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Franchising in the Hospitality Industry: Accounting Aspects

Abstract
Franchised businesses are a powerful factor in the American economy. The author provides a general overview of the area, citing statistics supporting its growth in the industry. Attention will be focused on accounting aspects of franchising, placing major emphasis on issues associated with the recognition of franchise fee revenue.

Keywords
Elisa S. Moncarz, Franchising in the Hospitality Industry: Accounting Aspects, Area franchises, Disclosure, Accounting for Franchise Fee Revenue, Franchise agreement, FIU

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Franchising in the Hospitality Industry:
Accounting Aspects

by
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Franchised businesses are a powerful factor in the American economy. The author provides a general overview of the area, citing statistics supporting its growth in the industry. Attention will be focused on accounting aspects of franchising, placing major emphasis on issues associated with the recognition of franchise fee revenue.

One of the “great American dreams” is to own a business. Franchising a hotel, restaurant, or leisure or travel business represents “an accessible means for men and women with limited capital to satisfy their entrepreneurial instincts with reasonable risk and expectation of success,” thus enabling them the fulfillment of their dreams while receiving the ongoing support, know-how, and proven concept of an established company.

Similarly, franchising, an increasingly popular alternative for hospitality firms considering expansion, is normally accomplished by opening new hotels, restaurants, or areas. These companies are finding franchising “a rapid and effective avenue toward expansion and/or diversification.” It comes as no surprise, then, that franchised businesses have come to be a powerful factor in the American economy, contributing an important portion of the gross national product.

Although fast food restaurants continue to be the most widely-known and “the fastest growing industry which is ‘franchised,’” other segments of hospitality service industries have also experienced substantial growth in the area in the recent past.

“Franchising is a method of doing business by which a franchisee is granted the right to engage in offering, selling, or distributing goods or services under a marketing format or system which is designed by the franchisor.” Simply stated, the franchisor (party granting the franchise) confers to the franchisee the right or privilege to carry on a business in a specific location, in a prescribed manner, over a particular period of time.

In return for this right, franchise holders are obligated to pay a one-time franchise fee, as well as continuing and advertising fees (or royalties) usually based on a percentage of sales (typically 3 to 12 percent of the gross). The nature and extent of the services to be rendered

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by the franchisor in connection with the acquisition of a franchised business, and on a continuing basis after the business is in operation, "may vary from situation to situation, depending on the ability of a particular franchisee to provide for himself the necessary services not required in the formal agreement."5

**Franchising Has Grown**

There were nearly half a million franchised businesses in the United States in 1983 (i.e., 439,384), accounting for approximately one-third of all retail sales ($376,432,585), according to a recent U.S. Department of Commerce annual report, "Franchising in the Economy."

It has been noted that franchise sales of goods and services by all franchising companies are expected to reach $457 billion in 1984, an increase of 9 percent over the estimated sales reported for 1983, while the number of establishments will reach 462,000 in 1984, up from 445,000 in 1983."6 At the same time, "Employment in franchising was 4.9 million in 1982 and will probably reach more than 5.3 million by the end of 1984."7

Tables 1 and 2 present the actual and estimated amounts of sales and the number of establishments for major segments of the hospitality industry for 1981 through 1984.

Franchised restaurants of all types will continue to be the fastest growing sector of franchising in the hospitality industry. Nonetheless, "socio-economic trends are playing a part in franchising too, particularly in the lodging industry,"8 where "maturing baby-boom hotel workers, bitten by the desire to own their own businesses, are now using their talent and hotel experience to strike out on their own. A franchise is the logical choice, providing the easiest and least risky course of action."9

Emerging trends in franchising include:

- Entry of women into franchising in numbers larger than ever before, both as franchisors and franchisees.
- Stepped-up effort to bridge the "partnership relationship" between franchisor and franchisee.
- Conversion franchising expected to show considerable strength in the '80s.

**Franchising Offers Many Benefits**

The parties involved in the franchising form of business operation are, in fact, "partners for profits," since both franchisors and franchisees are mutually interested in the success of the franchised business.

