PUBLICATION

The Perfect Financial Storm Hits Franchising

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Readers may remember the book and movie *The Perfect Storm* in which a confluence of dynamic weather events produces a monstrous Atlantic storm that sinks a fishing boat and causes other havoc on the high seas. A similar convergence of disconnected events has descended upon franchising, with no weather-eye cast towards the turmoil to be created. The franchising storm is purely man-made, perpetrated by well-intentioned regulatory bodies that focus on particular issues without appreciation of the broader context for application of their regulatory authority.

Financial Assurance. The state regulatory authorities for franchising[*] have recently become much more sensitive to the capitalization of franchisors at both the start-up and seasoned phases of their business lives. Although there have been few bankruptcies and failures of franchise systems, the financial engineering of private equity ownership and the resulting highly leveraged balance sheets makes these regulators nervous. Franchisees grouse about capital starved franchisors that do not invest sufficiently in infrastructure to support their franchise systems as cash flows out to investors. Start-up franchisors with thin capitalization are another target of concern, as cash flow financing of support for new franchises is frowned upon.

States have the right to demand "financial assurance" from franchisors in the forms of deferring initial fees until unit opening, escrow of the initial fees, posting of a surety bond, or some other form of financial security. The unpublished but privately articulated standards for a franchisor to avoid financial assurance measures are an audited, tangible net worth under GAAP of at least $100,000 to $150,000, positive working capital, and a "quick ratio" (cash plus accounts receivable divided by accounts payable) greater than one. Franchisors with financial statements that don't meet these criteria find themselves with a complex set of options, of which none are good, in regulated states. The exposure to franchisee whimsy or bad finances is exacerbated if the franchisor offers a turnkey outlet, or directly sells supplies, opening inventory, or equipment, because it cannot take deposits or receive payment in advance. There is also no guidance on what happens if the franchisee suddenly and without cause abandons the franchise, even when the franchisor has performed according to its obligations under the franchise agreement and as disclosed in the franchise disclosure document. Does the franchisor get to retain an escrowed initial fee? Does it get to sue for and collect the unpaid initial fee if it was deferred? The financial assurance regulations presume, without an articulated path to rebutting the presumption, that the failure of the franchised outlet to open is solely the result of the franchisor's failure to deliver its promised services, and not due to any default on the part of the franchisee.

The financial assurance rubric doesn't apply outside the regulated states, so franchisors are free to collect money as planned and manage their credit risk with new franchisees. Whether the franchisor is a strong enough credit to merit the trust of the franchisee and advance payment of fees and purchase prices for an outlet, inventory or equipment is a business decision of the franchisee, not a regulator.

Escrows. In the new world of bank regulation under Dodd-Frank and other recent federal legislation and regulation governing banking, the notion of bank escrows is antiquated and impractical. The "Know Your Customer" (KYC) rules mandate diligence on bank customers before accounts are opened. The process is expensive and time consuming. Banks want substantial deposits and predictable release schedules, like in a strategic transaction when a purchase price is escrowed for a year or 18 months. With a franchise escrow,

there may never be an escrow deposit if the franchisor makes no sale in the regulated state that imposes the escrow. The timeframe of the deposit will likely be only a few months for most franchises. The amount will also likely be modest, and unless the initial fees are numerous or singularly large, the total will not be more than $100,000 at any time. The regulated states may require a separate account for each franchisee. The bank must undertake the KYC effort with each franchisee before opening the account. That information isn't known until close to closing of the franchise transaction. Unlike commercial escrows where only the sender and receiver sign off on release, a regulated state agency may need to sign off on release of the franchise escrow, further complicating the escrow agent's task. Because of these inherent limitations and variations, most banks want nothing to do with the franchise escrow business.

Fee Deferral. The deferral of initial fees raises the transactional risk to franchisors considerably, as franchisees may exhaust their resources or exhibit buyer's remorse for reasons unrelated to any aspect of the franchise support or failure of performance by the franchisor. Franchisors may choose to post a surety bond in most regulated states. The bond must remain in place for two or three years after the end of the fiscal year in which it is used to qualify in the regulated state. However, the bond puts a contingent liability in the full amount of the bond on the balance sheet of the franchisor, extending the period until the franchisor can earn its way out of financial assurance. The surety bond may well be the only practical alternative for the capital short franchisor.

