Changes to revenue recognition for franchisors

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A. Introduction and background

In May 2014, the Financial Accounting Standards Board (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. FASB Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, provides a robust framework for addressing revenue recognition issues and replaces almost all pre-existing revenue recognition guidance in current U.S. generally accepted accounting principles (GAAP) (i.e., legacy GAAP), including the long-standing industry-specific guidance on franchisors.

Implementation of the robust framework provided by ASU 2014-09 will result in improved comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. For public business entities (PBEs) and certain not-for-profit entities, implementation was required no later than annual reporting periods beginning after December 15, 2017, and the interim periods therein. However, if a franchisor is a PBE solely because its financial statements or financial information is included in a filing with the SEC pursuant to certain SEC rules and regulations (e.g., an acquired private company when its financial statements must be included in the acquirer's filing with the SEC), it may choose to adopt the new guidance in accordance with either (a) the effective date otherwise applicable to PBEs or (b) the effective date applicable to private companies. For nonpublic franchisors that have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020, the new guidance is effective for annual reporting periods beginning after December 15, 2019, and interim periods within annual periods beginning after December 15, 2020.

The FASB has amended the guidance included in ASU 2014-09 several times since its issuance. The new guidance primarily is included within the following sections of the FASB's Accounting Standards Codification (ASC):

- Topic 606, "Revenue from Contracts with Customers"
- Subtopic 340-40, "Other Assets and Deferred Costs – Contracts with Customers"
- Subtopic 952-606, "Franchisors – Revenue from Contracts with Customers"

Please refer to A guide to revenue recognition and our Revenue Recognition Resource Center for additional information.

To help address issues identified by entities as they implement the new guidance, the FASB and IASB established the Joint Transition Resource Group (TRG). In addition, the American Institute of Certified Public Accountants (AICPA) organized several industry-specific task forces, including one focused on the hospitality industry (including franchisors), to identify and provide guidance on revenue recognition implementation issues. The culmination of the AICPA task forces' activities was the issuance in 2019 of a final comprehensive nonauthoritative revenue recognition guide (the Revenue Recognition AAG) that provides helpful discussion and illustrative examples on how to apply the new guidance. Additional information about the AICPA's industry-specific task forces and the Revenue Recognition AAG can be found on its website.

For franchisors, the new guidance is far more detailed than the industry-specific legacy GAAP. Although the new guidance is expected to have a significant impact on the industry overall, the impact on the individual franchisor will depend on its operating model and how it had been interpreting the current guidance. This white paper highlights aspects of the new guidance that are particularly relevant to franchisors.

B. 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 was 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 was provided to determine when revenue was earned, which was the point at which all material services or conditions relating to a sale have been substantially performed or satisfied by the franchisor. Specific guidance also was included for area development agreements, for which the timing of revenue recognition was dependent in part on whether the franchisor's substantial obligations depended significantly on the number of individual franchises established within the area and whether efforts and total costs of initial services provided were impacted significantly by the number of units opened. Application of this guidance involved judgment, which resulted in diversity in practice, especially as it relates to revenue recognition for area development agreements.

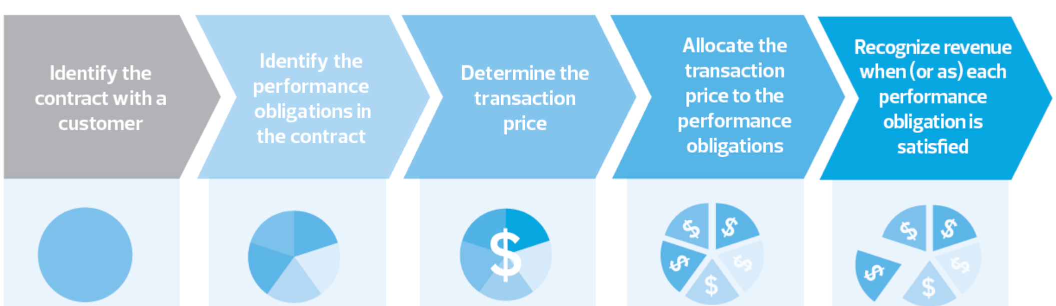
Specific services to be provided under an area development agreement will vary from franchisor to franchisor, but the common denominator in these agreements is that the franchisor is providing the opportunity for a franchisee to operate a certain number of units within an agreed-upon geographic area.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

Revenue recognition treatment with respect to initial franchise fees generally was more consistent in practice under legacy GAAP. Revenue related to initial franchise fees generally was recognized upon the opening of the related unit. However, what legacy GAAP referred to as "substantial performance" could affect the timing of recognizing initial franchise fees, especially if ongoing obligations of the franchisor existed 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 an advertising fund, which, along with any contributions to the fund from the franchisor (if the franchisor also operates its own units), are expended on system-wide marketing. Questions arose 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?). Legacy GAAP on this topic was also subject to significant judgment.

C. New five-step revenue recognition model

The new guidance includes the following five-step revenue recognition model:



An overview of each step is provided in this section of the white paper. For a comprehensive discussion of the five-step revenue recognition model and other aspects of the new guidance, refer to A guide to revenue recognition.

C.1. Identify the contract with a customer

A contract is defined in ASC 606-10-25-2 as "an agreement between two or more parties that creates enforceable rights and obligations." To account for a contract in accordance with the new guidance, the following five criteria (the contract existence criteria) must be met:

- Commercial substance exists
- Approvals have been obtained and a commitment to perform exists on the part of both parties
- Rights of both parties are identifiable
- Payment terms are identifiable
- Collection of substantially all of the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur) (the collectibility criterion).