Advantages of franchising are as follows:

- Possibility of starting a new business with the technical and financial backup of the franchisor. Franchising provides a network of support, and it is estimated that "independent hotel operators stand a four-to-one chance of failing when compared with chain-affiliated operators."10

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### Table 1
Franchising In The Hospitality Industry
Number of Establishments
1981 - 1984

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total: All Franchising</td>
<td>442,418</td>
<td>439,384</td>
<td>445,087</td>
<td>461,849</td>
</tr>
<tr>
<td>Restaurants (All Types)</td>
<td>61,846</td>
<td>64,176</td>
<td>68,723</td>
<td>74,842</td>
</tr>
<tr>
<td>Hotels, Motels and Campgrounds</td>
<td>6,416</td>
<td>6,376</td>
<td>6,576</td>
<td>6,830</td>
</tr>
<tr>
<td>Recreation, Entertainment and Travel</td>
<td>5,625</td>
<td>6,198</td>
<td>6,385</td>
<td>6,829</td>
</tr>
</tbody>
</table>


### Table 2
Franchising In The Hospitality Industry
Sales
1981 - 1984

<table>
<thead>
<tr>
<th>Kind of Franchise Business</th>
<th>1981 Total</th>
<th>1982 Total</th>
<th>1983 (Estimated)</th>
<th>1984 (Estimated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total: All Franchising</td>
<td>$364,773,276 $314,168,344</td>
<td>$376,432,585 $321,351,008</td>
<td>$418,748,521 $360,648,260</td>
<td>$456,759,443 $393,684,046</td>
</tr>
<tr>
<td>Restaurants (All Types)</td>
<td>30,042,348</td>
<td>19,259,142</td>
<td>34,158,158</td>
<td>22,173,450</td>
</tr>
<tr>
<td>Hotels, Motels and Campgrounds</td>
<td>9,903,890</td>
<td>7,143,596</td>
<td>11,230,581</td>
<td>8,160,169</td>
</tr>
<tr>
<td>Recreation, Entertainment and Travel</td>
<td>574,150</td>
<td>552,384</td>
<td>892,855</td>
<td>766,454</td>
</tr>
</tbody>
</table>

• Receipt of an established and widely-recognized name and image. According to Daniel Lee, a stock analyst with Drexel Burnham Lambert, “A brand name is vital now. Travelers won’t go out of their way to look for an independent.”

• In the lodging business, access to the chain’s room reservation system and the resultant referral business.

• Assistance in arranging for proper financing through association with franchisor.

• Economies of scale in purchasing achieved much faster by a small company expanding through the franchise route.

• Minimizing business risk as a result of the association with an established company.

• A feeling of independence: “they run their own show.”

Among the benefits of franchising to franchisors are the following:

• Rapid expansion with someone else’s money.

• A ratio of high return on investment because of little or no capital investment.

• Potential source of earnings from selling land, buildings, equipment, and supplies to franchisees.

• Motivation to do a better job because of an investment in the business with increasing royalty revenues.

• Economies of scale through bulk purchasing.

Franchise Agreements Have Common Provisions

The basis for the franchise relationship is the franchise agreement which can be relatively simple to very complex and should be tailored to fit particular circumstances. Among others, a franchise agreement may contain the following provisions:

• The amount and terms of payment of initial franchise fee and costs. All, part, or none of the initial fee may be paid in cash at the time the agreement is signed. If a cash payment is made, it may be non-refundable under the terms of the agreement, assuming full performance on the part of the franchisor.

• Description of the specific rights being transferred by the franchisors. For instance, the franchisee may be entitled to receive assistance in the selection of a site and in the negotiation of the lease in addition to receiving for the initial fee the right to use the name of the franchisor. The franchisee may also receive an initial amount of advertising and training of personnel.

• Amount or rate and terms of payment for the continuing franchise or royalty fees, usually based on a percentage of gross revenues or some other measure of volume.

• Terms, costs, and payment of assets, equipment, inventory, and
lease improvements acquired from suppliers or from franchisors. Some franchisors purchase their products centrally and provide warehousing and delivery services.

- Accounting reports to be provided by the franchisee and the franchisor’s right to inspect the franchisee’s operation. The franchisor may have the option to require annual audits of the franchisee’s financial statements to ascertain compliance with the terms of the agreement.

- Renewal rights, including terms and costs. Some agreements provide an option to the franchisor to purchase, or to the franchisee to sell to the franchisor, all or part of the franchised business.

