
IFA
INTERNATIONAL FRANCHISE ASSOCIATION
FRANCHISING
Building local businesses, one opportunity at a time.
FRANCHISE BUSINESS NETWORK
PITTSBURGH

INTRODUCTIONS

John Gotaskie – Partner, Fox Rothschild LLP

- John represents individuals, partnerships and companies in diverse legal matters including complex commercial litigation, bankruptcy litigation and franchising issues. He represents both franchisors and franchisees in litigation and general corporate matters, including advice respecting Franchise Disclosure Documents, franchise agreements and related contracts. He believes that a carefully coordinated approach to legal services is necessary not only to help his clients solve their legal problems but also to help his clients become more successful.

Jeff Deane – Managing Partner, BKD CPAs & Advisors

- Jeff is managing partner of BKD's Pennsylvania offices. He also leads the International niche within the PA practice and serves both inbound and outbound companies. He maintains relationships with professionals on six continents who provide advice on tax, audit and legal matters in their jurisdictions. He is treasure of the Pittsburgh Regional Alliance and serves on the audit committee of the Allegheny Conference.

Jim Powers, CFE – Executive Vice President, Ablak Holdings

- Jim has over 30 years in the restaurant/franchise industry and 25+ years with Ablak Holdings. Working up from a pizza delivery driver in 1989, Jim has now served as the Vice President of Marketing for Vocelli Pizza, and the CEO of three of the Ablak restaurant chains. Jim has a degree in marketing, a Franchise Management Certificate from Georgetown University and holds Certified Franchise Executive (CFE) credentials from the International Franchise Association.

FINANCIAL STATEMENT AUDITS FOR THE FDD

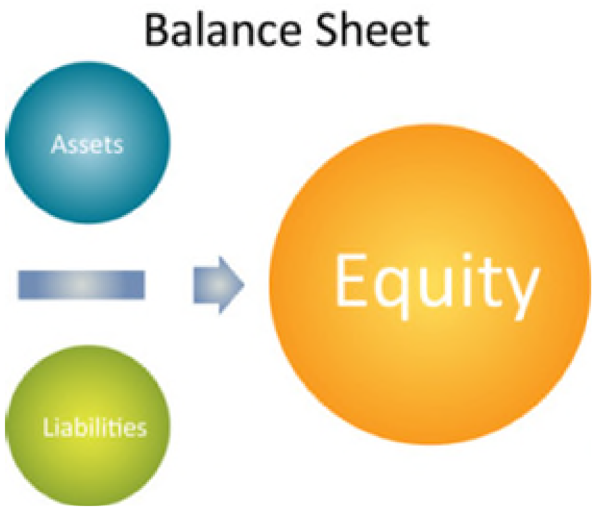
FDD Audit Philosophy

- Mandatory FTC requirement for pre-sale disclosure (FDD Item #21)
- The financial statements should be audited financial statements.
- The statements should contain three years of financial data (unless the franchisor has less than 3 years of operating history).

- FDD is a sales tool
- Audit should be minimalistic in its approach
- Read by franchise candidates to determine the financial condition of the franchisor

FDD Audit – Key Takeaways

- Read by the franchise candidate to determine the financial condition of the franchisor
- Things you want to see on a franchisor's balance sheet:
  - Increasing assets
  - Increasing stockholders' equity
  - More cash than debt
  - Amount of current debt < (less than) 1/2 of the total assets
  - Amount of current debt < 1/3 of the stockholders' equity



FDD Audit – Key Takeaways

- Things you want to see on a franchisor’s income statement:
  - Increasing profit
  - More revenue derived from royalties and system income than from selling franchises
  - Increasing revenue trends, usually > 15%
  - Increasing net income trends, usually > 15%
  - Increasing net income per share trend, usually > 15%
  - A profitable franchisor!

FASB REVENUE REPORTING REQUIRMENTS FOR FRANCHISORS

FASB 606 - Definition

Franchisors can no longer recognize initial franchise and certain other fees in the year they are received. With the exception of those fees separate and distinct from the award of a franchise right (such as a separate site selection fee), franchisors must amortize the fee over the term of the agreement.

FASB
FINANCIAL ACCOUNTING STANDARDS BOARD

FASB 606 – Impact

930 brands would have been at serious risk of bankruptcy or closure in the first three years of the rule going into effect. The associated 104,098 franchised small businesses would correspondingly have faced closure, causing approximately 1.1 million job losses.