Accounting Changes. That brings us to the application of a change in the accounting rules that apply to initial franchise fees. Under prior revenue recognition rules, the franchisor could recognize the initial franchise fee as income in the accounting period when it performed all of its pre-opening obligations to the franchisee. As a practical matter, this meant the fee was recognized when the outlet opened. The recently effective ASC 606 changes many years of this well understood treatment to require franchisors to amortize the initial fee over the life of the franchise, offset by recognition of certain expenses paid or incurred by the franchisor in connection with the franchise sale transaction. The offset opportunity is not clearly guided, and auditors have the ability to limit the recognition because the criteria articulated by FASB's publications lack the clarity of earlier FASB standards. The net effect is that some portion of the initial fee will be deferred and amortized into income over an extended period.

To seasoned franchisors, the impact of the accounting change is less material, as the larger portion of their income derives from royalties and supply chain earnings, not initial fees. But earlier stage franchisors formerly depended on the initial fee income to boost net worth and move past financial assurance. Now the young franchisor will need to wait longer for income to build balance sheet equity, or it must raise more capital and dilute ownership's share of equity. The paradox of this accounting change is that the faster an early stage franchisor grows, the worse its income statement and net equity will look until its royalty revenues grow substantially.

Here's an example of how this accounting change adversely affects franchisors:

> Assuming sale and opening occur in the same fiscal year:
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> Franchise Term of 10 Years
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> Sales Commission amortized over 10 years
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> Marginal Tax Rate of 37%

Old System

Initial Fee at Closing		$35,000
Unit Opening Costs		
Sales Commission	$10,000	
Training	$5,000	
Misc.	$5,000	
Total Costs	**$20,000**	
Net Profit		$15,000
Deferred Revenue		$ -
Deferred Expense		$ -
Cash Balance, Net of Expenses		$15,000
Tax at 37%/Reduction in Capital		$5,550
Worth		$9,450

New System

Sales Commission amortized over 10 years

Year 1

Initial Fee at Closing		$35,000
Value of General Training	$3,500	
Net Initial Fee		$31,500
Unit Opening Costs		
Sales Commission	$10,000	

New System

Sales Commission amortized over 10 years

General Training Cost	$2,500
Brand Specific Training Cost	$2,500
Misc.	$5,000
Total Costs	**$20,000**

Revenue Recognized	
One-Tenth of Initial Fee	$3,150
General Training Value	$3,500
Total	**$6,650**

Expense Recognized	
General Training Cost	$2,500
Specific Training*	$250
Misc.	$5,000
Sales Commission*	$1,000
Total Expense	**$8,750**

Net Loss/Reduction in Capital	$(2,100)
Deferred Revenue	$24,850
Deferred Expense	$11,250

New System

Sales Commission amortized over 10 years

Cash Balance, net of expenses	$15,000

Year 2 Tax Revenue

Recognition	**Tax**	**Book**
Balance of Initial Fee	$24,850	$3,150
Deferred Expense	$1,250	$1,250
Net Income	$23,600	$1,900
Tax at 37%/Reduction in Capital	$8,732	
Net Cash After Tax	$6,268	

Summary of Net Worth Changes from Franchise Sale

Year 1	$(2,100)
Year 2	$(6,832)

*Amortized over the 10 year franchise term

So what's the bottom line? An early stage franchisor can weather the accounting storm by initiating franchising only after establishing a capital base that is substantial and sustainable. It should also be able to replenish capital during the early stages of growth as the effect of deferred initial revenue recognition suppresses net income and produces losses instead of profits. Once royalty and other continuing fees produce substantial earnings that cover pre-opening expenses, the storm will clear and smooth financial sailing follows.

For assistance with navigating the franchising storm, contact the author, Joel Buckberg, or any member of Baker Donelson's Hospitality, Franchising and Distribution Group.

[*] States that review franchise disclosure documents and reserve regulatory authority over franchise sales are California, Hawaii, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia and Washington (collectively, the "regulated states").