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An AICPA Industry Accounting Guide

Accounting for Franchise Fee Revenue

AICPA
American Institute of Certified Public Accountants

Notice to Readers

This AICPA industry accounting guide is published for the guidance of members of the Institute in examining and reporting on financial statements of franchise companies. It represents the considered opinion of the Committee on Franchise Accounting and Auditing and as such contains the best thought of the profession as to the best practices in this area of financial reporting. Members should be aware that they may be called upon to justify departures from the Committee's recommendations.

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Accounting for Franchise Fee Revenue

Prepared by the Committee on Franchise Accounting and Auditing
of the American Institute of Certified Public Accountants

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Preface

The U.S. economy has witnessed an explosive growth in the franchising industry during the past ten years. This growth has highlighted a number of accounting questions related to franchising companies, primarily involving the recognition of franchise fee revenues. A study of past practice indicates that an accounting method which was generally accepted during this period was to recognize revenue from initial franchise fees at the time franchises were sold.

In January 1970 an article was published in *The Journal of Accountancy* which recommended that initial franchise fees be recognized as revenue when the related franchisee began its operations. Following the publication of that article, practice began to change toward the proposals contained in the *Journal of Accountancy* article. This change was supported by the staff of the Securities and Exchange Commission by their frequently requiring such accounting in financial statements subsequently filed with that body.

An ad hoc committee was established for the purpose of preparing recommendations as to franchise accounting to be issued by the AICPA for the guidance of practitioners. The recommendations herein relate to accounting practices for selected matters, with particular emphasis on accounting for initial franchise fees. These recommendations have been made with the objective of clarifying and improving accounting and reporting practices for the guidance of practitioners and are not intended to be applied retroactively or to be a criticism of financial statements prepared using practices generally accepted heretofore.

Committee on
Franchise Accounting and Auditing

December 1972

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Introduction

Franchising is a relatively old business concept. A wide variety of activities, organizations, and arrangements are covered by the broad mantle of franchising—so many, in fact, that it is difficult to define franchising in a way which is acceptable to all. Some describe franchising as an industry; others describe it as a distribution system crossing industry lines. Virtually all agree that revenues from franchising operations contribute an important portion of the gross national product.

The following excerpt from a study by The Conference Board[1] entitled "Some Guideposts to Definition" represents a description of the major representative features of franchising which will be useful as a backdrop for the comments in later sections of this guide.

> Despite some ambiguity and diverse opinion about what is and what is not franchising, it is possible to formulate a set of general criteria that business arrangements must usually meet if they are to be considered business franchises. Among the principal criteria are the following:
>
> 1. The relation between the two parties is contractual, and an instrument of agreement, confirming the rights and responsibilities of each party, is in force for a specified period of time.
> 2. The continuing relation has as its purpose the efficient distribution of a product or service—or an entire business concept within a particular market area.[See footnote 2 below.]
> 3. Both parties contribute resources toward the establishment and maintenance of the franchise. In the case of the

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[1] "Franchised Distribution," Report No. 253 (New York: The Conference Board, Inc., 1971), p. 3.

[2] The footnote to this paragraph reads as follows: "This is not to imply that a guarantee of territorial rights and protection is a prerequisite to the franchise agreement; but, the de facto effect of many franchise agreements is to create a limited number of franchised businesses within definable geographic territories."

franchisor, its contribution may be a trademark, a company reputation, products, procedures, manpower, equipment, a process, etc. The franchisee usually contributes operating capital as well as the managerial and operational resources required for the initiation and continuation of the local franchised business.

4. The contract between the parties outlines and describes the specific marketing practices to be followed and details the contribution of each party to the operation of the business. It also sets forth certain standards of operating procedure to which both parties agree to conform.

5. The establishment of the franchised business creates a business entity which will, in most cases, require and support the full-time business activity of the franchisee. (There are numerous other contractual distribution arrangements in which a local businessman becomes the "authorized distributor" or "representative" for the sale of a particular good or service, along with many others. But such sale usually represents only a portion of the businessman's total business.)

6. Both the franchisee and franchisor participate in a common public identity. This identity is achieved most often through the use of common trade names or trademarks and is frequently reinforced through advertising programs designed to promote the recognition and acceptance of these within the franchisee's market area.

Some have sought to embellish the definition of franchising with economic considerations, such as the existence of a particular remuneration formula between franchisee and franchisor. It has been occasionally argued, for example, that the payment of an initial franchise fee and/or the payment of the continuing royalty fee is integral and necessary to the existence of a franchise. However, while a majority of franchise agreements do provide for at least one or the other of such payments, there are numerous franchise distribution arrangements which require neither an initial franchise fee nor payment of a continuing royalty. Franchise companies in these cases frequently derive a major portion of their income from the continued sale of products or supplies to their franchised outlets.