Source: FRANdata, Nov. 5, 2018

FRANdata
Franchise Business Intelligence

FASB 606 - Impact

The majority of the remaining 1800 brands that could handle the negative financial impact would have to curtail their growth significantly, thus shrinking the rate of new small business development and corresponding job creation. Potentially as many as 35,000 new small businesses would not open and 364,000 jobs not created annually.

Source: FRANdata, Nov. 5, 2018

FRANdata
Franchise Business Intelligence

FASB 606 - Impact

Almost all of the 300+ start-up brands that begin to offer franchises each year would never get off the ground.

Source: FRANdata, Nov. 5, 2018

FRANdata
Franchise Business Intelligence

FASB 606 – The Math

- Year 1 – Example
  - Initial Franchise FEE (IFF) of $36,000
  - 10 Year Franchise Agreement
  - Recognize $3,600 of Revenue
  - Pay $1,400 in taxes on that revenue
  - Incur significant pre-opening expenses (recruiting, training, site selection, etc.)

Source: FRANdata, Nov. 5, 2018

IFA INTERNATIONAL FRANCHISE ASSOCIATION | FRANCHISING Building local businesses, one opportunity at a time.

FRANCHISE BUSINESS NETWORK

FASB 606 - Definition

Franchisors can no longer recognize initial franchise and certain other fees in the year they are received. With the exception of those fees separate and distinct from the award of a franchise right (such as a separate site selection fee), franchisors must amortize the fee over the term of the agreement.

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

FASB 606 – The Math

- Year 2 – Example
  - Recognize $3,600 of Revenue
  - Under tax law the franchisor can only defer revenue for one year so it would have to recognize the balance of the $36,000 IFF.
  - The franchisor would need to draw cash from the business of approximately $13,000 to pay the second year tax liability.
  - Because of the proposed FASB rule, it could only recognize two years of that initial franchise fee, or $7,200 but have paid taxes of approximately $13,000
  - Thereby reducing net worth by the difference, or <u>$7,200.</u>

Source: FRANdata, Nov. 5, 2018

Two Hyper-Critical Pieces of Analysis

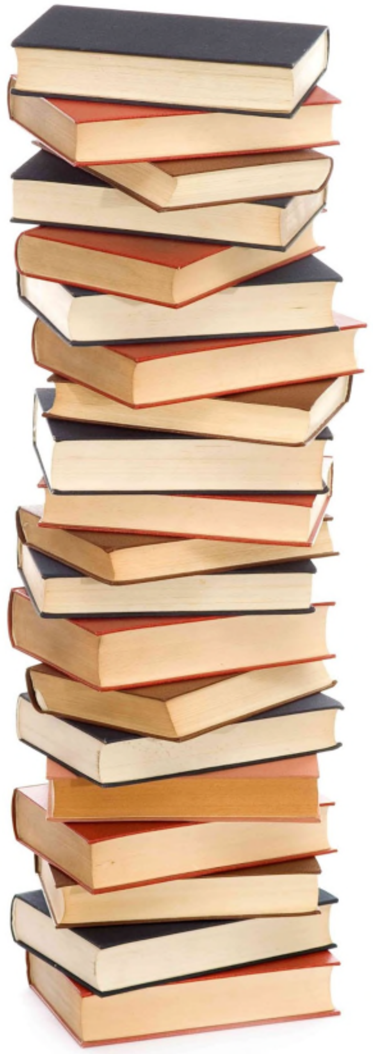
- First: What are the separate performance obligations?
  - Site Selection?
  - Floor Layout? (ADA & OSHA Compliance)
  - Project Management?
  - Training?
    - Essentially, you are looking for anything that can be broken out.
- Second: What is essential to the Brand?
  - Need to determine what is general—immediate recognition—versus specific to brand.
  - For Example: confidential recipes are specific/essential to brand

Recommendations

- First: Consider doing a full retrospective review.
  - Maybe consider going back 3 years
  - Permit franchisor to show trends, as opposed to dramatic fall-off demonstrated in earlier example
- Second: Franchisors are rarely if ever called out for being under-optimistic—only for being over-optimistic
- Third: Cash Flow remains KING, probably best to focus on it so as to demonstrate health of business
  - Show future deferred revenue clearly in statements.

