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**The New FASB Rules**

**James Kroeker  
Vice-Chair  
Financial Accounting Standards Board  
Norwalk, Connecticut**

**Christa LaBrosse  
Partner  
Plante Moran PLLC  
Southfield, Michigan**

and

**Lee Plave  
Partner  
Plave Koch PLC  
Reston, Virginia**

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\* FASB Vice Chair Kroeker did not participate in the preparation of this paper, which may not reflect his views or that of the Financial Accounting Standards Board.

## THE NEW FASB RULES

### I. INTRODUCTION

Revenue recognition has long been among the accounting topics that franchisors and their auditors must deal with when preparing financial statements. Although CFOs and in-house lawyers devote considerable attention to such accounting issues, they are not always of principal importance to all legal practitioners.

The implementation of new revenue recognition standards, however, unavoidably makes this accounting issue a central concern for all practitioners. The new guidance – formally titled “ASC 606, Revenue from Contracts with Customers”<sup>1</sup> (“ASC 606”) – merits full analysis, understanding of the accounting and business issues it raises, and realistic expectations as to what these considerations mean for franchisors, franchisees, and their advisors. Among other things, as discussed in this paper, ASC 606 requires franchisors to determine how to recognize revenue associated with the initial franchise fees paid by their new franchisees, which could result in deferral of recognition of some (or all) of the initial franchise fee.

ASC 606 has generated significant attention because it departs considerably from the current practice under ASC 952-605. Under ASC 952-605, a franchisor was generally able to recognize initial franchise fees into revenue when the franchisor substantially performed or otherwise met its material obligations to a new franchisee (which typically occurs when the franchisee opens for business).<sup>2</sup> As noted in this paper, ASC 952-605 is being replaced as ASC 606 is implemented.

#### A. What is the FASB?

The new standard for revenue recognition – like its predecessor<sup>3</sup> – was issued by the Financial Accounting Standards Board, commonly referred to as “the FASB.” The FASB was established in 1973, and describes itself as:

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<sup>1</sup> Financial Accounting Standards Board, “Revenue from Contracts with Customers (Topic 606),” No. 2014-09 (May 2014) (hereinafter, the “FASB ASU 2014-09”). The term “ASC” is an abbreviation for “Accounting Standards Codification,” which organizes the Financial Accounting Standards Board’s pronouncements systematically so that they can be more easily accessed and understood. The authors note that the ASC, which represents the current state of the ASCs as they exist (and reflecting various interim amendments) can be found on the FASB’s website, which requires a paid subscription. References in this paper to FASB ASU 2014-09 are to the then-current state of the standard, which may have been updated since issuance. References to ASC are to the Accounting Standards Codification.

<sup>2</sup> Financial Accounting Standards Board, “Summary of Statement No. 45: Accounting for Franchise Fee Revenue)” (March 1981) <https://www.fasb.org/summary/stsum45.shtml> (accessed Sept. 7, 2018).

<sup>3</sup> The predecessor standard, also referred to in this paper, is ASC 952-605, *Franchisors Revenue Recognition*.

[T]he independent, private-sector, not-for-profit organization ... that establishes financial accounting and reporting standards for public and private companies and not-for-profit organizations that follow Generally Accepted Accounting Principles (GAAP).<sup>4</sup>

The FASB is recognized by the Securities and Exchange Commission as the designated accounting standard setter for public companies. FASB standards are recognized as authoritative by many other organizations, including state Boards of Accountancy and the American Institute of CPAs (AICPA).<sup>5</sup>

The FASB is funded by fees paid by private parties, including publicly-traded companies, subscription and publication revenue, account support fees, and investment income.<sup>6</sup>

In December 1973, the SEC formally acknowledged and embraced the FASB's role:

The [FASB is the] body presently designated by the Council of the American Institute of Certified Public Accountants (AICPA) to establish accounting principles .... This designation by the AICPA followed the issuance of a report in March 1972 recommending the formation of the FASB, after a study of the matter by a broadly based study group. The recommendations contained in that report were widely endorsed by industry, financial analysts, accounting educators, and practicing accountants. The Commission endorsed the establishment of the FASB in the belief that the Board would provide an institutional framework which will permit prompt and responsible actions flowing from research and consideration of varying viewpoints. The collective experience and expertise of the members of the FASB and the individuals and professional organizations supporting it are substantial. Equally important, the commitment of resources to the FASB is impressive evidence of the willingness and intention of the private sector to support the FASB in accomplishing its task. In view of these considerations, the Commission intends to continue its policy of looking to the private sector for leadership in establishing and improving accounting principles and standards through the FASB with the expectation that the body's conclusions will promote the interests of investors.<sup>7</sup>

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<sup>4</sup> See discussion of GAAP in section 1.B. below.

<sup>5</sup> Financial Accounting Standards Board, "About the FASB," <https://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495> (accessed July 30, 2018).

<sup>6</sup> Financial Accounting Foundation, "How We're Funded," <https://www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1351027545591> (accessed July 30, 2018).

<sup>7</sup> Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, SEC Release No. AS-150, 1973 WL 149263, at \*1 (Dec. 20, 1973).

Taking note of the FASB's centrality, the D.C. Circuit observed, in an SEC enforcement action, that:

The FASB issues pronouncements in the form of Statements and Interpretations, often setting forth not only the basis for its conclusions about accounting issues, but also its reasons for rejecting other options. The [Securities and Exchange] Commission treats the "principles, standards and practices promulgated by the FASB ... as having substantial authoritative support" and views those contrary to the FASB's pronouncements as having "no such support."<sup>8</sup>

On July 1, 2009, the FASB released the authoritative version of the FASB Accounting Standards Codification ("Codification" or "ASC") as the single source of authoritative non-governmental U.S. Generally Accepted Accounting Principles (GAAP).<sup>9</sup> The results of ongoing standard-setting activity and amendments to the Codification are Accounting Standards Updates ("ASUs").<sup>10</sup>

#### **B. What are Generally Accepted Accounting Principles?**

Generally accepted accounting principles ("GAAP") are a set of accounting standards and guidance that companies follow when preparing their financial statements. The application of GAAP is meant to ensure a minimum level of consistency in the preparation of financial statements, making it easier for users of financial statements to analyze and extract useful information, and to enhance the efficient functioning of capital markets.<sup>11</sup> The use of GAAP also facilitates the comparison of financial information of different companies.

In a decision involving an SEC enforcement action, the Southern District of New York observed that:

The goal of financial reporting is to "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. ... and that "[t]he purpose of GAAP is "to

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<sup>8</sup> *Checkosky v. S.E.C.*, 23 F.3d 452, 473 (D.C. Cir. 1994).

<sup>9</sup> Financial Accounting Standards Board, "FASB Accounting Standards Codification, About the Codification (v4.10)" (<https://asc.fasb.org/imageRoot/71/58741171.pdf>) (accessed Sept. 11, 2018).

<sup>10</sup> *Id.*

<sup>11</sup> Financial Accounting Foundation, "About GAAP" (<https://www.accountingfoundation.org/jsp/Foundation/Page/FAFBridgePage&cid=1176164538898&pf=true>) (accessed Sept. 10, 2018) ("The high-quality financial reporting standards within GAAP are essential to the efficient functioning of our capital markets."). FAF - the Financial Accounting Foundation, oversees and administers both the FASB and the Government Accounting Standards Board. (<https://www.accountingfoundation.org/jsp/Foundation/Page/FAFLandingPage&cid=1175805317591>).

increase investor confidence by ensuring transparency and accuracy in financial reporting.”<sup>12</sup>

The significance of the FASB to determining GAAP in the U.S. is discussed above. The U.S. Supreme Court has noted, however, that GAAP is not a monolithic set of rules, but rather a compendium of standards:

GAAP is not the lucid or encyclopedic set of pre-existing rules that the dissent might perceive it to be. Far from a single-source accounting rulebook, GAAP “encompasses the conventions, rules, and procedures that define accepted accounting practice at a particular point in time.” GAAP changes and, even at any one point, is often indeterminate. “[T]he determination that a particular accounting principle is generally accepted may be difficult because no single source exists for all principles.”<sup>13</sup>

When issuing new guidance on the range of sources for determining what constitutes GAAP, the FASB observed in ASC 105-10 that “[t]he appropriateness of other sources of accounting guidance depends on its relevance to particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice.”<sup>14</sup>

### **C. How Does GAAP Differ from IFRS?**

Globally, there are different versions of generally accepted accounting principles. These include accounting principles generally accepted in the United States of America, in which the FASB plays the central role, and International Financial Reporting Standards (“IFRS”), which are determined by the International Accounting Standards Board (“IASB”) and are generally used outside the United States. When a company distributes its financial statements outside of the organization, it should indicate the specific body of generally accepted accounting principles that is being applied to those statements in the footnotes to their financial statements (e.g., Brazilian GAAP, German GAAP, U.K. GAAP). (In this paper, the authors refer to U.S. GAAP unless otherwise noted.)

While GAAP and IFRS are both types of generally accepted accounting principles, they differ as they are set by different regulatory bodies. As discussed previously, GAAP is determined by the FASB. In contrast, “IFRSs are developed through an international due process that involves accountants, financial analysts and other users of financial statements, the business community, stock exchanges, regulatory and legal authorities, academics and other interested individuals and

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<sup>12</sup> *S.E.C. v. KPMG LLP.*, 412 F. Supp. 2d 349, 355 (S.D.N.Y. 2006) (citations omitted).

<sup>13</sup> *Shalala v. Guernsey Mem'l Hosp.*, 514 U.S. 87, 101, 115 S. Ct. 1232, 1239 (1995) (citations omitted). (Note the difference between the Supreme Court’s perspectives on how GAAP is determined with the views of the D.C. Circuit panel that decided *Checkosky*, supra n. 8).

