LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com
THURSDAY, JUNE 29, 2017
PERSPECTIVE

New accounting rule may lower perceived value of franchisors

By Barry Kurtz and Christopher L. Passmore

Franchisors will need to adjust their methods when accounting for franchise fees either this year or next, depending on whether the system is publicly owned or not. The Financial Accounting Standards Board (FASB) updated a rule that changes when most franchisors recognize revenue in their financial statements from initial franchise fees.

The impact of this rule, FASB Accounting Standards Update 2014-09, Revenue from Contracts with Customers (ASC 606), will negatively affect many balance sheets and may have unintended consequences.

To provide context, initial franchisee fees used to be recognized as revenue for a franchisor upon receipt, generally on completion of a franchise sale.

Then in March 1981, the FASB Statement of Financial Accounting Standards No. 45, Accounting for Franchise Fee Revenue, changed standards for continuing franchise fees, product sales, agency sales, repossessed franchises, costs, comingled revenue and even relationships between franchisors and franchisees. In essence, Rule 45 prohibited franchisors from recognizing franchise fees until all initial services required under the franchise agreement were performed by the franchisor. Generally, a franchisee opening for business was the best indicator that the franchisor fulfilled these obligations.

Under Rule 45, the franchisor could count on additional cash on a balance sheet when that initial franchise fee was received. On the other hand, a corresponding liability for the deferred initial franchise fee remained — at least until the new franchisee began operations.

Negative Effects and Unintended Consequences

Fee recognition standards changed again with the FASB's issuance of new rules last May. Public companies will be required to apply the new revenue standards to annual reporting periods beginning after Dec. 15, 2017. Nonpublic companies have additional time to prepare and are required to apply the new standards to annual reporting periods beginning after Dec. 15, 2018.

As a result, franchisors will face several consequences, which may even cause a never-ending cycle of negative impact. Consider these scenarios:

Under the new accounting standards, the granting of a franchise right represents a distinct performance obligation that is satisfied over time, and initial franchise fees will be stretched out over the life of the franchise agreement. Franchisors will now have to determine how much of the initial franchise fee should be allocated to this franchise right.

This exercise will require franchisors to assess whether their other upfront services are distinct and separate performance obligations under their franchise agreements. In order to be a separate performance obligation, the provided service must represent distinct obligations within the franchise agreement and have a standalone value. Franchisors will have to evaluate their franchise agreements to determine whether the services provided to franchisees are distinguishable from the general franchise right.

Examples to consider are values that could be allocated to franchisors' advisory and consulting services on site criteria, selection and evaluation, facility specifications and design, pre-opening and continuing management training programs, operations manuals, product sourcing, marketing guidance and the like. Notwithstanding these possibilities, it is generally expected that most of the initial franchisee fee will be allocated to the franchise right performance obligation and recognized on a straight-line basis over the franchise term.

It is important to note that the recognition of revenue related to royalty income is expected to remain unchanged as a result of the new rules.

This could make income look a little thin. If an initial franchise fee is $50,000 and the term of the agreement is 20 years, revenue will be recognized as $2,500 per year for those 20 years. Additionally, the new rule will apply to multi-unit development as well. Franchisors face the stigma of lowered valuations, again because they will not be able to recognize all initial franchise fees as revenue when the first location opens, but rather, as each location opens, further diluting value.

In addition to the deferral of revenue, franchisors will have to retrospectively calculate the impact of the new revenue recognition standards for prior year franchise agreements in effect at the date of adoption. Franchisors have the choice to restate the financial statements of all prior periods presented or record a cumulative "true-up" in the year of adoption with comprehensive supporting footnote disclosure.

Income will be reduced and liabilities will increase.

Deferred liability reduces net worth and may trigger registration state restrictions on the franchisor's ability to collect initial franchise fees when a franchise agreement is signed, which also negatively reflects on the system's perceived value. Extrapolating further, the decreased value offers potential for unhappy unit owners to back out of agreements, citing misinformation on franchise disclosure statements. And that can lead to claims and litigation.

Growing franchise systems that rely on franchise sales for revenue could take a hit, as the system as a whole may be seen as less attractive. This could turn off potential franchise buyers.

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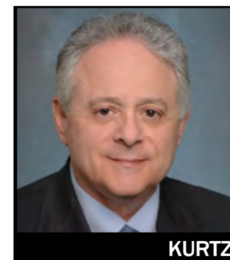
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