The past few years have seen a number of companies with accounting problems stemming from improperly recognized revenue. These companies have included America Online, BoardVision, Cendant, Lucent, Legato, Microstrategy, Sunbeam and Xerox. The failure to correctly apply revenue recognition rules and standards can result in serious consequences for a company, including SEC audits and fines, shareholder suits, the destruction of brand value, and the erosion of stock price. To avoid these serious consequences, franchisors and franchisees need to be savvy about the concept of revenue recognition and know the basic rules.

The phrase “revenue recognition” describes the point at which income may be included in a company’s profit and loss account. The fundamental principle of revenue recognition is that revenue should not be recognized until the revenue is realized or realizable and earned by the company. To ensure that this fundamental principle is followed, revenue recognition standards or guidelines have been promulgated by the Securities and Exchange Commission (“SEC”), Financial Accounting Standards Board, the Accounting Standards Executive Committee and the Emerging Issues Task Force. The SEC, in particular, has prepared staff accounting bulletins on the application of general accounting principles to revenue recognition.

In industries where expensive, custom products or solutions are delivered in multiple parts over an extended period, the sales teams, attorneys and accountants typically work hand-in-hand to structure the transaction and draft an agreement to maximize early revenue recognition. As a general rule, most companies prefer deferred revenue over no revenue. However, most companies also prefer to recognize revenue as soon as possible.

In the franchising world, Financial Accounting Standards Board Statement No. 45, Accounting for Franchise Fee Revenue (1981) ("Statement 45") establishes standards for franchise fee revenue obtained through a franchise agreement. The remainder of this article focuses on Statement 45.

**Single Unit Franchise Sale**

For a single unit franchise sale, Statement 45 provides that revenue should ordinarily be recognized when all material services or conditions related to the sale have been substantially performed or satisfied by the franchisor. In Statement 45, “substantial performance” is defined as the point at which (a) the franchisor has no remaining obligation or intent — by agreement, trade practice or law — to refund any cash received or forgive any unpaid note or receivable, (b) substantially all of the initial services of the franchisor required under the agreement have been performed, and (c) no other material conditions or obligations related to the determination of substantial performance exist. The commencement of operations by the franchisee is presumed to be the earliest point at which substantial performance has occurred unless the franchisor can demonstrate that substantial performance of all obligations has occurred before that time. When considering whether substantial performance has occurred, the franchisor must consider discretionary services and voluntary services that are provided by custom to determine if all services have been substantially performed.

Some franchisors allocate each part of the initial franchise fee to a specific right granted by the franchisor and service or product provided by the franchisor. This may be desirable for franchisors that (i) charge a large initial franchise fee, (ii) provide tangible property as part of the initial franchise fee, or (iii) grant franchises that take a long time to become operational. When the initial franchise fee covers tangible property, such as equipment, inventory and signs, the portion of the initial franchise fee attributable to the tangible property (based on the fair market value) may be recognized at a time unrelated to the performance of the initial services.

But usually, all services are viewed as interrelated, to such an extent that the cost attributable to each service cannot be separated objectively. Unless a franchisor has evidence available of the actual cost attributable for individual services, the initial fee should not be allocated as a means of recognizing any part of the fee before all of the services have been substantially performed. The additional documentation and structuring and accounting work required to facilitate early revenue recognition for single unit franchise sales does not ordinarily justify this approach. As discussed below, however, the additional documentation and structuring and accounting work merits consideration when collecting large fees for area development rights and master license rights.

**Area Development and Master License Sales**

For sales of area development rights and master license rights, Statement 45 applies the same principle of recognizing revenue discussed above: revenue should ordinarily be recognized when all material services or conditions relating to the sale have been substantially performed or satisfied. But consideration must also be given to whether the obligations depend significantly on the number of units to be established. If the franchisor’s obligations depend significantly on the number of units to be established, Statement 45 provides that it is usually necessary to regard the agreement as a divisible contract and estimate the number of units involved so that revenue can be recognized in proportion to the number of units for which the required services have been substantially performed. In estimating the number of units involved, consideration must be given to any maximum or minimum number of units provided for in the agreement.

