Franchise Business Network Podcast

Featuring John Gotaskie of Fox Rothschild,
Jeff Deane of BKD and Jim Powers of Ablak Holdings

Good morning and welcome to a podcast of the Franchise Business Network in Pittsburgh. We are talking today about new accounting standards about revenue recognition which are having a dramatic impact in the field of franchising. With us are three distinguished panelists – John Gotaskie of the Fox Rothschild law firm, Jeff Deane of BKD CPAs and Advisors and Jim Powers of Franchisor Ablak Holdings. Welcome to the podcast.

John Gotaskie: Thank you. Good morning.

Jeff Deane: Great to be here.

Jim Powers: Good morning.

Question*: John Gotaskie, new standards have been adopted by the Financial Accounting Standards Board, or FASB for short. Known as FASB 606, they change how revenue must be recognized and how this will impact franchise disclosure documents, or FDD for short. They will require that the FDD be audited, a sort of audit within an audit. What can you tell our listeners?*

John Gotaskie: Some of these changes have serious and, I honestly believe, unintended side effects that could cripple franchisor businesses and make it more difficult to attract franchisees for those franchisors. The International Franchise Association, or the IFA, the franchise industry trade association, is trying to convince lawmakers that some relief is necessary. Still, we need a deal with FASB 606 as it now exists. Let's start with the FDDs. They're mandated by federal law, and they give prospective buyers the material information needed to weigh risks and benefits of an investment in a franchise. Regulations require franchisors to provide all potential buyers with this disclosure document containing specific details about the offered franchise, its officers and affiliates, financial information. And beyond that, some states also have their own specific rules that have to be followed.

Under FASB 606, a franchise no longer may recognize a franchisee's investment as revenue right away but has to amortize it over a much longer period of time. As potential franchisees review the FDDs, this new standard is really going to have a significant and material impact on the financial statements included within that FDD document. For public companies, they've already begun to adopt the 606 standard this fiscal year and non-public companies have to do it for the next fiscal year.

Question*: Jim Powers, from the perspective of an owner of several brands, what are your concerns?*

Jim Powers: The FTC requires that an FDD be audited and contain three years of financial statements. Where I draw the line is what it's used for. For the most part, an audit should provide a good forensic deep dive to point out things that are good, bad or otherwise so you can improve your business. The difference here is that the FDD is being used for something very different. I mean it's a sales tool. It's to help a potential buyer to determine the financial condition of a franchisor. I'd like to see the FDD audit be a bit more minimalistic in its approach but of course follow the standards and guidelines.

Question*: Jim Powers, do you think candidate buyers actually understand the audit portion of the FDD?*

Jim Powers: That's a great question. There are two distinct groups of potential franchise candidates. One's a group or individual who wants to get involved with a particular franchise on their own, kind of a "hometown hero." There are others who see it as part of an investment portfolio. They're really the ones who have more of an investment mentality, understand those audits, get their heads around it and the value of that deep dive.

Question*: Jeff Deane, your thoughts as an auditor?*

Jeff Deane: Audited financial statements within the Financial Disclosure Document should not look any different than the financial statements that are given to a bank or shareholders or investors. The FDD audit should not be any more intrusive or overboard, but there are certain required disclosures within financial statements that continue to be needed, and that does not change. Also the audit firm is required to follow our auditing standards. The only additional responsibility or difference you would see that we in an FDD is our requirement to read the entire document to make sure there isn't anything that's inconsistent or significantly different than our knowledge of the company.

Question*: Jim Powers?*

Jim Powers: When a potential candidate is looking at those statements, to determine the financial condition of the franchisor from a balance sheet perspective, there might be some points that they focus on like increasing assets, increasing stock, equity or more cash than debts. Same thing on the income statement side, of course more revenue derived from royalties, system income than from selling franchises. However, the new revenue recognition standards, specifically how franchise fees are now recorded, have the potential of severely and negatively affecting buyers who are trying to assess that risk.

John Gotaskie: Jim, that's a good point. In my experience, what larger and special master franchisees are looking for is the potential risk factor of the parent. They're the ones taking that deep dive you mentioned earlier because they've got the resources to help with the analysis.

