial Statements Included in the FDD

The Federal Trade Commission Franchise Rule requires that franchisors include in item 21 of the FDD copies of their financial statements audited in accordance with GAAP for the three most recent fiscal years.⁵⁸ This allows a prospective franchisee and its counsel to analyze the financial condition of the franchisor and assess forward-moving trends which could impact the financial viability of the company. As discussed above, the audited financial statements included in FDDs for publicly traded companies must be audited in accordance with the standards promulgated by the PCAOB. For foreign franchisors whose statements are audited in accordance with a foreign comprehensive body of accounting principles, the company must disclose such foreign principles and explain any material differences between the foreign principles and United States GAAP. It must also reconcile, through the financial statement notes, various income statement and balance sheet items to present them in accordance with GAAP for the periods presented. Although foreign franchisors can prepare their financial statements according to foreign accounting principles, they still must be audited according to GAAS or PCAOB standards, depending on whether the foreign franchisor offers its securities for sale to the public.

In addition to the requirements imposed by the Federal Trade Commission, many states provide further protection for potential franchisees under their state laws by requiring franchisors to provide assurances of their financial capability to the state franchise regulators in certain circumstances prior to allowing a franchisor to register to sell franchises within the state. In determining whether a franchisor requesting registration in a certain state meets that state's requirements as to financial viability, there are certain "red flags" which will typically prompt regulators to do further investigation or require additional safeguards. For example, if a franchisor's financial statements show that it has a negative net worth⁵⁹, a state will usually require the franchisor to defer or escrow franchise fees, or possibly not allow registration at all. Some states assess the most current year-end income statement to determine if the franchisor was profitable and, in the event that it was not, require that the franchisor have enough net worth to withstand another year of similar losses. Other states will examine the assets used in the determination of net worth and may possibly eliminate some assets from the calculation based on the strength of those assets. For example, if a large part of a franchisor's net worth is based on receivables or intangible assets, a state regulator may discount, write-down or even completely eliminate certain assets when determining whether the company has sufficient net worth for registration.

At a minimum, an attorney who represents a client, either a franchisee or a franchisor, must have a basic understanding of financial statements and what information may be drawn

⁵⁸ 16 C.F.R. § 436.5(u)(1) (2007).

⁵⁹ Joshua Kennon, *Analyzing a Balance Sheet*, ABOUT.COM, <http://beginnersinvest.about.com/od/analyzingabalancesheet/a/shareholder-equity.htm> (last visited July 26, 2013).

from them. In addition, the notes to audited financial statements can provide great insight into a company's industry, accounting practices and potential strengths and weaknesses of the organization. Further, a study of a company's consecutive years' financial statements can reveal important trends in the industry as well as management's ability to respond to changing economic environments and industry standards. These trends may also reveal the likelihood that a company may no longer exist as a going concern and be able to fulfill its financial obligations to its franchisees. Prudent attorneys practicing in the area of franchising should also carefully compare the representations made in the notes to the financial statements with the provisions of both the FDD and the franchise agreement for consistency.

B. Comparison of Notes to the Financial Statements to Representations in FDD

The notes to audited financial statements contain a wealth of information, the review of which is critical for both attorneys who represent franchisees as well as those that represent franchisors. A review of the notes to the financial statements included in the Franchise Disclosure Document ("FDD") may disclose inconsistencies in information provided in the financial statements and that which is provided in the FDD or the franchise agreement. These discrepancies can provide a basis for, or evidence in support of, a claim against a franchisor by a franchisee. As the notes to the financial statements are typically drafted by the franchisor's accountants, and not the franchisor's attorney responsible for drafting and updating the FDD and franchise agreement, the information contained in the FDD and franchise agreement may be outdated or materially different than the current state of affairs of the company as reflected in the notes to the financial statements. Examples of items to review for consistency between the notes to the financial statements and the franchise documents are:

- Litigation disclosed in the notes to the financial statements under contingencies with that included in Item 3 of the FDD;
- Supplemental information contained in the notes to the financial statements about corporate-owned units and/or gross sales information and similar information included in Item 19 of the FDD;
- References to the rights and obligations to, and/or relationships or transactions with, related parties which could detrimentally affect the financial viability of the franchisor and its ability to perform its obligations under the franchise agreement disclosed in the notes to the financial statements and information represented in the FDD regarding the franchisor's offered resources and services;
- Vendor rebates or other revenues referenced in the notes to the financial statements must be adequately disclosed in Item 8 of the FDD;
- References in the notes to the financial statements concerning the number of units open at year-end, corporate and otherwise, should be consistent with the information provided Item 20 of the FDD;
- References in the notes to the financial statements regarding trademarks and other intellectual property, whether owned or licensed from an affiliate, should be consistent with the information provided in Items 1, 13 and 14 of the FDD;