<sup>14</sup> Financial Accounting Standards Board, Topic 105: Generally Accepted Accounting Principles (June 2009) No. 2009-01 at App. B, p. 18. See the Annex to this paper for the text of ASC 105-10.

organisations from around the world.”<sup>15</sup> GAAP is primarily used in the United States, but “...approximately 120 nations and reporting jurisdictions permit or require IFRS for domestic listed companies, although approximately 90 countries have fully conformed with IFRS as promulgated by the IASB and include a statement acknowledging such conformity in audit reports”<sup>16</sup> The biggest difference between the two sets of standards is that IFRS provide fewer detailed rules than GAAP. In other words, IFRS standards are more principles-based than rules-based. IFRS standards also contain limited industry-specific guidance.

In 2000, the SEC endorsed the concept of *convergence*, noting that “we have pursued a dual objective of upholding the quality of financial reporting domestically, while encouraging convergence towards a high quality global financial reporting framework internationally.”<sup>17</sup> In that same request for comments, the SEC specifically cited revenue recognition as one field where it believed that convergence would be useful, noting that:

[D]ifferences in recognition and measurement requirements related to transactions or events that are common to most enterprises could create pervasive differences in the line items and amounts reported by enterprises following [international] standards and those following U.S. GAAP for one or more reporting periods. For example, differences in revenue recognition or income tax accounting are likely to impact comparisons of the financial statements of the vast majority of enterprises provided elsewhere in the financial statements to enhance comparability, differences generally contribute to increased uncertainty for financial statement users in assessing and making investment decisions.<sup>18</sup>

To enhance uniformity and comparability, since 2002 the FASB has been engaged in what it formally refers to as a “bilateral convergence program.” The FASB’s issuance of ASC 606 – the new revenue recognition rules – arose out of that convergence initiative. The goal is to harmonize, where possible, U.S. GAAP with IFRS. The FASB indicated that among other things, this effort was intended to “enhance international comparability for the benefit of investors and other capital market participants.”<sup>19</sup> As part of its oversight responsibilities, the House Committee on Financial

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<sup>15</sup> International Accounting Standards Board, Preface to International Financial Reporting Standards, at p. A18 (2009) (available at <http://ifrs.skr.jp/preface.pdf>).

<sup>16</sup> Am. Inst. of Cert. Pub. Accts., “International Financial Reporting Standards: Questions and Answers” n. 3 ([https://www.ifrs.com/updates/aicpa/ifrs\\_faq.html](https://www.ifrs.com/updates/aicpa/ifrs_faq.html)) (accessed Sept. 4, 2018).

<sup>17</sup> Sec. & Exch’g Comm’n, *International Accounting Standards*, 65 Fed. Reg. 8896 (Feb. 23, 2000).

<sup>18</sup> *Id.* at 8910.

<sup>19</sup> Financial Accounting Standards Board, “Comparability in International Accounting Standards, An Overview,” <https://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156245663> (accessed Aug. 8, 2018). See also Am. Inst. of Cert. Pub. Accts., “Is IFRS That Different from U.S. GAAP?” (June 16, 2008), <https://www.ifrs.com/overview/General/differences.html> (accessed Aug. 7, 2018).

Services announced that it “will review efforts by the SEC, the FASB, and the International Accounting Standards Board to achieve robust, uniform international accounting standards.”<sup>20</sup>

In reviewing the differences between US GAAP and IFRS, the AICPA observed that “[b]ecause of the longstanding convergence projects between the IASB and the FASB, the extent of the differences between IFRS and GAAP has been shrinking. Yet significant differences do remain, most any one of which can result in significantly different reported results, depending on a company's industry and individual facts and circumstances.”<sup>21</sup>

#### **D. Why Not Just Deduct Expenses?**

Conceptually, of course, there is a considerable difference between the commercial reality that most franchisors face and how ASC 606 will require franchisors to recognize revenue. For example, franchisors typically do not earn a profit by collecting initial franchise fees. Initial franchise fees often defray (often not entirely) the franchisor's capital-intensive pre-opening expenses, such as training, site selection assistance, interior and exterior design assistance, guidance with respect to build-out and equipment sourcing, and various other pre-opening facets including regulatory compliance – in addition to the cost of recruiting new franchisees (also known as “development,” sometimes in the form of broker fees).<sup>22</sup>

Beyond that, most franchisors also pay income taxes on initial franchise fees when they receive the funds – not later, if they have to recognize the revenue at a later point. So in addition to incurring expenses during the pre-opening and initial start-up phase of their franchisees' operation, franchisors also pay income taxes on those initial fees. Thus, franchisors face a multi-faceted and significant challenge if they are unable to recognize revenue at the same time as they incur the underlying expenses as well as the obligation to pay taxes.

Some legal practitioners suggest that the simplest approach to addressing revenue recognition would have been to apply a formula:

$$(Initial\ Franchise\ Fees) - (Pre-Opening\ Expenses) = X$$

In that scenario, if X were a positive number, then X would be the figure that would be deferred over the course of the term of the franchise agreement, and if X were zero or a negative number, then no amount would need to be deferred.<sup>23</sup>

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<sup>20</sup> Committee on Oversight and Government Reform, U.S. House of Rep., “Authorization and Oversight Plans for All House Committees,” H.R. Rep. No. 115-69, at 84 (2017).

<sup>21</sup> Am. Inst. of Cert. Pub. Accts., “International Financial Reporting Standards: Questions and Answers” ([https://www.ifrs.com/updates/aicpa/ifrs\\_faq.html](https://www.ifrs.com/updates/aicpa/ifrs_faq.html)) (accessed Sept. 4, 2018).

<sup>22</sup> Indeed broker fees typically should be initially recognized as an asset and then amortized into expenses as the related revenue is being recognized throughout the term of the franchise agreement. ASC 340; *see also* FASB ASU 2014-09 at 6.

<sup>23</sup> The FASB issued examples to explain how to implement ASC 606. When it came to the franchise example, the FASB example posited a franchisor that charged and collected a \$1.0 million initial fee for a single franchise agreement. *See* FASB ASU 2014-09, ¶ 606-10-55-375, at 129

However attractive that formula may seem, ASC 606 does not allow a franchisor, or any other entity, to simply deduct expenses and costs. Rather, under ASC 606, the reduction to initial franchise fees would be the value (to the franchisee) of the separate performance obligations that the franchisor performs and the residual “franchise fees” would be deferred. Those performance obligations would have to indeed be “separate” – in that they are not inextricably woven into the grant of a license for intellectual property (for example, the portion of training as to how to operate a restaurant, not necessarily how to operate an “Acme Brand” restaurant”). As explained in this paper, a franchisor must conduct a five-step analysis to identify separate performance obligations, establish a value for those obligations, and go through the process for allocating the revenue.

## II. GAAP AND THE FRANCHISE SECTOR

### A. The Role of the FTC

Under the requirements for disclosing financial statements in Item 21 of the FTC Franchise Rule (the “FTC Franchise Rule”),<sup>24</sup> the FTC required franchisors to prepare financial statements according to “United States generally accepted accounting principles, as revised by any future government mandated accounting principles, or as permitted by the Securities and Exchange Commission.”<sup>25</sup>

The FTC Franchise Rule permits franchisors the flexibility of looking to accounting principles articulated by the SEC for the financial statements included in their franchise disclosure documents (“FDDs”). The FTC permits foreign companies registering securities to prepare financial statements using accounting principles other than GAAP if such statements are prepared “according to a comprehensive body of accounting principles,” such as IFRS.<sup>26</sup> If a foreign company determines that it will prepare its financial statements in such a manner, the company will have additional disclosure requirements. These include disclosure of the specific comprehensive body of accounting principles used to prepare the statements, an explanation of significant differences between the principles and GAAP, all additional disclosures required by GAAP and the applicable SEC regulations, and a reconciliation of the company’s financial statements to GAAP. For example, through additional footnotes to the financial statements, franchisors not using US GAAP may still be required to reconcile figures for net income and total stockholders’ equity for the period presented if they are not using a form of GAAP that adopts

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(Example 57). That example unfortunately served as the basis for many analyses of ASC 606, as (anecdotally) there are few if any single franchise agreements for which a franchisor has collected an initial franchise fee of \$1.0 million.

<sup>24</sup> 16 C.F.R. § 436.

<sup>25</sup> 16 C.F.R. § 436.5(u).

<sup>26</sup> Federal Trade Commission, Franchise Rule Compliance Guide (May 2008), at 113.

IFRS.<sup>27</sup> Australian and Canadian GAAP, for example, were harmonized to adopt IFRS standards effective 2007 and 2015, respectively.<sup>28</sup>

In many of the states that require franchisors to make disclosure under a pre-sale disclosure or registration law, franchisors must include as an exhibit to their franchise disclosure documents audited financial statements that are prepared according to GAAP – although unlike the FTC Franchise Rule, the text of those laws do not specifically reference US GAAP.<sup>29</sup> Under the NASAA Guidelines relating to preparing an FDD, franchisors also have the option of submitting financial statements “as permitted by the Securities and Exchange Commission.”<sup>30</sup>

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<sup>27</sup> *Id.* Notably, Section 436.5(u)(1) of the FTC Franchise Rule allows adherence to the applicable SEC standard, which the FTC recognized might change over time:

“The final amended Rule requires the use of GAAP, [but] also recognizes that what currently is “GAAP” may change by federal government oversight of the accounting profession. Accordingly, it provides that franchisors must use GAAP, *as revised by any future government mandated accounting principles. It also allows flexibility by permitting accounting standards recognized by the Securities and Exchange Commission.*”

Federal Trade Commission Franchise Rule Statement of Basis and Purpose, 72 Fed. Reg. 15444, 15559 (Mar. 30, 2007) (emphasis added).