Jim Powers: That's right. We've seen industry research which says that, due to FASB requirements and these required changes in revenue recognition, roughly 930 brands would have serious risk of bankruptcy or even closure, and up to 1,400 franchised small businesses would face closure causing about 1.1 million job losses.

John Gotaskie: Right. And that's because there could be big hits to the balance sheet if the FASB recognition standard is not interpreted correctly. In other words, it would appear that a liquidity crunch occurred in these companies overnight when it never did. At the same time, if a franchisor decides to restate its financials without thinking all this through, it's going to look like the financials fell off a cliff.

Jim Powers: Let's remember that half of the retail jobs in the U.S. are franchise-driven. While a majority of the franchise brands can handle the negative impact, they might have to curtail growth significantly to account for the revenue hit. Potentially as many as 35,000 new small businesses would not open and about 364,000 jobs would not be created annually. For startups, almost all of the 300-plus startup brands each year would never even get off the ground. Here's why, and here's the math. In year one, if you take an initial franchise fee of $36,000, over the life of a ten year agreement, that's $3,600 in revenue in one year that's recognized. You can only put $3,600 into that statement and will pay about $1,400 in taxes on average. Plus you'll incur all the significant pre-opening costs. Those don't go away. A franchisee might consider the $36,000 initial franchise fee as a significant cash outlay and a lot of money to them. From a franchisor's perspective, they might burn through all of that, if not way more in site selection, real estate and training. Year two really crunches the franchisor on top of that. We'll recognize another $3,600 in revenue, but under that tax law, we can only defer the revenue for one year. So we'd have to recognize the balance which would force us to draw cash from the business of about $13,000 to pay just the tax portion of it, which then leaves us about $7,200 underwater in equity for year two and beyond.

***Question**: So Jeff Deane, until we can get the change, what's the prescription?*

Jeff Deane: The prescription is going to be that the franchisors are going to have to look at the franchise fees collected and put them into separate categories or separate buckets. They should carve out amounts for services that they would sell otherwise, as then they would be able to recognize that piece of the revenue as the services are being performed as opposed to it all being included in one group and being deferred and amortized over the license period. So ultimately they should try to identify as many separate performance obligations as possible within the accounting standards to speed up the revenue recognition. This would result in a much smaller/unallocated balance of revenue to spread out over the term.

John Gotaskie: I think that's a really good point, Jeff. Some potential performance obligations that aren't directly tied to the brand are things like site selection, floor layout for ADA and OSHA compliance, project and construction management, training. For a food franchisor, maybe a portion of that fee can be limited to confidential recipes or doughnut batter or the correct temperature of the cooking oil. Things like that. Are those the types of buckets that we're thinking about?

Jeff Deane: Absolutely correct, yes.

***Question**: Jeff Deane, from an accounting perspective, if a company carves out as much as possible and recognizes less over the term, can it still report the entire franchise fee on its FDD?*

Jeff Deane: If you look at the overall audited financial statements within the FDD, it is consistent with any other financial statements and should match the accounting principles adopted by the franchisor. With that said, within the document itself, there are opportunities to report the total amount of franchise fees committed to within a year and how those franchise fees are being accounted for.

Jim Powers: That's true, and if an initial franchise fee is, again, we'll say $36,000, maybe now you change it to $10,000 plus $26,000 for the other obligations. Now certainly we haven't done that, and it's not ideal, but that's what's being discussed right now by franchisors.

Jeff Deane: That's where you're going to see an administrative or logistical nightmare or headache. Under the new standard you have an option to adopt under the Full Retrospective approach (where you ultimately recast revenue and expenses for all prior periods presented) or you have the Modified Retrospective approach where you would only apply the new standard to contracts entered into after the effective date of the new standard. What we'll see is that the Full Retrospective probably will be utilized more often, and will result in big headaches as they will need to revisit all the franchise agreements that are still outstanding and recast how much should have been recorded under the new standard (and break them out into the components) and determine what amount is left to spread out as deferred revenue. And ultimately I think we're going to see that this will be a nightmare for those adopting.