For franchisors, area development agreements and (or) individual franchise agreements will almost certainly be in place. That said, the preceding specific criteria must be met for the agreements to move forward to the next step in the new revenue recognition model. Each agreement will need to be analyzed to determine whether these criteria are met.

One of the criteria that must be met requires an assessment of whether it is probable the franchisor will collect the amount to which it will be entitled for goods and services that will be transferred to the customer. 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. This assessment should consider all relevant facts and circumstances, including whether the franchisor can mitigate its credit risk through its ability to stop transferring promised goods or services upon nonpayment by the customer.

When all of the contract existence criteria are met, the remaining steps in the five-step revenue recognition model are applied to the contract. If all of the criteria are not met, revenue is deferred for what may be a significant period of time that is dependent on the facts and circumstances.

C.1.1. Combining contracts

If one or more of the following criteria are met, individual contracts with the same customer (or parties related to the customer) that are entered into at or near the same time should be combined for accounting purposes:

- The contracts were negotiated as a package and share the same commercial objective.
- The consideration to be paid under one contract is tied to the other contract's price or performance.
- Some or all of the goods or services in one contract and some or all of the goods or services in the other contract(s) represent a single performance obligation (i.e., some or all of the goods or services in each contract are not distinct from each other).

Franchisors frequently enter into franchise agreements that also refer to franchise disclosure documents (FDDs). Paragraph 17.6.08 of the Revenue Recognition AAG indicates that the franchise agreement and the FDD generally should be combined and accounted for as a single contract.

C.2. Identify the performance obligations in the contract

Identifying the performance obligations in the contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized. The first step in identifying the performance obligations in the contract is to identify all of the promises to provide goods or services in the contract. Once that step is complete, criteria are applied to determine whether the promises to provide goods or services should be treated as performance obligations and accounted for separately.

C.2.1. Identifying promises to transfer goods or services

A franchisor should scrutinize its customer contracts and identify all the promises to transfer goods or services to the customer. Consideration also needs to be given to whether there are promises to transfer goods or services that arise out of a franchisor's customary business practices instead of an explicit contract provision.

Not all activities performed by the franchisor in connection with the contract transfer a good or service to the customer. For example, setup activities do not transfer a good or service to the customer. Instead, those activities are necessary for the franchisor to fulfill the contract and do not themselves represent a good or service transferred to the customer. As a result, they cannot represent a performance obligation.

C.2.2. Separating promises to transfer goods or services into performance obligations

If there is more than one promise to transfer goods or services in a contract, consideration must be given to whether the promises to transfer goods or services should each be considered performance obligations and treated separately for accounting purposes. The determining factor in this analysis is whether each promised good or service is distinct. If a promised good or service meets both of the following criteria, it is considered distinct and accounted for separately as a performance obligation unless the series exception applies:

- *Capable of being distinct*. If a customer can benefit from the promised good or service (or a bundle of goods or services) on its own or by combining it with other resources readily available to the customer, then the good or service is capable of being distinct. A promised good or service is capable of being distinct when the franchisor regularly sells that good or service separately or when the customer can generate an economic benefit either on its own or when combined with other readily available resources. The ability to sell the good or service only for scrap value would not, in and of itself, support a conclusion that the promised good or service is capable of being distinct. For a resource to be readily available to the customer, it must be sold separately either by the franchisor or another party or it must be a good or service that the customer already has obtained as a result of either a contract with the franchisor (including the contract under evaluation) or another transaction or event.
- *Distinct within the context of the contract*. If the promised good or service is separately identifiable from other promised goods or services in the contract, it is distinct within the context of the contract. To determine whether a promised good or service is distinct within the context of the contract, the franchisor must ascertain which of the following best describes its promise within the context of the specific contract:
  - *The promise within the context of the specific contract is to transfer the promised good or service individually*. If this best describes the franchisor's promise within the context of the specific contract, the promised good or service is distinct within the context of the contract.
  - *The promise within the context of the specific contract is to transfer a combined item or items to which the promised good or service is an input.* If this best describes the franchisor's promise within the context of the specific contract, the promised good or service is not distinct within the context of the contract.

Indicators are provided to assist in determining whether a promised good or service is distinct within the context of the contract. Answering yes to any of the following questions is an indication that the promised good or service is *not* distinct within the contract:

- Is the franchisor providing a significant service of integrating the promised good or service with one or more of the other promised goods or services in the contract, with the result of that integration being one or more of the combined outputs contracted for by the customer?
- Does the promised good or service significantly modify or customize one or more of the other promised goods or services in the contract, or is the promised good or service significantly modified or customized by one or more of the other promised goods or services in the contract?
- Is the promised good or service highly interdependent or highly interrelated with one or more of the other promised goods or services in the contract, such that each of the promised goods or services is significantly affected by one or more of the other promised goods or services?

If a promised good or service is distinct, it is considered a performance obligation and accounted for separately. However, a series of distinct promised goods or services that are substantially the same should be considered a *single* performance obligation and accounted for as one unit of account if each of the goods or services has the same pattern of transfer to the customer as a result of (a) each of the goods or services otherwise being considered satisfied over time and (b) the franchisor otherwise having to use the same method of measuring progress toward completion for each of the goods or services.

Promised goods or services that are not distinct are combined until the group of promised goods or services is considered distinct, at which point that group is considered a performance obligation and accounted for separately. It is possible that all of the promised goods or services in the contract might have to be accounted for as a single performance obligation. This happens when none of the promised goods or services are considered distinct on their own or together with less than all of the other promised goods or services in the customer contract.