Effective March 2008, the SEC eliminated the reconciliation requirements for foreign private issuers that used IFRS financial statements. See Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP, 73 Fed. Reg. 986 (Jan. 4, 2008). That notice announced that:

“The [SEC] is adopting rules to accept from foreign private issuers ... financial statements prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”) *without reconciliation to generally accepted accounting principles (“GAAP”) as used in the United States.*”

*Id.* (emphasis added).

<sup>28</sup> See “Who Uses IFRS Standards (Australia),” at <https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/australia> (accessed Sept. 14, 2018); and “Who Uses IFRS Standards (Canada),” at <https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/canada/#extent> (accessed Sept. 14, 2018).

<sup>29</sup> See, e.g., CAL. CORP. CODE §31109(a)(2)(B)(i); N.Y. GEN. BUS. L. § 683(14)(a).

<sup>30</sup> N. Am. Sec. Admins. Assoc., “2008 Franchise Registration and Disclosure Guidelines,” Bus. Fran. Guide (CCH) ¶ 5705 (Item 21) (for example, if the SEC would permit a registrant under the Securities and Exchange Act to file with financial statements prepared under IFRS or Canadian GAAP, the Guidelines would permit the franchisor to use those financial statements in their FDDs).

## **B. Overview of the New Revenue Recognition Standard and Its Impact on Initial Franchise Fees**

Responding to the convergence challenge, in 2014 the FASB issued ASC 606 – which upon implementation will affect how all entities, including franchisors, recognize revenue.<sup>31</sup> The new standard supersedes the previous industry-specific guidance applicable to franchisors (ASC 952-605) and replaces it with a five-step model that all entities must follow. The accounting standard also shifts from a rules-based to a more principles-based model for determining the timing and manner of a company’s revenue recognition. The principles-based model requires entities to make significant judgments about how to account for initial franchise fees. As a result, the franchise sector is now dealing with the difficulties and wide range of judgments and decisions that come with applying the guidance entails.

After the issuance of ASC 606, the AICPA formed 16 industry task forces to help develop a new accounting guide that recognized industry-specific effects on revenue recognition. The accounting guide helps entities in applying the judgments in the standard and also provides illustrative examples for application of the principles in ASC 606. The Hospitality Entities Revenue Recognition Task Force was one of those industry task forces.<sup>32</sup> This task force addressed the issue of franchise fees – albeit it in the hospitality industry – in its published *Hospitality Industry Working Draft: Hospitality Revenue Recognition Implementation Issue #7-1 - Franchise Fees* (the “Hospitality Industry Working Draft”).<sup>33</sup> The content of the Hospitality Industry Working Draft was subsequently incorporated into the *Accounting Guide on Revenue Recognition*.<sup>34</sup>

The Hospitality Industry Working Draft highlights one of the most prominent issues that franchisors have been grappling with regarding the implementation of ASC 606: the likely impact that adoption will have on when a franchisor may recognize initial franchise fees:

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<sup>31</sup> In the summary that accompanies FASB ASU 2014-09, the FASB indicated that “together with the IASB’s IFRS 15, [ASC 606] completes a joint effort by the FASB and the IASB to improve financial reporting...” and acknowledges some differences between the FASB and IASB standards as issued. FASB ASU 2014-09 at 10.

<sup>32</sup> See Am. Inst. of Cert. Pub. Accts., Hospitality Entities Revenue Recognition Task Force (<https://www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/rrtf-hospitality.html>)

<sup>33</sup> Available at <https://www.iasplus.com/en-us/publications/global/ifrs-industry-insights/rev-rec-thl>.

<sup>34</sup> As discussed in the Preface to the *Accounting Guide on Revenue Recognition* (the “Guide”), the Guide is recognized as interpretive guidance, and is therefore not an authoritative accounting standard. While not authoritative, it has been developed by industry experts, vetted through a public comment process, and approved by The Financial Reporting Executive Committee (FinREC). FinREC is the designated senior committee of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. The Guide is available for purchase on the AICPA’s website at: <https://www.aicpastore.com/Accounting/IndustryspecificGuidance/DepositLending/revenue-recognition---audit-and-accounting-guide/PRDOVR-PC-012516/PC-012516.jsp> (accessed Sept. 13, 2018).

Current: ASC 952-605	New:ASC 606
Franchisors recognize initial franchise fees when (or shortly after) the franchisor has performed its material pre-opening and opening obligations to a new franchisee (typically, when the franchisee commences operations). <sup>35</sup>	Depending on its operations and the nature of the initial services a franchisor provides to its franchisees, the franchisor may have to defer recognition of some or all of the initial franchise fees. If deferred, the franchise fees would likely be recognized as revenue over a much longer period of time, e.g., the term of the franchise agreement. <sup>36</sup>

We will illustrate these changes in detail in this paper through the use of a detailed example.

The impact of deferring all or some portion of the initial franchise fee could be significant to a franchisor, whether it is a start-up or an established franchise. Importantly, a change in the timing of revenue recognition could also affect key financial measurements, which could impact how outside parties such as state regulators, investors, banks, and potential franchisees view the financial strength of the franchisor.

**C. Basics of the New Revenue Recognition Standard**

After issuance in 2014, ASC 606 was amended several times. Given the broad applicability of the guidance and the potentially significant ramifications of applying it, the FASB provided a long timeline for implementation. Accordingly, the guidance and amendments were required to be adopted by public business entities for annual reporting periods (e.g., fiscal years and interim periods such as financial quarters) beginning after December 15, 2017.<sup>37</sup> All other entities that prepare GAAP financial statements, including non-public franchisors, are required to adopt the new guidance for annual reporting periods beginning after December 15, 2018 and interim periods starting after December 15, 2019.<sup>38</sup>

The objective of ASC 606 was to establish a revenue recognition model that would apply across different entities and industries with the goal of improving consistency in financial reporting.<sup>39</sup> Accordingly, with the adoption of ASC 606, substantially all previous FASB guidance related to revenue recognition, including the industry specific rules (including ASC 952-605), will

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<sup>35</sup> *Supra* n 2.

<sup>36</sup> *Supra* n 1.

<sup>37</sup> The FASB published these revised dates in May 2017 as part of Update 2017-10 (available at <https://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220137102>) (accessed Sept. 8, 2018).

<sup>38</sup> *Id.*

<sup>39</sup> FASB ASU 2014-09 at 1.

be superseded.<sup>40</sup> The basic tenet embodied 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.”<sup>41</sup> In practice, that standard means that revenue is to be recognized when (or as) the specific obligation for which the amount is paid is performed – whether that performance occurs at the outset of the parties’ arrangement (e.g., before or when the franchisee first opens) or throughout the term (e.g., for those performance obligations that are inextricable from and cannot be separated from the grant of the license to use the franchisor’s intellectual property, which lasts for the term of the franchise agreement).<sup>42</sup>

All entities should conduct a five-step analysis when applying the core principle to their customer contracts (here, franchise agreements are the equivalent of “customer contracts”). ASC 606 also provides significant guidance for application of each of these steps:

Step One	<b>Identify the contract with the customer</b> – defines contract, considers probability of collection of the amounts in the contract, provides guidance on how to treat multiple contracts entered into at or near the same time and contract modifications.
Step Two	<b>Identify the separate performance obligations in the contract</b> – defines performance obligations and whether or not they are distinct within the context of the contract.
Step Three	<b>Determine the transaction price</b> – defines the transaction price and provides guidance for consideration of variable payments, financing transactions, noncash payments, payments to the customer, and rights of return.
Step Four	<b>Allocate the transaction price to the separate performance obligations</b> – discusses the methodology for allocation, how to consider discounts and variable consideration in the allocation process, and discusses methods for determining the standalone selling price of the performance obligations.

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<sup>40</sup> *Id.* at 2.

<sup>41</sup> *Id.*

<sup>42</sup> For franchise transactions, the FASB considers the grant of IP rights to be “symbolic intellectual property” noting that “[s]ymbolic intellectual property is any intellectual property that is not functional intellectual property. In other words, symbolic intellectual property is intellectual property that does not have significant standalone functionality. Substantially all of the utility of symbolic intellectual property is derived from the association of the intellectual property with the entity’s past or ongoing activities that do not transfer a promised good or service to a customer, including its ordinary business activities.” Revenue from Contracts with Customers (Topic 606), at 75 (¶ BC57) (April 2016). Other examples of IP would include patents, motion pictures, and software. See *id.* at 11 (¶ 606-10-55-54).

Step Five	<b>Recognize revenue when (or as) each performance obligation is satisfied</b> – provides guidance for determining the timing of recognition of revenue for each performance obligation. <sup>43</sup>
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In addition to the guidance for application of each step, the standard has guidance for other considerations common in revenue-producing transactions. These include:

1. Requirements for capitalization of certain costs of obtaining the contract with the customer;
2. Costs incurred in fulfilling a contract with a customer; and
3. Considerations for other items such as onerous contracts, licenses, repurchase agreements, principal versus agent transactions, customer options to obtain additional goods and services, warranties, nonrefundable upfront fees, consignment arrangements, and bill-and-hold arrangements.<sup>44</sup>

Many aspects of the standard could affect the accounting for any individual franchisor. The focus of this discussion, however, is on the considerations that should be made relating to the initial franchise fee and royalty revenue streams of a franchisor. This paper is not intended to provide a full overview of the principles-based standard, nor is it intended to provide all possible considerations a franchisor should be making when applying the standard. For example, considerations of accounting implications of renewal periods, transfer fees, and advertising funds have not been included in this analysis. Any accounting conclusions related to the implementation of ASC 606 should be made by the franchisor’s accounting and finance team and in consultation with their auditors. Additionally, for some franchisors, the method by which the revenue recognition rules are implemented (e.g., whether to identify and allocate revenue to specific performance obligations) may be tempered by a subjective analysis of materiality.<sup>45</sup>

#### **D. Revenue Recognition Prior to Issuance and Adoption of ASC 606**

Prior to adoption of ASC 606, franchisors will continue to apply the industry-specific guidance included in ASC Topic 952-605. As noted above, under ASC 952-605, franchisors generally would take initial franchise fees into revenue when the franchisor has substantially performed its significant pre-opening and opening services – which is to say, typically when the franchisee opens for business.