The Franchise Agreement

The basis for franchise relationships is the franchise agreement. Franchise agreements, which are tailored to fit particular circumstances, vary from the relatively simple to the quite complex, and cover a wide variety of rights, privileges, duties, and obligations. Because of this variety, no general description will substitute for a careful reading and evaluation of a specific agreement when accounting and reporting matters are involved.

Following is a list of some of the more common provisions of franchise agreements which are pertinent to accounting and financial reporting.

1. *Rights transferred by the franchisor.* The agreement gives the franchisee the right to use the trademark, trade name, patents, processes, know-how, etc., of the franchisor for a specified period of time or perpetually. Although trademarks and trade names are more apparent, know-how is frequently a most important component of the rights transferred.

2. *The amount and terms of payment of initial franchise fees.* Payment of initial franchise fees, if any, may be completely, or partially, in cash. Cash received by the franchisor may or may not be refundable under the terms of the agreement, depending upon the circumstances. Any unpaid portion of an initial fee may be represented by interest-bearing or non-interest-bearing notes due on specific dates or payable upon the fulfillment of certain specified obligations or the occurrence of certain events stated in the agreement.

3. *Amount or rate and terms of payment of continuing franchise fee or royalty.* The franchisee may be required to pay a continuing fee or royalty to the franchisor. Such fees are usually based on a percentage of the franchisee's gross revenues or some other measure of volume. In some cases a portion of the royalty must be expended by the franchisor for advertising. The franchisee usually is required to make periodic reports to the franchisor on prescribed forms, and the franchisor may have the option to require annual audits of the franchisee's financial statements to ascertain compliance with terms of the agreement.

4. *Services to be rendered by the franchisor initially and on a continuing basis.* The franchisor will usually agree to provide a variety of services and advice to the franchisee, such as the following:

   a. Assistance in the selection of a site. Such assistance may be based on experience with factors such as traffic patterns and residential configurations, competition, etc.

   b. Assistance in obtaining facilities, including related financing. Such assistance may include providing architectural and engineering services. Facilities may be purchased or leased by the franchisee. In some cases, they may be leased by the franchisor to the franchisee or the

franchisor may guarantee lease payments for a franchisee.

c. Assistance in advertising, either for the individual franchisee or as part of a general program.
d. Training of the franchisee's personnel, either initially or on a continuing basis.
e. Preparation and distribution of manuals and similar material concerning operations, administration, and record keeping.
f. Bookkeeping and advisory services. These may include setting up a franchisee's records, advising him as to income, real estate, and other taxes or advising him as to local regulations affecting the franchisee's business.
g. Inspecting, testing, and other quality control programs.

5. *Acquisition of inventory, supplies or equipment, and terms of payment.* The franchisee may be required to purchase these items from the franchisor, or he may be required to purchase from suppliers designated by the franchisor. In other cases, he may be required only to adhere to specified standards of quality. Some franchisors manufacture products for sale to franchisees; others act as wholesalers. Terms of payment may be prescribed if franchisors sell to franchisees.
6. *Cancellation of franchise, reacquisition of franchise, or acquisition of franchisee.* Specified actions may result in cancellation of franchise agreements. Some franchise agreements provide options to the franchisor to purchase from the franchisee, or options to the franchisee to sell to the franchisor, all or part of the franchisee's business at fixed prices or prices determined by revenues, profit, or some other formula.

Accounting Problems: Revenue Recognition

The recent rapid growth of franchising companies has highlighted a number of questions involving accounting and financial reporting. Franchising is a broad subject involving many businesses and many kinds of transactions; it would be unrealistic, therefore, to attempt to discuss accounting for all business transactions encountered by franchising companies. Accordingly, this document is not an exhaustive treatise but is simply

a discussion of selected topics which are relatively unique or important to franchising companies generally.

Most of the accounting problems which have been identified relate to the activities of franchisors. This guide will be devoted entirely to the problems of the franchisor, the party who grants business rights (the franchise) to the party who will operate the franchised business (the franchisee).

Accounting problems of franchisors primarily involve (1) the timing of recognizing revenues, (2) the segregation of various kinds of revenues, and (3) the association of various costs with revenues. These problems are not unique to franchisors. The general presumption underlying this guide is that franchisors are subject to the same accounting standards and disciplines as are other businesses. Accordingly, accounting problems of franchisors should be solved by applying conventional accounting practices used in other areas of the business world. However, certain facets of the problems which are unique to franchisors, such as the relationship between franchisor and franchisee and the nature of the franchise right, demand careful analysis to assure appropriate conclusions.