When a franchisor is receiving a large fee for area development rights or master license rights and the agreement
is for a long period, it is important to consider the franchisor’s revenue recognition goals. Revenue recognition should not always dictate how the agreement and transaction are structured, but it should be considered. The franchisor’s training obligations, approval process, assistance obligations and the amount and timing for payment of additional unit franchise fees are some of the things that impact revenue recognition in these situations. How the agreement is structured could mean the difference between recognizing all or most of the initial fee in the first year of a thirty year agreement or recognizing 1/30th of the initial fee each year over a thirty year period.

**Area Representative Sales**

The SEC has found that Statement 45 does not apply to relationships where an area representative does not have the right to open, directly or indirectly, one or more franchises. Where the area representative is not authorized to enter into franchise agreements for new units, the area representative is not a party to franchise agreements for new units and the franchisor retains sole approval over franchises for new units presented by the area representative, the area representative should be treated like an exclusive sales agent in a territory. Because performance of an exclusive sales agent occurs over time, the SEC has determined that initial franchise fees collected from an area representative should be recognized over the term of the area representative’s agreement.

**Refund Rights and Option to Purchase Franchisee’s Business**

Any refund right or practice will also impact revenue recognition. Revenue cannot be recognized until there is no remaining obligation or intent (by agreement, trade practice or law) to refund the fees. Franchisors that include refund rights in their agreements or have such practices should understand that this will impact the timing of revenue recognition.

Additionally, if a franchisor retains the right to purchase the franchisee’s business, the likelihood of the franchisor acquiring the business should be considered in accounting for the initial fee. If, when the right is given, there is an understanding that the right will be exercised or it is likely that the franchisor will acquire the business, the initial franchise fee must be deferred and, when the right is exercised, the deferred fee will reduce the franchisor’s investment in the business. Both Boston Chicken, Inc. and Einstein Noah Bagel Corp. were the subject of class action claims by investors who alleged, among other things, that these companies improperly recognized revenue from area developers where the companies had rights, and the future intent, to exercise options to acquire the area developers’ businesses.

**Continuing Fees**

In structuring franchise relationships, it is also important to consider continuing services in relation to continuing fees that will be collected. There are times when initial franchise fees are large and continuing fees are small (or not required) in relation to future services. These include situations where a franchisor (i) only requires an initial franchise fee and does not impose a royalty or (ii) collects the entire or majority of the initial franchise fee in advance for units that will be developed under area development or master license rights. If it is likely that the continuing fee will not cover the cost of the continuing services and a reasonable profit on the continuing services, a portion of the initial franchise fee should be deferred and amortized over the life of the franchise. For example, if a franchisor offers continuing services to franchisees but the franchisor does not collect a royalty and operates a system where revenue is derived by products purchased by franchisees from an affiliate of the franchisor, the franchisor may need to defer and amortize the initial franchise fee over the life of the franchises.

**Conclusion**

When structuring and documenting franchise relationships, the sales teams, attorneys and accountants should work together to find the right structure that meets the operational, legal and revenue requirements of the franchisor. This collaborative approach also insures accurate revenue reporting that is grounded in the legal agreement.

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**The Fine Art of Franchise Law**

Mark your calendars! The Forum will present the 29th Annual Forum on Franchising in Boston, Massachusetts on October 11-13, 2006. The Forum on Franchising will be held this year at the Westin Copley Square, a hotel centrally located in the heart of Boston and providing easy access to many of Boston’s noteworthy attractions.

This year’s Forum will blend several novel program concepts with programs that will elucidate traditional franchise issues from a new perspective. The Wednesday Intensives will include a negotiation workshop to be presented in conjunction with the Harvard Program on Negotiation. The Forum will present, for the first time, a workshop on the psychology of the franchise relationship featuring Greg Nathan, an Australian consultant, psychologist, and former franchisor and franchisee. The program will also include workshops on understanding and using financial statements; planning for disasters and coping with them when they hit; and embracing diversity in franchise systems – managing associated legal risks.

Boston provides a wonderful venue for social interaction among Forum participants. The Thursday night reception will be held at the Museum of Fine Arts, and the Friday night reception and dinner will be held at the Kennedy Library. Both venues are very attractive and offer exciting and fascinating exhibits.

Be sure to watch for the meeting brochure! We look forward to seeing you there.

Jack Dunham and Andy Scott  
2006 Program Co-chairs