- The accounting treatment and obligations of the franchisor in connection with advertising and marketing fees collected from the franchisees should be adequately disclosed in the notes to the financial statements and consistent with the latest versions of the FDD and franchise agreement;
- References in the notes to the financial statements concerning the services provided by the franchisor to its franchisees should be consistent with the representations made in both the FDD and the franchise agreement;
- A qualified opinion or other reference to the franchisor's ability to continue as a going concern may prevent registration of the franchise offering in certain states and should be adequately disclosed in the FDD. This disclosure is typically required to be included as a risk factor within the state cover page, but disclosure requirements vary from state to state.

These are just a few examples of the various items that could appear in the notes to the financial statements which must be reconciled with the information contained in a franchisor's FDD and franchise agreement. An understanding of this is an absolute must for attorneys drafting franchise documents on behalf of a franchisor client. For attorneys who counsel franchisees, the notes can provide insight into possible misrepresentations made by the franchisor as well as its failure to live up to its obligations as outlined in the FDD and franchise agreement. Further, a comparison of various ratios based on consecutive years' financial statements can reveal a trend in a franchisor's declining expenditures in the various services which the franchisor is obligated to provide to its franchisees pursuant to the terms of the FDD and franchise agreement. Accordingly, although they are frequently disregarded and rarely examined in detail, the notes to the financial statements contain a large amount of relevant information which should be thoroughly examined by counsel for both the franchisor and the franchisee.

IV. Business Valuations

There are many instances where an attorney representing either franchisees or franchisors will need to have an understanding of the various methods used to value businesses. These scenarios can arise both in the litigation and transactional arenas. Generally speaking, there are three main approaches to valuing a business; the income approach, the asset approach and the market approach. The appropriate approach depends on the type of industry the business is engaged in, the premise of value and the business value standard used in the valuation. The standard of value is the hypothetical conditions under which the business will be sold, while the premises of value are the assumptions made surrounding the valuation. These assumptions include whether the business will continue forever in its current state and, therefore, the value lies in the ongoing operations of the business or whether the value of the business lies in the proceeds from the sale of its assets upon liquidation. The results of a business' valuation will vary considerably based on the selection of both the standard of value and the premise of value chosen.

The starting point for all valuations are the financial statements of the enterprise and the directional trends revealed by year to year, year to date, and actual to budget comparisons. The snapshot and trending financial health of the business uncovered by the ratio analysis described above allows the valuation to reflect reality, rather than a theory of value based on hypothetical or pro forma financial performance. The ratio analysis supports the assumptions used in the premises of value, or present an opportunity to challenge the premises of value if

ignored or minimized. The reviewer may consider the ratio analysis as a reality check on the expert, one that can be performed by counsel in advance of any *Daubert* challenge.⁶⁰

A. The Concept of Present Value

An understanding of any of the types of income-approach based methods of business valuations begins with an understanding of the concept of present value. The concept of present value, also called present discounted value, revolves around the related concept of the “time value of money.” The concept of the time value of money is based on the fact that money has interest-earning ability and that money is lent and borrowed every day for an associated cost of interest. Due to money’s interest-earning ability, the value of one dollar received today is worth more than a dollar received a year from now. The reason for this is that one can invest the dollar received today and it will earn interest for the entire upcoming year. This means in one year’s time the same dollar will be worth its original \$1.00 value plus a year’s worth of interest. Whereas a dollar received in a year will only be worth its \$1.00 value because it has not been earning interest. Conversely, money received in the future is always worth less than the same amount of money received today because it cannot be invested and earn interest until it is received. The present value of an amount of money to be received in the future has an inverse relationship to the discount rate used – the larger the discount rate, the smaller the present value today of monies to be received in the future. In sum, present value discounts money to be received in the future to the amount one would need to invest today at a certain interest rate for that amount of money to turn into the amount received in the future.

B. Determining the Appropriate Discount Rate

The key to determining the appropriate present value of an amount of money to be received in the future is applying the appropriate interest rate in the calculation. The interest rate used in this calculation is also referred to as the discount rate. There are several ways to determine the appropriate discount for a particular business transaction or damage analysis, but that is beyond the scope of this paper. The determination of the discount rate can be very complicated, but simply put, it requires an analysis of the risk-free rate and the risk premium. The risk-free rate is the rate of return that an investor in a particular industry would expect from a completely secure, risk-free investment. The risk premium is an additional return which an investor would require to be compensated for the relative risk associated with a particular investment. In all cases, the discount rate selected should be consistent with the stream of benefits to be received in the future to which it is applied.