Initial Franchise Fees

The primary and most controversial franchise accounting problem relates to the recognition of revenue from the initial franchise fee. Most of the more recently created franchise systems have required payment of an initial franchise fee. The initial franchise fee represents consideration for establishing the franchise relationship and for some initial services provided. Occasionally the fee includes consideration for initially required equipment and inventory, but these items are usually the subject of separate consideration. The costs of the rights and services associated with each individual franchise may not be significant, and therefore the timing of recognition of initial fee revenue may have an important effect on net income. Because the initial fee is usually received for intangible rights and services, the appropriate time for recognition of revenue is more difficult to determine than is the case, for example, when merchandise is sold and shipped.

There are two distinct problems in connection with the recording of revenue from initial franchise fees: (1) the time at which the fee is properly regarded as earned, and (2) the assurance of collectibility of the receivable arising from any unpaid portion of the fee.

When the Fee Is Earned. The first aspect to be considered, the timing of recognition, is complex. Unique aspects of the franchise agreement are involved which can be interpreted differently by different persons; several different proposals with respect to the timing of recognition have been advanced and should be evaluated.

Cash Basis. In view of the complexity of the franchise agreement and the possibility of collectibility problems, some have proposed that initial fees be accounted for as received in cash. Despite a certain pragmatic appeal, the use of the cash basis with respect to initial franchise fees has all the weaknesses that have caused its unacceptability in other areas of accounting. The receipt of cash frequently does not coincide with significant events which create assets, liabilities, income, and expense and is therefore an unreliable indicator of the results of operations of a business. Cash may be received either before or after recognition of revenue is appropriate. Accordingly, except for certain extreme cases based on circumstances discussed below, the cash basis of accounting should not be used to account for initial franchise fees.

Spread Over Life of Agreement. Although some franchise agreements are perpetual, most of them have a specified life. Frequently this is a relatively long period, such as 20 years. This has caused some to suggest that the initial fee be regarded as a prepayment for the privilege of using the franchised rights during the specified life of the agreement and, accordingly, that the initial fee be recognized ratably as revenue over that period.

Most franchisors indicate that the basis for charging an initial franchise fee is the combination of initial services and the transfer of valuable rights. Thus, they establish the initial fee as compensation for the transfer of rights and services at inception and the continuing fee or royalty as compensation for the use of rights and services over the period of the agreement. The degree to which such an association can be made obviously varies according to the circumstances. Usually, however, the pro rata recognition of revenue would give inadequate consideration to the substantial benefits and services provided by the franchisor at the beginning of the franchise relationship.

This proposal to spread initial fees over the life of the franchise agreement would be more persuasive if the franchise agreement did not provide other means of compensating the

franchisor over the franchise period. Most agreements provide periodic payments to the franchisor over the life of the agreement related to the level of business of the franchisee in the form of (1) continuing fees and royalties, which usually are a percentage of sales, (2) a share of the franchisee's profits, or (3) sales of products to franchisees. Under normal circumstances these periodic payments are adequate to compensate the franchisor for the continuing responsibilities of the agreement.

Perhaps the most important consideration is whether the initial fee is earned by the franchisor without reference to the life of the agreement. In most cases, after the franchisor has performed the initial responsibilities assumed in the agreement, amounts received as an initial fee are irrevocably his regardless of whether the franchisee actually begins operation or operations are successful. This condition suggests that the fee be recognized at or near the inception rather than over the life of the agreement.

After evaluating the foregoing, the committee has concluded that, where there is no direct relationship between the initial fee and the life of the agreement and the fee is irrevocably the property of the franchisor, there is no reason to require recognition of the fee over the life of the agreement. If an agreement provides that cancellation of the franchise agreement or other conditions could result in a pro rata refunding of the initial fee, the initial fee should not be recognized as revenue prior to the time it irrevocably inures to the benefit of the franchisor.

At Inception of the Franchise Relationship. The sale of a franchise has the same economic significance as the sale of other commercial property, tangible or intangible. The sale represents the transfer of specified rights in exchange for specified consideration. Accounting practice generally recognizes revenue when a sale takes place.

The word "sale" ordinarily implies a consummated transaction; when some substantial aspect of the sale transaction remains unperformed by the seller, accounting recognition is ordinarily withheld. The usual sale of a franchise is linked to certain conditions, such as the performance of certain services, which affect the consummation of the transaction in much the same way as delivery, installation, or meeting certain qualitative specifications affect the consummation of a conventional sale of equipment. Perhaps the most difficult aspect of accounting for the sale of a franchise is determining when these conditions

have been sufficiently met so that the franchise sales agreement may be regarded as consummated and the fee regarded as irrevocably earned.

