

PART 13

# FRANCHISE MODEL

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## Scaling a System Without Owning Every Store

ASC 606 for initial franchise fees and performance obligation analysis, royalty revenue recognition and accrual mechanics, advertising fund pass-through accounting, franchisee four-wall EBITDA economics, refranchising gain/loss calculation, area development agreement recognition, FDD Items 19, 20, and 21 financial disclosure requirements, multi-state royalty income sourcing, Section 197 amortization for franchisees, and the complete franchise system metrics framework.

## SECTION 1

## THE FRANCHISE BUSINESS MODEL

## Franchising: Scaling a System Without Owning Every Store

Franchising is the business model through which a company — the franchisor — licenses its brand, operating system, and intellectual property to independent operators — franchisees — who pay for the right to use that system in a defined territory. The franchisee invests their own capital to open and operate a business unit (a restaurant, a fitness studio, a hotel, a cleaning service) under the franchisor's brand and according to the franchisor's standards. In return, the franchisor earns royalties on the franchisee's revenue, collects initial franchise fees, and often earns additional income from selling products or services to franchisees.

The financial architecture of franchising is one of the most capital-efficient in commerce. The franchisor grows its brand and system without deploying capital into individual locations — that capital comes from franchisees. The franchisor's income is recurring (royalties on system-wide sales), largely variable (it rises as franchisees succeed), and carries extraordinarily high margins (royalty income has minimal direct cost). McDonald's, Marriott, Subway, Anytime Fitness, and thousands of other brands have used this model to build global networks of thousands of units while maintaining asset-light balance sheets.

But franchising is also operationally and legally complex. The Franchise Disclosure Document (FDD) imposes stringent financial disclosure requirements. Revenue recognition under ASC 606 for initial franchise fees is counterintuitive and frequently misapplied. Advertising fund accounting requires separation from franchisor financials. Refranchising transactions create unique gain/loss accounting. This part covers all of it — the financial architecture of franchising from initial fee recognition through royalty economics, advertising fund management, franchisee unit economics, and the complete CFO metrics framework.

### 1.1 The Franchisor Revenue Architecture

Revenue Stream	Structure	Margin Profile	ASC 606 Recognition
Initial Franchise Fee	One-time fee per new franchisee (\$20K–\$50K typical)	High gross margin; offset by pre-opening services	Over time (pre-opening obligation period)

Revenue Stream	Structure	Margin Profile	ASC 606 Recognition
Royalty Fees	% of franchisee gross sales (4%–12% typical)	Very high (70%–85%+ gross margin)	As franchisee earns revenue (weekly/monthly)
Advertising Fund Contributions	% of sales for national marketing (2%–4%)	Pass-through; not franchisor income	Not recognized as revenue (pass-through fund)
Product / Supply Sales	Franchisor sells required products to franchisees	Moderate (product margin)	At delivery of products to franchisee
Technology / POS Fees	Monthly fee for required technology systems	High (SaaS-like margin)	Ratably over service period
Transfer / Renewal Fees	Fee when franchisee sells or renews agreement	High margin; low frequency	At completion of transfer or renewal
Refranchising Proceeds	Sale of company-owned units to franchisees	Gain or loss on transaction	At closing of the sale transaction

## SECTION 2

## REVENUE RECOGNITION UNDER ASC 606

## ASC 606 for Franchisors: The Most Counterintuitive Revenue Recognition in Commerce

The revenue recognition rules for franchisors under ASC 606 are among the most counterintuitive in all of GAAP — and among the most consequential for how a franchise company's financials look to investors. The core issue is the initial franchise fee: before ASC 606, most franchisors recognized the initial franchise fee as revenue when the franchise agreement was signed and the fee was received. Under ASC 606, that treatment is almost always wrong. The initial franchise fee must now be recognized over the period during which the franchisor satisfies its pre-opening performance obligations to the franchisee — which may span months or years.

### 2.1 Initial Franchise Fee Recognition

Under ASC 606, the franchisor must identify all performance obligations associated with the initial franchise fee. These typically include: providing a license to operate under the brand, providing site selection assistance, providing training, providing pre-opening support and inspections, and in some cases providing equipment or initial inventory. The license is distinct from the pre-opening services; revenue for the license is recognized when the franchisee has the right to use the IP (typically when the store opens), while revenue for pre-opening services is recognized as those services are performed.

