

When are Parent Company Financial Disclosures Required?

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By Thomas Pitegoff

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A franchisor selling franchises in the U.S. must disclose its audited financial statements in Item 21 of the franchise disclosure document (FDD). Sometimes, parent company financials are used instead of the franchisor's financials. This is easily done when the parent company is a public company that already has audited financials. But most franchisors are not public companies. They are not likely to have parent company audited financials and would prefer not to incur the added expense of auditing a group of companies rather than just the franchisor entity. Audits are expensive. The franchisor may also want to shield its parent company from liability to franchisees.

The FTC Rule requires parent company financial disclosures in certain cases. Specifically, the FTC Rule requires disclosure of the financial statements of "any parent that commits to perform post-sale obligations for the franchisor or guarantees the franchisor's obligations."

So if the franchisor wants to avoid disclosing parent company financials and to protect the parent company from the liabilities of the franchise company subsidiary, the simplest approach is to be sure that the parent company does not perform any post-sale obligations of the franchisor to the franchisee. In other words, a franchisor should ensure that either the franchisor itself or an affiliated company, and not the parent company, performs any post-sale obligations of the franchisor. These obligations might be, for example, a requirement to supply specified equipment, goods, inventory or services to franchisees. An affiliate other than a parent company is permitted to provide goods or services to franchisees without triggering an added obligation to disclose financials.

FAQ 4 of the [FTC's frequently asked questions](#) states that if the franchisor "is obligated to provide goods and services and the parent assumes that responsibility, or the franchisor arranges for the parent to provide goods and services directly to franchisees on its behalf, then the parent's financials must be disclosed."

FAQ 30 qualifies this requirement. It states that "if a franchisor's parent is the sole supplier of a good or service without which a franchise cannot be operated," the parent company's financials must be disclosed in Item 21. "To the extent that a prospective franchisee is asked to rely on a parent to perform post-sale contractual obligations or relies on a parent's guarantee, the financial stability of the parent becomes a material fact that should be disclosed." [Statement of Basis and Purpose, 72 Fed. Reg. 15444, 15511 \(Mar. 30, 2007\)](#)

In other words, parent company financials are not required when the franchisee may optionally purchase the goods or services either from the parent company or other sources. But parent company financials are also not required when an affiliate is the supplier and the affiliate does not guaranty the obligations of the franchisor. For this reason, many franchisors will have a

holding company that owns both a supply company and a franchisor entity (as well as an operating company that owns the “company” outlets). These are affiliated companies or sister companies.

The requirement of audited financials is one reason that many new franchisors form a new entity to be the franchisor, rather than the company that has been operating the business through company-owned locations. The first FDD can include an audit of the newly-formed franchisor’s opening balance sheet. Or the balance sheet may be unaudited in most states (but not New York) in the first year.

If the franchisor prefers not to disclose its own financials, the franchisor has the option of including financial statements of any affiliate if the affiliate “absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement.” (See Item 21 of the FTC Rule.) In most cases, though, the franchisor does not want to disclose the financials of its affiliate or of its parent company.

Avoiding disclosure of affiliate company financial statements does not mean that no financial disclosures of affiliates are required.

Item 8 (restrictions on sources of products and services) requires disclosure of required purchases from the franchisor or its affiliates. This includes disclosure of the total revenue, revenues from all required purchases, and the percentage of total revenues that the franchisee or its affiliates receive from required purchases. This can result in a required disclosure along these lines:

“In 2016 [the most recent fiscal year], our affiliate ABC LLC received \$_____ based on sales to our franchisees, which represented ____% of the total 2016 revenues of ABC LLC or \$_____ based on the company’s internal books and records.”

This is a meaningful disclosure. But it is far less of a disclosure than audited financial statements of the affiliate.

Aside from the financials, other affiliate disclosures are required in Items 1 (the franchisor and any parents, predecessors and affiliates), 3 (litigation) and 4 (bankruptcy). Items 5 (initial fees), 6 (other fees) and 7 (estimated initial investment) require disclosure of payments that must be made to affiliates. Item 20 (outlets and franchisee information) requires disclosures of the numbers of “company” outlets, which may actually be those of an affiliate.

Tom Pitegoff,
Tom.Pitegoff@offitkurman.com