Application of the above guidance often resulted in recognition of the franchise fee revenue shortly after the franchisee commenced operations, because – based on the nature of

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<sup>43</sup> *Id.*; see also Am. Inst. of Cert. Pub. Accts., Financial Reporting Brief: Roadmap to Understanding the New Revenue Recognition Standards (Sept. 2016) (available at [https://www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/downloadabledocuments/frc\\_brief\\_revenue\\_recognition.pdf](https://www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/downloadabledocuments/frc_brief_revenue_recognition.pdf)) (accessed Sept. 6, 2017).

<sup>44</sup> See generally FASB ASU 2014-09 at 6 and 49 (¶ 606-10-55-3).

<sup>45</sup> *Id.* at 12, ¶ 606-10-10-9.

initial services as defined by the FASB – that is often when the franchisor’s initial services were completed.

### III. THE IMPACT OF THE NEW STANDARD ON ACCOUNTING FOR THE INITIAL FRANCHISE FEE

#### A. A Detailed Example of Implementing the New Accounting Standard for the Initial Franchise Fee – Assumptions

We will use a theoretical franchisor (“Franchisor X”) to walk through the five steps and highlight issues relating to the franchise fee and royalty revenue streams. We assume the following about Franchisor X:

- Initial services provided to franchisees feature:
  - Site selection;
  - Training;
  - Equipment;<sup>46</sup>
  - Marketing materials and signage;<sup>47</sup>
  - All initial services are provided to each franchisee and completed prior to the commencement of the franchisee’s operations, which occurred in June 2018; and
  - All initial services were completed by the end of 2018.
- Key terms of franchise agreement include:
  - Nonrefundable initial franchise fee of \$35,000, due at signing of the agreement;
  - Royalty rate of 3% of gross sales, paid monthly; and
  - Franchise agreement term of 10 years, beginning on June 30, 2018.

Before the adoption of ASC 606, Franchisor X was required to apply the guidance in ASC 952-605, as previously outlined. The example below still assumes that Franchisor X provides and completes all initial services before the franchisee starts operating its business. Thus, under ASC 952-605, Franchisor X would have recognized revenue for the initial franchise fee when the franchisee commenced operations. In contrast, under ASC 606, the franchisor has to analyze the

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<sup>46</sup> Assume that Franchisor X is providing the physical equipment, rather than the specifications for equipment to be purchased.

<sup>47</sup> Assume that Franchisor X is providing the actual marketing materials and signage, rather than the specifications for the materials.

circumstances under each of the five steps of the model to determine the appropriate timing of revenue recognition for the initial fee. Considerations and conclusions for each step of the model are highlighted in the following sections.

## **1. Step 1: Identify the Contract**

Step 1 of the revenue recognition model requires the franchisor to identify the contract with the customer, the entity to which goods and services are being provided. In the context of a franchisor's business, the franchisee is considered its customer for purposes of applying ASC 606. There are specific criteria stated in ASC 606-25-1 (see Annex, Part C for the relevant text) that define whether a contract exists for the purpose of ASC 606.

Franchisor X has individual franchise agreements in place with each franchisee. Each agreement will need to be analyzed to determine whether the criteria in ASC 606 outlined above have been met. If the criteria are not met, revenue recognition for the entire contract will be deferred until the certain events have occurred.

The criteria for determining whether there is a valid contract are generally met when the franchise agreement is signed, because the franchise agreement shows that the parties have exchanged consideration, undertaken various obligations toward one another, and reached agreement on key terms (e.g., goods and services to be provided to the franchisee, payment terms).

One of the five criteria that must be met is that collection of the consideration is probable. Presumably, that factor is inherent in that the parties entered into the franchise agreement in good faith, with reasonable due diligence of one another, and a realistic expectation that each would perform (including that the franchisee would pay the royalties due over time). Certainly if the initial fee is paid upon signing the franchise agreement, there is no risk of collection. However, given the timing of the payment terms for the royalties, evaluation of the probability of collection of the royalties should occur and will require significant judgment by Franchisor X. In assessing the probability of collecting ongoing royalty fees, Franchisor X in our example focused on the ability and intent of the franchisee to pay. Assessment of the franchisee's intent to pay is assumed and was largely based on Franchisor X's interactions with the franchisee, which did not raise any red flags about the intent to honor the agreement. More focus was placed on the franchisee's ability to pay, which was assessed during the due diligence process and considered the credit risk of the franchisee, results of background checks, and likelihood of the success of the franchise's operations.

Based on this evaluation, Franchisor X has determined that its franchise agreement meets the criteria in Step 1. If the circumstances were different – if, for example, Franchisor X had significant doubts about the ability of the franchisee to pay its obligations – it may have come to a different conclusion about meeting the Step 1 criteria, which could include determination that a contract does not exist, thus precluding recognition of revenue until the criteria are met.

## **2. Step 2: Identify Separate Performance Obligations**

Step 2 of the process is to identify the separate performance obligations in the contract. The relevant text of ASC 606-10-25 can be found in Part D of the Annex.

Typically, the underlying and primary obligation of Franchisor X is to grant the franchisee with the license to use intellectual property. However, Franchisor X will have additional performance obligations to the franchisee.

Under ASC 606, the portion of the initial fee that is attributable to the grant of the intellectual property license will have to be recognized over the term of the franchise agreement (the discussion that follows addresses the possibility of allocating some of the initial fee to specific performance obligations).<sup>48</sup>

When assessing Step 2 of the revenue recognition model, Franchisor X must determine if any of the initial services that it provides to the franchisee are sufficiently distinct from the franchise license to be deemed “separate performance obligations” under ASC 606. If so, then Franchisor X may be able to recognize a portion of the initial fee attributable to those services when those services are performed for (or, in the case of goods, when those goods are provided to) the franchisee).

If the initial services do not qualify as separate performance obligations, then there would be just a single performance obligation in the contract – the integrated grant of the franchise right (including the IP rights) – so the full initial fee would be recognized over the term of the franchise agreement.<sup>49</sup> The determination of the performance obligations in a contract is a key piece of the ASC 606 analysis, as revenue is allocated and recognized on the basis of each performance obligation, as discussed further in the subsequent analysis of Steps 4 and 5 of the model.

In assessing whether its initial services are distinct, and thus representative of separate performance obligations, Franchisor X would consider the following possibilities (and, depending on the circumstances, perhaps other services as well):

- Site selection – If we assume that the franchise is for a fixed-location retail business; then Franchisor X’s site selection services are quite important to a new franchisee, as well as any assistance in reviewing and negotiating the terms of the lease. Given that operating model, Franchisor X concludes that the site of the franchisee’s operations is significant to the initial and ongoing operations of the franchise agreement. Franchisor X also determines that this initial service represents a distinct service transferred to the franchisee, when the site is chosen, and that the site selection services are not specific to the brand – so the service

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<sup>48</sup> Under ASC 606-10-55-60: “a license to symbolic intellectual property grants the customer a right to access the entity’s intellectual property, which is satisfied over time”.

<sup>49</sup> Under ASC 606-10-25-19: “a good or service that is promised to a customer is distinct if both of the following criteria are met:

- a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct); and]
- b. The entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).” (FASB ASU 2014-09 at 26.)

can be recognized as a distinct performance obligation. (Note that if the franchisee operates from a mobile location, then site selection services, e.g., for a back office, are likely to be substantially less valuable to the franchisee, except to the extent customers or employees need to visit that location to interact with the franchisee.)

- Training – Assume Franchisor X provides an in-person classroom training program to each franchisee, as well as on-site training at the franchisee’s location just before and after the grand opening. The training has two components:
  - One component is designed to provide general business training to the franchisee. It includes topics such as general business management, accounting and recordkeeping, banking, payroll, opening and closing, efficient operation and cleanliness, vendor relationships, purchasing procedures, and general information about starting and operating a business of the general type that is part of the “Franchisor X system” (up to the part of the training that is specific to the “Franchise X system brand standards). Franchisor X concludes that the general training modules are a performance obligation that is distinct from the franchise right, because the content of the training provides the franchisee with information from which it can benefit on its own, without access to the franchise right (in other words, the franchisee could use this part of the training to operate a generic business without Franchisor X’s brand, if there were no agreement not to compete). Therefore, this portion of the training can be separated, as it is distinct from the other performance obligations.
  - The second component is designed to train the franchisee about Franchisor X’s brand standards and distinctive operating processes. This part of the training includes topics such as using the customized order entry system, how to apply Franchisor X’s proprietary process, as well as details such as how to use brand-specific methods, recipes, formulae, etc. Franchisor X concludes that the second brand-specific component of the training program is interwoven with the grant of the IP rights – and therefore not a separate performance obligation – because this part of the training could not be used outside of the “Franchisor X system” (and could be used only with access to the franchise right and other intellectual property). Therefore, Franchisor X determines that this component of the initial service does not represent a distinct service, and the value of the training (see Step 3) would be combined with the value of the intellectual property license granted to the franchisee for the purpose of recognizing revenue under ASC 606.
- Equipment – Assume that the equipment is generic and able to be used in processes other than the proprietary processes of Franchisor X. Further assume the franchisee has the ability to purchase the equipment directly from the manufacturer, with or without the franchise right. Owing to bulk purchases made by Franchisor X from the equipment manufacturer, however, the franchisee benefits from significant discounts if the franchisee purchases the equipment from Franchisor X. Franchisor X concludes that the equipment is another performance obligation that is distinct from the franchise right, because the franchisee can benefit from the equipment on its own, without access to the franchise right.