If the license and the pre-opening services are bundled into a single initial franchise fee, the transaction price must be allocated to each performance obligation based on relative standalone selling prices. The allocated amount for pre-opening services is recognized as those services are performed; the allocated amount for the license right is recognized when the franchisee can use the IP. The result is that most of the initial franchise fee is deferred at contract signing and recognized over the pre-opening period — which can be 6 to 24 months depending on the complexity of the concept.

#### INITIAL FRANCHISE FEE RECOGNITION

Initial Franchise Fee: \$40,000

##### Step 1: Identify performance obligations

PO1: License to use brand IP (recognized when store opens)

PO2: Site selection assistance (recognized as rendered)

PO3: Training program (recognized as training delivered)

PO4: Pre-opening inspection (recognized at inspection completion)

##### Step 2: Allocate based on standalone selling prices

License: \$22,000 (55%) | Site selection: \$6,000 (15%)

Training: \$9,000 (22.5%) | Inspection: \$3,000 (7.5%)

##### Step 3: Recognize as each obligation is satisfied

At signing: \$0 (no obligations yet satisfied)

During pre-opening (over 9 months): \$18,000 (site + training + inspection)

At store opening: \$22,000 (license right transferred)

**ACCOUNTING ALERT**

Many franchise companies that adopted ASC 606 discovered that their historical practice of recognizing initial franchise fees at contract signing was incorrect, requiring restatement. If your franchise system has not completed a thorough ASC 606 analysis of your initial franchise fee structure — including a documented performance obligation identification, SSP analysis, and recognition timeline — do this immediately. The SEC has issued comment letters to publicly traded franchise companies specifically on this issue, and private equity-backed franchisors face equivalent scrutiny during due diligence.

## 2.2 Royalty Revenue Recognition

Royalty revenue — the franchisor's share of franchisee gross sales — is the most straightforward revenue stream to recognize: it is recognized as franchisee revenue is earned. If the royalty rate is 6% of gross sales and the franchisee reports \$100,000 in weekly gross sales, the franchisor recognizes \$6,000 in royalty revenue in that week. The recognition timing follows the franchisee's revenue — weekly or monthly, depending on the reporting structure.

The practical challenge in royalty revenue recognition is that franchisors often receive royalty payments based on franchisee self-reported sales, which may lag actual sales by a week or more. The franchisor must estimate royalty revenue accruals for the period between the franchisee's last reported sales and the financial statement date. This accrual is based on historical patterns, seasonal trends, and any available real-time data (POS system integration, where available). The estimate should be reviewed for reasonableness at each period end.

### ROYALTY ACCRUAL CALCULATION

Monthly Royalty Revenue = Reported Franchisee Sales x Royalty Rate  
+ Accrual for unreported period-end sales

Accrual = (Days in reporting gap / Days in prior reporting period)  
x Prior period royalty revenue from that franchisee

**Example:** Franchisee reports weekly; month ends on Wednesday

Last weekly report: Monday through Sunday of prior week

Unreported: Monday, Tuesday, Wednesday (3 days)

Prior week royalty: \$6,200

Accrual:  $(3/7) \times \$6,200 = \$2,657$

## SECTION 3

## ADVERTISING FUND ACCOUNTING

## Advertising Fund: The Pass-Through That Isn't Revenue

Most franchise systems require franchisees to contribute a percentage of their gross sales — typically 2% to 4% — to a national or regional advertising fund. This fund is used to purchase brand advertising, develop marketing materials, and fund promotional campaigns that benefit the entire franchise system. The advertising fund is not the franchisor's money — it belongs to the fund, held in trust for the benefit of all franchisees — and it must be accounted for separately from the franchisor's own operating revenues and expenses.

### 3.1 Advertising Fund Accounting Structure

Under ASC 606, advertising fund contributions collected by the franchisor from franchisees are generally not recognized as the franchisor's revenue. The franchisor is acting as an agent — collecting funds on behalf of the franchisee group and spending them for the group's benefit — rather than as a principal providing advertising services for its own account. The contributions are recorded as a liability (advertising fund liability) when received and reduced as advertising expenditures are made.