Committee Recommendation: Substantial Performance. The committee believes that, in keeping with conventional accounting theory and practice, revenue should be recognized when the franchise sale transaction is consummated, i.e., when any material conditions which attach to the sale have been substantially performed. Substantial performance as to the franchisor means that (1) he has no remaining obligation or intent—by agreement, trade practice or operation of law—to refund any cash already received or to excuse nonpayment of any unpaid notes; (2) substantially all of the initial services of the franchisor required by the contract have been performed; and (3) any other conditions which affect consummation of the sale transaction have been met.

The complexity of the circumstances and the indefinite nature and extent of some of the services involved in franchise agreements, characterized as advice, consultation, and assistance, make the timing of recognition a very difficult and sometimes controversial subject. Because of these characteristics a proposal in a *Journal of Accountancy* article in January 1970 has been adopted by many franchisors under which revenue is recognized when the franchisee begins operation.[3] Many found this proposal desirable because (1) this point in time is easily determined; (2) for most franchisors, the required services have been rendered by that point in time; and (3) it results in a more conservative determination of income than recognition at the date a franchise agreement is signed, a time which was commonly thought to be previously appropriate. Since the article was published, the staff of the SEC has advocated, and frequently required, that revenue be recognized on the basis of initial franchise operations.

Because of the variety of conditions which may exist, it is difficult to refer to any specific condition or event as the sole criterion for recognition of revenue. Substantial performance may occur at different times for different franchisors. For example, the recognition of revenue when the franchisee begins operation would erroneously defer revenue if, although the

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[3] Archibald E. MacKay, "Accounting for Initial Franchise Fee Revenue," *The Journal of Accountancy* (January 1970), pp. 66-72.

franchisor has fulfilled all obligations, the franchisee never begins operations; similarly, it may prematurely recognize revenue if the franchisor has agreed to manage the franchised outlet for a period of time following the beginning of operations. Nevertheless, conservatism justifies the presumption that commencement of operations by the franchisee is the earliest point at which substantial performance has occurred; recognition of revenue at an earlier point in time carries with it a burden of demonstrating that the presumption has been overcome.

A careful evaluation will be necessary to establish that, even though the franchise agreement does not require the franchisor to perform initial services, business circumstances will not cause the franchisor to render substantial services on a voluntary basis. If a practice of voluntarily rendering substantial services exists or is likely to exist, substantial performance should not be assumed to exist in spite of the franchise agreement. Accordingly, substantial performance should not be assumed until the uncertainty has been eliminated via either the substantial performance of the services or assurance that services will not be performed.

Substantial weight should also be given to the experience of the franchisor and the length of time he has engaged in the franchise business. The difficulties and uncertainties faced by new enterprises (which may, and frequently has, resulted in the cancellation of refund of initial franchise fees) should be carefully considered. Franchisors who engage in an entirely different franchising operation or who expand an existing franchise into a new geographic area may be in the same position as a new enterprise in this regard.

Effect of Collectibility Considerations on Revenue Recognition. Having decided that substantial performance by the franchisor has occurred, a second important question remains to be answered before the revenue to be recognized can be determined. That question involves a judgment as to whether any receivable arising from an unpaid portion of the initial franchise fee is reasonably assured of collection. (See the section on "exceptional cases" below.)

A number of circumstances exist which may make this determination a difficult matter. Some of the more important of these are as follows:

1. Unpaid franchise notes may be significant to the individual franchisee and payment may depend upon the franchisee's

future operations, or current or prospective capitalization or a combination thereof.

2. The franchisee may be inexperienced in business with a consequent effect on his credit standing.
3. The franchise agreement, which is important as a basis for making collection estimates, may require interpretation by legal counsel as to uncertainties.
4. The credit standing of guarantors or other indirect sources of credit to the franchisee may require investigation.

This determination is, in the final analysis, a matter of estimate and judgment. The procedures used by management in establishing a reserve, if necessary, and by the auditor in reviewing the reasonableness of management conclusions are dependent upon the existent circumstances and information available.

Inadequate Continuing Fees. There may be situations in which large initial fees are required but continuing franchise fees are small in relation to future services. If the continuing fee appears to be inadequate to cover both the cost and a reasonable profit of the continuing services to be provided by the franchisor, some or all of the initial franchise fee should be deferred and amortized over the life of the franchise, as appropriate.