C. Income Approaches

There are several types of income approach-based business valuation methods. The most common fall into three major categories: direct capitalization, discounted cash flow, and income or cash flow multipliers. Similar to discount rates, capitalization rates (“CAP rates”) determine the value today of what a business will produce in the future. However, for purposes of business valuations, they differ in that discount rates are applied in methods of business valuations that analyze streams of future cash flows, whereas CAP rates are applied in valuation methods which focus on data for a single period of time.

⁶⁰ *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993); See also Alex Kozinski, *Expert Testimony After Daubert*, J. OF ACCT. (July 2001), available at <http://www.journalofaccountancy.com/Issues/2001/Jul/ExpertTestimonyAfterDaubert.htm>.

1. Direct Capitalization Method

A business valuation based on direct capitalization simply divides net operating income by the CAP rate. This is the typical method for valuing income-producing real estate. This method assumes that the cash flow will persist in perpetuity and that the CAP rate will remain constant. CAP rates inherently include the investment-specific risk premium.

2. Discounted Cash Flow Method

A business valuation based on the discounted cash flow method determines the price of an investment based on the net cash flow to be received from an investment over a period of years discounted to its present value. There are various techniques used in the application of the discounted cash flow method based on the business and the industry involved, but all variations similarly value the business based on its ability to produce cash in the future. This type of business valuation analyzes the business based on all of the cash it will ever provide in the future as a going concern.

3. Valuation by Multiples

A business valuation based on multiples takes various income statement or cash flow statement line items and uses them as the basis by which the business is valued. A valuation based on multiples estimates the market value of a business based on a key statistic or line item of the financial statements which has a reasonable correlation to the driver of the market value of the business. Just a few of the commonly used valuation multiples include gross income, net income, EBITDA and net cash flow.

Other more industry and fact-specific valuation multiples, are based on what the financial investment industry calls the enterprise value of the company. The enterprise value of a company is based on a valuation multiplier which equals:

$(\text{Market Capitalization} + \text{Debt} + \text{Minority Interests} + \text{Preferred Shares}) - (\text{Cash} + \text{Equivalents})$

Enterprise value (“EV”) is the estimated market take-over price. This is true because, in the event of a buy-out of the acquired company, the acquiring entity would assume the acquired company’s debt and would receive all of its cash and cash equivalents. Accordingly, an acquiring company can only afford to meet its newly acquired debt and equity financing obligations if it acquires sufficient liquidity through cash and cash equivalents received in the transaction. EV differs significantly from simple market capitalization in several ways, and many consider it to be a more accurate representation of a company's value. For example, a selling company’s debt would need to be paid off by the buyer after it acquires the selling company, thus EV provides a much more accurate takeover valuation because it includes outstanding debt in its value calculation.

D. Asset Approach

Unlike the various income-based approaches to business valuations, asset-based approaches do not base the value of a company on on-going revenue streams. The premise behind asset-based approaches is that no rational investor would pay more for the business than it would cost to purchase similar assets on the open market. Asset-based approaches are premised on the company’s liquidation value upon dissolution or acquisition, completely irrespective of a company’s future profitability or its ability to continue as an on-going concern.

E. Market Approach

The market-based approaches of business valuations stem from the principles of free competition and supply and demand. Economists have long theorized that a free market, subject solely to its own forces of supply and demand, will inherently force the determination of the price of any commodity to its natural market price by virtue of the underlying forces of availability and demand in the open market.

Obviously, this approach is based on the availability of adequate information on comparable company sales. Therefore, practically speaking, these methods lend themselves to valuing public companies or private companies with similar characteristics to public companies which have publicly disseminated available information for comparison. Determination of whether comparable information provides a reasonable basis for comparison requires consideration of: (1) the similarity of qualitative and quantitative investment characteristics; (2) the extent to which an investor can obtain reliable data regarding the comparable transactions; and (3) whether the transaction was one at arms-length or whether it was some fashion of a distressed sale.