The advertising fund typically has its own separate set of financial statements — a fund balance sheet (showing the accumulated contributions and expenditures) and a fund income statement. Many franchise systems present the advertising fund as a separate entity in their financial disclosures. If advertising fund contributions collected exceed advertising fund expenditures, the fund runs a surplus — an asset on the fund balance sheet but a liability to franchisees (the franchisor has collected more than it has spent). If expenditures exceed contributions, the fund runs a deficit — often funded temporarily by the franchisor, which may or may not be repaid.

**ADVERTISING FUND ACCOUNTING****At Collection from Franchisee:**

DR: Cash	\$10,000
CR: Advertising Fund Liability	\$10,000

**As Advertising Expenditures Are Made:**

DR: Advertising Fund Liability	\$9,500
CR: Cash (paid to ad agency / media)	\$9,500

**End of Period Fund Balance:**

Surplus: Liability > \$0 (franchisor owes franchisees more spending)

Deficit: Liability < \$0 (franchisor has overspent; receivable from future contributions)

**Franchisor P&L: Advertising fund contributions are NOT franchisor revenue**

They flow through the balance sheet, not the income statement

**CFO INSIGHT**

Advertising fund deficits — situations where the franchisor has spent more from the advertising fund than it has collected from franchisees — create a de facto loan from the franchisor to the fund. This deficit must be recorded as a receivable from the fund and disclosed in the FDD. Large and persistent advertising fund deficits attract franchisee complaints and regulatory attention because they suggest the franchisor may be using franchisee money to cross-subsidize other activities or is managing the fund poorly. The CFO should monitor the advertising fund balance monthly and present it separately in board reporting.

**SECTION 4****FRANCHISEE UNIT ECONOMICS**

## Franchisee Unit Economics: The Health of the Ecosystem

The financial health of the franchisee is the most important leading indicator of the franchisor's financial health. A franchisee who is not making money will not renew their agreement, will not open additional units, and may ultimately sue the franchisor alleging misrepresentation of the system's financial prospects. Franchisee profitability is not just a franchisee concern — it is the franchisor's most important business

health metric. The CFO of a franchise company must understand franchisee unit economics as deeply as the franchisor's own P&L;

## 4.1 The Four-Wall Franchisee P&L;

Four-wall economics — the P&L of a single franchise unit including all revenues and all costs directly attributable to that unit — is the fundamental unit of analysis in franchise finance. A franchisee who is making money at the four-wall level is a franchisee who will renew, expand, and refer new franchisees. A franchisee whose four-wall economics are marginal or negative is a system problem in the making.

### FRANCHISEE FOUR-WALL P&L (QSR RESTAURANT EXAMPLE)

Gross Sales:	\$1,200,000	100%
Less: Food Cost:	(\$396,000)	33%
Less: Labor Cost:	(\$312,000)	26%
= Prime Cost:	\$492,000	41%
Gross Profit:	\$492,000	41%
Less: Royalty (6%):	(\$72,000)	6%
Less: Advertising Fund (4%):	(\$48,000)	4%
Less: Occupancy (rent + CAM):	(\$156,000)	13%
Less: Utilities:	(\$36,000)	3%
Less: Supplies / Paper:	(\$24,000)	2%
Less: Insurance / Maintenance:	(\$24,000)	2%
Less: Miscellaneous:	(\$18,000)	1.5%
= Four-Wall EBITDA:	\$114,000	9.5%
Less: Depreciation (on FF&E / build-out):	(\$48,000)	4%
= Four-Wall EBIT:	\$66,000	5.5%

A four-wall EBITDA of 9.5% on \$1.2M in sales is a viable franchise unit — the franchisee is making \$114,000 in operating cash flow before debt service on their initial investment. Whether this is a good return depends on the initial investment required. If the franchisee invested \$350,000 to open the unit, \$114,000 represents a 32.6% cash-on-cash return — excellent. If the investment was \$800,000, the return is 14.3% — acceptable but less compelling for the franchisee.

