Changes to revenue recognition for franchisors

Prepared by:

Chris Banse, Partner, RSM US LLP
+1 972 764 7061, chris.banse@rsmus.com

Daniel Sullivan, Senior Manager, RSM US LLP
+1 617 241 1492, daniel.sullivan@rsmus.com

January 2018

Franchisors are in for major changes in the way they recognize franchise revenues in the future. For years, relevant U.S. generally accepted accounting principles (GAAP) had been subject to significant interpretation across the industry, primarily because the standards were broadly written—leaving them open to interpretation and subject to judgment. However, in May 2014, the Financial Accounting Standards Board (FASB), the organization that establishes U.S. GAAP, issued a new standard intended to converge U.S. GAAP and International Financial Reporting Standards (IFRS).

For franchisors, these new standards are far more detailed than the standards they supersede and therefore, subject to far less interpretation. Although the new standards are expected to have a significant impact on the industry overall, the impact on the individual franchisor will depend on their operating model and how they had been interpreting the current guidance. Before we examine the changes and the potential impact, let’s take a brief look at the chronology of the project and the effective date of the changes, which will be different for privately held and publicly traded companies.
Background

In May 2014, the FASB and International Accounting Standards Board (IASB) issued substantially converged final standards on revenue recognition. These final standards were the culmination of a joint project between the boards that spanned many years. The new guidance in these standards provides a comprehensive revenue recognition model that replaces virtually all pre-existing revenue recognition guidance in U.S. GAAP (legacy GAAP) and IFRS, including the long-standing guidance in legacy GAAP specific to franchisors.

When the FASB’s Accounting Standards Codification (ASC) Topic 606, Revenue from Contracts with Customers, is implemented, there is an expectation of improved comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. Given the broad applicability and potentially significant ramifications of the guidance in Topic 606, the FASB provided significantly delayed effective dates for its adoption. The new revenue recognition guidance will be effective in 2018 for most calendar year-end public entities, which includes most public business entities and certain nonprofit entities and employee benefit plans. For all other calendar year-end entities, the new guidance will be effective in 2019. Early adoption is permitted.

Applying the new guidance to both area development and franchise agreements entered into by franchisors could significantly affect the timing and amount of revenue recognized. Let us first revisit legacy GAAP to understand the most significant potential changes forthcoming.

Legacy GAAP

The sources of revenue and nature of operations of a franchisor differ greatly from that of a restaurant or retailer operating company-owned units. As a result, franchisor accounting, including revenue recognition, is unique. Revenue recognition guidance for franchisors within legacy GAAP is based on the notion included in a FASB concepts statement that revenue should be recognized when it is realized or realizable and earned. Specific guidance is provided to determine when revenue is earned, which is the point at which all material services or conditions relating to a sale have been substantially performed or satisfied by the franchisor. Specific guidance is also included for area development agreements, for which the timing of revenue recognition is dependent in part on whether the franchisor’s substantial obligations depend significantly on the number of individual franchises established within the area and whether efforts and total costs of initial services provided are impacted significantly by the number of units opened. Application of this guidance involves judgment, which has led to diversity in practice, especially as it relates to revenue recognition for area development agreements.

Specific services to be provided under an area development agreement will vary from franchisor to franchisor, but the common denominator in these agreements is that the franchisor is providing the opportunity for a franchisee to operate a certain number of units within an agreed-upon geographic area. The question then becomes at what point is it appropriate for the franchisor to recognize revenue for fees received (or receivable) under the area development agreement? Given the judgmental nature of this evaluation and the differing facts and circumstances of each franchisor, a search of SEC filings of public franchisors would make it abundantly clear that there is significant diversity in practice on how this question is answered. From scenarios in which revenue is recognized ratably over the number of units expected to be opened under the area development agreement, to scenarios in which revenue is recognized upon receipt of payment (if the fee is nonrefundable) and various scenarios in between, the reality is that legacy GAAP is far from unambiguous.

Revenue recognition treatment with respect to initial franchise fees is generally more consistent in practice under legacy GAAP. Revenue related to initial franchise fees is generally recognized upon the opening of the related unit. However, what legacy GAAP refers to as “substantial performance” could affect the timing of recognizing initial franchise fees, especially if ongoing obligations of the franchisor exist in the franchise agreement.

Another area of revenue recognition for franchisors relates to advertising or brand fund fees. Franchisees may be required to contribute a percentage of their net sales into a brand fund, which, along with any contributions to the fund from the franchisor (if the franchisor also operates its own units), are expended on systemwide marketing. Questions arise in practice as to whether the fees...
collected from franchisees for advertising should be presented as revenue or as a reduction of the related advertising expense (i.e., is the franchisor a principal or an agent in the transaction?). Current guidance on this topic is also subject to significant judgment.