**Proper Accounting Is Significant**

Fundamentally, the actual timing of revenue recognition has traditionally been a difficult and controversial consideration in accounting for franchise fee revenue.

Generally speaking, the moment when revenue should be recognized is often called the point of sale, and is subject to the following conditions which must be fulfilled before revenue may be recognized:

- The earnings process is essentially complete.
- The exchange value can be objectively determined.

"Determining precisely when to recognize revenue has never been as simple as it might appear."

In fact, one typical example of a difficult revenue recognition situation is accounting for franchise fee revenue. The initial franchise fee, for instance, often calls for a down payment at the time of signing the franchise agreement and the balance in equal installments over a specified future period. In deciding when this initial fee revenue is to be recognized, several alternatives are available:

- When the payments are actually received by the franchisor.
- At the time of signing the franchise agreement.
- Spread over the life of the franchise agreement.
- When substantial performance has occurred.

In practice, the proper timing of recognizing franchise fee revenue (by selecting one of the above alternatives) is, indeed, a crucial factor in evaluating a franchisor’s financial and operating performance since this will have a dramatic effect on reported earnings.

Data taken from the consolidated statement of income of McDonald’s Corporation (a well-known franchising company in the restaurant industry) for the year ending December 31, 1982, can be examined as an illustration.
Table 3
McDonald's Corporation
Selected Operating Data
Year Ending December 31, 1982
In Millions of Dollars

<table>
<thead>
<tr>
<th>Enormous restaurant</th>
<th>620</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenue</td>
<td>2,770</td>
</tr>
<tr>
<td>Ratio of revenue from franchised restaurants to total revenue (620 ÷ 2,770)</td>
<td>22.4%</td>
</tr>
<tr>
<td>Earnings from franchised restaurants</td>
<td>527</td>
</tr>
<tr>
<td>Earnings before general, administrative, selling expenses and income taxes</td>
<td>935</td>
</tr>
<tr>
<td>Ratio of earnings from franchised restaurants to earnings before general, administrative, selling expenses and income taxes (527 ÷ 935)</td>
<td>56.4%</td>
</tr>
</tbody>
</table>


An examination of the above data reveals that though franchise fees revenue represented only 22.4 percent of McDonald's total revenue for 1982, they accounted for 56.4 percent of McDonald's earnings (before general, administrative, selling expenses, and income taxes). Thus, the timing selected for the recognition of revenue from franchise fees will have a major effect on the reported earnings of a franchising company such as McDonald's. That is, are revenues recognized at the inception of the franchise (i.e. when the agreement is signed), in the middle, at the end, or are they pro-rated?

Franchise Fee Revenue Recognition Evolves

In order to put things in perspective, it is helpful to review the accounting practices followed in recognizing franchise fee revenue over time.

Prior to 1970, initial franchise fee revenue was generally recognized as revenue when the franchise was sold. In the early '70s a major international accounting firm, Peat, Marwick, Mitchell & Co., conducted a study of the accounting practices being followed in the franchising industry. The study concluded that many franchisors were using accounting methods "that raised doubt as to the fairness of presentation of their financial statements."

Thomas L. Holton, a partner in this major accounting firm, listed the following questionable items in an article on the subject:

- Initial franchise fees were recognized as revenue at the time the franchise agreement was signed, even though the franchisor was committed to provide substantial services to the franchisee.
- Little or no provision for collection and cancellation of losses was being made.
- Notes received in payment for the initial franchise fees and tangible assets (inventories and equipment) often did not bear interest,
or the contract interest rate was unreasonably low, say 4 to 6 percent.

- Many of the franchisors had financial interests in the franchisees through stock ownership, options, or obligations to purchase the franchisee’s business, etc.

Based on these practices, many franchisors were recognizing revenues before they were earned through performance. This resulted in earnings being overstated, especially in the cases of companies where most revenues were derived from initial fees and were rapidly expanding through franchising. Also, “it may be difficult in later years when initial franchise fees became a small part of total revenue to maintain an earnings trend of the company. Accordingly, future investor disappointment was almost inevitable.”