F. The Importance of Accurate Financial Information in Business Valuations

Regardless of the type of valuation employed, the key to any accurate business valuation is reliable and accurate financial information. This highlights the need for accurate financial statements as the starting point for any business valuation and, when available, audited financial statements are preferable. When analyzing businesses for trends and industry comparisons, the normalization of the financial statements is crucial. Most of the common normalization adjustments fall into the below categories:

- **Comparability Adjustments** - These require a potential investor to make adjustments between the target company and the comparable sales based on geographic location and industry specific presentation of the financial data.
- **Non-operating Adjustments** – These adjustments are necessary when attempting to derive the fair market value of the target company when the seller will retain all assets of the company not related to the production of earnings. Under this scenario, a purchaser will need to eliminate items such as cash and cash equivalents from the balance sheet before performing its analysis.
- **Non-recurring Adjustments** – These adjustments are required when a potential investor identifies unusual events which are unlikely to recur in the future. Adjusting for nonrecurring financial statement events help to better reflect the company’s ongoing future performance. Examples include a one-time purchase or sale of assets, lawsuits or any unusually large revenue or expense item.
- **Discretionary Adjustments** – These types of adjustments are most commonly required when an investor is analyzing the value of a private company. It may be necessary to adjust owner compensation, benefits and distributions to that of industry standards to obtain a meaningful valuation of the company.

The old adage “Garbage in – Garbage out” holds true with every form of valuation and analysis of any financial statement. Even small inconsistencies or differences in accounting treatment of various line items can result in large variations in valuation. Therefore, determining

the reliability and uniformity of the financial information being used is the first step in valuing a potential investment.

V. REMEDIES AND DAMAGE THEORIES IN LITIGATION

A. Flexible Theory of Damages

The “Flexible Theory of Damages” is routinely applied in state and federal courts throughout the country. The theory is based on the premise that a plaintiff should not be allowed double recovery for its claims. Whether suing in contract or tort, a plaintiff is allowed to recover either its out-of-pocket costs or its lost profits (also referred to as benefit of the bargain), but not both.⁶¹ This is a determination which is made by the finder of fact and should not be confused with alternative pleading. In most jurisdictions, a plaintiff is allowed to plead alternative theories of liability. Alternative pleading allows the plaintiff to present different elections of remedies based on inconsistent causes of action in the hope of recovering under any one theory. In contrast, under the flexible theory of damages, a plaintiff’s damage theory, either out-of-pocket costs or lost profits, are mutually exclusive and will depend on the facts presented to the finder of fact. Accordingly, if a plaintiff cannot prove causation for either cause of action pled via alternative pleading, the issue of damages is never reached and the Flexible Theory of Damages never comes into play.

The main difference in proving the two theories lies in the necessary foreseeability and proof required to prove each theory. Lost profits requires proof of the gains that the plaintiff would have realized had the defendant performed in full under the contract less the operational costs associated with realizing those gains. Under a lost profits damage theory, a plaintiff seeks to recover its “expectation interest.”⁶² On the other hand, a plaintiff who is unable to prove his “expectation interest” may attempt to recover its out-of-pocket costs. Under this theory, a plaintiff is entitled to recover his actual expenditures made before the breach or non-performance under the contract, which were reasonably foreseeable. A plaintiff is attempting to recover his “reliance interest” when pursuing out-of-pocket expenditures, as this is the amount of money spent by the plaintiff based on the plaintiff’s reliance that the defendant would perform as required under the contract.⁶³

Under all theories of damage recovery, the plaintiff’s financial statements play a key role in calculation of damages. Damages experts will analyze the financial statements and utilize the information in their formulation of the damages amount. Arguments between experts arise over whether the values on the financial statements, which are based on historical costs at a given point in time, truly represent the economic worth of the enterprise. The experts may argue about what is and what is not represented in the financial statements.

1. Certainty Requirement of Proving Lost Profits

Proving lost profits inherently includes some level of speculation, as the plaintiff was presumably unable to realize these profits due to some wrongdoing on the part of the defendant. It requires many assumptions about the future which may never materialize and is, therefore, not a precise science. For these reasons, a lost profit recovery requires a higher standard of proof. The standard typically used throughout the country is the reasonable certainty standard. The reasonable certainty standard requires proving to the fact finder that a

⁶¹ Jonathan S. Coleman, *Understanding and Applying Florida’s Flexible Theory of Damages*, 80 Fla. B.J. 10 (2006).

⁶² *Id.*

⁶³ *Id.*

prudent impartial person would be satisfied that the damages requested by the plaintiff are not the result of speculation and conjecture.⁶⁴ The entitlement to lost profits by a plaintiff is a fact-specific analysis which requires reasonable foreseeability and disallows damages which are found to be too remote or speculative and contingent. Accordingly, in practice, it becomes extremely difficult to recover lost profits for a new business without a proven track record. Similarly, a plaintiff will most likely have great hurdles in proving lost profits for a business engaged in a volatile industry. However, similar to a rescission claim, a claim for out-of-pocket costs associated with a failed business due to a defendant's wrong-doing is relatively concrete and focuses on merely putting the plaintiff back into the position it would have been in had it not entered into the contract.