The future of revenue recognition

Now let’s take a closer look at the new guidance and the potential impact of certain areas on the revenue recognition practices of franchisors. The core principle included in ASC 606–10–10–2 is to “recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.” Topic 606 sets out the following five steps for an entity to use when applying the core principle to its customer contracts:

Step 1: Identify the contract with a customer

For franchisors, area development agreements and (or) individual franchise agreements will almost certainly be in place. That said, there are specific criteria that an agreement must meet to move forward to the next step in the new revenue recognition model. Each agreement will have to be analyzed to determine whether those criteria are met. If the criteria are not met, revenue recognition will be deferred for a period of time that is dependent on the facts and circumstances.

One of the criteria that must be met requires an entity to assess whether collection of the transaction price for goods and services that will be transferred to the customer is probable. With many area development and initial franchise agreements, fixed payments occur in advance of or at the time of signing the related agreements. There would be no franchisor risk associated with those fixed payments. Given the typical payment terms for ongoing royalty fees included in an area development or initial franchise agreement, such fees will need to be evaluated by the franchisor. Assessing the probability of collection of these royalty fees will sometimes require significant judgment to be exercised. For example, there is often more franchisor risk associated with a franchisee operating in certain countries. In addition, as time passes, circumstances could arise, both in and out of the control of the franchisee that call into question whether it is probable that the franchisee will be able to pay the future royalty fees due.

Step 2: Identify the performance obligations in the contract

Area development agreements are often basic, providing the franchisee the rights to a defined geographic territory. Area development agreements in some instances also require the franchisor to review the proposed site and related lease or purchase agreement for each unit before giving the franchisee consent to proceed with construction. Individual franchise agreements typically include, but are not limited to, site selection (if not already covered under the area development agreement), review and approval of architectural and design plans, access to proprietary manuals and handbooks, equipment, training and pre-opening assistance (and in some cases an opening team for a period of time after the grand opening), and most importantly, use of the franchisor’s intellectual property (IP) (e.g., trade name). Many franchisors also establish an advertising fund. The franchise agreement would typically discuss the manner in which advertising funds are to be calculated and remitted to the franchisor (typically as a percentage of sales, paid concurrent with royalties) and how the funds will be utilized by the franchisor. The franchise agreement may also provide for additional services subsequent to opening on an as-needed basis. These additional services, if used by the franchisee, may or may not require additional consideration be paid to the franchisor.
In applying Step 2, franchisors will need to identify all of the goods and services promised under area development agreements and individual franchise agreements, and determine whether such goods and services are distinct and considered performance obligations accounted for separately, or whether they must be combined with other goods and services to arrive at a performance obligation. In the context of Step 2, which of the aforementioned activities typically found in area development agreements and individual franchise agreements represent promised goods or services that should be considered distinct? Facts and circumstances will differ, but in many cases, it is likely that other than equipment, the activities undertaken by the franchisor either will not represent promised goods or services because they are essentially setup activities or will not be considered distinct promised goods or services because, without the license of the IP, they provide little to no benefit on their own (or together with other readily available resources) or they cannot be separately identifiable from the license of the IP. Therefore, in many cases, the license of IP will be combined with other promised goods or services as one performance obligation. The services provided to franchisees in return for advertising funds are also not likely to be separately identifiable from the license of the IP, as the promise to market and promote the brand through the use of the advertising fund is highly dependent on the IP.

**Step 3: Determine the transaction price**

The transaction price is the amount the franchisor expects to be entitled to for the goods and services that will be transferred to the customer in connection with the area development and (or) individual franchise agreement. The transaction price in a typical franchise arrangement would include any upfront fees, as well as royalty and advertising fund fees. While the royalty and advertising fund rates are generally stated in the agreements, the timing of when they are included in the transaction price depends on whether they are subject to the sales and usage-based royalties constraint on licenses of the IP. If subject to this constraint, such royalties and advertising fund fees will only be included in the transaction price and recognized as revenue at the later of when the sales or usage occurs or the related performance obligation is satisfied.

In determining the transaction price, franchisors also must consider whether there is a significant financing component, particularly for area development and franchise fees received in advance (as is typical). Franchisors should note that a significant financing component does not exist in any of the following situations:

1) The customer makes an advance payment and the timing of transferring the promised goods or services to the customer is at the customer’s discretion.

