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Making Sense of the Franchise Disclosure Document

Peter Birkeland (Franchising Dreams)
John Francis (Next Level Franchise)

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Before buying a franchise, learn how to use the FDD to spot risks, costs, churn, and signs of system health.

Third in a series about franchising

If you're looking into franchising, you've likely seen the Franchise Disclosure Document (FDD)[1]. Now you're staring at 300+ pages trying to make sense of it. Where do you begin?

This article will help you move from reading the FDD as a legal document, or only looking at a few items, to using it as a practical guide for evaluating franchise system health and risks.

The FDD is actually an improvement over the previous disclosure document, the Uniform Franchise Offering Circular, or UFOC. The UFOC was biased in favor of the franchisor. It was written in dense legal language, structured in ways that made it easy to hide a franchisor's litigation history with its own franchisees, and it did not require earnings claims to be disclosed at all.

The FDD corrects some of those shortcomings. It is a 23-item list of disclosures that franchisors must make to potential franchisees 14 calendar days before signing a franchise agreement or paying any money.[2] Although the FDD is an improvement, it's not a guarantee that you're making a good investment.

We're not lawyers and won't go into the legal details of the FDD, but we can share our experience with the FDD -- what it's for, how to use it, how to understand it, and which of the 23 items need close attention. While it might seem like the FDD is a random laundry list of items, it covers essentially four areas: litigation and litigation history; financial disclosures; disclosures on territories, suppliers, and renewals; and system health (unit growth, decline, and churn).

Items in the Franchise Disclosure Document

Below we have listed all 23 items -- and while they all provide some useful information, a few items warrant special attention.

Item 1 — The Franchisor and Any Parents, Predecessors, and Affiliates. Background on the franchisor's business history, corporate structure, and any parent or affiliated companies.

Item 2 — Business Experience. Names and business backgrounds of the franchisor's key executives and directors, including how long they've been with the company.

Item 3 — Litigation. Any past or pending lawsuits involving the franchisor, its officers, or suits the franchisor has filed against franchisees in the past fiscal year.

Item 4 — Bankruptcy. Whether the franchisor, its affiliates, or any of its executives have filed for bankruptcy in the past 10 years.

Item 5 — Initial Fees. All fees paid to the franchisor before the franchise opens, including the initial franchise fee and any other upfront costs.

Item 6 — Other Fees. Ongoing fees such as royalties, advertising contributions, technology fees, and transfer or renewal fees.

Item 7 — Estimated Initial Investment. A table showing the full estimated cost of opening the franchise, from real estate and equipment to working capital and training expenses.

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Item 8 — Restrictions on Sources of Products and Services. What the franchisee must buy, from whom, and whether the franchisor receives any financial benefit from those supplier relationships.

Item 9 — Franchisee's Obligations. A reference table listing all the franchisee's key obligations under the franchise agreement, cross-referenced to the relevant contract sections.

Item 10 — Financing. Whether the franchisor offers any direct financing or has arrangements with third-party lenders, and the terms of those arrangements.

Item 11 — Franchisor's Assistance, Advertising, Computer Systems, and Training. Any support the franchisor provides before and after opening, including training programs, advertising funds, technology requirements, and ongoing operational assistance.

Item 12 — Territory. Whether the franchisee gets an exclusive territory, what protections it includes, and whether the franchisor or other franchisees can compete within it, including through online sales.

Item 13 — Trademarks. The trademarks, service marks, and trade names the franchisee is licensed to use, and whether they are federally registered and legally protected.

Item 14 — Patents, Copyrights, and Proprietary Information. Any patents or copyrights that are part of the franchise system, and restrictions on how the franchisee can use them.

Item 15 — Obligation to Participate in the Actual Operation of the Franchise Business. Whether the franchisee is required to be personally involved in running the business day-to-day.

Item 16 — Restrictions on What the Franchisee May Sell. Limits on the products or services the franchisee can offer, and whether the franchisor can change those restrictions.

Item 17 — Renewal, Termination, Transfer, and Dispute Resolution. The terms under which the franchise can be renewed, sold, or terminated, and how disputes between the franchisor and franchisee must be resolved.

Item 18 — Public Figures. Whether any celebrity or public figure is associated with the franchise, and how they are compensated.

Item 19 — Financial Performance Representations. Any earnings or revenue claims the franchisor chooses to make. This item is optional — if it is blank, the franchisor has made no performance claims and cannot make them verbally either. That’s telling you something, too. Be wary and ask lots of questions to understand the business economics beyond whatever is included in Item 19.

Item 20 — Outlets and Franchisee Information. Detailed tables showing system growth, closures, transfers, and terminations over the past three years, plus contact information for current and former franchisees.

Item 21 — Financial Statements. The franchisor's audited financial statements for the past three years, showing the financial health of the company behind the franchise.

Item 22 — Contracts. Copies of all agreements the franchisee will be asked to sign, including the franchise agreement, leases, and any other binding documents.

Item 23 — Receipts. Two copies of a receipt the prospective franchisee signs to confirm they received the FDD. Signing this page starts the legally required 14-day review period. Keep one signed copy for your records.

A first step for anyone considering franchising is to read through the FDD. Don’t just glance at it or look at only a few parts: Read through the whole thing. That will give you an overall sense of the franchise system, its history, financials, and health. But to really capitalize on the information in the FDD we suggest digging deep on a few key areas.

The Important Items

Items 1-4 all answer the questions you ought to have about any franchisor: Who are these people? How long have they been in business? Are they publicly traded, owned by private equity, or a corporation? Who are the executives and what is their experience? Are there lawsuits against the franchisor or officers? Has the franchisor, its affiliates, or any executive filed for bankruptcy in the past 10 years?