License

Franchise agreements include a right to use the franchisor's intellectual property (e.g., trade name) for a period of time. Because the intellectual property has value primarily due to its association with the franchisor's past or ongoing activities, it is considered symbolic intellectual property (IP). Paragraph 17.6.14 of the Revenue Recognition AAG indicates that although the license is capable of being distinct because the franchisor can benefit from the license on its own or with other available resources, it is generally highly interdependent on or highly interrelated with other promised goods and services in the contract and therefore usually will be combined with other goods or services in the contract.

Further, as noted in paragraph 17.6.25 of the Revenue Recognition AAG, the license represents a series of distinct services, which is the franchisor's promise to provide daily access to the license over a period of time. While the underlying activities vary day-to-day, each day is distinct in that the franchisee benefits from each day's right to access the license and the license is satisfied over time as the customer simultaneously receives and consumes the benefit from the franchisor's performance of providing access.

Advertising fund

Many franchisors also establish an advertising fund. The franchise agreement typically discusses the manner in which advertising fees are to be calculated and remitted to the franchisor (typically as a percentage of sales, paid concurrently with royalties) and how the fees will be utilized by the franchisor. The services covered by these fees usually consist of marketing and reservation activities that are performed at the brand level and not on an individual franchisee basis. Paragraphs 17.6.20 and 17.6.21 of the Revenue Recognition AAG indicate that these promises should be combined with the license because the marketing and reservation activities do not relate to the individual franchisee but generally enhance the value of the intellectual property included in the license.

Pre-opening services

Individual franchise agreements typically include, among other services, 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 IP (e.g., trade name). Franchisors will need to evaluate these services to determine whether they are distinct from the license.

Paragraphs 17.6.30 through 17.6.34 of the Revenue Recognition AAG indicate that certain pre-opening services, such as brand signage and property inspection, generally should be combined with the license and system assessment services and accounted for as a single performance obligation that is a series of distinct goods or services. However, some pre-opening services, such as architectural design services, training, or property improvement plans, may be considered distinct depending on the specific facts and circumstances.

There are no presumptions on how many performance obligations are included in an individual franchise agreement or an area development agreement. Facts and circumstances often will differ from contract to contract, 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. Paragraphs 17.6.12 through 17.6.34 of the Revenue Recognition AAG discuss the application of these criteria to the promises in a typical franchise agreement.

See Section C.2.5. of this white paper for discussion regarding a practical expedient that permits a franchisor that is not a public business entity to account for certain pre-opening services provided to a franchisee as distinct from the franchise license.

C.2.3. Area development agreements

Area development agreements (ADAs) provide the franchisee the rights to a defined geographic territory. They typically include a required minimum number of units to be opened and specify a time frame during which no other franchisee can operate in the defined geographic territory. In some instances, ADAs 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. In general, a franchisee will pay an upfront fee to enter into an ADA and then will enter into a separate franchise agreement as each unit is opened.

When determining the promises in an ADA, a franchisor will need to exercise significant judgment when identifying performance obligations. The assessment of whether an ADA creates additional performance obligations prior to the execution of the individual franchise agreement, how many performance obligations are identified in an ADA and the ultimate timing of recognition may vary depending on the facts and circumstances, including whether there is a specified or unlimited number of units that may be opened and whether the franchisee has the right to subfranchise within a designated area.

C.2.4. Customer loyalty programs

Many franchisors administer customer loyalty programs. Franchisors should determine whether the option for additional goods or services provided in a customer loyalty program is a material right that the customer would not have received had it not entered into the contract with the franchisor. When evaluating whether an option provides a material right, the franchisor should consider (a) both quantitative and qualitative information about the customer loyalty program and (b) all relevant transactions related to the customer loyalty program, which includes current, past and future transactions.

Consider the following example.

Example 1: Evaluating whether a specific loyalty program includes an option that provides the customer with a material right

The following example is from paragraphs 20 and 21 of TRG 6:

> Entity A has a loyalty program in which its customers accumulate one point for every dollar spent. Points may be exchanged for free products when the customer accumulates enough points. Based on its historical data, Entity A determines that it is likely that its customers will accumulate enough loyalty points to receive a free product.
>
> In the current transaction, Customer Y purchases a product from Entity A for $50 and receives 50 loyalty points. Entity A concludes that each loyalty point has a standalone selling price of $0.01.

Applying the conclusions of the FASB staff and TRG to this example results in the following (from paragraph 23 of TRG 6):

> Entity A would consider whether the loyalty points earned from the current transaction are expected to contribute to a material right that the customer has (or will) accumulate. The evaluation would consider that an element of the right granted to Customer Y in the current transaction is the customer's ability to accumulate loyalty points that will entitle the customer to a free product.

RSM commentary: By considering the customer's ability to accumulate loyalty points on future transactions when assessing whether a material right exists in this example, the TRG and FASB staff rejected the position that if the loyalty points earned in the current transaction alone (i.e., the 50 points from the current sale) are not enough to entitle the customer to a benefit (e.g., free hotel room stay, $100 discount), they do not provide the customer with a material right.