Exceptional Cases: Installment Method or Cost Recovery Method. There are extreme cases in which revenue is recognized based on cash collections using the installment method or the cost recovery method. The most recent statement in AICPA literature is paragraph 12 of APB Opinion No. 10:

> Chapter 1A of ARB No. 43, paragraph 1, states that "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured." The Board reaffirms this statement; it believes that revenues should ordinarily be accounted for at the time a transaction is completed, with appropriate provision for uncollectible accounts. Accordingly, it concludes that in the absence of the circumstances[8] referred to above, the installment method of recognizing revenue is not acceptable.

Footnote 8 to this paragraph reads as follows:

> The Board recognizes that there are exceptional cases where receivables are collectible over an extended period of time and,

> because of the terms of the transactions or other conditions, there is no reasonable basis for estimating the degree of collectibility. When such circumstances exist, and as long as they exist, either the installment method or the cost recovery method of accounting may be used. (Under the cost recovery method, equal amounts of revenue and expense are recognized as collections are made until all costs have been recovered, postponing any recognition of profit until that time.)

The principle enunciated in the footnote to paragraph 12 is not intended to permit avoidance of the responsibility for making estimates and judgments whenever credit evaluation is a complex, difficult matter. Every provision for collection losses, or a decision that no provision is required, is an estimate that is difficult to make and is subject to judgmental error since it is based on the opinion of management. The accrual basis of accounting requires that installment or cost recovery accounting be regarded as an exception to the norm—that it be reserved for the extreme situations in which the receivables are collectible over an extended period of time and it be determined, after a careful, responsible attempt has been made, that "no reasonable basis for estimating the degree of collectibility" exists. Thus, whenever it is possible to do so, fair presentation requires that revenue from the sale of franchises be reported, together with an appropriate provision for estimated collection losses, if necessary, based upon the best available information. Such reserves should be adjusted periodically thereafter whenever circumstances change.

The use of the installment method or the cost recovery method must be based on the circumstances and, accordingly, should be applied only to appropriate portions of a franchisor's revenues. Depending upon the circumstances, one of the special methods may be applied only to a given contract or a group of similar contracts.

Area Franchise Sales

The accounting problems involved in initial franchise fees related to area franchise sales (territorial sales) may be even more complex than the sale of individual franchises. As used herein the term "area franchise" means an agreement which transfers franchise rights within a geographical area permitting the opening of a number of franchised outlets. Under these circumstances, decisions as to the number of outlets, their location, etc., are more likely made unilaterally by the franchisee

than in collaboration with the franchisor. In some cases a franchisor sells an area franchise to a franchisee who operates the franchise outlets; in other cases a franchisor sells an area franchise to a middleman franchisee who then sells individual franchises to other franchisees who operate the outlets.

In general, with respect to initial franchise fees related to area franchises, an attempt should be made to follow the same principles described previously for the sale of individual franchises. The primary difficulty arises in determining when substantial performance has occurred in view of the large number of outlets which may ultimately exist. The point of departure for determining whether the franchisor has substantially performed its obligations under an area franchise agreement, as in the case of an individual franchise, is the agreement itself. If the franchisor's substantial obligations under the agreement run to the area franchisee and do not depend significantly upon the number of individual franchisees to be established, the determination of when substantial performance has occurred involves the same considerations as are applicable to individual franchises. However, where performance of substantial obligations of the franchisor is dependent upon the number of individual franchisees established within the area, special provisions for the recognition of income from the initial franchisee should be made. It would be unreasonable to await completion of all services to all of the individual franchise units which might be opened before any revenue is recognized—this might involve a period of many years. Rather, it seems appropriate to adopt some practice of recognizing a portion of the area franchise fees in concert with the performance of a portion of the mandatory services. No amounts should be recognized as revenue if they might have to be refunded because of nonperformance of future services. This, too, conforms to the principle stated earlier as to individual franchise sales that revenue should not be recognized until such amounts irrevocably inure to the benefit of the franchisor.

The measure of substantial performance will be determined by the substance of the arrangement. In some cases the services to be performed by the franchisor may be performed without reference to the number of outlets in the area. Conversely, the franchise agreement may require significant services to be performed which are related to the opening of outlets in the area. In the latter case, it may be necessary to regard the franchise agreement as a divisible contract and estimate the number of outlets involved in order to recognize revenues in proportion to the outlets

for which the required services have been substantially rendered. Estimates should give appropriate consideration to maximum or minimum numbers of outlets and any time limitations on the opening of outlets specified by the agreement. Any change in estimate resulting from changes in circumstances should result in recognizing remaining fees as revenue in relation to remaining services to be rendered.

Other Revenue Problems

Franchisors may encounter a number of other specific problems in accounting for revenue; a number of these are listed below. Their resolution is subject to consideration of the facts in each case and it is not practical to deal with them at length. However, some of the major factors leading to their solution are highlighted.