**CFO INSIGHT**

The franchisor's royalty rate and advertising fund contribution directly reduce franchisee four-wall economics. A 10% total system fee (6% royalty + 4% ad fund) on a system where franchisees average 41% gross profit means franchisees are sharing 24% of their gross profit with the franchisor and the advertising fund before paying a single dollar of rent. If the franchise system has low four-wall economics, raising royalty rates — even slightly — can push marginal franchisees into loss. The CFO must model franchisee unit economics before any royalty rate change and present the impact on franchise system health alongside the franchisor's revenue gain.

**SECTION 5****REFRANCHISING AND AREA DEVELOPMENT AGREEMENTS**

## Refranchising: Strategic Asset Sales and Their Accounting

Refranchising — the sale of company-owned restaurant or retail units to franchisees — is one of the most significant strategic and financial transactions a franchise company undertakes. McDonald's, Burger King, Dunkin', and many other major franchise systems have undergone large-scale refranchising programs over the past two decades, moving from asset-heavy models (owning many company-operated units) to asset-light models (franchising the vast majority of units). The financial impact of refranchising is complex: it reduces revenue (company-operated unit revenue is replaced by royalty revenue) but dramatically improves margins and capital efficiency.

### 5.1 Refranchising Transaction Accounting

When a company-owned unit is sold to a franchisee, the transaction is accounted for as a sale of a business or a sale of assets, depending on whether the unit constitutes a business under ASC 805. The proceeds from the sale include cash received from the franchisee, plus the present value of any future royalties that would not have been earned without the franchise agreement (which is not separately recognizable — royalties are recognized as earned over the franchise term). The gain or loss on the transaction is the difference between the net proceeds and the carrying amount of the assets sold (primarily PP&E; and any allocated goodwill).

**REFRANCHISING GAIN / LOSS CALCULATION**

Refranchising Proceeds (cash received):	\$850,000
Net Book Value of Assets Sold:	
PP&E (net of accumulated depreciation):	(\$520,000)
Allocated goodwill:	(\$80,000)
Working capital transferred:	(\$15,000)
Lease intangible (if favorable lease):	(\$45,000)
Total Net Book Value of Assets:	(\$660,000)

Refranchising Gain:  $\$850,000 - \$660,000 = \$190,000$

P&L Presentation: Refranchising gains/losses presented separately from operating income (often as 'Other income' or non-operating) NOT included in restaurant-level or segment operating income

## 5.2 Area Development Agreements

Area development agreements (ADAs) — contracts in which a developer commits to open a specified number of franchise units in a defined territory over a defined period — create a complex revenue recognition situation. The developer typically pays an area development fee upfront in exchange for the exclusive right to develop the territory. Under ASC 606, this area development fee is a form of consideration received for a performance obligation — granting the exclusive territorial right.

The analysis of how to recognize the area development fee depends on whether the territorial exclusivity is a distinct performance obligation from the individual franchise licenses that will be granted as each unit opens. Most franchise systems conclude that the territorial exclusivity is not distinct from the individual franchise licenses — the developer is paying for the right to open franchises, not for exclusivity as a separate service. Under this analysis, the area development fee is allocated to the individual franchise licenses as they are granted and recognized in accordance with the recognition of each franchise fee (i.e., as pre-opening services are performed and as each unit opens).

### SECTION 6

## THE FRANCHISE DISCLOSURE DOCUMENT (FDD)

# The FDD: Financial Disclosure Requirements for Franchisors

The Franchise Disclosure Document is a federally mandated disclosure document that franchisors must provide to prospective franchisees at least 14 calendar days before a franchise agreement is signed or any fees are paid. The FTC's Franchise Rule (16 CFR Part 436) governs the FDD's content and format. For the CFO, the most critical items in the FDD are Items 19 (Financial Performance Representations), 20 (Outlets and Franchisee Information), and 21 (Financial Statements) — together these items create the most significant financial disclosure obligation in franchising.