C.2.5. Private company practical expedient for certain pre-opening services

In January 2021, the FASB issued ASU 2021-02, *Franchisors—Revenue from Contracts with Customers (Subtopic 952-606): Practical Expedient*, to help reduce the cost and complexity of applying the revenue recognition guidance for certain franchisors. This ASU provides a practical expedient that permits a franchisor that is not a public business entity that enters into a franchise agreement to account for the following pre-opening services provided to a franchisee as distinct from the franchise license:

- Assistance in the selection of a site
- Assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural, and engineering services, and lease negotiation
- Training of the franchisee's personnel or the franchisee
- Preparation and distribution of manuals and similar material concerning operations, administration and record keeping
- Bookkeeping, information technology and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate and other taxes or about regulations affecting the franchisee's business
- Inspection, testing and other quality control programs

If a franchisor elects to use the practical expedient, the franchisor will have to determine whether the pre-opening services are distinct from one another, unless it makes an accounting policy election to account for the pre-opening services as a single performance obligation.

This practical expedient only applies to identifying performance obligations and does not impact the remaining aspects of applying the guidance on recognizing revenue from contracts with customers, including allocating the transaction price and recognizing revenue. In other words, franchisors will still need to estimate the standalone selling price of the pre-opening services in order to appropriately allocate revenue, and will need to apply the guidance in Step 5 to determine the timing and pattern of revenue recognition. If a franchisor makes the policy election to account for the pre-opening services as a single performance obligation, it will need to select a single measure of progress to apply to the pre-opening services performance obligation.

Franchisors that elect the expedient should apply it consistently to contracts with similar characteristics and in similar circumstances and cannot apply it to services other than those pre-opening services specifically identified in the list above. Any services provided that are not consistent with the list of services noted above should be evaluated under the guidance in Step 2 to determine whether the services are distinct and should be accounted for as separate performance obligations.

This practical expedient is available for a franchisor that has not yet adopted ASC 606 by following the existing transition provisions and effective date guidance in ASC 606. If a franchisor already has adopted ASC 606, the practical expedient is effective in interim and annual periods beginning after December 15, 2020 and should be applied retrospectively to the date ASC 606 was adopted. Early application is permitted.

C.3. Determine the transaction price

The transaction price is the amount to which the franchisor expects to be entitled for the goods and services that will be transferred to the customer in connection with the area development and (or) individual franchise agreements. 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 generally are 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 IP. Paragraph 17.6.37 of the Revenue Recognition AAG indicates that the license to the franchisor's intellectual property generally is the predominant deliverable in the combined performance obligation. As a result, the royalty and advertising fees are subject to the sales- and usage-based royalties constraint and only will 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. Franchisors should note that a significant financing component does not exist in any of the following situations:

- 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.
- There is substantial variable consideration and payment of that consideration is contingent on the resolution of an uncertainty that is not substantially in the franchisor's or customer's control.
- 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.

Although area development and franchise fees typically are due in advance, paragraph 17.6.38 of the Revenue Recognition AAG indicates that such fees generally do not result in the identification of a significant financing component because the difference in timing of the payment is to protect the franchisor in the event the franchisee fails to complete its obligations under the contract (e.g., the franchisee doesn't open a location after initial services are provided).

C.4. Allocate the transaction price to the performance obligations

If a contract has more than one performance obligation, the transaction price generally should be allocated to each performance obligation based on the standalone selling prices of each performance obligation in relation to the total of those standalone selling prices (i.e., on a relative standalone selling price basis). Exceptions are provided for certain situations involving discounts and (or) variable consideration that can be shown to be related to one or more (but less than all) performance obligations. In addition, a contract with one performance obligation also may be affected by the guidance on allocating variable consideration when that one performance obligation is made up of a series of distinct goods or services that are treated as a single performance obligation under the series exception.

Variable consideration included in the transaction price should be allocated on a proportionate basis to each of the performance obligations in a contract, except when the following two criteria are met:

- The terms of the variable payment are specifically related to the franchisor's efforts to (a) satisfy, or achieve a specific outcome from satisfying, a specific performance obligation or (b) transfer, or achieve a specific outcome from transferring, a distinct good or service in a single performance obligation resulting from application of the series exception.
- Allocating the variable payment to the specific performance obligation or distinct good or service in a single performance obligation resulting from the series exception depicts the amount of consideration to which the franchisor expects to be entitled in exchange for transferring that good or service to the customer when considering all of the performance obligations and payment terms in the contract.

When these criteria are met, the variable payment included in the transaction price that meets these criteria, and any change in the estimate of that payment, should be allocated in their entirety to the specific performance obligation or distinct good or service to which the variable payment relates.

Franchise agreements typically are structured to align compensation with the related services. For example, variable license fees and system assessment fees generally relate to satisfying the license obligation for the period in which they are assessed. Paragraph 17.6.43 of the Revenue Recognition AAG indicates that if the performance obligation is a series of daily services for which the uncertainty regarding the consideration is resolved on a daily basis, then the allocation of the monthly variable royalty and system assessment fees to the daily services provided during the month they are billable is consistent with the allocation objective. The Revenue Recognition AAG also notes that, as a practical expedient, if the franchisor has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the franchisor's performance completed to date, the franchisor may recognize revenue in the amount to which it has a right to invoice.

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.

The FASB Memo, *Update on Implementation Activities for Franchise Industry*, illustrates the importance of appropriately allocating the transaction price in a franchise arrangement that includes multiple performance obligations. For example, consider a franchise agreement in which two performance obligations are identified: the license of IP and training services. The transaction price consists of an upfront fee and a sales-based royalty. If the standalone selling price of the training service is more than the upfront fee, the entire fee would be recognized upfront and the royalty would be recognized as earned because the guidance in ASC 606-10-55-65 does not allow sales-based royalties on IP to be recognized upfront. If, however, the standalone selling price of the training service is less than the upfront fee, then a portion of the fee would be deferred and recognized as revenue over the term of the license.

