A Practical Guide for Franchisors

Implementing the New Revenue Recognition Standards for Initial Franchise Fees

What is the new Revenue Recognition Standard?

Businesses issuing financial statements in accordance with Generally Accepted Accounting Standards (GAAP) are now subject to new revenue recognition standards. These standards are part of a series of changes being implemented to bring U.S. GAAP into conformity with International Financial Reporting Standards (IFRS).

Businesses affected by these changes must now look at the obligations of contracts and agreements with customers to determine if changes in the method for recognizing revenue are required under the standards.

Specifically, franchisors must evaluate the contractual obligations to deliver goods and services associated with the initial franchise fee. The Financial Accounting Standards Board (FASB) evaluated the potential impact on the franchise industry and released the FASB staff paper to provide implementation examples when applying the standards to our specific industry.

We'll cover the process for evaluating initial franchise fees in this article. Call or email us, if you would like to download our **Initial Franchise Fee Revenue Calculator** worksheet to assist you in this process. If you are familiar with the background and issues, you may want to skip to the next section of this article.

Ongoing fees such as royalties are generally not affected by the standards covered in this article and franchisors will most likely continue to record royalty revenues as they have previously.

Previously, franchisors have recognized the initial franchise fee as revenue prior to or near the time of the opening of the franchise location. With the new standards becoming effective in 2019, members of the International Franchise Association worked with the FASB to obtain clarification specific to our industry.

Without clarification, the level of initial franchise fees required to be deferred on franchisor balance sheets and recognized over the term of the franchise agreement would have resulted in detrimental regulatory and credit issues. Specifically, by locking franchisors into recognizing revenue over the term of the franchise agreement, the resulting deferred revenue carried on the balance sheet would have negatively impacted the current and debt-to-equity ratios of franchisors that are evaluated by state regulators and by creditors. It would have also had an immediately negative impact on the earnings of franchisors and the comparability of financial performance to previously reported results.

Imagine waking up one day and being told that regulators and creditors are scrutinizing your financial statements and contemplating whether to allow your business to continue to operate when nothing has changed in your business model. Furthermore, your customers have already paid you cash for the revenue that you are being required to defer. Undoubtedly, this would have caused significant disruption in regulation, as well as the credit and equity markets.

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Understanding the Agreement and Performance Obligations

Step 1: Franchisors must look at the franchise agreement to determine separate performance obligations. In the FASB staff paper, these performance obligations are categorized as the distinct[1] and non-distinct pre-opening goods and/or services elements of the initial franchise fee. Think about it as if those items that are distinct include elements the franchisee can benefit from without respect to the franchise brand. The remaining elements are categorized as non-distinct and attributed to the intellectual property element of the initial franchise fee.

An example of a distinct service might include a 4 hour basic accounting and finance course that could benefit the owner in any business, not just the specific franchise business. Some performance obligations may include distinct and non-distinct elements. Let's add 2 more hours to the accounting and finance course to cover brand specific processes and now we have a service that has both distinct and non-distinct elements.

In the FASB staff paper example, distinct elements of the franchise agreement included training and site selection services. Other distinct services could include footprint designs as they could be applied to other non-franchise businesses.

Valuing Distinct and Non-Distinct Performance Obligations

Step 2: The franchisor must allocate a portion of the initial franchise fee to the distinct elements of franchise agreement. The FASB staff paper refers to three methods for assigning values to the distinct elements: Adjusted Market Assessment Approach, Expected Cost plus Margin Approach and the Residual Approach[2].

Franchisors will most likely use a combination of these approaches. When the goods or services are obtained or obtainable through a third party, using the third party pricing is considered a reasonable approach. Franchisors can also value the element based on the expected cost plus margin approach. In some cases the franchisor may already offer the good or service separate from the franchise fee. For example, a franchisor's FDD indicates that the initial franchise fee includes training for 3 persons and that addition personnel may be trained at a specified cost per person.

Applying the New Revenue Recognition Standards

Let's use Leathershoe Café, a fictional franchise restaurant concept, as an example. The initial franchise fee for a Leathershoe Café is set in the franchise agreement at $50,000. Review of the franchise agreement indicates that Leathershoe Café promises to train 3 employees, assist the franchisee with site selection and provide a footprint layout of the Café to be used in the construction buildout. The initial franchise term agreement is for a period of 10 years.

