Seminar

Addressing Information Gaps in Business and Macro-Economic Accounts to Better Explain Economic Performance

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Franchise accounting
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Introduction

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Key Discussion Points

- System Revenue vs. Revenue of the Franchisee/Franchisor
- Franchisor Accounting and Reporting
  - Rent and Service Fees and Revenue
- Franchisee Accounting and Reporting
- Other Considerations
System Revenue

► Definition
   — System revenues include sales of the overall business, whether operated by the franchisor, by franchisees or by affiliates.

► Non-GAAP (not in accordance with external reporting)

► Usefulness
   — Overall picture of the business’ financial performance
   — Generally the basis on which the franchisor calculates and records franchised and affiliated revenues
   — Is indicative of the financial health of the franchisee base.
Rent and Service Fees

► Rent
  — In certain cases the franchisor owns/leases land and building, then rents to franchisee
  — This does not exist where the franchisee owns the land and buildings

► Service Fees
  — Initial franchise fee
  — Fees for continuing sales
  — What it represents – use of brand, corporate services like supply chain and brand management, product research, management of advertising arm
US GAAP Guidance on Accounting for Franchise Fee Revenue ("FAS 45")

► When to recognize initial fee
► When to recognize later revenues
  — Service fees – as based on revenue producing activity
  — Rent – monthly rent (tangible and can be separated from revenue recognition)
► Franchisee/franchisor – selling back and forth
► Indirect costs of managing system expensed as incurred by franchisor
Franchisor Accounting

► Rent and service fee income
  – Depends on franchisor’s investment
► COS = occupancy
► Record initial fee when store is operating and franchisor has satisfied performance obligations
► Record rent and service fee based on revenue producing activity – recorded monthly, based on sales
► SG&A – to manage the system
Intangible Value

- Franchising company owns/licensees intellectual property (trademarks, service markets, patents, copyrights)
  - Because these are generally developed internally, they may not have “recorded” value
- Goodwill often arises from purchase of franchisees or investments
Franchisee Accounting

► Revenue = sales from actual goods
► Cost of sales = rent and service fees, food, payroll
► General and administrative – administration of the franchise operations, advertising
► Initial franchise fees related to purchase of business would often be recorded on franchisees’ books as an intangible asset to be amortized over the franchise term
Other Considerations: Property and Equipment

- Ownership structures of buildings
- Reconstruction, major maintenance, expenditures on upgrades, whether required or not required by the franchise agreement
Other Considerations: Supply Chain Management

► In the case where suppliers are parties other than the franchisor, related inventory costs are to a 3rd party

► G&A – franchisees may pay the franchisor to manage and test (as a component of service fees)
Other Considerations: Income Tax

- Franchisee – taxable income is based on revenue from sales of goods less costs to operate business
- Franchisor – taxable income includes amounts recorded on rent and service fee income
  - And business operations, if franchisor also operates its own businesses
Other Considerations: Consolidation

► Franchisor generally does not consolidate franchisees to extent control is < 50%
  — US GAAP includes specific guidance regarding franchises
► JV’s sometimes used as an ownership structure
Marketing Co-ops

- Separate businesses with responsibility for purchasing regional or national advertising
- Generally owned proportionally by all franchise operators (both company-owned and franchisees)
- Often funded with a percentage of operator’s revenue
- Governed by a board of owners with oversight responsibility
Conclusion

► Be cognizant of the role of the franchisor when reading financial results
► Understand franchisor’s role and obligations
► Understand franchisee’s responsibilities
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