C.4.1. Estimating standalone selling price

The standalone selling price of a performance obligation is the amount the franchisor charges (or would charge) when the distinct goods or services that make up the performance obligation (i.e., the underlying distinct goods or services) are sold on their own to a customer. Standalone selling prices are determined at contract inception and are not subsequently adjusted for changes in facts and circumstances.

The best evidence of the standalone selling price of the underlying goods or services is the observable price charged by the franchisor for those goods or services when they are sold separately in similar circumstances to similar customers. Absent evidence of a directly observable standalone selling price, the franchisor is required to estimate a standalone selling price. While there are any number of approaches to estimating a standalone selling price that are consistent with the overall objective of allocating the transaction price, ASC 606 discusses the following three approaches:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach

In making this estimate, the franchisor should maximize observable inputs and consider all reasonably available and relevant information, which includes information specific to the franchisor, the market, the customer and the customer class. In addition, a franchisor should be consistent in how it applies an estimation method and the situations in which it applies an estimation method.

C.5. Recognize revenue when (or as) each performance obligation is satisfied

Revenue is recognized when (or as) a performance obligation is satisfied, which is when control of the underlying good or service (i.e., an asset) is transferred to the customer. The amount of revenue recognized upon satisfaction of a performance obligation is the transaction price allocated to it. To properly assess when revenue should be recognized, a franchisor must perform at contract inception an evaluation focused on whether a performance obligation is satisfied over time or at a point in time.

If a performance obligation meets one or more of the following criteria, it is considered satisfied over time:

- *Customer simultaneously receives and consumes benefits as the entity performs.* A performance obligation is satisfied over time if the customer consumes the benefits of the franchisor's performance at the same time as (a) the customer receives those benefits and (b) the franchisor performs and creates those benefits. If it is not readily apparent whether this criterion is met for a particular set of facts and circumstances, then a performance obligation is satisfied over time if another entity could step in and fulfill the remaining performance obligation without having to substantially reperform the work already performed by the entity.
- *Customer controls the asset as the entity creates or enhances the asset.* A performance obligation is satisfied over time if the customer controls the asset (which could be tangible or intangible) as it is created or enhanced by the entity's performance.
- *No alternative use and an enforceable right to payment.* A performance obligation is satisfied over time if (a) the asset created by the entity's performance does not have an alternative use to the entity upon its completion and (b) the entity's right to payment for its performance to date is enforceable.

If a performance obligation does not meet any of these three criteria, then it is considered satisfied at a point in time and revenue is recognized at the point in time the customer obtains control over the underlying good or service.

C.5.1. Identifying a method to measure progress toward complete satisfaction of a performance obligation made up of multiple promised goods or services that are not distinct

When a promised good or service in a contract is not distinct, it is combined with other promised goods or services in the contract until a bundle of promised goods or services is identified that is distinct. (This often is the case in a franchise agreement.) The result is a performance obligation made up of multiple promised goods or services. In many cases, these performance obligations will meet one of the criteria that results in recognizing the revenue related to the performance obligation over time. The difficulty that may then arise in these cases is identifying an appropriate method for measuring progress toward the complete satisfaction of the performance obligation. The FASB staff and TRG discussed this difficulty. The basis for these discussions was TRG 41, and a summary of the discussions is provided in TRG 44.

The FASB staff and TRG concluded that a franchisor must identify a single method by which to measure progress toward the complete satisfaction of a performance obligation even when the performance obligation is made up of a bundle of promised goods or services. In other words, a franchisor may not identify different methods to apply to different nondistinct goods or services for purposes of measuring its progress toward the complete satisfaction of the performance obligation as a whole. To do so likely would circumvent the reasons the promised goods or services were bundled together to form one performance obligation in the first place.

Ultimately, the franchisor's goal is to identify a method for measuring progress toward the complete satisfaction of a performance obligation that achieves the intended objective, which is to "depict an entity's performance in transferring control of goods or services promised to a customer." Identifying this method will require a franchisor to exercise significant judgment and carefully consider all the facts and circumstances. Consider the following example.

Example 2: Identifying a method for measuring progress to completion for a performance obligation consisting of a franchise license and consulting services

The following example is from paragraph 32 of TRG 41:

> A franchisor enters into a 10-year license agreement with a new franchisee. The franchisor also promises to provide consulting services over the first year of the license agreement. The consulting services provide the franchisee with hours of service to help it set up operations to run its franchise.
>
> For the purpose of this example, it is assumed that the franchisor concludes that the license and services should be combined into a single performance obligation because the license and services are highly interrelated (that is, each promise is capable of being distinct because the customer can derive some benefit from each item – from the franchise license on its own and the services together with the license granted upfront – but the promises are not distinct in the context of the contract). Furthermore, the entity concludes that the license is satisfied over time.[footnote omitted] The transaction price consists of an upfront fee of CU 1 million for the license and CU 150,000 for a fixed number [of] hours of consulting service that are performed in the first year.

The following is the view of the FASB staff and TRG included in paragraph 33(a) of TRG 41:

> *View A (Staff View) – Use a measure of progress that best depicts the performance of the license.* Under View A, the nature of the overall performance obligation is the franchisee's right to access the license and, therefore, the measure of progress would depict the transfer of the license. For example, using a time-based output method, the entire transaction price would be recognized ratably over the 10-year period. The entire transaction price of CU 1,150,000 would be recognized over the 10-year license agreement.