**Accounting Standards Are Enacted**

In response to the doubtful and misleading accounting practices previously mentioned, an American Institute of Certified Public Accountants (AICPA) industry accounting guide on “Accounting for Franchise Fee Revenue” was issued in 1972. This guide recommended accounting and reporting standards for franchise fee revenue that was obtained through a franchise agreement. In 1981 the Financial Accounting Standards Board (FASB) enacted its Statement No. 45, “Accounting for Franchise Fee Revenue,” which adopts, with minor modifications, the standards included in the AICPA guide and is effective for fiscal years beginning after June 15, 1981.

According to this pronouncement, franchise fee revenue from an individual franchise sale would typically be recognized upon substantial performance of all material services. “Substantial performance for the franchisor means that (a) the franchisor has no remaining obligation or intent . . . 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.”

Generally, the commencement of operations by the franchisee “shall be presumed to be the earliest point at which substantial performance has occurred.” In the simplest of all possible situations,” the franchisor would recognize revenue at ‘the point of sale,’ and make an appropriate provision for estimated uncollectibles associated with the initial franchise fees.” Nonetheless, if it can be demonstrated that substantial performance has taken place prior to the commencement of operations, franchise fee revenue would be recognized at such an earlier time.

To illustrate the basis for revenue recognition used by McDonald’s Corporation, the following statements were extracted from the notes to McDonald’s 1982 financial statements:

- Initial location and license fees are recorded as income when the related restaurant is opened. Expenses associated with site assignment and the issuance of franchise agreements are charged to
expense as incurred.

- Continuing fees from franchised restaurants are recorded in income on the accrual basis.
- Gains on sales of restaurant businesses are recorded as income when the sales are consummated and other stipulated conditions are met.\textsuperscript{21}

**Area Franchises**

A franchisee may be permitted to operate a territory, which is defined as a state, a city, or even an entire country, instead of just one individual establishment. For instance, Wendy's International granted an area franchise in 1977 to a private Canadian company for Wendy's restaurant operations in Canada. In those cases, franchisees may in turn become franchisors with the right to find their own franchisees for parts of the franchised area.

As in the case of individual franchise sales, initial franchise fees pertaining to area franchises shall be recognized as revenue "when all material services or conditions relating to the sale(s) have been substantially performed or satisfied by the franchisor."\textsuperscript{22}

At times, the franchisor's substantial obligations depend on the number of individual franchises established within the specified area. In such a case, "franchise fees shall be recognized in proportion to the initial mandatory services provided."\textsuperscript{23}

**Continuing Services Covered By Royalties**

"Continuing services normally performed by franchisors include employee training, quality control, and advertising and promotion."\textsuperscript{24} These are covered by continuing fees (or royalties), which "shall be reported as revenue as the fees are earned and become receivable from the franchisee."\textsuperscript{25} Similarly, costs associated with continuing franchise fees shall be expensed as incurred.

In some instances, the continuing fees are not adequate to cover future services to be provided by the franchisor because of a large franchise fee paid for that purpose. When this is the case, all or a portion of the initial franchise fee should be amortized to income over the life of the franchise. By apportioning this fee over several future years, "a reasonable profit" is recorded on the continuing services.

Costs directly related to franchise sales for which revenue has not yet been recognized ordinarily shall be deferred until the related revenue is recognized. But the deferred costs shall not exceed anticipated revenue after deducting any estimated additional related costs.

In order to make the franchisor's financial statements as meaningful as possible, the following disclosures should be made in the financial statements or in related footnotes:

- The nature of all significant commitments and obligations under franchise agreements, including a description of the services that the franchisor has agreed to provide for franchise agreements that have yet to be substantially performed.
• The details of any franchise fees that have been deferred, including an identification of the accounting method used.
• If not otherwise apparent, the relative contribution to net income of initial franchise fees.
• If material, initial franchise fees shall be separated from other franchise fees revenues.
• Revenues and costs related to franchisor-owned outlets distinguished from revenue and costs related to franchised outlets where practicable.

Internal Control Areas Are of Concern

There are some other accounting-related aspects of franchising that are of concern to franchisors. They relate to internal control within the franchisor's operation and to the relationship between the franchisor and its franchisees.