- Supplier Programs – Franchisor X has established relationships with various approved vendors to the franchise system. Before engaging these vendors, Franchisor X has evaluated their goods and services, their quality controls, insurance, and their pricing. The franchisee has an advantage to purchasing products through the system that Franchisor X has established, but cannot use that advantage without also being a franchisee of Franchisor X, so Franchisor determines that providing the franchisee with access to the brand-specific supplier program is not distinct and therefore not a separate performance obligation.
- Marketing materials and signage – The marks and logos used in the marketing materials and signage are part of Franchisor X’s intellectual property and cannot be legally used by the franchisee without the permissions granted to them with the franchise right. Therefore, Franchisor X determines that this initial service does not represent distinct goods and services transferred to the franchisee. These activities are inputs into a combined output that the franchisee has paid to receive, which is the right to operate the franchise location. Accordingly, this is not a separate performance obligation.

In summary, Franchisor X concludes that under the provisions of ASC 606, it has four separate and distinct performance obligations resulting from the franchise agreement:

- The franchise right;
- Site selection services;
- General component of the training program; and
- Equipment.

### **3. Step 3: Determine the Transaction Price**

Step 3 is to determine the “transaction price” under the franchise agreement. The transaction price under ASC 606-10-32-2 is the amount Franchisor X expects to be entitled to for the goods and services that are transferred to the franchisee in connection with the franchise agreement.

The definition of transaction price is stated in ASC-606-10-32-2:

An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.<sup>50</sup>

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<sup>50</sup> FASB ASU 2014-09 at 32 (text bolded in original).

The transaction price would include the initial franchise fee and the ongoing royalty fees. Franchisor X concludes, however, that — although the royalty rate is specifically stated and is part of the overall consideration that it will receive under the contract — the royalty meets the criteria to be subject to the sales and usage-based royalties’ exception for licenses of intellectual property. ASC-606-10-55-65 states the following regarding sales and usage-based royalties:

Sales-based or usage-based royalties promised in exchange for a license of intellectual property should be recognized *when the later* of the following events occurs:

- Subsequent sale or usage occurs, or
- The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied or partially satisfied.<sup>51</sup>

Because Franchisor X is subject to the sales or usage-based royalty exception, the royalties are only included in the transaction price and recognized as revenue at the later of when the sale occurs or when the performance obligation is satisfied. In practical terms, therefore, the royalties to be expected over the life of the franchise relationship would be considered when they are earned, not as part of the total “transaction price” under the franchise agreement.

Finally, Franchisor X should also consider whether the initial franchise fee, in effect, provides “significant financing” to benefit Franchisor X. In effect, this test is to determine whether the franchisee, by making payment in advance of performance, is directly or indirectly financing Franchisor X’s activities. To undertake this review, Franchisor X analyzes the nature of the payments under ASC 606-10-32-15 and 16 (found in Part E of the Annex to this paper). Franchisor X concludes that the initial franchise fee is collected principally to compensate it for the initial services rendered to the franchisee. Therefore, Franchisor X determines that there is no “significant financing component” to collecting the initial fees. In practical terms, this is consistent with the vast majority of franchise arrangements, especially because (as noted previously) franchisors typically do not make a profit on initial fees, which are rather used to defray the costs that franchisors incur in establishing a new franchisee (apart from revenue recognition considerations).

#### **4. Step 4: Allocate the Transaction Price**

If the franchisor determines that there are multiple performance obligations within a contract, then the franchisor would conduct the analysis under Step 4 to allocate value to each of those performance obligations. Under Step 4, the franchisor would allocate the transaction price, as determined in Step 3, to the performance obligations determined in Step 2.

In Step 2, Franchisor X had determined that it had four separate performance obligations: (1) the franchise right, (2) site selection services, (3) the general training program, and (4) the equipment. In Step 3, Franchisor X determined that it met the sales and usage-based sales exception; therefore, the transaction price for purposes of the allocation step is the initial franchise fee of \$35,000.

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<sup>51</sup> *Id.* at 63.

In order to apply Step 4, Franchisor X also must determine the standalone selling price, when the contract was signed, for each of the performance obligations. For this purpose, we assume that Franchisor X always bundles the initial services and the franchise right within the franchise agreement and does not sell any of the initial services separately (in other words, the Franchisor does not sell training services separately outside of the terms of the franchise agreement). Accordingly, Franchisor X must estimate the standalone selling prices using one of the methods described in ASC-606-10-32-28 through 32-35, or another suitable method. The method utilized by the franchisor should be the method that best depicts the estimated price that Franchisor X would expect to be entitled to if the good or service were sold separately.

Franchisor X considered the following when determining the standalone selling price of each separate performance obligation:

- Site selection – Because there is significant market data and there are many providers of similar site selection services, Franchisor X determined that the “adjusted market assessment approach” was the best approach to determine the estimated standalone selling price of the site selection services. Using that approach, Franchisor X obtained pricing from other parties in the relevant market that perform similar services and adjusted those prices to reflect its own cost structure and expected margins (that is, profit) from performing the same service. Franchisor X determined that the estimated standalone value of the site selection services was \$3,000.
- General training program – Franchisor X noted that there are many sources to compare to determine the value of general training to a prospective franchisee.<sup>52</sup>
  - Franchisor X used the “adjusted market assessment approach” here as well, and looked to other entities that provide similar general business training, such as colleges and universities, and compared the tuition that a student would pay to obtain similar credit hours or a certificate in the same topics. Using this approach, Franchisor X determined that 40 hours of training obtained through local universities would be at an average of \$1,600 per credit hour for an eight-week course that has 3 hours of instruction per week, or \$200 per hour of actual instruction. Using that approach, Franchisor X determines that the market value of 40 hours of training is \$8,000.
  - Franchisor X also considered an expected cost-plus-margin approach to estimate the standalone value of the general components of its training program. After estimating its costs to provide the training and adding an appropriate margin, Franchisor X determined its standalone value under this approach to be \$10,000. However, since there was readily available market data for similar general business training, Franchisor X determined that the

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<sup>52</sup> Notably, the value is measured by the benefit to a generic prospective franchisee, not to the specific person who is receiving the training services. Accordingly, the franchisor is not required to calculate the value to a newcomer differently than someone with previous experience in some or all of the modules that are taught in the training session. See Annex, Part F for the paragraphs from FASB’s ASC 606-10-32 relevant to this analysis.

adjusted market assessment approach would produce the best estimate of the standalone selling price of the training program.

- Equipment – Franchisor X determined the standalone selling price of the equipment that it provided to the franchisee as part of the opening package by finding out the cost of purchasing it directly from the manufacturer. The franchisee would have had to pay \$6,000.
- Franchise right – Franchisor X concluded that the standalone selling price of the franchise right is highly uncertain. Its reasoning was that a significant portion of the fee it charges for the franchise right is attributable to the ongoing royalties, which are payable over a long period of time, are variable in nature, and subject to the sales and usage-based royalties exemption. Additionally, the range of license fees (i.e., royalties) that Franchisor X receives will vary broadly by franchisee. The percentage of sales being applied may be consistent; but in many cases, the sales base that the royalty rate is being applied to will vary based on quality of the franchisee, location, and a number of other factors. Based on these factors, Franchisor X determined that the standalone selling price for the franchise right is highly uncertain and therefore applied the residual approach to estimate the amount of the initial franchise fee to be allocated to the franchise right, as follows:

Transaction price (initial franchise fee only):	\$35,000
Estimated standalone selling price:	
Site selection services	(\$3,000)
General training program	(\$8,000)
Equipment	(\$6,000)
Residual = Estimated standalone selling price of franchise right	\$18,000

Anecdotally, if the same assumptions noted above were present, but Franchisor X had previously sold franchises for which no initial services were performed, the method used to estimate the standalone selling price of the franchise right would be different. Assume that the royalty rates in these contracts were the same royalty rate being charged in the example above, however the initial franchise fee charged in those circumstances was only \$20,000. Based on this information, Franchisor X estimates that \$20,000 represents the additional standalone value of the franchise right, above the amounts it will receive in royalties. The estimated standalone selling prices and amounts allocated to each performance obligation in this example would be as follows:

Transaction price:	\$35,000
Estimated standalone selling price:	
Site selection services	(\$3,000)
General training program	(\$8,000)
Equipment	(\$6,000)
Franchise right	<u>\$20,000</u>
Total estimated standalone selling prices	\$37,000

Allocation of the transaction price to each performance obligation based on relative estimated standalone selling prices:

Site selection services	\$2,838
General training program	\$7,568
Equipment	\$5,676
Franchise right	<u>\$18,918</u>
Total Allocation	\$35,000

The results of the allocation process are the amounts that would have been assigned to each performance obligation for purposes of recognizing revenue in the final step of the revenue recognition process had this fact pattern applied to Franchisor X. Importantly, using different methods of estimation could result in different amounts to be allocated to each performance obligation, thus affecting the overall timing of revenue recognition. Franchisors will need to use significant judgment to determine which method of estimation is appropriate given their unique circumstances.