RSM commentary: One of the views rejected by the FASB staff and TRG would have used a measure of progress depicting the performance of the consulting services in the first year of the license agreement. The FASB staff and TRG rejected this view because it essentially would ignore the right to access the IP subject to the license over the last nine years of the ten-year license period. The other view rejected by the FASB staff and TRG would have recognized the license fee over the license period and the consulting services fee as each hour of service is transferred to the customer. One of the reasons this view was rejected was because it circumvented the reasons why the franchise license and consulting services were bundled together as one performance obligation.

C.5.2. Sales- and usage-based royalties

The overall variable consideration guidance in ASC 606 should not be applied to a sales- and (or) usage-based royalty when the only, or predominant, item(s) to which the royalty relates is the license of IP. As noted in paragraph 17.6.44 of the Revenue Recognition AAG, in most franchise agreements, the promises to perform system assessment services and non-distinct pre-opening services should be bundled with the license to form a single performance obligation. Because the license is considered the predominant item in the bundled performance obligation, the royalties received related to the license should not be included in the transaction price until the later of (a) the resolution of the related uncertainty (i.e., sales and [or] usage occur) or (b) the satisfaction of the related performance obligation in whole or in part.

Any additional products or services that are not included in the combined performance obligation in which the license is the predominant deliverable should be evaluated under the general guidance in ASC 606 to assess when control is transferred.

It should be noted that the point in time at which the franchisor receives sales data from its customers has no bearing on when the franchisor includes royalties related to those sales in the transaction price. As discussed earlier, royalties subject to the sales- and (or) usage-based royalties exception should not be included in the transaction price until the later of (a) the resolution of the related uncertainty (i.e., sales and [or] usage occur) or (b) the satisfaction of the related performance obligation in whole or in part. If the franchisor does not yet have the sales data from its customer upon the later of those two events happening, it should estimate the royalties to which it expects to be entitled for purposes of including them in the transaction price at that point in time. This answer is consistent with the views expressed by an SEC staff member in his Remarks before the 35th Annual SEC and Financial Reporting Institute Conference on June 9, 2016.

If there is a subsequent change in the franchisor’s estimate of the royalties to which it expects to be entitled as a result of receiving the sales data from the customer, the franchisor should account for that change as it would account for any other change in the transaction price.

C.5.3. Gift card programs

Many franchisors sell gift cards that are redeemable at company-owned and franchise locations. ASC 606 only covers gift cards redeemed at company-owned locations. Gift cards redeemed at franchise locations are within the scope of ASC 405, *Liabilities,* which requires the same accounting treatment for unredeemed gift cards (i.e., breakage) as that in ASC 606.

Gift cards provide for the customer to prepay for goods and (or) services, which obligates the franchisor to provide or stand ready to provide those goods or services. The prepayment received when a gift card is sold should be recognized as a contract liability. When the customer exercises its rights by redeeming the gift card at a company-owned location in the future, revenue is recognized by derecognizing the contract liability. When gift cards are redeemed at a franchise location, the franchisor typically reimburses the franchisee for the gift card value net of any administrative costs and derecognizes the related liability at that time. However, customers do not always exercise all of the rights for which they prepaid. Those rights that are unexercised are referred to as breakage.

To the extent a franchisor expects to be entitled to an amount of breakage, that amount should be proportionately recognized as revenue as the other performance obligations in the contract (i.e., those contractual rights expected to be exercised by the customer) are satisfied. However, the franchisor will need to apply the variable consideration constraint and conclude it is probable that a significant reversal in cumulative revenue recognized will not occur as a result of proportionately recognizing breakage as revenue as the other performance obligations in the contract are satisfied. When the franchisor does not proportionately recognize all breakage as revenue as the other performance obligations in the contract are satisfied (perhaps because of the variable consideration constraint), the transaction price related to that breakage should not be recognized as revenue until the likelihood that the customer will exercise those rights becomes remote. However, when the franchisor does not expect to be entitled to an amount of breakage because it is required to remit amounts received related to a customer's unexercised rights to another party (e.g., a governmental authority), it should recognize a liability for those amounts.

Example 3: Accounting for breakage related to gift cards when it can be reasonably estimated, and there is no escheatment law

While this example addresses the accounting for a single gift card (for ease of illustration), the same approach should be used if a franchisor elects to account for a portfolio that includes a large volume of similar gift cards.

Customer B buys a $50 gift card from Franchisor A. The gift card expires in one year, and Franchisor A enforces the expiration date.

Based on its historical data, Franchisor A estimates that Customer B only will use $45 of the gift card and that $5 will go unused. Franchisor A concludes it is probable that recognizing $1.11 of revenue ($50 gift card ÷ $45 expected to be redeemed) per $1 of gift card value redeemed will not result in a significant reversal of cumulative revenue recognized when the uncertainty related to how much of the gift card is used before its expiration is resolved. There are no escheatment laws in the state in which the gift card was sold or used that require Franchisor A to pay the state proceeds from the sale of gift cards that are unused.

When Franchisor A sells the gift card to Customer B, it records the following journal entry:

	Debit	Credit
Cash	$50	
Contract liability		$50

When Customer B uses the gift card six months later to purchase a meal for $30 at a franchisor-owned location, Franchisor A records the following revenue-related journal entry:

	Debit	Credit
Contract liability (Note 1)	$33	
Revenue (Note 1)		$33

Note 1: $30 gift card value redeemed × $1.11 of revenue per $1 gift card value redeemed

Franchisor A still expects $15 of the remaining value on the gift card to be redeemed and the other $5 of the remaining value to expire unused.