## 6.1 Item 19: Financial Performance Representations

Item 19 allows — but does not require — franchisors to make representations about the actual or potential financial performance of franchised or company-owned units. These representations may include average unit volumes (AUV), average franchise fees earned, or average unit-level profitability metrics. If made, these representations must be based on actual historical data and must be presented in a manner that is not misleading.

The CFO is responsible for ensuring that any Item 19 representations are accurate, appropriately caveated, and based on data that has been audited or verifiably documented. Inaccurate or misleading Item 19 representations are one of the most common bases for franchisee litigation — a franchisee who invested based on representations of average unit volumes that were not achieved has a potential misrepresentation claim. The CFO should review the Item 19 content annually, ensure it is reconciled to the system's audited financials, and advise the CEO and franchise legal counsel on what can and cannot be responsibly disclosed.

FDD Financial Item	What It Discloses	CFO Responsibility
Item 19: Financial Performance Representations	AUV, franchisee P&L; data, sales ranges, profitability if disclosed	Ensure accuracy and reconciliation to audited data; avoid material omissions
Item 20: Outlets and Franchisee Information	Unit count by type (franchised, company-owned, transferred, terminated)	Accurate unit count tracking; churn rate implied in the data
Item 21: Financial Statements	Audited financials for the franchisor (last 3 fiscal years)	Ensure GAAP compliance; auditor engagement; timely completion

FDD Financial Item	What It Discloses	CFO Responsibility
Item 7: Estimated Initial Investment	Range of total investment required to open one franchise unit	Annual review of investment ranges; cost increase disclosures
Item 8: Restrictions on Sources	Required purchases from franchisor or approved suppliers	Revenue from required product sales disclosed; potential ROR analysis

## 6.2 Item 21: Audited Financial Statements

The FDD must include the franchisor's audited financial statements for the past three fiscal years. This means any franchise company — even a private company — that sells franchises must have GAAP-compliant, independently audited financial statements. The audit must be completed before the FDD is filed and before it is used to sell franchises. Many small and emerging franchise systems are caught off guard by this requirement: they have been operating without audited financials, discover the FDD requirement, and then must complete their first audit retroactively while simultaneously trying to sell franchises.

For emerging franchise systems making their first FDD filing, the CFO must ensure that the financial statements are prepared in accordance with GAAP — including the correct application of ASC 606 to franchise fee revenue recognition — and that the auditor is an independent CPA firm with experience in franchise accounting. Item 21 disclosures are reviewed by state franchise regulators in the registration states (California, Maryland, Illinois, Minnesota, New York, and others require FDD registration before franchises can be sold), and deficiencies in the financial statements will result in registration comments that delay the franchisor's ability to sell franchises.

### SECTION 7

## TAX ISSUES FOR FRANCHISE BUSINESSES

# Tax Architecture: Franchisors and Franchisees

Franchise businesses face a layered tax structure — the franchisor's income from royalties, fees, and product sales; the franchisee's income from unit operations; and the interplay between them when the franchisor and franchisee are related parties (as in the case of a franchisee who is also an officer of the franchisor). Each layer has distinct tax treatment, and the structure of the franchise relationship affects both parties' tax obligations.

## 7.1 Tax Treatment of Initial Franchise Fees

The tax treatment of initial franchise fees differs between the franchisor and the franchisee, and between the characterization of the fee as a sale of a franchise versus a licensing payment. For the franchisor, initial franchise fees received are ordinary income recognized when the services to which they relate are performed — consistent with the ASC 606 treatment for financial reporting purposes. For the franchisee, the initial franchise fee is generally capitalized as an intangible asset (a section 197 intangible) and amortized over 15 years for tax purposes.

The 15-year amortization period for the franchisee's initial fee is set by IRC Section 197, which covers the amortization of acquired intangibles. This means a franchisee who pays \$40,000 in initial fees can deduct only \$2,667 per year ( $\$40,000 / 15$  years) — a relatively slow recovery of a significant upfront cost. The CFO advising franchisee operators should ensure they understand this limitation and plan their cash flow accordingly.