A complete evaluation of the credit standing of prospective franchisees prior to signing the franchise agreement is of vital concern to the franchisor. This should be done by credit or financial personnel instead of sales people responsible for franchise sales within the franchisor's organization.

An improvement in this area appears to be needed, especially in the food service industry. "Terminations are far more common among food service franchisees than franchisees in other industries," yet, of the more than 500 franchisor-initiated terminations of franchisees reported for 1979," over two-thirds were justified on grounds of non-payment or default," serving as evidence that many franchisors have been doing an inadequate job of checking the credit standing of potential food service franchisees.

Since continuing fees are based on a percentage of the franchisee's gross sales, the franchisor has to be in a position of reviewing the franchisee's operating performance. As a result, the franchisee is ordinarily required to submit periodic accounting reports to the franchisor on prescribed forms.

Many franchisors require separate and "certified" internal control examinations and reports by independent certified public accountants. Indeed, it appears that "many of the more successful franchisors require the operators to have audited financial statements." Moreover, a number of franchisors have their own internal audit groups to make examinations of the franchisee's activities. This seems to be particularly important in periods of economic downturns when some franchisees tend to under-report sales in order to reduce royalty payments. "In reaction, franchisors typically tighten their audit procedures when the economy begins nosing down."

Franchisor Prescribes Detailed Standards

In most franchise operations, the franchisee is required to operate under detailed operating procedures prescribed by the franchisor. Indeed, the proper adherence to these standards is a most important ingredient in the franchisor's relationship to the franchisee. These guidelines might include, among others, the enforcement of pricing
policies and the purchase of inventory, supplies, and equipment.

The specific operating standards required of the franchisee should be clearly identified in the franchise agreement, if at all possible. In addition, adherence to these standards should be strongly enforced.

**Long-Range Planning**

Another area of prime concern to franchisors is long-range planning. Many franchising companies have a very aggressive franchising program in which specially designed marketing personnel “gear up to get all the franchisees into operation by establishing large real estate, construction, and training departments.”30 A problem arises when the market for new locations reaches a saturation point and “the franchisor finds himself in the position of having too many of the wrong kinds of employees and not enough continuing income to support them.”31 This situation can be avoided by utilizing sound long-range planning that includes reliable estimates of projected revenue and expenses, as well as effective market research. For instance, foreign market expansion by small and medium-sized restaurant franchising companies, along with the nation’s large chains, has shown continuous growth as a result of the franchisor’s desire to increase earnings.

**Summary**

Franchising growth in the hospitality industry has shown rapid advancement in recent years. This trend is expected to continue into the ’80s. “As chains proliferate in number and types of offering, the path to profitability is clearly marked ‘franchising’.”32 As a result, franchising will remain an important source of revenue for restaurant and hotel chains that use this marketing technique to expand their operations.

Proper recognition of franchise fee revenue (particularly initial fees) will play a paramount role in the financial reporting of these franchising chains in view of the fact that financial statements are used in making credit, investment, and other business decisions concerning the future of these companies.

Although doubtful and misleading accounting practices were used in the past, the problem was essentially resolved in 1981 through the issuance of FASB Statement No. 45, which established official accounting and disclosure standards for recognition of franchise fee revenue and deferral of related direct costs. In essence, initial franchise fee revenue is to be recognized when all material services and conditions relating to the franchise sale have been substantially performed. On the other hand, continuing fees are recognized as the fees are earned and become receivable from the franchisee.

In addition to the revenue recognition guidelines, other accounting areas of prime concern to franchisors include the review of credit worthiness, financial reporting requirements, franchisee’s adherence to prescribed standards, and long-range planning.

**Footnotes**


2Ibid.
9 Ibid.
10 Ibid, p. 70.
11 Ibid.
14 Vaughn, p. 96.
16 Holton and Hoover, p. 50.
17 The organization currently responsible for financial reporting requirements and for the development of generally accepted accounting principles.
19 Ibid., p. 3.
20 Tiller and Williams, p. 44.
21 McDonald’s 1982 Annual Report, p. 33.
22 FASB Statement No. 45, p. 3.
23 Ibid, p. 4.
24 A separate advertising fee might be required.
28 Holton and Hoover, p. 55.
30 Holton and Hoover, p. 55.
31 Ibid.
32 Askin, p. 70.