Relationships Between Franchisee and Franchisor. Occasionally a franchisor has an equity interest in a business acquiring a franchise. Because of the intercompany nature of the transaction, any profit on the sale of the franchise to this business should be recognized only after the elimination of intercompany profits. The elimination of intercompany profits is discussed in ARB No. 51, APB Opinion No. 18, and related AICPA accounting interpretations.

Other unusual relationships may exist in addition to those established by the franchise agreement or an equity interest. Occasionally, a franchisor guarantees borrowings of a franchisee. In other instances the franchisor may have a creditor interest in the franchisee or, by sales or other agreements, control the operations of a franchisee to such an extent that the franchisee is for all practical purposes an affiliate of the franchisor. In still another situation two franchisors may agree to pool their risks through sales of their respective franchises to each other. Before recognizing revenue from sales between such parties, consideration must be given to the substance of the sale transaction in context with the other relationships. Revenue should not be recognized if these other relationships overcome the concepts of revenue recognition referred to above.

In some cases, a potential relationship is established by a franchise agreement which contains a provision giving the franchisor an option to purchase the franchisee's business. An analysis of business practices indicates that franchisors may purchase a profitable franchisee as a matter of management policy or may

purchase a franchisee who is in financial difficulty or is unable to continue in business in order to preserve the reputation and goodwill of the franchise system. Although the existence of such an option provision does not dictate the accounting, its existence requires that consideration be given to the likelihood of acquisition of the franchisee's business when accounting for the initial franchise fee. The substance of such transactions may, in certain circumstances, differ from their form. If an analysis of all of the surrounding circumstances indicates little doubt that the franchisor ultimately will acquire the franchised outlet or that an understanding exists that the option will be exercised, the initial franchise fee should not be reported as revenue; on exercise of the option, the amount deferred would serve to reduce the franchisor's investment in the outlet.

Non-Interest-Bearing Notes. In some cases notes taken in full or partial consideration for initial fees do not bear realistic interest. When maturity dates are fixed, accounting recognition should be given to the fact that the principal amount of the note includes an element of implicit interest. APB Opinion No. 21 requires that the interest portion of such notes be determined and recognized as interest revenue over the life of the notes.

Commingled Revenues. The franchise agreement usually establishes a single initial franchise fee as consideration for the basic franchise rights and the initial services to be rendered by the franchisor. In some cases, however, the fee may additionally cover signs, equipment, inventory, and even land and buildings. An accounting determination must be made in such circumstances in order to allocate the fee to the respective items sold. If the franchisor's practice is to offer alternatives to the franchisee under which arm's-length prices are established for the individual goods and services, such amounts ordinarily can be used as a basis for the allocation of the fee to the various elements of revenue. If such evidence of arm's-length negotiation is not present, the determination must be based on the best estimate and judgment of the fair value of the goods and services provided. Although the franchise agreement may specify an amount relating to each of the foregoing items or groups thereof, such amounts may not always be appropriate for accounting purposes.

Based upon the concept of substantial performance, a portion of the fee deemed applicable to tangible assets may be recognized prior to or later than recognition of another portion deemed applicable to services. For example, depending upon the terms of

the agreement, the portion of the fee related to the sale of specific tangible assets may, under appropriate circumstances, be recognized when title passes, whereas the balance of the fee related to services may be recognized when the balance of the contract has been substantially performed.

Although an individual franchise agreement may on occasion specify portions of the total fee that relate to specific services provided by the franchisor, the services usually are interrelated to such an extent that an objective segregation of the amount applicable to each service is virtually impossible. Unless the franchisor has established objective prices for individual services, for example, through separate sales of specific services, the fee should not be allocated among the different services as a means of recognizing any part of the fee for services as revenue before substantial performance of all the services has occurred.

Continuing Franchise Fees. Reference has been made earlier to continuing franchise fees or royalties paid to the franchisor over the life of the franchise agreement. Such fees are consideration for the continuing rights granted by the agreement and for general or specific services during its life. Accordingly, continuing franchise fees should be reported as revenue on the accrual basis, as the fees are earned and become due from the franchisee. Expenses relating to these fees should also be recorded on the accrual basis.

Although a portion of the continuing fee may be designated for a particular purpose, such as an advertising program, that portion of the fee should be reported as revenue as described in the preceding paragraph.

The related costs should be charged to expense as incurred. An exception to the foregoing would exist if the arrangement constituted an agency relationship under which the designated portion of the continuing fee is required to be segregated and expended for the specified purpose. In this case the designated amount should be recorded as a liability against which the specified expenditures would be charged.