## 7.2 Royalty Income: Self-Employment and State Tax

For franchisors organized as pass-through entities (partnerships, S corporations, or LLCs taxed as partnerships), royalty income flows through to the owners and is subject to federal income tax at the individual level. Royalty income from franchises is generally not subject to self-employment tax (it is passive income from the licensing of IP, not income from the active conduct of a trade or business). However, if the franchisor provides ongoing services to franchisees as part of the royalty arrangement — which is almost always the case — the IRS may argue that the royalties are active business income subject to self-employment tax.

State income tax on royalty income is particularly complex for franchisors whose franchisees are located in many states. Most states source royalty income to the state where the IP is used — which is the state where the franchisee operates. A franchisor with 500 franchisees in 40 states has royalty income sourced to 40 different states, potentially creating filing and tax payment obligations in each. The CFO must work with state tax counsel to determine the filing threshold in each state and to manage the multi-state royalty income apportionment.

### SECTION 8

## COMPLETE FRANCHISE METRICS FRAMEWORK

# The Franchise CFO Metrics Framework

The franchise metrics framework spans four domains: system growth (how the franchise network is expanding), system health (how franchisees are performing), franchisor financial performance, and franchisee economics. All four must be tracked — a franchisor whose system is growing rapidly but whose franchisees are struggling financially is building a fragile structure that will eventually collapse.

## 8.1 System Growth Metrics

Metric	Formula / Definition	Benchmark
Total Units (System-Wide)	Franchised units + company-owned units	Track YoY; primary scale metric for the system
Net Unit Growth	New openings - Closures - Terminations	Must be positive; net negative signals system contraction
Unit Opening Rate	New units opened / Beginning units	>10%/yr healthy; >20% rapid expansion
Closure / Termination Rate	Closures + terminations / Beginning units	<5% healthy; >10% signals systemic franchisee health issue
Franchise Sales Pipeline	Signed FDDs, qualified leads, signed agreements	Leading indicator; track conversion at each stage
Area Development Commitments	Units committed under ADAs / Total committed	Track ADA fulfillment rate; lagging ADA is a risk signal

## 8.2 System Health Metrics

Metric	Formula / Definition	Benchmark
System-Wide Sales (SWS)	Total gross sales across all franchised and company units	Primary volume metric; royalty base; report QoQ and YoY
Average Unit Volume (AUV)	System-Wide Sales / Total Units	Track trend; declining AUV = franchisee health risk
Same-Store Sales Growth (SSSG)	(Current period SWS for same units - Prior) / Prior	>2% healthy; negative signals competitive or operational problems
Franchisee Four-Wall EBITDA %	Avg (Unit Revenue - Direct Unit Costs) / Revenue	>10% healthy; <5% fragile; monitor closely

Metric	Formula / Definition	Benchmark
Royalty Compliance Rate	Royalties paid on time / Total royalties due	>97% excellent; <90% signals franchisee financial stress
Franchisee Satisfaction Score	Annual or semi-annual franchisee survey score	Track trend; declining satisfaction precedes termination
Renewal Rate	Agreements renewed / Agreements coming due	>85% healthy; <70% signals system health problem

### 8.3 Franchisor Financial Metrics

Metric	Formula / Definition	Benchmark
Royalty Revenue	SWS x Royalty Rate	Primary recurring revenue stream; track vs. SWS growth
Royalty Revenue as % of Total	Royalty Revenue / Total Franchisor Revenue	>60% signals asset-light model; rising = refranchising progress
Initial Franchise Fee Revenue	Fees recognized in period per ASC 606	Track alongside unit openings; not a leading indicator
System-Wide Revenue per Employee	Total Franchisor Revenue / Franchisor FTE	High leverage ratio is asset-light advantage
Franchise EBITDA Margin	Franchisor EBITDA / Franchisor Net Revenue	>30% healthy for mature system; >40% excellent
Advertising Fund Balance	Cumulative contributions - Cumulative expenditures	Track monthly; surplus or deficit disclosed in FDD
Refranchising Gain/Loss	Gains or losses on company-owned unit sales to franchisees	Non-recurring; present separately from operating results

#### SECTION 9

### FRANCHISE CFO OPERATING CHECKLIST

## The Franchise CFO Checklist

The following checklist covers the minimum capabilities the CFO of a franchise company must maintain across revenue recognition, disclosure, advertising fund, franchisee health monitoring, and tax domains.

