

Statement of Financial Accounting Standards No. 45

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Accounting for Franchise Fee Revenue

March 1981



Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 45: Accounting for Franchise Fee Revenue

FAS 45 Summary

This Statement extracts the specialized accounting principles and practices from the AICPA Industry Accounting Guide, *Accounting for Franchise Fee Revenue*, and establishes accounting and reporting standards for franchisors. It requires that franchise fee revenue from individual and area franchise sales be recognized only when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor. This Statement also establishes accounting standards for continuing franchise fees, continuing product sales, agency sales, repossessed franchises, franchising costs, commingled revenue, and relationships between a franchisor and a franchisee.

INTRODUCTION AND BACKGROUND INFORMATION

1. As discussed in FASB Statement No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*, the FASB is extracting the specialized ¹ accounting and reporting principles and practices from AICPA Statements of Position (SOPs) and Guides on accounting and auditing matters and issuing them in FASB Statements after appropriate due process. This Statement extracts the specialized principles and practices from the AICPA Industry Accounting Guide, *Accounting for Franchise Fee Revenue* (Guide), and establishes accounting and reporting standards for franchise fee revenue that is obtained through a **franchise agreement**.²

2. The Board has not undertaken a comprehensive reconsideration of the accounting issues discussed in the Guide and has extracted the specialized accounting and reporting principles without significant change. Accordingly, some of the background material and discussion of accounting alternatives have not been carried forward from the Guide. The Board's conceptual framework project on accounting recognition criteria will address revenue recognition issues similar to those addressed in this Statement. A Statement of Financial Accounting Concepts resulting from that project in due course will serve as a basis for evaluating existing standards and practices. Accordingly, the Board may wish to evaluate the standards in this Statement when its conceptual framework project is completed.

3. The Guide was developed to clarify and standardize accounting by **franchisors**, particularly the timing of

recognizing revenue from **initial franchise fees**. Before 1970, franchisors generally recognized revenue from initial franchise fees when franchises were sold. The Guide recommended that revenue from initial franchise fees be recognized when the franchise sale transaction was completed, that is, when all material services or conditions relating to the sale had been substantially performed or satisfied by the franchisor. In addition, the Guide stated a presumption that commencement of operations by the **franchisee** ordinarily would be the earliest point at which substantial performance could occur.

4. The Board has concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraph 25 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Individual Franchise Sales

5. Franchise fee revenue from an individual franchise sale ordinarily shall be recognized, with an appropriate provision for estimated uncollectible amounts, when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor. Substantial performance for the franchisor means that (a) the franchisor has no remaining obligation or intent—by agreement, trade practice, or law—to refund any cash received or forgive any unpaid notes or receivables; (b) substantially all of the **initial services** of the franchisor required by the franchise agreement have been performed; and (c) no other material conditions or obligations related to the determination of substantial performance exist. If the franchise agreement does not require the franchisor to perform initial services but a practice of voluntarily rendering initial services exists or is likely to exist because of business or regulatory circumstances, substantial performance shall not be assumed until either the initial services have been substantially performed or reasonable assurance exists that the services will not be performed. The commencement of operations by the franchisee shall be presumed to be the earliest point at which substantial performance has occurred, unless it can be demonstrated that substantial performance of all obligations, including services rendered voluntarily, has occurred before that time.

6. Installment or cost recovery accounting methods ³ shall be used to account for franchise fee revenue only in those exceptional cases when revenue is collectible over an extended period and no reasonable basis exists for estimating collectibility.

7. Sometimes, large initial franchise fees are required but **continuing franchise fees** are small in relation to future services. If it is probable that the continuing fee will not cover the cost of the continuing services to be provided by the franchisor and a reasonable profit on those continuing services, then a portion of the initial franchise fee shall be deferred and amortized over the life of the franchise. The portion deferred shall be an amount sufficient to cover the estimated cost in excess of continuing franchise fees and provide a reasonable profit on the continuing services.

Area Franchise Sales

8. Initial franchise fees relating to **area franchise** sales shall be accounted for following the same principles described in paragraphs 5-7 for individual franchise sales, that is, revenue ordinarily shall be recognized when all material services or conditions relating to the sale(s) have been substantially performed or satisfied by the franchisor. If the franchisor's substantial obligations under the franchise agreement relate to the area franchise and do not depend significantly on the number of individual franchises to be established, substantial performance shall be determined using the same criteria applicable to individual franchises (paragraph 5). However, if the franchisor's substantial obligations depend on the number of individual franchises established within the area, area franchise fees shall be recognized in proportion to the initial mandatory services provided. Revenue that may have to be refunded because future services are not performed shall not be recognized by the franchisor until the franchisee has no right to receive a refund.

