

Case 93-8

Franchise Fee Revenue

Hero's, an SEC registrant, has developed a new approach to selling sandwiches which has been very successful in various company-owned stores. This "formula" encompasses the decor of the sandwich shop, the presentation of the sandwich to the customer, the speed in which the order can be processed, and, of course, the quality of the food.

Hero's has developed this concept to the point where management believes that the company can now franchise its sandwich shops and become a national chain. Hero's offers two types of franchise agreements whereby a franchisee can purchase an individual franchise or an area development franchise.

Each franchisee is required to enter into an individual franchise agreement relating to the operation of a single sandwich shop. The franchisee must pay an initial franchise fee and monthly royalty fees based on the gross sales of the shops. In order to maintain the high standards of appearance, service and food quality, franchisees are required to adhere to Hero's specifications and standards in connection with the selection and purchase of products used in the operations of the sandwich shops.

Hero's requires all new franchisees to attend a training program provided by the company. This program consists of classroom training as well as on-the-job training in managing the day-to-day operations of the sandwich shops. Hero's also provides its "swat team" to provide hands-on training to all employees in the operations and standards of its sandwich shops.

The area development franchise agreement provides a franchisee with the exclusive right to open a specified number of stores, based on a development schedule, within a specified area. Each time a store is opened under the area development agreement, the franchisee must enter into an individual franchise agreement. This means that Hero's will provide the same services it would if the franchisee were opening its first store. Conversely, the franchisee is required to pay the initial franchise fee and the monthly royalty based on the sandwich shops sales each time the franchisee opens a sandwich shop. An area development franchise is not given any price break on the initial franchisee fee because of the existence of the area development agreement.

Hero's collects the area development fee at the inception of the agreement. The area development fee charged to a franchisee is dependent on the number of stores the franchisee will be allowed to open and the area in which the stores will be developed. This fee is refundable, at Hero's option, within the first 180 days if the franchisee is unable to obtain a store site which Hero's approves and Hero's wishes to cancel the agreement. Hero's must also approve all other sandwich shop sites opened under the development schedule. After the franchisee has opened its first store, the fee becomes nonrefundable, regardless of the franchisee's adherence to the agreement's development schedule. That is, Hero's is able to invalidate the area franchise agreement and resell the area if the franchisee does not adhere to the development schedule without refunding any of the area franchise fee.

Hero's recognizes initial franchise fees as income when substantially all services and conditions relating to the sale of the franchise have been performed or satisfied, which occurs generally when the franchised shop commences operations.

Required:

- How should Hero's account for the collection of the area development fee under the area development franchise agreement?