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FRANCHISING

Looking Anew at Accounting Duties

Revisions Raise Prospect of Consolidation by Franchisors of Franchisee Data

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THE ACCOUNTING revolution that followed the Enron fiasco has reached franchisors. The Financial Accounting Standards Board (FASB) issued in December 2003 a revised interpretation of rules governing the consolidation of financial statements[1] which may require some franchisors to consolidate their franchisees' operations on their own financial statements. FASB Interpretation No. 46[2] (FIN 46) is a sweeping effort to expose the financial sleights of hand that allowed companies like Enron to hide their true financial status by entering into various types of "off-book" transactions. Despite some last-minute efforts to include certain exceptions for classic franchise relationships, the early returns suggest that some franchise systems may still be caught in the broad scope of FIN 46 and may be required to consolidate their franchisees' operations.

At a minimum, franchisors will now be burdened by an expensive, lengthy and highly technical evaluation of their franchise relationships as part of their audit process and will need to re-evaluate the sufficiency of their system-wide accounting policies and practices. At worst, franchisors and franchisor executives may be exposed to significant liability as a result of the consolidation of unreliable, incomplete or fraudulent franchisee data into the franchisor's financial statements.

The first group of franchisors to address FIN 46 is composed of public companies which have begun complying for accounting periods ending after Dec. 15, 2003. For other entities, FIN 46 provides a phase-in period which will require compliance by various dates in 2004 and 2005.[3] For the companies that have not yet had to face the implementation of FIN 46, they will benefit from the experience of those companies that have gone before them, but many unanswered questions remain about FIN 46's ramifications for franchisors.

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Prior to the issuance of FIN 46, a company was required to consolidate another entity for financial statement purposes if it held a majority of the entity's voting interests. The rise of "special purpose entities," as utilized by Enron and others, made it clear that control could be exercised in many ways short of voting interests. FIN 46 seeks to expand the definition of the "control" necessary to trigger an obligation to consolidate. To do so, FIN 46 adopts new terminology designed to identify the primary beneficiary of an entity's operation.

'Variable Interest Entity'

The first step in determining whether FIN 46 will apply is determining whether an entity is a "variable interest entity" covered by the interpretation. Unless a scope exception applies, an entity may be a variable interest entity if it: (a) will need additional subordinated financial support in order to finance its activities; (b) has a group of at-risk equity owners who are not able to make decisions about the entity's activities through voting or similar rights; or (c) has at-risk equity that is insufficient to absorb the entity's losses or the entity's residual returns.[4]

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Generally, the entity that has the right to receive or the obligation to absorb the majority of the potentially variable interests[5] of the variable interest entity will be deemed to be the primary beneficiary and must consolidate the variable interest entity's operations. These definitions are so broad that many franchisees could be subject to consolidation based on the extensive prescribed system standards contained in the franchise agreement and the franchisor's right to receive royalty payments from the franchisee. To the extent that the franchisor offers financing to the franchisee, leases the franchised premises to the franchisee or has an equity interest in the franchisee, the applicability of FIN 46 becomes more likely.

Since a franchisor will only be a primary beneficiary — and therefore obligated to consolidate — if it holds a majority of the variable interests in the variable interest entity, determining how to quantify the variable interests is one of the most significant hurdles presented by FIN 46.

Each potential variable interest entity (i.e., a franchisee) must be evaluated separately to determine whether it is a variable interest entity, and if it is, whether it must be consolidated. To determine whether an entity possesses a majority of the variable interests, all variable interests in the entity must be quantified. Because all variable interests are — by definition — variable, the amount of each interest cannot be determined in advance with certainty. Estimates and multiple scenarios of potential results must be prepared, which are, by many accounts, tricky and a form of art.

Although accounting rules provide some guidance on how to arrive at these estimates,[6] a significant portion of any calculation will be the judgment of management about the relative likelihood of different results. Regardless of whether FIN 46 will ultimately require that a franchisor consolidate its franchisees on its financial statements, franchisors should expect that their audit costs will increase substantially as a result of these complicated case-by-case assessments.

The final version of FIN 46, adopted in December 2003, attempts to provide an exception for many franchisors in the form of the "business scope exception."[7] If a franchisee is a "business,"[8] FIN 46 will typically only apply if (a) it "is designed so that substantially all of its activities either involve or are conducted on behalf of"[9] the franchisor, or (b) the franchisor and its affiliates "provide more than half of the total of the equity, subordinated debt and other forms of subordinated financial support" to the franchisee.[10]

Because modern franchise systems often include detailed operational specifications and procedures and because the franchisor usually has a pecuniary interest in every transaction into which the franchisee enters, the question of whether "substantially all" of the franchisee's activities "involve or are conducted on behalf of" the franchisor may be a close judgment call. Also, to the extent that the franchisor or its affiliates provide direct or indirect financing, each relationship will be scrutinized to determine whether the business scope exception is available.

If FIN 46 requires a franchisor to consolidate its franchisees' operations on its financial statements, the franchisor and its management face an additional challenge. Simply obtaining the data from a franchisee necessary to comply with FIN 46 may be impractical.[11] Franchisees typically do not observe the same accounting norms as their franchisor. Indeed, franchisees often do not keep their books in accordance with generally accepted accounting principles, so even if the franchisor is able to obtain data from each franchisee, it may not be in a form that will be able to be properly incorporated into the franchisor's financial statements.