9. The substance of an area franchise agreement shall determine when material services or conditions relating to a sale have been substantially performed or satisfied. Sometimes, the efforts and total cost relating to initial services are not affected significantly by the number of outlets opened in an area and, therefore, the area franchise sale is similar to an individual franchise sale. Conversely, when the efforts and total cost relating to initial services are affected significantly by the number of outlets opened in an area, it may be necessary to regard the franchise agreement as a divisible contract and to estimate the number of outlets involved so that revenue may be recognized in proportion to the outlets for which the required services have been substantially performed. Estimates shall consider the anticipated number of outlets based on the terms of the franchise agreement (for example, time limitations and any specified minimum or maximum number of outlets). Any change in estimate resulting from a change in circumstance shall result in recognizing remaining fees as revenue in proportion to remaining services to be performed.

Relationships between Franchisor and Franchisee

10. A franchisor may guarantee borrowings of a franchisee, have a creditor interest in the franchisee, or control a franchisee's operations by sales or other agreements to such an extent that the franchisee is, for all practical purposes, an affiliate of the franchisor. Sometimes, two franchisors may agree to pool their risks by selling their respective franchises to each other. In all those circumstances, revenue shall not be recognized if all material services, conditions, or obligations relating to the sale have not been substantially performed or satisfied (paragraph 5).

11. A franchise agreement may give the franchisor an option to purchase the franchisee's business. For example, a franchisor may purchase a profitable franchised outlet as a matter of management policy, or purchase a franchised outlet that is in financial difficulty or unable to continue in business to preserve the reputation and goodwill of the franchise system. If such an option exists, the likelihood of the franchisor's acquiring the franchised outlet shall be considered in accounting for the initial franchise fee. If at the time the option is given, an understanding exists that the option will be exercised or it is probable that the franchisor ultimately will acquire the franchised outlet, the initial franchise fee shall not be recognized as revenue but shall be deferred.

When the option is exercised, the deferred amount shall reduce the franchisor's investment in the outlet.

Commingled Revenue

12. The franchise agreement ordinarily establishes a single initial franchise fee as consideration for the franchise rights and the initial services to be performed by the franchisor. Sometimes, however, the fee also may cover tangible property, such as signs, equipment, inventory, and land and building. In those circumstances, the portion of the fee applicable to the tangible assets shall be based on the fair value of the assets and may be recognized before or after recognizing the portion applicable to the initial services. For example, when the portion of the fee relating to the sale of specific tangible assets is objectively determinable, it would be appropriate to recognize that portion when their titles pass, even though the balance of the fee relating to services is recognized when the remaining services or conditions in the franchise agreement have been substantially performed or satisfied.

13. Although a franchise agreement may specify portions of the total fee that relate to specific services to be provided by the franchisor, the services usually are interrelated to such an extent that the amount applicable to each service cannot be segregated objectively. The fee shall not be allocated among the different services as a means of recognizing any part of the fee for services as revenue before all the services have been substantially performed unless actual transaction prices are available for individual services; for example, through recent sales of the separate specific services.

Continuing Franchise Fees

14. Continuing franchise fees shall be reported as revenue as the fees are earned and become receivable from the franchisee. Costs relating to continuing franchise fees shall be expensed as incurred. Although a portion of the continuing fee may be designated for a particular purpose, such as an advertising program, it shall not be recognized as revenue until the fee is earned and becomes receivable from the franchisee. An exception to the foregoing exists if the franchise constitutes an agency relationship under which a designated portion of the continuing fee is required to be segregated and used for a specified purpose. In that case, the designated amount shall be recorded as a liability against which the specified costs would be charged.

Continuing Product Sales

15. The franchisee may purchase some or all of the equipment or supplies necessary for its operations from the franchisor. Sometimes, the franchisee is given the right to make **bargain purchases** of equipment or supplies for a specified period or up to a specified amount, when the initial franchise fee is paid. If the bargain price is lower than the selling price of the same product to other customers or if the price does not provide the franchisor a reasonable profit on the equipment or supply sales, then a portion of the initial franchise fee shall be deferred and accounted for as an adjustment of the selling price when the franchisee purchases the equipment or supplies. The portion deferred shall be either (a) the difference between the selling price to other customers and the bargain purchase price or (b) an amount sufficient to cover any cost in excess of the bargain purchase price and provide a reasonable profit on the sale, as appropriate.

Agency Sales

16. Some franchisors engage in transactions in which they are, in substance, an agent for franchisees by placing orders for inventory and equipment and selling to franchisees at no profit. The franchisor shall account for such transactions as receivables and payables in its balance sheet and not as revenue and costs or expenses.