D. Presentation of advertising funds

Under ASC 606, the overall principle with respect to gross vs. net presentation of revenue focuses on whether the franchisor controls the specified goods or services before they are transferred to a customer. If so, the franchisor is a principal and should recognize revenue gross. If not, the franchisor is an agent and should recognize revenue net.

The same analysis used to identify the performance obligations in a contract also is used to identify the specified goods or services to which the principal vs. agent guidance is applied when another party is involved in providing those goods or services to the customer. As such, identifying the specified goods or services involves identifying all of the promises to provide goods or services in the contract and then determining whether those promised goods or services are distinct. The concept of distinct used for this purpose is the same as the concept of distinct used to identify performance obligations (see Section

C.2.2). If a promise to provide a good or service is distinct, it is considered a specified good or service, and the entity must determine whether it is acting as a principal or an agent with respect to providing the good or service to the customer. If a promise to provide a good or service is not distinct, it is combined with one or more other promises to provide goods or services until the combined group is considered distinct.

Under legacy GAAP, many franchisors recognized advertising fund fees on a net basis, under the premise that the franchisor is acting as an agent. Under ASC 606, the opposite will be true, with advertising fund fees recorded gross within revenue as the advertising fund fees generally will not be considered payment for distinct services that are separable from the license of the IP.

E. Disclosure requirements

The new guidance includes many new qualitative and quantitative disclosure requirements. The objective of the disclosure requirements is to help financial statement users understand the nature, amount, timing and uncertainty of revenue and related cash flows. In general, entities are required to disclose a variety of information about the contracts they have with customers and significant judgments used in the application of the new guidance.

While the most disclosures are required of public entities (which includes certain franchisors), many disclosures also are required of nonpublic entities. In addition, more disclosures are required of public entities on an annual basis than an interim basis, with many of the disclosures required on an interim basis being quantitative in nature.

A franchisor should review its systems, processes, procedures and controls to determine whether it is capable of providing the information necessary to satisfy the new disclosure requirements discussed in the remainder of this section, and if not, what changes it must make to enable it to provide the necessary information.

E.1. Disaggregated revenue

Public companies are required to disclose a quantitative disaggregation of revenue based on how economic factors affect the nature, amount, timing and uncertainty of revenue recognition and cash flows.

Nonpublic companies that do not elect to provide the quantitative disclosures required for public franchisors should disaggregate revenue based on when control of the goods or services transfers to the customer (e.g., over time or at a point in time). In addition, such nonpublic franchisors should provide qualitative discussion about how economic factors (such as those that might otherwise serve as the basis for quantitative disaggregation) affect the nature, amount, timing and uncertainty of revenue recognition and cash flows.

When determining the appropriate disaggregation levels and categories to use in financial statement disclosures, public franchisors (and other franchisors that elect to provide the disclosures required of public companies) should consider how they present revenue for other purposes, such as to investors and members of management or governance committees. In considering the needs of financial statement users, a franchisor will want to carefully evaluate all sources of revenue and the varying judgments used to recognize different types of revenue. Common categories of disaggregated revenue include (a) type of good or service (e.g., by major product line), (b) geographic region, (c) contract and customer type (e.g., fixed-price and time-and-materials contracts), (d) contract duration, (e) timing of transfer of goods or services (e.g., at a point in time or over time) or (f) market type (revenue from international or U.S. governments), among others.

E.2. Contract balances

All franchisors should disclose, or present separately on the face of the balance sheet, the opening and closing balances of accounts receivable, contract assets and contract liabilities.

Public franchisors also are required to disclose the following, which are optional for nonpublic franchisors:

- *The amount of revenue recognized in the current reporting period that was included in the contract liability balance at the end of the previous reporting period.* For example, if a franchisor had a contract liability balance at the end of the previous reporting period due to it receiving upfront nonrefundable payments for which it had not yet fully performed, it should disclose the amount of that liability that was recognized as revenue in the current reporting period.
- *An explanation (which may be qualitative) of the timing of the franchisor's satisfaction of its performance obligations compared to the timing of when it typically receives payment for providing the underlying goods or services and how the contract asset and contract liability balances are affected by this timing.*
- *A qualitative and quantitative explanation of what caused significant changes in the contract assets or contract liabilities during the reporting period.* For example, if a franchisor acquires another franchisor during the reporting period, it should explain the acquisition's effects on contract assets and contract liabilities.

A franchisor's revision of estimates (e.g., variable consideration, percentage of completion), if any, should be evaluated for its impact on contract balances. If material, a franchisor should explain the effects on contract assets and contract liabilities of revising an estimate. This will provide relevant information about the timing of revenue recognition that was not a result of current period performance.

E.3. Performance obligations

A franchisor is required to disclose the following about its performance obligations:

- When its performance obligations typically are satisfied
- Significant payment terms
- Nature of the promised goods or services provided to customers
- Obligations it has in its customer contracts related to rights of return or refund or other similar customer rights
- Warranties and related obligations
- Revenue recognized in the current reporting period related to performance obligations satisfied (or partially satisfied) in the prior reporting period

E.4. Transaction price allocated to remaining performance obligations

Remaining performance obligations are those performance obligations identified in a customer contract entered into before the end of a reporting period for which control of some or all of the underlying goods or services has not been transferred to the customer at the end of the reporting period. A remaining performance obligation may be a partially satisfied performance obligation or a completely unsatisfied performance obligation.