Continuing Product Sales. Sometimes, as a matter of choice or, in some cases, as required by the terms of the franchise agreement, the franchisee purchases a portion or all of his products from the franchisor. If the franchisor has no equity interest in the franchisee, this transaction presents no particular accounting problem; the transaction should be reported following conventional guidelines by recognizing revenue and expense

when sale and delivery take place. If there is an equity relationship between the franchisor and the franchisee, then significant intercompany profit should be eliminated pending sale by the franchisee (see the previous discussion on page 13).

On occasion, a franchisee is given the right to make bargain purchases (i.e., prices of equipment or supplies are lower than would be set by unrelated parties) for a specified period or up to a specified amount, concurrent with the payment of the initial franchise fee. If the bargain price allowed is lower than the selling price of the same products to other customers, or if it does not provide the franchisor a reasonable profit on the sales of equipment or supplies, then some or all of the franchise fee should be deferred and, if otherwise recognizable, taken into income as an adjustment of the selling price as the franchisee purchases the equipment or supplies.

Agency Sales. Some franchisors engage in transactions in which they are, in substance, an agent for franchisees by placing orders for inventory and equipment and selling to the franchisee at no profit. The purchase and sale of these items should not be regarded as revenue transactions. They are adequately reported by accounting for the receivables and payables in the balance sheet and should not be reflected in the income statement.

Accounting Problems: Costs

Franchising companies incur costs related to the sale of franchises. Many of these costs are incurred prior to the time at which it is appropriate, using the accounting principles previously described, to recognize revenue. Because of the desirability of reporting directly related costs and revenue simultaneously in the income statement, insofar as possible, there is a question as to when such costs should be charged to income. The magnitude of costs incurred by franchisors with respect to sales of franchises varies widely. In many cases, costs related solely to sales of franchises are not significant in relation to the initial franchise fee.

Matching of Costs and Revenues

For the most part, accounting principles applicable to commercial and industrial companies require that the cost of merchandise acquired for sale and direct costs of disposal be matched

by accrual accounting against related revenues by reporting them as components of income in the accounting period in which the revenue transaction takes place. Other costs incurred, but not directly associated with, transactions generating revenue are generally expensed as incurred. Franchisors are likely to encounter somewhat different circumstances because their costs and revenues may not be as regular and recurring and because the source of revenues, being services and intangibles, is not as readily identifiable. This is especially true for transactions involving initial franchise fees. It is possible, however, to establish a general analogy between transactions of franchisors and transactions of other commercial and industrial companies. The objective is to match, insofar as possible, related costs and revenues by reporting them as components of income in the same accounting period.

Costs to Be Deferred

For this reason franchisors should ordinarily defer direct costs relating to specific franchise sales for which revenue has not yet been recognized. Indirect costs of a regular and recurring nature which are incurred irrespective of the level of sales such as general selling expenses and administrative expenses should be expensed as incurred. A guiding principle should be that costs directly related to specific revenue-producing transactions, usually incremental costs, should be deferred pending recognition of revenue, and costs not directly related to specific revenue-producing transactions, including fixed costs, should be expensed as incurred. Costs should not be deferred, however, without reference to anticipated revenue and its realizability. The amount of deferred costs should not be permitted to exceed anticipated revenues less estimated additional costs related thereto.

In some cases, revenues may be recognized based upon substantial performance of the responsibilities and obligations required under the contract even though some remaining costs have not yet been incurred. Because the concept of substantial performance as a standard for revenue recognition would not tolerate substantial services yet to be rendered, such costs should be relatively minor and susceptible to reasonable estimation. Accordingly, any material costs should be accrued and charged against income no later than the period in which the related revenues are recognized; as a practical matter, accrual of minor remaining costs is unnecessary when any remaining services involve only fixed costs.

Accounting for Reacquired Franchises

Cancellation of Original Sale

A franchisor may come into possession of a franchise previously sold in one of several ways. Franchise rights may be repossessed in circumstances in which the franchisee has changed his mind and decided not to open an outlet. If, for any reason, the franchisor refunds the consideration received, this situation represents a cancellation of the original sale, and if revenue had been recognized, should be accounted for by a reduction in revenue in the year the franchise is reacquired. Such circumstances should be rare when the substantial performance criterion is used as a basis for recognizing revenue because of the probability that the franchisor would enforce collection rather than rescind the sale. If franchise rights are repossessed but no refund is made, the transaction should not be regarded as the cancellation of a sale; any revenue previously recognized should be permitted to stand, provision should be made for any collection losses sustained with respect to any unpaid receivables, and any consideration retained for which revenue was not previously recognized should be reported as revenue.

Business Combination

In a second kind of transaction, a franchisor may acquire the business of an operating franchisee. Such a situation could take place for a variety of reasons, but most frequently will result from a desire by the franchisor to operate his own retail outlets. When this is the case, it may be more desirable to acquire the going businesses of franchisees than to open new outlets in unproven territories.