These questions are just table stakes and should help

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you rule out poorly managed or questionable franchise systems. Any Google search will be able to help you dig further into any issues you find.

The items most important to people considering franchise opportunities involve the startup investment, the fees, the performance of the system, and the list of current (and former) operators. You might think that you'll get performance data in Item 19, but it's optional and many franchisors choose ***not*** to report it. So, you'll have to find performance data another way, most likely by talking with other franchisees. We wouldn't expect anyone to pull out their latest P&L and share it with you, but they will provide some ballpark estimates. And that ought to be enough to get a basic understanding of performance.

With the list of current and former franchisee operators you can figure out the churn factor: How many people come in, how many people go out, and why this is happening. The churn of franchisees is important to understand before you buy a franchise, because churn can be interpreted as a forward-looking view of the system from the franchisee's perspective. Is the franchisor just good at selling franchises? Is human failure an issue? Or, are current franchisees snapping up new units? You are looking for trends and patterns: Anything consistent can give you a better understanding of the momentum in the past. With this background in hand, you should then complete your due diligence by speaking with current franchisees and others in the brand to get a fuller and more accurate perspective.

When a brand is new it's difficult to determine the churn factor, but things change as a brand matures. People start to fail. Well, why are they failing -- because they didn't work hard or because they're bad at managing? Or is it because the system hasn't evolved or hasn't remained competitive?

You'll find real answers by moving beyond the data. You'll need to ask questions and learn more to truly evaluate the situation and determine whether a particular franchise is a good fit. How willing are franchisees to talk? What are their attitudes? Do they seem confident or frustrated? Asking why will help determine more than the FDD information can provide.

Your goal is to identify the brands that are very successful at selling franchises but not so great at creating successful franchisees, and differentiate them from the brands that are creating successful franchisees.

Having a list of current and former franchisees will help you ask questions about the health of the franchise system. Are people leaving because the system isn't working, or because of personal reasons or a failing unit?

While the FDD only requires franchisors to list franchise outlet data yearly, we suggest you look at FDDs for the prior five or more years to better understand franchise system growth, stagnation, or decline.

In a mature brand you can expect some ups and downs with franchise system size. Not all consolidation is bad, and it might indicate a superior strategy. At Sport Clips, for example, the stronger operators bought out the weaker operators, and they scaled their units. Instead of every franchisee having one or two units, they had five people who owned 5, 10, or more units. It was better for everybody. The success factor improved; the hiring and service improved; and even hair stylists and customers benefited.

How to Use the FDD to Your Advantage

The FDD should be the starting point to learning more about a franchise system. It's not perfect, but it provides enough information to help a prospective franchisee narrow down the vast world of franchising to maybe a half-dozen options. Most people don't look at it all that carefully; they look to see how much a franchise is going to cost, and look to see how much they can make.

Since FDDs are reported annually, we strongly recommend that prospective franchisees look at several years of FDDs to identify long-term trends and changes. Has there been litigation? Are there trends in growth, or renewals? Have results been inconsistent? Have key people left the franchisor? The more time you spend with the FDD, the better you can understand the trajectory of the company beyond just the last year.

A second way to use the FDD is to compare it to other franchise systems in the same category or same industry. This provides you with an apples-to-apples comparison, since companies in the same industry are facing the same issues. Check to see if there are anomalies, outliers in costs, or structure.

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For example, most franchisors will list a range of startup costs along with other fees, advertising and marketing, and royalties. That's a good place to start determining your potential return on investment and timeline. Our advice is to be conservative in using FDD data, so choose the *highest cost* for your financial models.

Competing brands often have similar structures with fees and territories, but sometimes they can be different enough to be a better opportunity for you and your market. Learning what others offer can help you ask better questions for whichever brand you find most interesting.

The third way to use the FDD is to research the brand's management. Successful brands have real talent on the team -- people with integrity and experience. Look beyond the list of executives on the FDD, and do additional research that really drills deeply into what they've done and the general culture of the franchise. A few simple LinkedIn or Google searches is a good starting point. Culture in a brand and system is real, intended or not. Meaningful talks with other franchisees will help you determine if it's healthy and successful, and whether it's right for you.

You should also talk with founders or C-level people about their visions and goals. Are they building the franchise to sell it to private equity soon, or do they hope to preserve it for future generations in the family? They may not know, and they may not be honest, but you should certainly ask. Study their past moves as well. Do they have a pattern of private equity turnarounds? That's not always a bad thing, just as keeping a business as a legacy is not a bad thing.

Conversations with top executives and other franchisees are the most important part of your due diligence before you commit to a franchise. The conversation starts with the Franchise Disclosure Document. Take your time with this important document -- and do your homework very carefully and thoroughly to make a well-informed decision.

References

[1] The FTC's own plain-language guide to reading the FDD, published on its website, walks readers through Items 1 through 22 but item 23, the receipts page, is not discussed. This is worth noting because Item 23 is not a formality. It is the page a prospective franchisee signs to confirm they received the FDD, and that signature is what starts the legally required 14-day review period. Signing it without understanding its purpose — or failing to keep a copy — leaves the franchisee without proof of their most basic protection under the Franchise Rule.

https://www.ftc.gov/business-guidance/blog/2023/05/franchise-fundamentals-taking-deep-dive-franchise-disclosure-document

[2] See https://nasaaefd.org/ to find free Franchise Disclosure Documents. Not all companies are listed, but it's a good place to start.

See
https://www.franchimp.com
(https://www.franchimp.com/) for summary information of most Franchisor Disclosure Documents. For a fee you can download the current or previous FDD.

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