With certain exceptions, the following information about remaining performance obligations at the end of a reporting period should be disclosed by public franchisors and may be disclosed by nonpublic franchisors:

- *The total amount of the transaction price allocated to those performance obligations*.
- *An explanation of when the franchisor expects to recognize the transaction price allocated to these performance obligations as revenue*. This disclosure requirement can be satisfied either quantitatively (using appropriate time bands for when the allocated transaction price is expected to be recognized as revenue) or qualitatively.

As described further in ASC 606-10-50-14 to 50-14B, there are two optional exemptions related to these remaining performance obligation disclosure requirements. A franchisor should disclose which of the optional exemptions it has elected to apply, as well as the following information about the related remaining performance obligations: (a) their nature, (b) their remaining duration and (c) a description of any variable consideration excluded from the disclosures as a result of electing one or both of the optional exemptions.

E.5. Significant judgments

A franchisor should disclose judgments (and changes to those judgments) it makes in applying the new guidance that significantly affect when and how much revenue is recognized related to its customer contracts. The disclosures should include those judgments (and changes in judgments) involved in determining the transaction price, allocating the transaction price to performance obligations and determining when performance obligations are satisfied.

The following information should be disclosed by all franchisors:

- *For performance obligations satisfied over time, the specific input or output method used to recognize revenue.*
- *In applying the variable consideration constraint, the judgments involved in identifying the methods, inputs and assumptions used.*

The following additional information should be disclosed by public franchisors and may be disclosed by nonpublic franchisors:

- *For performance obligations satisfied over time, an explanation of why the specific input or output method used to recognize revenue over time provides a faithful depiction of how the franchisor transfers control of goods or services to its customers.*
- *For performance obligations satisfied at a point in time, the significant judgments made in determining when control of the goods or services transfers to the franchisor's customers*.
- *The judgments involved in identifying the methods, inputs and assumptions used to determine and allocate the transaction price and measure any obligations related to the customer contract* (e.g., returns, refunds), including (but not limited to) the following:
  - If there is variable consideration, the franchisor should explain how it estimates the variable consideration (e.g., the most likely amount method or the expected value method).
  - If there is a significant financing component, such as certain long-term payment plans, the franchisor should disclose how it was reflected in the transaction price.
  - If there is noncash consideration, the franchisor should disclose how it was measured.
- *For contracts that include more than one performance obligation, the judgments involved in identifying the methods, inputs and assumptions used to (a) estimate the standalone selling price of each performance obligation and (b) allocate any discount or variable consideration included in the contract.*
- *For rights of return or refund (e.g., right of refund related to some or all of an advance payment), the judgments involved in identifying the methods, inputs and assumptions used to estimate the related obligation.*

E.6. Contract costs

The following information related to costs incurred to obtain or fulfill a customer contract should be disclosed by public franchisors and may be disclosed by nonpublic franchisors:

- A description of the judgments made in identifying the costs that should be capitalized
- A description of the method used in each reporting period to amortize the capitalized costs and the amount of related amortization recognized for the reporting period
- The ending balances of capitalized costs by main category of asset (e.g., incremental costs to obtain a contract, setup costs)
- Any impairment loss recognized in the reporting period related to the capitalized costs

E.7 Practical expedients

If a public franchisor elected either of the following practical expedients, it should disclose that fact: (a) the practical expedient that results in not reflecting a significant financing component in the transaction price or (b) the practical expedient that results in not capitalizing certain incremental costs related to obtaining a contract. As applicable, nonpublic entities may elect to make these disclosures.

A non-public franchisor that elects to use the practical expedient as noted in Section C.2.5 should disclose that fact. Additionally, a non-public franchisor that makes the accounting policy election to recognize pre-opening services as a single performance obligation should disclose that fact.

E.8 Policy elections

There are two policy elections that an entity may make, which require additional disclosure for all entities:

- The accounting policy under which shipping and handling activities that occur after the customer obtains control of the promised goods are considered fulfilment activities and not promised services that have to be further evaluated under ASC 606
- The accounting policy under which the entity excludes from the transaction price taxes it collects from its customers that were assessed by a government authority on (or contemporaneous with) the entity's revenue-generating transactions with its customers

If an entity elects either of these accounting policies, the following information should be disclosed:

- The fact the accounting policy has been elected
- A description of the accounting policy
- The method used to apply the accounting policy if such policy materially affects the balance sheet, cash flows or operating results

F. Conclusion

This white paper discusses those aspects of the new guidance that are likely to have the most significant effects on how franchisors account for revenue contracts. For comprehensive discussion about the new guidance, including its scope, core principle and key steps, implementation guidance, presentation and disclosure requirements, and effective date and transition provisions, refer to A guide to revenue recognition.

All franchisors whose financial statements are prepared in accordance with U.S. GAAP will be affected by the new guidance because their accounting policies for revenue recognition will need to change to reflect the five-step revenue recognition model. In addition, every franchisor will be significantly affected by the disclosure requirements in the new guidance because they substantially increase the volume of revenue-related information disclosed in the financial statements, particularly for public franchisors. The new guidance will require franchisors to evaluate whether any changes are needed to their current revenue accounting and financial reporting processes, systems and procedures. This undoubtedly will require substantive involvement by more than just those involved in the accounting function.

We believe many middle market franchisors will need to dedicate significant resources to properly assess and implement the changes brought about by ASC 606. Because compliance may be more challenging than many believe, franchisors should be well on their way to assessing how the new guidance will affect revenue recognition policies and disclosures, developing an implementation plan and completing that implementation plan. To discuss the impacts of the new guidance on your company and its financial statements, please contact your RSM representative or Chris Banse, RSM US LLP's national franchise leader (+1 972 764 7061).

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