Courts across the country are split as to whether a plaintiff can recover lost profits in a claim for fraud or fraudulent inducement. Those courts which do allow the recovery of lost profits based on a claim of fraud allow a plaintiff to recover the difference between the represented value at the time of purchase and the actual value at the time of purchase, but for the misrepresentation.⁶⁵ The difference between these two values could be viewed in some circumstances as a measure of lost profits. However, a plaintiff attempting to prove this theory still will find itself constrained by the burden of proof and the certainty requirements associated with proving lost profits.

B. Legal vs. Equitable Remedies

As stated above, most jurisdictions allow for alternative pleading up until judgment. This means that no plausible cause of action should be dismissed until liability is determined. Therefore, it is only until liability on the various causes of action is determined that a remedy should be disposed of. However, the remedy chosen follows the cause of action and certain causes of action can provide multiple remedies based on the proof available to substantiate the remedy sought. However, a plaintiff cannot receive duplicative recovery for any one cause of action. Therefore, after liability has been proven, the remedy is elected at the award stage in the litigation. Notwithstanding, some remedies can only be sought upon the want of availability of other remedies.

There are two basic categories of remedies - legal remedies and equitable remedies. A plaintiff is only entitled to the award of an equitable remedy, like specific performance or injunctive relief, when it can prove that there is no adequate remedy at law. This means that the award of the legal remedy of money damages will not be sufficient relief to compensate the plaintiff for the damage caused by the defendant's wrongdoing.⁶⁶ This is true because equitable remedies act "in personam," meaning that the equitable remedy awarded to the plaintiff requires some sort of personal response from the defendant - either take some action or cease some action. Whereas legal remedies are said to act "in rem," meaning that the remedy is directed, not directly towards the defendant, but rather towards the real or personal property of the defendant. This distinction is important to understand when counseling a client on the proper remedy to pursue against a defendant.

Some causes of action, such as fraud, if proven, can support either legal or equitable remedies. Another important consideration is whether a plaintiff should elect to sue in contract or in tort in a dispute based on a transaction. A plaintiff's lawyer must choose from remedial

⁶⁴ Jonathan S. Coleman, "Want for a Nail": Applying Florida's Reasonable Certainty Test to Lost Profit Damage Claims, 83 Fla. B.J. 10 (2012).

⁶⁵ *Id.*

⁶⁶ DOUG RENDLEMAN, REMEDIES: CASES AND MATERIALS 217 (7th ed. 2006).

alternatives carefully as the substantive and remedial rules a court may apply to an agreement are complex and subtle. For example, a seller's breached warranty will lead a buyer to suing in contract, yielding only contract remedies. However, a seller's misrepresentation, fraud or deceit allows a plaintiff to sue in tort and recover tort remedies. Further, a defendant's mistake may only allow a plaintiff rescission-restitution relief.

C. The Economic Loss Rule

Another important doctrine for lawyers to be familiar with is the economic loss rule. It is employed in most jurisdictions, but can differ dramatically in its application. Generally speaking, the economic loss rule limits a plaintiff to relief in contract and not tort when the plaintiff's damage arises from the defendant's failure to fully perform under the terms of the contract in some fashion unless the damage was caused by an independent tort where the tortfeasor had an independent duty other than to perform under the contract. However, most courts do not apply the economic loss rule to claims of fraudulent inducement under the rationale that the defendant's misrepresentation which induced the plaintiff to enter into the agreement is separate and apart, and is therefore distinguishable from the contractual obligations contained within the contract.⁶⁷ The doctrine also has a limiting effect on tort actions. When applied to lawsuits sounding in tort, the economic loss rule bars plaintiffs in products liability cases from recovery in tort under the theories of strict liability, negligence and innocent misrepresentation when the plaintiff's damages are purely economic. The three most common exceptions to this rule applied throughout courts in the United States are (1) when the plaintiff has suffered damage, either personal injury or property, resulting from an unreasonably dangerous occurrence, (2) when the plaintiff's damages are proximately caused by a defendant's intentional false misrepresentation or (3) when the plaintiff has been damaged by a negligent misrepresentation by a defendant who is in the business of providing information for the guidance of others in business transactions.⁶⁸ It is important for both the plaintiff's and defendant's counsel to have a strong understanding of how the economic loss rule may be applied in their particular jurisdiction and the limitations it may place on the various remedies sought in a particular matter.

D. Limitations on Recovery

In addition to understanding the appropriate claims a plaintiff may bring via alternative pleading, counsel should also understand what other limitations may be imposed by courts on a plaintiff's recovery.