It is also important to note that the FASB specifically recognized that franchise transactions involve the grant of a license to symbolic intellectual property and that under the FASB's sales- and usage-based royalty exception, the calculation of the "transaction price" under Step Four should not include ongoing royalties that are earned over the course of the franchise term.<sup>53</sup>

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<sup>53</sup> See *supra* n. 42. See also Revenue from Contracts with Customers (Topic 606), at 40 (¶¶ 606-10-55-380, and 606-10-55-382) (April 2016); and Chris Draney, "Sales- And Usage-Based Royalties," *Revenue Hub* (Aug. 12, 2015) at <https://www.revenuehub.org/sales-and-usage-based-royalties/> (accessed Sept. 14, 2018).

**5. Step 5: Recognize Revenue When (or as) Each Performance Obligation is Satisfied**

Step 5 is the final step of the revenue recognition model. It requires an entity to recognize revenue when it has satisfied the respective performance obligations by transferring the promised good or service.

For purposes of the Step 5 analysis, we will use the amounts determined from the first example in the Step 4 allocation process above. The relevant guidance for determining when each performance obligation is satisfied is found in ASC 606-10-25-23 through 606-10-23-32 (found in Part G of the Annex to this paper).

Franchisor X has assessed the timing of each performance obligation as follows:

- Site selection – Franchisor X concluded that the site selection services do not meet the criteria to be recognized over time because:
  - The franchisee does not simultaneously receive and consume the benefits provided by Franchisor X's performance as Franchisor X is performing the services. Rather, the benefit to the franchisee is having the fully negotiated site/lease agreement in place.
  - Franchisor X's performance does not create or enhance an asset that the customer controls. Franchisor X concluded that its negotiations would have to be re-performed by another entity or the franchisee if Franchisor X's services were terminated in the middle of the process. Franchisor X's performance does not create an asset with an alternative use to Franchisor X. If site selection services for a particular franchisee were not successful, Franchisor X would need to re-perform the services for another franchisee based on their specific needs and financial circumstances. Because the site selection services do not meet the criteria to be recognized over time, they are recognized when control transfers to the franchisee. Franchisor X determined that control transfers to the franchisee once the site has been selected and the lease has been successfully executed. Therefore, Franchisor X will recognize the \$3,000 allocated to the site selection services as revenue upon execution of the lease agreement by the franchisee.
- General training program – Franchisor X concluded that the general training program meets the criteria to be recognized over time, since the franchisee simultaneously receives and consumes the benefits provided by the training as it is being delivered. Franchisor X has selected the training days as the best measure of complete satisfaction of the training obligation. Accordingly, assuming the training is delivered over 5 days, the franchisor will recognize revenue of \$1,600 ( $\$8,000 \div 5$ ) after each day of training is delivered (or, if the general training is completed in one week, all \$8,000 at the conclusion).
- Equipment – Franchisor X concluded that the purchase of the equipment on behalf of the franchisee does not meet the criteria to be recognized over time, because the franchisee does not receive benefit from the equipment until the franchisee takes physical control over the equipment. Accordingly, the \$6,000 of revenue

allocated to the equipment is recognized upon delivery of the equipment to the franchisee.

**6. Relevant Guidance and Analysis – Franchise Right.**

Franchisor X also considered the license guidance in ASC 606-10-55-59 through 606-10-55-63 (see Part H of the Annex) when determining how to recognize revenue for the franchise right.

The franchise right meets the criteria to be considered symbolic intellectual property. Accordingly, Franchisor X should recognize the revenue allocated to the franchise right over the period that the franchisee receives the benefits from being able to utilize the franchise right, which Franchisor X determined to be the term of the franchise agreement (in this example, 10 years).

**7. Additional Consideration: Incremental Costs to Obtain a Contract**

In addition to the impact of the five steps of the revenue recognition model, ASC 606 introduced changes relating to capitalization of certain costs of obtaining the contract with the customer. Costs to obtain a contract, such as broker fees, that are incremental and would not have been incurred had the contract not been entered into are initially required to be recognized as an asset.<sup>54</sup> These costs are recognized as a component of expenses as the related franchise revenue is recognized over the term of the franchise agreement.<sup>55</sup>

Alternatively, if the costs to obtain the contract would have been incurred whether or not the contract was successfully negotiated, the costs should be expensed as they are incurred by the franchisor.<sup>56</sup>

Franchisor X incurred a broker fee of \$15,000 upon the sale of the franchise. The broker fees would not have been incurred if the franchise agreement were not signed, therefore, the cost is incremental. Accordingly, Franchisor X initially recognizes the \$15,000 as an asset. The amount initially recorded as an asset is amortized (recognized) into expenses over the period of the franchise agreement, which represents transfer of the services to which the asset relates, i.e. the use of the franchise right.

In obtaining the contract, Franchisor X also incurred costs associated with discovery day activities as well as broker fees paid to a third-party sales team. The discovery day costs totaled \$2,500 (including travel costs covered by Franchisor X, dinner, and personnel costs associated with providing a tour of an operating unit to the prospective franchisee and interviews with team members). The discovery day costs would have been incurred by Franchisor X regardless of whether the franchise agreement was entered into. Accordingly, Franchisor X determined that the

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<sup>54</sup> See Part I of the Annex for the paragraphs from FASB's ASC 340-40 relevant to this analysis.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

costs should not be capitalized, since they are not incremental, and therefore should be expensed as incurred.

### 8. Example – Comparison Between Old and New Methods

A summary of the resulting revenue changes for Franchisor X in applying ASC 606, as compared to applying the previously applicable GAAP in ASC 952-605 is as follows:

	Revenue recognized in 2018, initial year of the franchise agreement	
	Previous GAAP ASC 952-605	Under ASC 606
Franchise fee revenue	\$35,000	\$900
Training revenue	n/a	\$8,000
Equipment revenue	n/a	\$6,000
Site selection revenue	n/a	\$3,000
Broker fee expense	(\$15,000)	(\$750)
Discovery day expenses	(\$2,500)	(\$2,500)
Net income effect	\$17,500	\$14,650
Decrease in 2018 net income resulting from ASC 606	(\$2,850) <sup>57</sup>	

As the data in the table indicates, the application of ASC 606 would result in Franchisor X recognizing less income in the first year of the franchise agreement than under ASC 985. It is important to note that the effects on any one particular franchisor cannot be extrapolated to others. In many instances, it is expected that franchisors will experience similar decreases in net income in the first year of a franchise agreement. The result will depend on the nature of the franchisor's performance obligations and the amounts allocated to each performance obligation. Each franchisor will need to apply the framework to their particular franchise agreements, taking into account their unique facts and circumstances to determine the appropriate accounting treatment.

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<sup>57</sup> Since the amount allocated to the franchise right and the broker fee are being recognized as revenue and expense, respectively, over the term of the agreement, there is also an impact to net income in all remaining years of the franchise agreement, though smaller than in the initial year when the franchise agreement was signed.

## **B. Business and Financing Issues Related to the New Standard**

### **1. Valuation and Regulatory Considerations**

The adoption of ASC 606 has the potential to have considerable effect on key valuation inputs, such as EBITDA, and other operating metrics of franchisors. The changes to these inputs are due to the effects of the new accounting standard; however, the cash flows and operations of the franchisor will not have changed. Since the business model isn't changing, in theory, the value shouldn't differ. However, there will invariably be an impact on retained earnings and balance sheet ratios, all of which are currently relevant to state examiners.

If valuation models are not updated to address the changes in inputs, those models could indicate changes in value simply due to adoption of ASC 606. As a result, those who are determining the value of a franchisor should consider historical metrics, such as revenue and EBITDA, and the consistency of those metrics in the valuation model.

If using a market approach valuation model – for example, by considering guideline public companies – the impact of implementation on those peer company metrics should be considered. Additionally, consideration of the timing of when peer companies adopt ASC 606, as well as the transition method used by those entities, will be critical to ensure that an “apples to apples” comparison is used in the valuation model.

Because of possible changes to the valuation model inputs, ASC 606 could have positive or potentially negative impacts on the overall valuation of a franchisor. Methods of valuation and inputs to the models should be carefully considered to ensure that the adoption of ASC 606 on valuation is understood.

It seems, however, that for many new, small, and even medium-sized franchisors, the impact of ASC 606 to retained earnings, ratios, and valuation may have a significant detrimental effect. Among other things, this may impact state franchise registrations, where examiners (at least initially) may look disapprovingly at a company's financial statements that show a negative current ratio, lower retained earnings, and other factors (including higher expenses due to implementation and accounting) as a direct result of implementing ASC 606.<sup>58</sup> Some franchisors may also discover that their retained earnings drop below a threshold needed to qualify for (or maintain) a “large franchisor” exemption under state franchise laws, which may have additional negative impacts under state registration regimes.<sup>59</sup> Finally, it is also not difficult to posit that fewer start-up franchisors will launch because of these factors.

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<sup>58</sup> See generally Marisa Faunce and Charlene York, *State Franchise Registration Procedures* at 16 (IFA Legal Symposium paper) (May 2015); Joel Buckberg and Robert Einhorn, *The Use & Analysis of Financial Statements*, ABA 36th Annual Forum on Franchising W-10 (2013).

<sup>59</sup> For a discussion of exemption standards and thresholds under federal and state law, see generally *Exemptions and Exclusions under Federal and State Franchise Registration and Disclosure Laws*, ABA (2017) (Curran and Krakus, eds.). Cf. *Dollar Sys, Inc. v. Avcar Leasing Sys, Inc.*, 890 F.2d 165 (9th Cir. 1989) (the purported exempt sale of a franchise without satisfying the underlying exemption requirements exposes the franchisor to a claim of an unregistered franchise sale).