Franchising Costs

17. Direct (incremental) costs relating to franchise sales for which revenue has not been recognized ordinarily shall be deferred until the related revenue is recognized; however, the deferred costs shall not exceed anticipated revenue less estimated additional related costs. Indirect costs of a regular and recurring nature that are incurred irrespective of the level of sales, such as general, selling, and administrative costs, shall be expensed as incurred. Costs yet to be incurred shall be accrued and charged against income no later than the period in which the related revenue is recognized. Because of the concept of substantial performance (paragraph 5), such costs should be relatively minor.

Repossessed Franchises

18. A franchisor may recover franchise rights through repossession if a franchisee decides not to open an outlet. If, for any reason, the franchisor refunds the consideration received, the original sale is canceled, and revenue previously recognized shall be accounted for as a reduction in revenue in the period the franchise is repossessed. If franchise rights are repossessed but no refund is made, (a) the transaction shall not be regarded as a sale cancellation, (b) no adjustment shall be made to any previously recognized revenue, (c) any estimated uncollectible amounts resulting from unpaid receivables shall be provided for, and (d) any consideration retained for which revenue was not previously recognized shall be reported as revenue.

Business Combinations

19. A transaction in which a franchisor acquires the business of an operating franchisee ordinarily shall be accounted for as a business combination in accordance with APB Opinion No. 16, Business Combinations, assuming no relationship existed at the time of the franchise sale to preclude revenue recognition (paragraphs 10 and 11). If the transaction is accounted for as a pooling of interests, the financial statements of the two entities are retroactively combined and the original franchise sales transaction as well as any product sales shall be eliminated in the combined financial statements. If the transaction is accounted for as a purchase, the financial statements of the two entities are not retroactively combined and revenue shall not be adjusted. If such a transaction is, in substance, a cancellation of an original franchise sale, the transaction shall be accounted for in accordance with paragraph 18.

Disclosures

20. The nature of all significant commitments and obligations resulting from franchise agreements, including

a description of the services that the franchisor has agreed to provide for agreements that have not yet been substantially performed, shall be disclosed.

21. If no basis for estimating the collectibility of specific franchise fees exists, the notes to the financial statements shall disclose whether the installment or cost recovery method is being used to account for the related franchise fee revenue. Furthermore, the sales price of such franchises, the revenue and related costs deferred (both currently and on a cumulative basis), and the periods in which such fees become payable by the franchisee shall be disclosed. Any amounts originally deferred but later recognized because uncertainties regarding the collectibility of franchise fees are resolved also shall be disclosed.

22. Initial franchise fees shall be segregated from other franchise fee revenue if they are significant. If it is probable that initial franchise fee revenue will decline in the future because sales predictably reach a saturation point, disclosure of that fact is desirable. Disclosure of the relative contribution to net income of initial franchise fees also is desirable if not apparent from the relative amounts of revenue.

23. Revenue and costs related to franchisor-owned outlets shall be distinguished from revenue and costs related to franchised outlets when practicable. That may be done by segregating revenue and costs related to franchised outlets. If there are significant changes in franchisor-owned outlets or franchised outlets during the period, the number of (a) franchises sold, (b) franchises purchased during the period, (c) franchised outlets in operation, and (d) franchisor-owned outlets in operation shall be disclosed.

Amendment to Other Pronouncement

24. The reference to the AICPA Industry Accounting Guide, *Accounting for Franchise Fee Revenue*, is deleted from Appendix A of Statement 32. The specialized accounting provisions of that Guide are superseded by this Statement.

Effective Date and Transition

25. This Statement shall be effective for financial statements for fiscal years beginning after June 15, 1981. Earlier application is encouraged. The provisions of this Statement shall be applied retroactively and any accompanying financial statements presented for prior periods shall be restated.

**The provisions of this Statement need
not be applied to immaterial items.**

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March

Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: GLOSSARY

26. This appendix defines certain terms that are used in this Statement.

Area franchise

An agreement that transfers franchise rights within a geographical area permitting the opening of a number of franchised outlets. Under those circumstances, decisions regarding the number of outlets, their location, and so forth are more likely made unilaterally by the franchisee than in collaboration with the franchisor. A franchisor may sell an area franchise to a franchisee who operates the franchised outlets or the franchisor may sell an area franchise to an intermediary franchisee who then sells individual franchises to other franchisees who operate the outlets.

Bargain purchase

A transaction in which the franchisee is allowed to purchase equipment or supplies for a price that is significantly lower than the fair value of the equipment or supplies.

Continuing franchise fee

Consideration for the continuing rights granted by the franchise agreement and for general or specific services during its life.