1. The Collateral Source Rule

At common law, the collateral source rule stood for the proposition that, a defendant may not try to reduce its liability to a plaintiff based on compensation the plaintiff has received from other collateral, independent third-party sources, such as insurance proceeds or disability benefits.⁶⁹ However, the tort reform movement has resulted in many states passing legislation which disallows plaintiffs from recovering from both the defendant and collateral sources for the same injury. Some states have completely abolished the common law collateral source rule, while others have simply modified it in some fashion. Therefore, it is of great importance for an attorney to fully understand how the laws of the jurisdiction may place limits on a plaintiff's recovery based on compensation received from other sources.

⁶⁷ *Id.* at 634.

⁶⁸ *Id.* at 824-25.

⁶⁹ *Id.* at 102.

2. Avoidable Consequences

The concept of avoidable consequences is based in fairness and equity. Generally speaking, it means that a plaintiff has a duty to minimize its damage after it becomes aware of the wrongdoing on the part of the defendant. It places a responsibility on the plaintiff to take affirmative action to mitigate its damages from the point in time that it recognizes such damages. Courts routinely reduce a plaintiff's damage award by the amount attributable to that which could have been avoided by the plaintiff's reasonable efforts to mitigate. The standard applied by the majority of courts is the reasonably prudent person standard. By applying the reasonable prudent person standard, courts are able to standardize a judge or jury's assessment of a particular plaintiff's decisions and courses of action following its injury.⁷⁰ The doctrine of avoidable consequences is an important factor to consider and plays a significant role when attempting to quantify a plaintiff's recoverable damage.

3. Expert Testimony

To prove damages, a plaintiff must prove (1) the fact that it has been damaged and (2) the amount that is has been damaged. The standard for proving the amount that a plaintiff has been damaged is far less exact than the standard for proving the existence of such damage and, in most cases, will depend, in large part, on the persuasiveness of the parties' respective expert witnesses. The importance of selecting the proper expert witness in a particular case cannot be stressed enough. Expert testimony can be critical in proving both the liability of the defendant as well as the damage suffered by the plaintiff. The knowledge and skill of an expert in a particular industry or subject matter becomes paramount, as a case can be won or lost based on the testimony of an expert witness. The disposition of many cases will ultimately be determined by the believability of one side's expert witness compared to the other. Because the rules of civil procedure in the United States require litigants to disclose their experts early in the litigation process, the selection of expert witnesses should not be taken lightly and the process to identify one's experts should start early in the preparation of the case. For these reasons, the selection of the expert witnesses is critical and can have wide-reaching consequences on the ultimate outcome of the case.

VI. CONCLUSION

This paper provides the reader with a foundation in basic accounting and analysis with a focus on the elements most directly affecting franchising, followed by an application of this information to the specific task of valuation of a franchised business. Financial statements should never be a mystery to any franchise lawyer, whether representing a franchisor or a franchisee. Transactional lawyers need this information for FDD and franchise agreement drafting, as well as regulatory filings and responses. Audits are a key element of franchising, but have their limits and can be misunderstood if viewed as a guaranty of the audited party's financial performance. Litigators must evaluate the risks and merits of claims, and the issues inherent in damages assessment, proof and strategy. Raw numbers and calculations are affected by rules, doctrines and other judicial constructs to equate accounting with reality of an uncertain economic world. If our work has offered some insights on the integration of accounting principles into franchising in a manner that enhances the reader's understanding, we have succeeded.

⁷⁰ *Id.* at 92.

Biographies

JOEL R. BUCKBERG

Joel Buckberg counsels business clients, particularly in hospitality, franchising and distribution, on strategic planning, transactions, financing, mergers and acquisitions, regulatory compliance, international trade and operations. He is rated AV by Martindale Hubbell. Among his honors, he has been listed in Best Lawyers in America® in the area of Franchise Law since 2008, named to Who's Who Legal: The International Who's Who of Business Lawyers (2009, 2010, 2012), named to The International Who's Who of Franchise Lawyers (2008, 2009, 2010, 2012), named to "Legal Eagles" by Franchise Times since 2007, and named to "20 People to Watch in Franchising" by Franchise Times (November 2001). Active in the International Franchise Association (IFA), he is a frequent speaker at its annual Legal Symposium, and serves as administrator for the IFA's Franchise Compliance Training Program, a remedial educational program for violators of federal and state franchise regulations. He is a legal advisor and trainer for IFA's FranGuard compliance and business culture training program. He served as co-editor of the 2009 edition of *Annual Developments in Franchise and Distribution Law* published by the American Bar Association, and is a frequent speaker at IFA and ABA meetings. He is the editor of Baker Donelson's *Hospitalitas* electronic newsletter on franchising and hospitality. Additionally, Mr. Buckberg serves as the host for the IFA's quarterly Franchise Business Network meetings in Tennessee, Alabama, Louisiana and Mississippi. He is admitted to practice in Texas, Georgia, New Jersey and Tennessee. He holds J.D. and M.B.A. degrees from Vanderbilt University, and a B.A. from Union College. Prior to joining the firm, he was Executive Vice President and Deputy General Counsel of Cendant Corporation, and engaged in private and in-house practice in Houston and Atlanta. He is a member of the United States Coast Guard Auxiliary and serves as a trustee of the Immune Deficiency Foundation.