John Gotaskie: Yes Jeff, I think it is going to be a nightmare. It goes into effect this fiscal year, so if you have a franchise agreement in year five of a 10 year agreement, you've now got to recast it for those five years. Many people are suggesting that a franchisor do a full retrospective review so it doesn't look like that agreement suddenly fell off a cliff.

Jim Powers: If you have stores that are in year five of a 10-year term and transfer the location, John, how do you treat the deferred revenue?

John Gotaskie: I'll turn that one over to Jeff.

Jeff Deane: That's a good question – I am not aware that it's covered in the new standard. Ultimately what we'll see as oftentimes with new standards is that it will get framed by industry practice. So as the IFA provides guidance, as we see financial statements being issued and the industry adopts the standard we will ultimately get our guidance from what is being practiced.

***Question**: Jeff Deane, what are some of the most important issues when it comes to impact on franchisees?*

Jeff Deane: There's the good news and that is the impact should not be significant. As an example, if you take a coffee franchise, and if you think about it, about 99.9 percent of what they do is sell coffee and they record the revenue at the point of sale. The only area that the coffee franchisee could see a change is if they were to offer some time of loyalty program. As an example, let's assume that the coffee franchisee has a coffee club for its customers, where you buy three cups and get the fourth one free with your coffee club card. So ultimately in exchange for entering the coffee club, the customer gets a special benefit. That benefit is a free cup of coffee. The new revenue recognition standard says that the franchisee has to carve out the value of that benefit, that free cup of coffee, and record it as a deferred revenue liability and then recognize that as people redeem their card for their free cup of coffee. And ultimately the accounting guidance as you look at it calls that special benefit a "material right."

***Question**: So, Jeff, what makes it "material right?"*

Jeff Deane: Basically it is the customer receiving something special/unique by entering into the program that the average consumer for that store is getting something where the normal person cannot get. Did the customer have to enter into a transaction to get that right for a free cup or could they have received it online for clicking onto a coupon? So the key point there is that it is something unique that your normal everyday customer won't have access to, and the reason why they're getting this free cup of coffee is that they've done something such as purchase the original three cups. Another point to consider is that in recording the liability there is the likelihood that you have to figure out that a customer will redeem the points or get the free cup of coffee. Maybe it's a 60 percent likelihood. Then ultimately only 60 percent of the total value is recorded as deferred revenue and that deferred revenue does not become revenue until the person redeems their loyalty card for their free cup of coffee. For many, we may find out that this whole area is going to be immaterial and not an issue at all.

***Question**: Jeff, is the likelihood based on historical performance?*

Jeff Deane: Typically yes. As an auditor I would expect that the franchisee would present its data, explain its bonus points system, quantify the number of points or the cards that are still outstanding and determine again the percentage of likelihood that the points or cards would be redeemed based on whatever historical data that they may have.

Jim Powers: That's true. For larger franchises which have apps and so forth which can be tracked, franchises know how many people have points, making it a bit easier. But businesses that just hand out points and cards would require way more record keeping.

John Gotaskie: I agree with you there, Jim. Jeff, I'm wondering, let's say I'm just starting a new "buy four coffees and get one free" loyalty program, for example. How at the beginning like that do I look at the likelihood of redemption at that stage?

Jeff Deane: Ultimately if you think about it, it is an estimate. And we're trying to figure out what's a reasonable estimate. Ideally you would use historical data and that would be the best predictor. But if you are starting a new program if you're a new company and do not have anything similar, you would most likely look at industry data. And you'd continue to utilize that and eventually what will occur is you will adjust the "likelihood of redemption" factor based on your own actual historical results as the program continues throughout years.

We're unfortunately out of time today. Listeners, be sure to check out our companion podcast about how FASB 606 changes how a franchise recognizes lease obligations. Again, our thanks to our panelists John Gotaskie of the Fox Rothschild law firm, Jeff Deane of BKD CPAs and Advisors and Jim Powers of Ablak Holdings.

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