Although newer franchise systems may grant the franchisor broad rights to require the franchisee to maintain its books using specific software and in accordance with the franchisor's specifications, many mature franchise systems may have little ability to monitor or enforce minimum accounting standards.

Scrutinizing Data

In situations where a franchisor determines that it must consolidate, the consequences can be grave. While it remains to be seen precisely what steps a franchisor executive must take to obtain and verify franchisee data in order to certify the franchisor's financial statements in accordance with the Sarbanes-Oxley Act of 2002,[12] clearly a franchisor will be required to scrutinize the data it collects from franchisees. And, in systems where there has been a history of franchisee under-reporting of sales or revenue, a franchisor executive may be faced with the difficult question of how to certify financial statements produced, in part, from data that has been historically inaccurate.

The possibility of faulty franchisee data may expose the company's executives to civil fines and criminal penalties under the Sarbanes-Oxley Act. While it is likely that any consolidated financial statement will contain qualifications and explanatory notes detailing the limitations of the audit, for franchisors with mature franchise systems with many franchisees and few company-owned units, a distinct possibility exists that the weight of uncertainty associated with the franchisee data may lead the auditors to refuse to issue an opinion. If the auditors issue a highly qualified opinion, the franchisor will be an attractive target for securities fraud claims and derivative actions.

Due to the highly technical nature of FIN 46 and the lack of any precedent relating to its application to franchising, franchisors face the possibility that their decision to consolidate or not under FIN 46 will be second-guessed by a court. Regardless of whether a franchisor determines it is required to consolidate under FIN 46, in the present climate of securities fraud class actions, shareholder derivative suits and claims of breach of fiduciary duty, there is a serious risk that an enterprising plaintiffs' attorney will disagree with the company's decision and file suit. Similarly, franchisors can expect that failing franchisees will claim that the franchise offering circular they received was materially misleading or that they were fraudulently induced into signing the franchise agreement based on the franchisor's allegedly faulty decision to consolidate, or not.

Financial misstatements resulting from consolidation of inaccurate franchisee data, or failure to consolidate, can also subject the company to enforcement actions by the Securities and Exchange Commission and state securities and franchise authorities for material misrepresentations in connection with filings made with government agencies.

Finally, franchisors should be wary of potential unintended consequences of consolidation in addition to litigation. In particular, changes in the franchisor's net worth or current accounts, for example, resulting from consolidation may cause the franchisor to be in violation of its loan covenants or no longer to be eligible to be registered or exempt from franchise registration in some states.

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Whatever consequences consolidation may have, FIN 46 has undoubtedly changed the calculus that a potential franchisor must employ when determining whether to franchise its system or grow its system directly. The increased costs of being a franchisor, both in terms of internal administrative time and attention, outside auditing fees and insurance costs must give pause to potential franchisors in industries with thin franchisee margins and, therefore, razor-thin potential royalties. In these industries, the costs of complying with FIN 46 and the existing regulatory framework governing franchising may encourage more companies to eschew franchising in favor of direct distribution.

Alternatively, franchisors may decide to structure their franchises in order to minimize the potential application of FIN 46. Because several of the factors that are likely to trigger FIN 46's application are generally defined by an involvement by the franchisor in the franchisee's business, franchisors may decide to reduce the control and assistance offered as part of the system. Many franchisors will re-evaluate the desirability of providing financing assistance to their franchisees. Certainly, franchisors can be expected to pass on their increased costs, associated with complying with FIN 46 and auditing their books, to their franchisees in the form of higher fees.

One interesting option for franchisors intent on avoiding application of FIN 46 is to require their franchisees to operate as sole proprietors. If franchisees are prohibited from incorporating or forming any legal entity, they will not be deemed to be an "entity" for the purposes of FIN 46 and will not be subject to consolidation.[13] While requiring personal ownership seems draconian and could be challenged under a number of state laws that protect a franchisee's ability to transfer its rights under the agreement, it is not clear that a franchisor would be prohibited from requiring it.

1. Consolidated Financial Statements, Accounting Research Bulletin No. 51 (Financial Accounting Standards Bd. 1959).
2. Consolidation of Variable Interest Entities, FASB Interpretation No. 46 (revised December 2003) (Financial Accounting Standards Bd. 2003).
3. FIN 46, ¶¶27-36.
4. FIN 46, ¶5.
5. A "variable interest" is a "contractual, ownership, or other pecuniary interest in an entity that change[s] with changes in the fair value of the entity's net assets exclusive of other variable interests." FIN 46, ¶2.c.
6. Using Cash Flow Information and Present Value in Accounting Measurements, FASB Concepts Statement No. 7 (Financial Accounting Standards Bd. 2000).
7. FIN 46, ¶4.h.
8. An entity will be deemed to be a "business" for the purposes of FIN 46 if it "is a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors." FIN 46, Appendix C.
9. FIN 46, ¶4.h(2).
10. FIN 46, ¶4.h(3).
11. FIN 46 provides a scope exception for entities created before Dec. 31, 2003, where the putative primary beneficiary does not have the contractual right or otherwise have the ability to obtain the information necessary to evaluate the potential application of or apply FIN 46. This exception applies on a case-by-case basis and only as long as the necessary information is unobtainable. If a franchisor utilizes this scope exception, it has a continuing obligation to use "exhaustive effort" to obtain the necessary information. FIN 46, ¶4.g.
12. 15 U.S.C. §7241 (2003); 18 U.S.C. §1350 (2003).
13. An "entity" for the purposes of FIN 46 is "any legal structure used to conduct activities or hold assets." FIN 46, ¶3.