## **2. Debt Covenants and Lending Issues**

ASC 606 does not change the underlying economics or cash flows of a business, but the application of the accounting standard can have indirect economic repercussions for franchisors. The changes resulting from application of the standard could trigger contractual terms in banking arrangements, employment contracts, earn-outs, or other similar existing contracts.

With respect to banking arrangements, the biggest concern is with the financial covenants included in debt arrangements. These covenants often rely on leverage or EBITDA-based ratios that may be affected by new accounting standards. The adoption of ASC 606 will not only affect the timing of revenue recognition for franchisors, it could also impact the balance sheet.

Many debt covenants are effective for the term of debt arrangement and do not consider changes in GAAP. For example, if a franchisor enters into a five-year term debt agreement with a debt service coverage ratio and a debt to equity ratio, those ratios are computed based on the GAAP applicable at each reporting date. If application of ASC 606 triggers a violation that would not have existed under ASC 952, the franchisor is in default of the debt agreement. Once in default, the franchisor may seek a waiver from the bank. Obtaining such a waiver, however, is likely to result in banks charging fees for the waiver, additional time to go through the loan committee process, and transaction expenses (such as legal and accounting fees) that otherwise would not have been incurred.

If a franchisor is a party to a debt agreement with a bank or other entity, the franchisor should start the process early of considering the impact of ASC 606 on its financial statements and covenants – especially given the likelihood that some portion of the initial franchise fee could be deferred under the new accounting guidance. Having the knowledge of the impact of ASC 606 will prepare the franchisor with the information it needs to negotiate appropriate covenants that are properly adjusted for the impact of the new accounting standard.

### **C. Methods for Transitioning to the New Standard**

A company that is adopting the new revenue recognition standard has a choice on how to transition to the new accounting principle in the year of adoption. ASC 606-10-65-1d provides for the following transition methods:

An entity shall apply the pending content that links to this paragraph using one of the following two methods:

1. Retrospectively to each prior reporting period presented in accordance with the guidance on accounting changes in paragraphs 250-10-45-5 through 250-10-45-10 subject to the expedients in (f).
2. Retrospectively with the cumulative effect of initially applying the pending content that links to this paragraph recognized at the date of initial application in accordance with (h) through (i).

Item 1 is generally referred to as the “full retrospective” method, while item 2 is referred to as the “modified retrospective” method.

When applying the full retrospective method, a company would restate all of the years presented in its financial statements as if those years were being reported under the guidance in

the new standard. The first year presented would include a cumulative effect adjustment on equity to account for the effect of initially applying the standard on that year.

For example, assume that a franchisor adopts the revenue recognition standard effective January 1, 2019. Its December 31, 2019 financial statements would include comparative financial statements for both 2018 and 2017. If the franchisor elects to use full retrospective approach, then the company would restate its 2018 and 2017 financial statements as if the standard were applied by the Company as of January 1, 2017.

When applying the modified retrospective method, a company would apply ASC 606 only to the year of adoption. Beginning equity for the year of adoption would include a cumulative effect adjustment to account for the effect of initially applying the standard on that year.

For this example, assume that a franchisor was adopting the revenue recognition standard effective January 1, 2019. Its December 31, 2019, financial statements would include comparative financial statements for both 2018 and 2017. If the modified retrospective approach were elected by the company, the entity would *not* restate the 2018 and 2017 financial statement amounts. Rather, it would apply ASC 606 to its financial results for 2019 and include a cumulative effect accounting adjustment to its equity balance at January 1, 2019, to account for the effects of the restatement.

The full retrospective approach is much more thorough and therefore takes more time and resources to complete. However, it provides comparability across financial reporting periods, which is helpful to users of the financial statements. Alternatively, the modified retrospective approach includes a few practical expedients that make adoption easier, in addition to having fewer periods to restate. Through a review of several public company financial statements, we have noted that most public franchisors are applying both the full retrospective transition method and the modified retrospective transition method. Franchisors should consider the time and resources of their team as well as the users of their financial statements, including state regulators, in determining which transition approach is right for them.

#### **IV. CONCLUSION**

As advisors to franchisors, it is important for legal practitioners to have an understanding of the potential effects that implementation of ASC 606 can have on a franchisor – both on the franchisor's accounting and their business. A thorough understanding of the full standard is necessary in order to appropriately apply the judgments in the revenue recognition model, and the conclusions generated will differ franchisor by franchisor.

Practitioners should encourage those that they are advising to obtain an understanding of the standard and its effect on the franchisor's financial statements well before implementation, and to do so in concert with their auditors. Addressing the standard in advance of its implementation date will assist in identifying other indirect effects of application, including potential valuation, debt covenant compliance, or other regulatory issues that could result from a change in the timing of revenue recognition of the franchisor.

## Annex

This annex provides the text of certain portions of the Accounting Standards Codifications that are referred to in Main Text. This Annex presents the text as it appears in the ASC, including passages that are in bold type in the original.

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### Part A ASC 105-10, *Generally Accepted Accounting Principles* Sources of GAAP

ASC 105-10 considers the various sources of GAAP, and how companies should apply GAAP to accounting transactions and events:

- 05-1 This Topic establishes the *Financial Accounting Standards Board (FASB) Accounting Standards Codification (Codification)* as the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by **nongovernmental entities**. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. In addition to the SEC's rules and interpretive releases, the SEC staff issues Staff Accounting Bulletins that represent practices followed by the staff in administering SEC disclosure requirements, and it utilizes SEC Staff Announcements and Observer comments made at Emerging Issues Task Force meetings to publicly announce its views on certain accounting issues for SEC registrants.
  
- 05-2 If the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider nonauthoritative guidance from other sources. An entity shall not follow the accounting treatment specified in accounting guidance for similar transactions or events in cases in which those accounting principles either prohibit the application of the accounting treatment to the particular transaction or event or indicate that the accounting treatment should not be applied by analogy.
  
- 05-3 Accounting and financial reporting practices not included in the Codification are nonauthoritative. Sources of nonauthoritative accounting guidance and literature include, for example, the following:
  - a. Practices that are widely recognized and prevalent either generally or in the industry
  
  - b. FASB Concepts Statements
  
  - c. American Institute of Certified Public Accountants (AICPA) Issues Papers

- d. International Financial Reporting Standards of the International Accounting Standards Board
- e. Pronouncements of professional associations or regulatory agencies
- f. Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids
- g. Accounting textbooks, handbooks, and articles.

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**Part B**  
**ASC 952-605, *Franchisors Revenue Recognition***  
**Current Revenue Recognition Standard**

ASC 952-605 is the current standard that franchisors following in recognizing revenue. In relevant part, it provides that:

25-1 Franchise fee revenue from an individual franchise sale shall be recognized, with an appropriate provision for estimated uncollectible amounts, when all material services or conditions relating to the sale have been substantially performed or satisfied by the **franchisor**.

25-2 Substantial performance for the franchisor means that all of the following conditions have been met:

- a. The franchisor has no remaining obligation or intent — by agreement, trade practice, or law — to refund any cash received or forgive any unpaid notes or receivables.
- b. Substantially all of the **initial services** of the franchisor required by the **franchise agreement** have been performed.
- c. No other material conditions or obligations related to the determination of substantial performance exist.

25-3 If the franchise agreement does not require the franchisor to perform initial services but a practice of voluntarily rendering initial services exists or is likely to exist because of business or regulatory circumstances, substantial performance shall not be assumed until either the initial services have been substantially performed or reasonable assurance exists that the services will not be performed. The commencement of operations by the **franchisee** shall be presumed to be the earliest point at which substantial performance has occurred, unless it can be demonstrated that substantial performance of all obligations, including services rendered voluntarily, has occurred before that time.

The glossary to ASC 952-605-20 provides additional explanation:

#### Initial Services

Common provision of a franchise agreement in which the franchisor usually will agree to provide a variety of services and advice to the franchisee, such as the following:

- a. Assistance in the selection of a site. The assistance may be based on experience with factors such as traffic patterns, residential configurations, and competition.
- b. Assistance in obtaining facilities, including related financing and architectural and engineering services. The facilities may be purchased or leased by the franchisee, and lease payments may be guaranteed by the franchisor.
- c. Assistance in advertising, either for the individual franchisee or as part of a general program.
- d. Training of the franchisee's personnel.
- e. Preparation and distribution of manuals and similar material concerning operations, administration, and record keeping.
- f. Bookkeeping and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate, and other taxes or about local regulations affecting the franchisee's business.
- g. Inspection, testing, and other quality control programs.

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**Part C**  
**ASC 606-10-25-1**  
**Step One, Identify the Contract**

Step 1: ASC 606-10-25-1 provides, in part, the following guidance regarding contracts:

**An entity shall account for a contract with a customer that is within the scope of this Topic only when all of the following criteria are met:**

- a. **The parties to the contract have approved the contract...and are committed to perform their respective obligations.**
- b. **The entity can identify each party's rights regarding the goods or services to be transferred.**
- c. **The entity can identify the payment terms for the goods or services to be transferred.**

- d. **The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).**
- e. **It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer...**

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**Part D**  
**ASC 606-10-25-14, 606-10-25-19 – 20**  
**Step Two, Identify the Separate Performance Obligations**

The following portions of ASC 606-10-25 relevant to the analysis to be applied by Franchisor X in Step 2:

**25-14 At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:**

- a. **A good or service (or a bundle of goods or services) that is distinct**
- b. **A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer...**

25-19 A good or service that is promised to a customer is distinct if both of the following criteria are met:

- a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).
- b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

25-20 A customer can benefit from a good or service in accordance with paragraph 606-10-25-19(a) if the good or service could be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a

good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

25-21 In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable in accordance with paragraph 606-10-25-19(b), the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

- a. The entity provides a significant service of integrating goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
- b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
- c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

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**Part E**  
**ASC 606-10-25-14, 606-10-25-19 – 20**  
**Step Three, Determine the Transaction Price**  
**Financing Component**

ASC 606-10-32-15 and 16 state:

In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the **contract** (either explicitly or implicitly) provides the **customer** or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize **revenue** at an amount that

reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (that is, the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

- a. The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services
- b. The combined effect of both of the following:
  1. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
  2. The prevailing interest rates in the relevant market.