The second transaction constitutes a business combination. Assuming the absence of a relationship between the franchisor and the franchisee at the time of the franchise sale sufficient to have precluded revenue recognition (see earlier discussion), the business combination will ordinarily represent a transaction which should be accounted for using conventional practices. It is important to evaluate such transactions carefully to determine that, although in form a business combination, they are not in substance cancellations of the original franchise sale; the accounting for the cancellation of a sale is described above. Accounting for business combinations, whether as purchases or as poolings of interests, is described in APB Opinion No. 16.

If a transaction is accounted for as a pooling of interests, intercompany transactions prior to the date of combination are required to be eliminated at the time of combination. Accordingly, in the combined financial statements prepared after the pooling is consummated, the original franchise sales transaction as well as any product sales would be eliminated. If the transaction is accounted for as a purchase, financial statements of the two companies are not retroactively combined. The current transaction, being at arm's length, should not affect prior accounting, and no adjustment of revenue is appropriate merely because the companies had transacted business while they were independent.

Disclosure

Conventional disclosure practices applicable to all commercial and industrial companies are equally applicable to franchisors. In addition, disclosure should be made of the information which is unique or significant to franchisors. The more commonly encountered subjects are described below.

Disclosure should be made of the basis of accounting for all important aspects of transactions with franchisees such as recognition of initial franchise fees, deferred costs, continuing fees or royalties, etc. In addition, a general disclosure should be made of the nature of all significant commitments and obligations arising from franchise agreements, including a reference to services which the franchisor has agreed to provide relative to agreements which have not yet been substantially performed.

In those cases which have no basis for estimating the degree of collectibility of specific notes, there should be disclosure that the installment method or the cost recovery method is in use. Further, there should be disclosure of the sales price of all franchise fees which would otherwise have been included in revenue but for the collectibility problem, the amount of revenue and related costs deferred (both currently and on a cumulative basis), and the periods in which such fees become payable. Any amounts originally deferred but recognized later because the uncertainties as to collectibility are no longer present should also be disclosed.

Revenue from initial franchise fees is different in nature from continuing royalties or product sales. Revenues from initial franchise fees, especially those derived from selling relatively few but large area franchises, are less likely to be recurring than most revenues of commercial and industrial companies. Because of these aspects, it is necessary to segregate initial franchise

fee revenues from other franchising revenues. In some cases where sales predictably reach a saturation point and initial franchise fee revenues are expected to decline in the future, a general explanation of the situation is also desirable. If not apparent from the relative amounts of revenue, consideration should also be given to disclosing the relative contribution to net income of initial franchise fees.

Because of the relationship between franchisor and franchisee, when a company operates its own outlets and also derives revenues from franchise outlets operated by others, it is appropriate to distinguish, insofar as possible, between the two areas of the company's business. This may be done by segregating, insofar as possible, revenues and costs related to company-owned retail outlets from revenues and costs related to franchised outlets. Usually, when there are significant changes during the period, there should also be footnote disclosure of the number of (1) franchises sold, (2) franchises purchased during the period, (3) franchised outlets in operation, and (4) company-owned retail outlets in operation so that the reader will be able to assess the changes in the business.

Change in Accounting

An accounting change made to comply with the committee's recommendations should be applied to transactions entered into on or after the date the change is made. These recommendations are not intended to be applied to transactions reflected in prior fiscal periods, except as permitted by paragraph 29 of APB Opinion No. 20, but may be applied to all transactions entered into during the fiscal year in which the change occurs. The nature of any changes and their effect on income before extraordinary items and on net income (and on related per share amounts) of the period of the change should be disclosed. Disclosure of the pro forma effect for the full fiscal year of the year of change should be made if the change has only been applied for a portion of that year. A change, whether applied for the whole year or a portion thereof, will require a consistency in the accountants' report.

The use of the installment method or the cost recovery method of recognizing revenue under the circumstances previously described sometimes gives rise to questions about the consistent application of accounting principles. The application of one of these methods to revenues from a given franchise agreement or

a group of similar agreements, even though the franchisor previously has been able to recognize revenues on substantial performance of his obligations under franchise agreements, does not represent a change in the consistent application of accounting principles. The adoption of the special method is required by the circumstances; it does not result from selecting an alternative accounting practice.

However, if a franchisor using the installment method of accounting for franchise fees involving extreme uncertainty were to change to the cost recovery method for such fees, or vice versa, a change in accounting exists. In that circumstance, a consistency reference in the accountants' report, as well as disclosure of the change and its effect on the financial statements, is required.