FASB 606 - Resources

- Update on Implementation Activities for Franchise Industry
  - FASB – Nov. 5, 2018
- FASB Press Release
  - IFA - Nov. 5, 2018
- Analysis of the Impact of the FASB Rule Change
  - FRANdata – Nov. 5, 2018
- Are You Aware of Upcoming FASB Revenue Reporting Requirements?
  - IFA – Apr. 9, 2019
- When is a Franchise Fee Considered Income?
  - IFA – Apr. 12, 2019



FASB REVENUE REPORTING REQUIRMENTS FOR FRANCHISEES

FASB 606 - Definition

Impact on Franchisees:

- Normal transactions – Regular retail activity
  - Recognize income the same – At the point of sale
- Potential deferral in recognition of revenue:
  - Loyalty cards
  - “Bounce-back” coupons

FASB
FINANCIAL ACCOUNTING STANDARDS BOARD

FASB 606 - Definition

Key Question: Does a "material right" exist?

- Does incentive provide the customer with an option to purchase additional goods at a price that does not reflect the "stand-alone" price (e.g. Coffee Club: Buy four cups of coffee – Fifth cup is free)
- Those incentives are only earned as a result of the customer entering into an arrangement (e.g. signing up as a member of the Coffee Club)

FASB 606 - Impact

If a “material right” exists and is material to the financial statements

- Portion of the original sales price is allocated to the incentive and is deferred until the incentive/option is exercised
  - Determine the value of the incentive (net of likelihood of exercise)
  - Calculate the gross value of separate units (original item & value of incentive)
  - Allocate sales price to individual components (revenue & deferred revenue)
  - Relieve deferred revenue when redemption occurs

FASB 606 – The Math (Buy 4 cups – 1 Free)

- Original purchase price of $4
- Initial allocation to incentive is 20% of sale price or $.80
  - Revenue = $3.20
  - Deferred revenue = $.80
- Redemption of Coffee Card for free cup of coffee
  - Deferred revenue relieved of $3.20 (4 cups at $.80/cup deferred)
  - Revenue is recorded of $3.20

FASB 606 - Impact

*"Effective October 2018, we launched a loyalty program… Eligible customers who enroll in the program generally earn points for every dollar spent. After accumulating a certain number of points, the customer earns a reward that can be redeemed for a free entrée…**We defer revenue associated with the estimated selling price of points earned by program members as each point is earned.** The estimated selling price of each point earned is based on the estimated value of product for which the reward is expected to be redeemed, net of points we do not expect to be redeemed. **Our estimate of points we expect to be redeemed is based on historical company specific data. We recognize loyalty revenue when a customer redeems an earned reward. Deferred revenue associated with Chipotle Rewards is included in unearned revenue in our consolidated balance sheet.**"*

Source: Chipotle 2018 10K

LEASE STANDARDS

FASB ASC Topic 842 - Leases

- The new accounting standard is effective for fiscal years of public business entities beginning after **December 15, 2018 (FY19)**, including interim periods within those years and may be adopted early.
- Privately-owned company effective 1 year later (FY20)
- Modified retrospective adoption
  - Earliest period presented within financial statements
- Optional transitional method (most likely)
  - Apply at adoption date (1/1/20)
  - Cumulative effect adjustment to RE in year of adoption

FASB
FINANCIAL ACCOUNTING STANDARDS BOARD

FASB ASC Topic 842 - Leases

Under the new definition, a contract contains a lease if it:

- Explicitly/implicitly specifies the use of property, plant or equipment
- Grants the customer control of the identified asset for a period of time

Leases are separated into two classes:

- Finance leases (previously capital leases)
    - Transfers substantially all risks & rewards of ownership
- Operating leases
    - Must be presented on the balance sheet as a (ROU) asset
    - Corresponding lease liability.