ROBERT M. EINHORN

Robert Einhorn is a partner at Zarco Einhorn Salkowski & Brito, P.A. For the past twenty years, Robert has focused on representing franchisees in litigation throughout the United States and internationally. He and his Firm have represented franchisees from almost every major franchise system in the hotel, restaurant, and service industries. Robert holds a Bachelor of Business Administration degree from the University of Wisconsin-Madison, where he dual-majored in Accounting and Risk & Insurance. He holds a law degree from the University of Miami and is both an attorney and Certified Public Accountant. Robert has represented franchise clients in federal and state courts across the country and is currently admitted to practice before several trial and appellate courts across the nation. He also frequently represents clients in arbitration proceedings both nationally and internationally. Robert also frequently represents the interests of area developers and sub-franchisors and has assisted in establishing several franchisee associations. Robert regularly serves as an author and speaker on franchise related topics. Robert has been involved with the ABA Forum on Franchising for numerous years and has been a frequent speaker at the ABA's Annual Franchise Forum. He has also served as an editor of the Franchise Law Journal. Robert is recognized in the *Best Lawyers of America* in the area of franchise law and listed among the Very Best U.S. Attorneys in Franchising by the *Franchise Times*. He maintains the highest peer review rating for legal ability and ethical standards designated by *Martindale-Hubbell*.

**Appendix A
Uniform Hotel System
Income Statement
Summary Statement of Operations**

	<u>Period</u>	
	Current Year	Prior Year
REVENUE	\$	\$
Rooms		
Food and Beverage		
Other Operated Departments		
Rentals and Other Income		
Total Revenue		
EXPENSES		
Rooms		
Food and Beverage		
Other Operated Departments		
Administrative and General		
Sales and Marketing		
Property Operation and Maintenance		
Utilities		
Management Fees/Franchise Fees		
Rent, Property Taxes, and Insurance		
Interest Expense		
Depreciation and Amortization		
Loss or (Gain) on the Disposition of Assets		
Total Expenses		
INCOME BEFORE INCOME TAXES		
INCOME TAXES		
Current		
Deferred		
Total Income Taxes		
NET INCOME	\$	\$

Summary Operating Statement¹

	CURRENT PERIOD						YEAR-TO-DATE					
	ACTUAL		FORECAST		PRIOR YEAR		ACTUAL		FORECAST		PRIOR YEAR	
	\$	%	\$	%	\$	%	\$	%	\$	%	\$	%
REVENUE²												
Rooms												
Food and Beverage												
Other Operated												
Departments												
Rentals and Other												
Income												
Total Revenue												
DEPARTMENTAL EXPENSES³												
Rooms												
Food and Beverage												
Other Operated												
Departments												
Total Departmental Expenses												
TOTAL DEPARTMENTAL INCOME												
UNDISTRIBUTED OPERATING EXPENSES												
Administrative and General												
Sales and Marketing												
Property Operation & Maintenance.												
Utilities												
Total Undistributed Expenses												
GROSS OPERATING PROFIT												
MANAGEMENT FEES												
INCOME BEFORE FIXED CHARGES												

	CURRENT PERIOD						YEAR-TO-DATE					
	ACTUAL		FORECAST		PRIOR YEAR		ACTUAL		FORECAST		PRIOR YEAR	
	\$	%	\$	%	\$	%	\$	%	\$	%	\$	%
FIXED CHARGES												
Rent												
Property and Other Taxes												
Insurance												
Total Fixed Charges												
NET OPERATING INCOME												
LESS: REPLACEMENT RESERVES												
ADJUSTED NET OPERATING INCOME												

¹ For a complete Statement of Income, refer to page 11.

² Departmental Revenue is shown as a percentage of Total Revenue.

³ Departmental Expenses is the sum of Cost of Sales (when applicable) and Total Expenses. Departmental Expenses are shown as a percentage of their respective department revenue.

