The Revenue Recognition Roller Coaster: Get Ready for the Ride

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Lots of unexpected twists and turns await franchisors in this new ruling that is far from straightforward.

You might think that you know all about the Finanicial Accounting Standards Board's new Revenue Recognition Standard that will take effect in 2018 for public companies, and 2019 for private companies. Sure, you are aware that the standard may impact a franchisor's financial statements, and that it raises a series of questions and concerns about how and when revenue is recognized. However, are you aware of all of its unexpected twists and turns? Sit back and hold tight; you're in for a ride. The new standard is far from straightforward. Franchisors should not delay in evaluating the standard and how it impacts their business.

Under current revenue recognition standards, franchisors may only recognize franchise fee income when substantially all of their obligations are met pursuant to the franchise agreement. As a result, it is already the case that franchise fee income is generally not recognized as income immediately upon receipt. While revenue recognition may be complex for certain franchisors, all franchisors should have policies and processes in place to ensure that revenue is appropriately recognized according to the current revenue recognition standard. However, just like loose pocket change after a 360-degree loop, a franchisor's carefully constructed policies and processes will be lost after the new standard comes into effect.

THE NEW STANDARD

Under the new standard, it is a requirement that all (or at least a portion of) the franchise fee income must be deferred and earned over the entire term of the franchise agreement. For example, because franchise agreements provide the franchisee with the right to access the franchisor's trademark (intellectual property) for the entire term of the agreement, under the new standard, franchisors will need to defer (for the entire term of the franchise arrangement) all, or a portion of, the franchise fee.

What about the portion of the franchise fee that is for "services" performed by the franchisor in granting the franchise? Franchisors also provide various services to the franchisees that are, for the most part, earned at the outset such as training, relationship introductions, site selection, and more. Thus, franchisors will need to make important decisions about whether they should be allocating their franchise fees between different rights and services granted to franchisees, and whether to create multiple distinct fees in their legal documents.

In determining the allocation of franchise fees, franchisors should closely analyze the rights granted to franchisees, their obligations to franchisees, and particularly the support provided. In doing so, franchisors may want to consider which aspect(s) of the agreement provide the most value to the franchisee: the right to access the franchisor's trademark, training, support, or something else? Services provided by franchisors vary widely, as does trademark popularity or prestige.

Another consideration to bear in mind is that often, the array of services provided by a franchisor are not distinct from its intellectual property. If the right to access the IP is entangled with the other franchisor obligations pertaining to goods or services, there may be an argument that the franchisor may need to treat the entire franchise fee as consideration for a single performance obligation (tied to the use of the IP) and recognize the entire franchise fee as income earned, amortized over the entire term of the franchise agreement (i.e., not in a fixed point in time). It will be interesting to

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see how franchisors analyze, allocate and justify such allocation as part of the new recognition standards.

MORE HILLS AHEAD: LEGAL CONSIDERATIONS

While the new standard may have its "thrills" from a financial reporting perspective, it's no surprise that legal issues abound.

Franchisors typically do not set out in their franchise agreement or their franchise disclosure document an itemized account of what franchisee fees cover. Moreover, it is not uncommon for franchisors to simply set franchise fees based on the amount and general approach of other franchisors (i.e. in the same industry), that is, without considering the actual market values for the various rights/services/benefits that the franchisee is actually receiving.

Clearly, this approach will meet with challenges under the new recognition rules. The more pertinent question is whether franchisors will be inclined to adopt the approach of actually itemizing franchise fees in their FDDs and franchise agreements. Of particular concern, is the risk that such approach may provide franchisees with an opportunity to scrutinize, criticize, and potentially "claw back" various elements of the allocated franchise fees (as itemized under the franchise agreement) in circumstances where they believe that particular rights, services, or benefits have not in fact been provided by the franchisor.

Itemization may also create a challenge to those franchisors that market their franchise on the basis that the franchise fees are a general "cost" for granting the franchise, and so post-payment services are performed on a "complimentary" basis (everyone appreciates something given for free). Essentially, it may create additional obstacles for franchisors in marketing and negotiating the sale of their franchises to prospective franchisees. In this regard, and more generally, the sophistication of the franchisees (and the franchisor for that matter) will play a part in the determination of whether itemizing franchise fees in the legal documentation, makes sense.

As is often the case, business imperatives will rule the day. If it is overall more beneficial (especially for the franchisor, and more so if for both the franchisor and the franchisee) to itemize the franchise fee in FDDs and franchise agreements, then we will expect to see that practice widely adopted following the adoption of the new revenue recognition standard.

FRANCHISORS KEEP YOUR EYES OPEN

All franchisors should expect practical and noticeable effects from the required deferment of revenue under the new recognition standard. That said, the impact will be unique in each situation and will depend upon the franchise system, its structure, and its relative financial strength and integrity. Importantly, a franchisor that relies upon credit facilities may face issues as a result of the apparent changes in the franchisor company's tangible net worth (and decrease in equity) which could affect bank-imposed standards and loan covenants.

Franchisors should also anticipate how regulators in registration states may view future financials prepared under the new recognition standard. The terms, or necessity, of financial assurance requirements and mandated terms for realization of escrowed or deferred fees may be impacted. Likewise, franchise sales systems involving brokers and commission structures may require assessment to address the deferment of franchise fee revenue for commission payments.

Franchisors using regional developers or master franchisors will also require specific attention. A franchisor that adapts its agreements and fees to meet these apparent challenges will ultimately be required to justify to their auditors what revenue should be deemed earned rather than deferred over the term of the agreement. In this regard, early planning and discussions are critical.

IS THE RIDE OVER YET?

Imagine, a year or two from now, the franchisor that has evaluated its franchise fees, its legal documents, and its system and has adopted the new revenue recognition policy. It may have been an arduous and time-consuming process (involving discussions with their beloved accounting and legal professionals), but the ride will, at that time, be over, right?

Guess again! There are steep climbs and tight turns ahead. Franchisors will then need to file their tax returns, and face additional concerns and considerations. For example, any delay, no matter how large or small, in the recognition of income for financial statement purposes will result in a bigger gap between income earned on the financial statements and income reported on the tax return. For tax purposes, franchise fees received can generally be deferred for only up to one year. Yes, managing a franchisor's cash flow will become more strenuous as cash will be needed for tax dollars long before the profits show up on the financial statements

Like any thrilling roller coaster ride, there is an unexpected twist at the end. Did we mention the new standard will be retrospectively applied? Once a franchisor implements the new standard, two years of previously-issued financial statements must be conformed to the new standard. Yes, this means more work for the franchisor (which should begin now). And unfortunately, you won't even get a souvenir photo when this ride is over. ■

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