Additionally, ASC 606-10-32-17 states that a significant financing component does not exist in any of the following situations:

- a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.
- b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).
- c. The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

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**Part F**  
**ASC 606-10-32-28 through 32-35**  
**Step Four, Allocate the Transaction Price**

ASC-606-10-32-28 through 32-35 state the following with respect to allocation of the transaction price:

**32-28 The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the**

**entity expects to be entitled in exchange for transferring the promised goods or services to the customer.**

- 32-29 To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the **contract** on a relative **standalone selling price** basis in accordance with paragraphs 606-10-32-31 through 32-35, except as specified in paragraphs 606-10-32-36 through 32-38 (for allocating discounts) and paragraphs 606-10-32-39 through 32-41 (for allocating consideration that includes variable amounts).
- 32-30 Paragraphs 606-10-32-31 through 32-41 do not apply if a contract has only one performance obligation. However, paragraphs 606-10-32-39 through 32-41 may apply if an entity promises to transfer a series of distinct goods or services identified as a single performance obligation in accordance with paragraph 606-10-25-14(b) and the promised consideration includes variable amounts.
- 32-31 To allocate the **transaction price** to each **performance obligation** on a relative **standalone selling price** basis, an entity shall determine the standalone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those standalone selling prices.
- 32-32 The standalone selling price is the price at which an entity would sell a promised good or service separately to a **customer**. The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service.
- 32-33 If a standalone selling price is not directly observable, an entity shall estimate the standalone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 606-10-32-28. When estimating a standalone selling price, an entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximize the use of observable inputs and apply estimation methods consistently in similar circumstances.
- 32-34 Suitable methods for estimating the standalone selling price of a good or service include, but are not limited to, the following:
- a. Adjusted market assessment approach - An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
  - b. Expected cost plus a margin approach - An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

- c. Residual approach - An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met:
1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).
  2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

32-35 A combination of methods may need to be used to estimate the standalone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain standalone selling prices. For example, an entity may use a residual approach to estimate the aggregate standalone selling price for those promised goods or services with highly variable or uncertain standalone selling prices and then use another method to estimate the standalone selling prices of the individual goods or services relative to that estimated aggregate standalone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the standalone selling price of each promised good or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated standalone selling prices would be consistent with the allocation objective in paragraph 606-10-32-28 and the guidance on estimating standalone selling prices in paragraph 606-10-32-33.

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## Part G

### ASC 606-10-25-23 through 25-32

#### Step Five, Recognize Revenue When (or as) Each Performance Obligation is Satisfied

The performance obligation is satisfied when “control” of the respective good or service is transferred to the franchisee, as discussed in ASC 606-10-25-23 through 25-32:

**25-23 An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.**

25-24 For each performance obligation identified in accordance with paragraphs 606-10-25-14 through 25-22, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 606-10-25-27 through 25-29) or satisfies the performance obligation at a point in time (in accordance with paragraph 606-10-25-30). If an entity does not satisfy a

performance obligation over time, the performance obligation is satisfied at a point in time.

25-25 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

- a. Using the asset to produce goods or provide services (including public services)
- b. Using the asset to enhance the value of other assets
- c. Using the asset to settle liabilities or reduce expenses
- d. Selling or exchanging the asset
- e. Pledging the asset to secure a loan
- f. Holding the asset.

25-26 When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the asset (see paragraphs 606-10-55-66 through 55-78).

25-27 An entity transfers control of a good or service over time and, therefore, satisfies a **performance obligation** and recognizes **revenue** over time, if one of the following criteria is met:

- a. The **customer** simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6).
- b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph 606-10-55-7).
- c. The entity's performance does not create an asset with an alternative use to the entity (see paragraph 606-10-25-28), and the entity has an enforceable right to payment for performance completed to date (see paragraph 606-10-25-29).

25-28 An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the

assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation. Paragraphs 606-10-55-8 through 55-10 provide guidance for assessing whether an asset has an alternative use to an entity.

- 25-29 An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 606-10-25-27(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Paragraphs 606-10-55-11 through 55-15 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date.
- 25-30 If a **performance obligation** is not satisfied over time in accordance with paragraphs 606-10-25-2 through 25-29, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a **customer** obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the guidance on control in paragraphs 606-10-25-23 through 25-26. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:
- a. The entity has a present right to payment for the asset—If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.
  - b. The customer has legal title to the asset—Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
  - c. The entity has transferred physical possession of the asset—The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84

provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.

- d. The customer has the significant risks and rewards of ownership of the asset - The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
- e. The customer has accepted the asset—The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.

25-31 For each **performance obligation** satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity shall recognize **revenue** over time by measuring the progress toward complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation).

25-32 An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress toward complete satisfaction of a performance obligation satisfied over time.

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## Part H

### ASC 606-10-55-59 through 606-10-55-63

#### **Step Five, Recognize Revenue When (or as) Each Performance Obligation is Satisfied When to Recognize Revenue for Franchise Rights**

Guidance for the recognition of revenue related to franchise rights, a form of intellectual property, is discussed in ASC 606-10-55-59 through 55-63:

55-59 To determine whether the entity's promise to provide a right to access its intellectual property or a right to use its intellectual property, the entity should consider the nature of the intellectual property to which the customer will have rights. Intellectual property is either:

- a. Functional intellectual property. Intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired). Functional intellectual property derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality.
- b. Symbolic intellectual property. Intellectual property that is not functional intellectual property (that is, intellectual property that does not have significant standalone functionality). Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its ordinary business activities.

55-60 A customer's ability to derive benefit from a license to symbolic intellectual property depends on the entity continuing to support or maintain the intellectual property. Therefore, a license to symbolic intellectual property grants the customer a right to access the entity's intellectual property, which is satisfied over time (see paragraphs 606-10-55-58A and 606-10-55-58C) as the entity fulfills its promise to both:

- a. Grant the customer rights to use and benefit from the entity's intellectual property
- b. Support or maintain the intellectual property. An entity generally supports or maintains symbolic intellectual property by continuing to undertake those activities from which the utility of the intellectual property is derived and/or refraining from activities or other actions that would significantly degrade the utility of the intellectual property.

55-62 A license to functional intellectual property grants a right to use the entity's intellectual property as it exists at the point in time at which the license is granted unless both of the following criteria are met:

- a. The functionality of the intellectual property to which the customer has rights is expected to substantively change during the license period as a result of activities of the entity that do not transfer a promised good or service to the customer (see paragraphs 606-10-25-16 through 25-18). Additional promised goods or services (for example, intellectual property upgrade rights or rights to use or access additional intellectual property) are not considered in assessing this criterion.
- b. The customer is contractually or practically required to use the updated intellectual property resulting from the activities in criterion (a).

If both of those criteria are met, then the license grants a right to access the entity's intellectual property.

55-63 Because functional intellectual property has significant standalone functionality, an entity's activities that do not substantively change that functionality do not significantly affect the utility of the intellectual property to which the customer has

rights. Therefore, the entity's promise to the customer in granting a license to functional intellectual property does not include supporting or maintaining the intellectual property. Consequently, if a license to functional intellectual property is a separate **performance obligation** (see paragraph 606-10-55-55) and does not meet the criteria in paragraph 606-10-55-62, it is satisfied at a point in time (see paragraphs 606-10-55-58B through 55-58C).

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**Part I**  
**ASC 340-40-25-1 through 340-40-25-3**  
**Additional Considerations**  
**Incremental Costs to Obtain a Contract**

ASC 340-40-25-1 through 340-40-25-3 state the following related to incremental costs of obtaining a contract:

- 25-1 **An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.**
- 25-2 The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).
- 25-3 Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

ASC 340-40-35-1 states the following regarding the amortization of any assets recognized as a cost to obtain a contract:

An asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 shall be amortized on a systematic basis that is consistent with the transfer to the **customer** of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated **contract** (as described in paragraph 340-40-25-5(a)).

### Co-Panelist Biographies

**James Kroeker** was appointed a member and vice chairman of the Financial Accounting Standards Board on September 1, 2013, and later reappointed to a second term that extends to June 30, 2024. Before he joined the FASB, Vice Chair Kroeker was Deputy Managing Partner for Professional Practice at Deloitte, and from 2009 to 2012, he was the Chief Accountant of the Securities and Exchange Commission.

**Christa LaBrosse** is a partner at Plante Moran PLLC in Southfield, Michigan. She serves as a member of the firm's professional standards team, and oversees the firm's implementation efforts of new accounting pronouncements, in particular as a leader of the firm's Revenue Recognition Task Force.

**Lee Plave** is a partner at Plave Koch PLC in Reston, Virginia. He has experience counseling franchisors on all aspects of franchise and distribution law, and has served on two IFA task forces relating to FASB matters – the first in 2003 (addressing FIN46R concerning variable interest entities) and the second in 2017-18 (concerning ASC 606 and revenue recognition issues).