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DEPARTMENT OF ECONOMIC AND SOCIAL AFFAIRS
STATISTICS DIVISION

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Seminar

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

New York, 23 – 24 June 2008
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Franchise accounting
Norman Prestage



Franchise Accounting

United Nations Statistics Division Seminar
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Introduction

▶ Norm Prestage

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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

Franchisor Accounting (continued)

▶ 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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