## Revenue Recognition and FDD Compliance

- ASC 606 performance obligation analysis completed for initial franchise fee: all obligations identified, SSP-based allocation documented, recognition timeline established per agreement structure; auditor approval obtained.
- Initial franchise fee deferred revenue waterfall maintained by franchisee: obligations completed, revenue recognized, and balance remaining tracked at each franchisee level.
- Royalty revenue accrual prepared monthly: period-end accrual for days between last franchisee report date and financial statement date calculated by franchisee; reconciled to cash received.
- Area development fee recognition policy documented: allocation to individual franchise licenses confirmed with auditors; recognition schedule maintained by ADA agreement.
- FDD Item 19 content reviewed annually: all financial performance representations reconciled to audited system data; legal counsel sign-off before publication.
- FDD Item 21 audited financials completed on schedule: audit engagement planned to ensure completion before FDD filing deadline in registration states.

## Advertising Fund Management

- Advertising fund financial statements prepared monthly: contributions received, expenditures made, and fund balance (surplus or deficit) tracked separately from franchisor operating financials.
- Advertising fund deficit monitored: franchisor advance to fund tracked as a receivable; recovery plan documented if deficit exceeds one month of average contributions.
- Advertising fund expenditure approval process operational: expenditures reviewed against fund charter; franchisee advisory council informed of major expenditure decisions per franchise agreement.
- Advertising fund balance disclosed in FDD: annual surplus/deficit reconciled to fund financial statements; material deficits disclosed with explanation.

## Franchisee Health Monitoring

- Franchisee four-wall economics model maintained: average unit volume, prime cost %, occupancy %, royalty %, and four-wall EBITDA % calculated and updated quarterly using franchisee-reported data.
- Royalty compliance rate calculated monthly: delinquent accounts identified within 30 days of due date; escalation protocol followed for accounts >60 days past due.

- Same-store sales growth calculated weekly using franchisee POS data or self-reported sales; negative SSSG for three consecutive months triggers unit-level review.
- Franchisee renewal tracking maintained: agreements expiring in next 18 months identified; renewal conversations initiated 12 months before expiration.

## Tax and Intercompany

- Multi-state royalty income sourcing analysis completed: states where franchisees operate assessed for filing threshold; tax returns filed in all required states.
- Initial franchise fee tax treatment documented: ordinary income recognition timed consistently with ASC 606 financial reporting; deferred revenue and taxable income reconciled.
- Refranchising transactions reviewed for tax treatment: gain/loss calculation confirmed; installment sale election evaluated if proceeds are paid over time.
- Related-party franchise transactions (franchisees who are officers or related parties) reviewed for arm's-length compliance; royalty rates and supply prices confirmed at market rates.

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# Closing Perspective: The Franchise CFO as System Steward

The franchise CFO occupies a unique position in commerce: they are simultaneously responsible for the franchisor's financial performance and for the financial health of hundreds or thousands of independent businesses who have staked their capital on the franchisor's system. This dual responsibility is what makes franchise finance distinctive — and what makes it one of the most consequential CFO roles in consumer business.

The most important insight in franchise finance is that franchisee profitability is not a separate issue from franchisor profitability — it is the same issue, expressed at different points in the system. A franchise system where franchisees are making 15% four-wall EBITDA margins will grow: franchisees will open more units, will recruit friends to join the system, and will renew their agreements enthusiastically. A system where franchisees are making 4% margins will contract: franchisees will not invest in new units, will sell their agreements to anyone who will buy, and will spend their remaining term looking for ways to exit. The royalty rate and advertising fund levy that the CFO manages are not just revenue levers — they are the primary determinants of franchisee economics, and they must be set with both the franchisor's and the franchisee's financial health in mind.

**Part 14** examines the Multi-Location Brick-and-Mortar Retail model — four-wall EBITDA, same-store sales mechanics, sales per square foot, shrinkage accounting, lease accounting under ASC 842, markdown cadence, and the financial architecture of managing a distributed retail portfolio.

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*End of Part 13: Franchise Model | Financial Architecture of Different Business Models*

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