FASB
FINANCIAL ACCOUNTING STANDARDS BOARD

Finance Lease Criteria

1. Ownership of asset transfers to lessee by end of lease term
2. Lessee has purchase option that it is reasonably certain to be exercised
3. Lease term is for major part of the economic life of asset (Not applicable for leases that commence "at or near the end" of the underlying asset's economic life, *e.g.*, in the final 25 percent of an asset's economic life)
4. PV of minimum lease payments amounts to at least substantially all of fair value of leased asset
5. NEW: The underlying asset is of such a **specialized nature** that it is expected to have no alternative use to the lessor at the end of the lease term

Comparison of Lessee Accounting Models

Finance Lease

Balance Sheet

Right of Use (ROU) Asset*

Lease Liability

Income Statement

Interest Expense (on lease liability)

Amortization Expense (ROU asset)

Cash Flow

Cash paid for principal payments (financing activities) & interest payments (operating activities)

*Periodically reduced by straight-line amortization

Operating Lease

Balance Sheet

Right of Use (ROU) Asset**

Lease Liability

Income Statement

Lease/Rent Expense (straight-line)

Cash Flow

Cash paid for lease payments (operating)

**Periodically reduced by the difference between straight-line lease expense & interest cost on lease liability

Contracts with Multiple Components

Lease Component	Nonlease Component	Not a Separate Component
• A separate right to use an asset • Lessee can benefit from the right of use of the underlying asset either on its own or together with other readily available resources. The use is neither highly dependent on nor interrelated with other assets • Payments accounted for as a separate lease	• An activity that transfers a separate good or service to the customer • Includes maintenance services • Allocated payments are nonlease period expense	• Related to administrative tasks to initiate the lease & payment of lessor costs that do not transfer a separate good or service separate from the ROA • Includes payments for insurance or property taxes • Payments are part of lease payment, not separately allocated

Lessee Accounting – Initial Measurement

Lease Liability (obligation to make lease payments)	• Measured at the present value of the future lease payments
Right of Use Asset	• ROA = lease liability + initial direct cost + lease prepayments - lease incentives received

Amount initially recorded as an ROU asset & lease liability is computed the same regardless of whether the lease is classified as an operating lease or a finance lease

Initial Direct Costs

Initial Direct Costs	
Included	Excluded
Commissions	Fixed employee salaries
Legal fees resulting from the execution of the lease	Internal engineering costs
Lease document preparation costs incurred after the execution of the lease	Legal fees for services rendered before the execution of the lease
Certain payments to existing tenants to terminate a lease	Negotiating lease term & conditions
Consideration paid for a guarantee of a residual asset by an unrelated third party	Advertising
	Other origination efforts
	Depreciation
	Costs related to an idle asset

FASB ASC Topic 842 - Impact

- Identifying and accounting for all leases
- Calculating impact on opening balance sheet retained earning
- Impact on key business metrics & debt covenants
  - Working capital
  - Current ratio
  - Debt to equity

FASB ASC Topic 842 - Impact

"In February 2016, FASB issued ASU 2016-02, "Leases (Topic 842)," and issued additional clarifications and improvements throughout 2018. The pronouncement requires lessees to recognize a liability for lease obligations, which represents the discounted obligation to make future minimum lease payments, and a corresponding right-of-use asset on the balance sheet. The guidance requires disclosure of key information about leasing arrangements that is intended to give financial statement users the ability to assess the amount, timing, and potential uncertainty of cash flows related to leases. ***We have adopted the requirements of the new lease standard effective January 1, 2019. We have elected the optional transition method to apply the standard as of the effective date and therefore, we will not apply the standard to the comparative periods presented in our financial statements.*** *At the beginning of the period of adoption, we will recognize a cumulative-effect adjustment in retained earnings due to impairment of certain right-of-use assets at the effective date. "*

Source: Chipotle 2018 10K

FASB ASC Topic 842 - Impact

"The adoption of ASU 2016-02 will have a significant impact on our consolidated balance sheet as we will record material assets and obligations primarily related to approximately 2,500 restaurant operating leases and corporate office leases. ***We expect to record operating lease liabilities of approximately $2.7 billion based on the present value of the remaining minimum rental payments using discount rates as of the effective date.*** *We expect to record corresponding right-of-use assets of approximately $2.4 billion, based upon the operating lease liabilities adjusted for prepaid and deferred rent, unamortized initial direct costs, liabilities associated with lease termination costs and impairment of right-of-use assets recognized in retained earnings as of January 1, 2019. We do not expect a material impact on our consolidated statement of income or our consolidated statement of cash flows."*

Source: Chipotle 2018 10K


IFA
INTERNATIONAL FRANCHISE ASSOCIATION
FRANCHISING
Building local businesses, one opportunity at a time.
FRANCHISE BUSINESS NETWORK
PITTSBURGH