**Appendix B
Uniform Restaurant System
Chart of Accounts**

Name of Restaurant Company Statement of Income for the Period Ended (insert Date)			
	Page #	Amounts	Percentages*
Sales:			
Food			
Beverage			
Merchandise & Other			
Total Sales			100%
Cost of Sales:			
Food			
Beverage			
Merchandise & Other			
Total Sales			
Labor			
Management			
Staff			
Employee Benefits			
Total Labor			
Prime Cost			
Other Controllable Expenses:			
Direct Operating Expenses			
Music and Entertainment			
Marketing			
Utilities			
General & Administrative Expenses			
Repairs & Maintenance			
Total Other Controllable Expenses			
Controllable Income			
Non-Controllable Expenses			
Occupancy Costs			
Equipment Leases			
Depreciation & Amortization			
Total Non-Controllable Expenses Net			
Restaurant Operating Income			
Corporate Overhead			
Interest Expense			
Other (Income) Expense			
Income before Income Taxes			

ACCOUNT NUMBER	ACCOUNT NAME
ASSETS (1000)	
1100	Cash
1200	Accounts Receivable
1300	Inventory
1400	Prepaid Expenses
1500	Property and Equipment
1600	Other Assets
LIABILITIES (2000)	
2100	Payables
2200	Payroll Taxes Payable
2300	Sales Taxes Payable
2400	Accrued Expenses
2500	Other Liabilities
2600	Current Portion of Long-Term Debt
2700	Notes Payable
EQUITY (3000)	
Corporation	Capital Stock
	Shareholders' Equity
	Retained Earnings (Loss)
Limited Liability Company	Members Capital Accounts
Partnership:	Partners' Capital Accounts
SALES (4000)	
4100	Food Sales
4300	Liquor Sales
4400	Beer Sales
4500	Wine Sales
4600	Merchandise Sales
4700	Other Operating Income
COST OF SALES (5000)	
5100	Food Cost
5200	Soft Beverage Cost
5300	Liquor Cost
5400	Beer Cost
5500	Wine Cost
5600	Merchandise Cost
5700	Paper Cost
LABOR (6000)	
6100	Management Salaries and Wages
6200	Staff Salaries and Wages
6300	Employee Benefits
OPERATING EXPENSES (7000)	
7100	Direct Operating Expenses
7200	Music and Entertainment
7300	Marketing
7400	Utilities

7500	General and Administrative Expenses
7600	Repairs and Maintenance
NON CONTROLLABLE EXPENSES (8000)	
8100	Occupancy Costs
8200	Equipment Rental
8300	Depreciation and Amortization
CORPORATE OVERHEAD, INTEREST AND OTHER (9000)	
9000	Corporate Overhead (multi-restaurant companies)
9100	Management Fee/Franchise Fees
9200	Interest Expense
9300	Other (Income) Expense
INCOME TAXES (9500)	
9500	Federal and State Income Taxes

Appendix C
Uniform Restaurant System⁷¹
Rules of Thumb

Cost Line	Full Service		Limited Service		Reference Account
	Low %	High%	Low%	High%	
Food Cost	28	38	28	34	Food Sales
Hourly Employee Gross Payroll	18	20	15	18	Total Sales
Total Payroll	30	35	25	20	Total Sales
Management Salaries	10	10	10	10	Total Sales
Paper Costs	1	2	3	4	Total Sales
Liquor	18	20	-	-	Liquor Sales
Wine	35	45	-	-	Wine Sales
Bottle Beer	24	28			Bottle Beer Sales
Draft Beer	15	18			Draft Beer Sales
Soft Drinks	10	15	10	15	Soft Drink Sales
Coffee	15	20	15	20	Coffee Sales
Specialty Coffee	12	18	12	18	Specialty Coffee Sales
Iced Tea	5	10	5	10	Iced Tea Sales
Prime cost		65		60	Total Sales
Employee Benefits	5 20	6 23	5 20	6 23	Total Sales Gross Payroll
Rent		6		6	Total Sales
Occupancy (note 2)		10		10	Total Sales

- a. Total Sales to Investment Ratio: For leaseholds, at least 1.5 to 1, or owned real estate, at least 1:1
- b. Occupancy Costs include rent, real estate taxes, personal property taxes, other municipal taxes and assessments, insurance on the building and contents and common area maintenance. Utility costs are not included.

⁷¹ NAT'L REST. ASS'N, UNIFORM SYSTEM OF ACCOUNTS FOR RESTAURANTS 5 (Jim Laube & Barry K. Shuster eds., 8th ed. 2012).