Franchise agreement ⁴

A written business agreement that meets the following principal criteria:

- a. The relation between the franchisor and franchisee is contractual, and an agreement, confirming the rights and responsibilities of each party, is in force for a specified period.
- b. The continuing relation has as its purpose the distribution of a product or service, or an entire business concept, within a particular market area.
- c. Both the franchisor and the franchisee contribute resources for establishing and maintaining the franchise. The franchisor's contribution may be a trademark, a company reputation, products, procedures, manpower, equipment, or a process. The franchisee usually contributes operating capital as well as the managerial and operational resources required for opening and continuing the franchised outlet.
- d. The franchise agreement outlines and describes the specific marketing practices to be followed, specifies the contribution of each party to the operation of the business, and sets forth certain operating procedures that both parties agree to comply with.
- e. The establishment of the franchised outlet creates a business entity that will, in most cases, require

and support the full-time business activity of the franchisee. (There are numerous other contractual distribution arrangements in which a local businessperson becomes the "authorized distributor" or "representative" for the sale of a particular good or service, along with many others, but such a sale usually represents only a portion of the person's total business.)

- f. Both the franchisee and the franchisor have a common public identity. This identity is achieved most often through the use of common trade names or trademarks and is frequently reinforced through advertising programs designed to promote the recognition and acceptance of the common identity within the franchisee's market area.

The payment of an initial franchise fee or a continuing royalty fee is not a necessary criterion for an agreement to be considered a franchise agreement.

Franchisee

The party who has been granted business rights (the franchise) to operate the franchised business.

Franchisor

The party who grants business rights (the franchise) to the party (the franchisee) who will operate the franchised business.

Initial franchise fee

Consideration for establishing the franchise relationship and providing some initial services. Occasionally, the fee includes consideration for initially required equipment and inventory, but those items usually are the subject of separate consideration.

Initial services

Common provision of a franchise agreement in which the franchisor usually will agree to provide a variety of services and advice to the franchisee, such as the following:

- a. Assistance in the selection of a site. The assistance may be based on experience with factors, such as traffic patterns, residential configurations, and competition.
- b. Assistance in obtaining facilities, including related financing and architectural and engineering services. The facilities may be purchased or leased by the franchisee, and lease payments may be guaranteed by the franchisor.
- c. Assistance in advertising, either for the individual franchisee or as part of a general program.
- d. Training of the franchisee's personnel.
- e. Preparation and distribution of manuals and similar material concerning operations, administration, and record keeping.
- f. Bookkeeping and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate, and other taxes or about local regulations affecting the franchisee's business.
- g. Inspection, testing, and other quality control programs.

Appendix B: SUMMARY OF CONSIDERATION OF COMMENTS ON EXPOSURE DRAFT

27. An Exposure Draft of a proposed Statement, *Accounting for Franchise Fee Revenue*, was issued December 1, 1980. The Board received 25 comment letters in response to the Exposure Draft. Certain of the comments received and the Board's consideration of them are discussed in this appendix.

28. Some respondents indicated that the requirement in the last sentence of paragraph 5 that the commencement of operations by the franchisee shall be presumed to be the earliest point at which substantial performance has occurred was too restrictive. They said that the Guide was less restrictive because it provided for recognition of revenue before the franchisee began operations when substantial performance could be demonstrated. The Board agrees with those respondents and has clarified paragraph 5 to state that the presumption may be overcome if the franchisor can demonstrate that it has substantially performed all of its obligations, including services rendered voluntarily, before the franchisee begins operations.

29. Some respondents requested that the phrase "portion of the initial franchise fee" in paragraphs 7 and 15 be clarified. They indicated that the phrase could be interpreted to mean either an amount necessary to cover net future costs only or an amount sufficient to cover net future costs plus a reasonable profit. The Board agrees with those respondents and has clarified those paragraphs to indicate that the appropriate portion represents cost and reasonable profit in excess of anticipated continuing franchise fees (paragraph 7) or bargain purchase price (paragraph 15).

30. Several individual respondents suggested various substantive changes to the Exposure Draft. Adoption of those suggestions would have required a reconsideration of the provisions of the Guide. Those suggestions were not adopted because such a reconsideration is beyond the scope of extracting the specialized accounting and reporting principles and practices from the Guide and because none of the changes was broadly supported.

Footnotes

FAS45, Footnote 1--The term *specialized* is used to refer to those accounting and reporting principles and practices in AICPA Guides and SOPs that are neither superseded by nor contained in Accounting Research Bulletins, APB Opinions, FASB Statements, or FASB Interpretations.

FAS45, Footnote 2--Terms defined in the glossary (Appendix A) are in **boldface type** the first time they appear in this Statement.

FAS45, Footnote 3--See footnote 8 of APB Opinion No. 10, *Omnibus Opinion--1966* .

FAS45, Appendix A, Footnote 4--This definition has been developed for purposes of this Statement and may not be appropriate for other uses.