2) There is substantial variable consideration and payment of that consideration is contingent on the resolution of an uncertainty that is not substantially in the entity’s or customer’s control.

3) There are reasons not related to financing that justify the nature and amount of the difference between the cash selling prices of the promised goods or services and the promised consideration.

**Step 4: Allocate the transaction price to the performance obligations**

Each identified performance obligation should be allocated a portion of the transaction price based on its relative standalone selling price. Given the relative significance of the license of the IP in area development and initial franchise agreements, it will not be uncommon for a majority of the transaction price to be allocated to the performance obligation that includes the license of the IP. In situations where multiple performance obligations exist, care will need to be exercised to ensure appropriate allocation of the transaction price.

**Step 5: Recognize revenue when (or as) each performance obligation is satisfied**

Performance obligations may be satisfied at a point in time or over time. Let’s use the following example to illustrate:
A franchisor and franchisee sign an area development agreement which will allow the franchisee to open five units in the greater Boston area. The area development fee is $50,000. Prior to the opening of each unit, the franchisor and franchisee sign a 10-year franchise agreement, which includes a franchise fee of $25,000 and equipment priced at $10,000. The franchise agreement includes the license of the franchisor’s IP. Royalties and advertising fund fees due under each franchisee agreement are 6 percent and 1 percent, respectively, of net sales of the franchised units. For simplicity purposes, assume that all fees are equal to the estimated standalone selling prices of the related goods and services and there is no significant financing component. Assuming that the two performance obligations identified are the license of the IP (which is combined with other items such as site selection, review and approval of design plans, access to manuals and handbooks and training and pre-opening assistance as one performance obligation) and the sale of equipment, when are such performance obligations deemed to be satisfied?

This is the question that franchisors will have to answer, and that answer may drive the change in revenue recognition under Topic 606 compared to legacy GAAP. Under Topic 606, revenue is recognized when or as control of the goods and (or) services that make up a performance obligation transfer to the customer. Based on the guidance in Topic 606 and additional facts and circumstances, the franchisor will likely conclude in this example that control of the equipment transfers to the franchisee at a point in time, which would typically be upon its delivery. Additional guidance is provided in Topic 606 with respect to whether a license of the IP represents a right to access the licensor’s IP over a period of time (symbolic IP – for which revenue is recognized over time) or a right to use the entity’s IP as it exists at a point in time (functional IP – for which revenue is generally recognized at a point in time). Under Topic 606, the franchisor will typically conclude that the license of its IP represents a right to access its IP over time. If there are no renewal rights or other facts and circumstances in this example that would draw into question the period over which the transaction price allocated to the license of IP would be recognized as revenue, recognition over the period the franchisee has access to the IP (the term of the franchise agreement), on a straight-line basis, would be appropriate.

**Presentation of advertising funds**

Under Topic 606, the overall principle with respect to gross vs. net presentation of revenue focuses on whether the entity controls the promised goods or services before they are transferred to a customer. If so, the entity is a principal and should recognize revenue gross. If not, the entity is an agent and should recognize revenue net. Various indicators are provided in ASC 606–10–55–39 that would need to be considered in determining whether the entity controls the promised goods or services before they are transferred to the customer. The overall principle and indicators in Topic 606 will need to be reviewed closely when a franchisor determines proper treatment for brand fund fees as either net against advertising costs (agent) or gross in revenue (principal). Under legacy GAAP, many franchisors recognized such fees on a net basis, under the premise that the franchisor is acting as an agent. Under Topic 606, the opposite will likely be true, with brand fund fees recorded gross within revenue as the brand fund fees would likely not be considered payment for distinct services that are separable from the license of the IP.

**Disclosure**

Disclosure requirements under Topic 606 will be more robust and informative than under legacy GAAP. Those requirements include, among other things, quantitative and qualitative information about contracts with customers and significant judgments made in applying the new guidance to those contracts.

**Additional information**

For a comprehensive discussion about the guidance in the ASC, including its scope, core principle and key steps, implementation guidance, presentation and disclosure requirements, and effective date and transition provisions, refer to our RSM white paper, *Revenue recognition: A whole new world*. 
Next steps

If you have not yet already done so, now is the time to begin assessing and evaluating the impact Topic 606 may have on your organization. Public companies with calendar years must adopt as of the first day of calendar 2018 while other entities must adopt one year later. While the severity of changes to a franchisor’s current revenue recognition practices will vary, one thing is certain: Nearly all franchisors will see changes upon adoption of the new guidance. Start the conversation today by contacting your RSM representative or Chris Banse, RSM US LLP’s national franchise specialist (+1 972 764 7061).