Leathershoe's FDD allows the franchisee to bring additional trainees at a discounted rate of $3,333 per person. Review of the training materials indicates that 70% of the training course is considered distinct with the remaining 30% focused on brand specific processes and procedures. The site selection process is generally handled by Leathershoe's real estate department, but they also have a contract with a national firm that provides this service at a rate of $10,000 per site. The footprint layout is also provided by

Leathershoe's real estate department, however in a few cases they have outsourced this to a firm at the rate of $12,000.

Based on the information above, Leathershoe can expect to recognize $29,000 in revenue when the training, site selection and footprint design services are provided. This will leave $21,000 considered as non-distinct or the value of the intellectual property associated with the franchise and recognized over the term of the agreement. Leathershoe will recognize the $21,000 over the remainder of the franchise agreement at a rate of $175 per month or $2,100 per year.

Figure 1 - Leathershoe Café Allocation of Initial Franchise Fee

Goods, Services & Non-Distinct Elements	Distinct	Non-Distinct	Total
Training	$ 7,000	$ 3,000	$ 10,000
Real Estate Location Services	10,000	-	10,000
Location Design & Footprint	12,000	-	12,000
Trademarks and IP	N/A	18,000	18,000
Total	**$ 29,000**	**$ 21,000**	**$ 50,000**

Other Implications and Considerations

Classification and Ratios

Since a portion of the deferred franchise fees are classified as current liabilities, it is important that users of franchisor financial statements understand the effect of deferred revenue on the current ratio. This is particularly important when working with state regulators. For this reason, we are advising franchisors to provide regulators with an explanation of the effect of the new standards on their financial statements and ratios when submitting their FDD registrations and renewals. Franchisors may find it beneficial to provide regulators with the calculation of an adjusted current ratio removing the current portion of deferred revenue from the calculation.

Figure 2 - Example of Current Ratio and Adjusted Current Ratio

Current Ratio:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} \quad \frac{\$750{,}000}{\$500{,}000} \quad = 1.5 \text{ Current Ratio}$$

Adjusted Current Ratio:

$$\frac{\text{Current Assets}}{\text{Current Liabilities – Current Portion of Deferred Revenue}} \quad \frac{\$750{,}000}{\$300{,}000\ (\$500{,}000 – 200{,}000)} \quad =2.5 \text{ Current Ratio}$$

Retroactive Restatement

GAAP financial statements will require that Franchisors apply the revenue recognition standards to the last three years of financial statements. In effect, Franchisors will need to calculate the effect going back over the number of years of their initial franchise term in order to determine the cumulative effect of the change in this accounting method.

When the Value of Distinct Goods and Services Exceeds the Initial Franchise Fee

In Franchising, part of the value proposition to the franchisee is the use of the Franchisor's name and trademarks. These intangibles are in fact why many franchisees make the decision to invest in the franchise model versus starting an independent business. Hopefully very few Franchisors find themselves in a position where the distinct elements of the initial franchise fee exceed the total initial franchise fee. However, in the rare situations where this occurs, the FASB staff paper calls for the Franchisor recognizing 100% when the performance obligations of the distinct elements are satisfied and thus, there is no deferral of revenue from the initial franchise fee.

Closure of a Franchisee during Initial Term of Agreement

Another situation that we hope no Franchisor finds themselves addressing is the closure of a franchise unit within the initial term of the franchise agreement. First, we advise all Franchisors to monitor franchise performance and work with Franchisees to avoid such situations. Also, due to the potentially negative impact of disclosing franchise units closed in the FDD, Franchisors should consider buying struggling units from the franchisee or assisting with finding a buyer for the struggling unit. None-the-less, when a Franchisee closes during the initial franchise term, the Franchisor should evaluate the performance obligations remaining to the closed unit. If it is determined that no additional performance obligations exists, then the Franchisor may choose to record the remainder of the deferred revenue.

Taxation of Initial Franchise Fees

With change in the accounting treatment of the initial franchise fee, one would logically ask "Does the change in GAAP accounting affect the tax treatment of the initial franchise fee?" Our research and communication with numerous other accounting and tax professionals indicates that receipt of the initial franchise fee is still taxable in the year received, thus creating a book/tax timing difference. Franchisors should plan accordingly and not be surprised when filing their 2019 tax returns.

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If you want to learn more or have questions specific to franchises, technology or accounting, please contact me.

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[1] FASB defined distinct as a good or service that is promised to a customer when both of the following criteria are met:

a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).
b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

[2] The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. Typically, the best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. However, if a standalone selling price is not directly observable, an entity estimates the standalone selling price. The guidance does not prescribe any particular method for estimation but provides the following examples of estimation methods:

a. Adjusted market assessment approach—An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
b. Expected cost plus a margin approach—An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
c. Residual approach—An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract.