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New FASB Revenue Recognition Guidance for Franchisors

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New FASB Revenue Recognition Guidance for Franchisors

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*The views expressed in this presentation are those of the presenter. Official positions of the FASB are reached only after extensive due process and deliberations

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Key Takeaways

- Franchisors must evaluate timing of recognition of initial franchise fees under new revenue standard
- Whether pre-opening services are accounted for separately will depend on “what” the Franchisor is providing
- The Financial Accounting Standards Board issued educational material to help Franchisors apply the new guidance at www.fasb.org

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Core Principle

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.

5 Step Model

Steps to apply the core principle:

1. **Identify the contract** with the customer
2. Identify the **separate performance obligations** in the contract
3. Determine the **transaction price**
4. **Allocate the transaction price** to the separate performance obligations
5. **Recognize revenue** when (or as) each performance obligation is satisfied

Applying the 5 step model

- Legacy revenue standard, the initial franchise fee typically was recognized when the location opened

- The new revenue standard, requires a FR to **evaluate each pre-opening service and determine whether it is a separate performance obligation**, which could affect the timing of revenue recognition

Example: Applying the 5 step model

Consider the following example:

- 10-year Franchise Agreement
- $25,000 initial franchise fee
- Royalty of 4% on future sales
- Before opening the location the Franchisor provides:
    - Training, both general and brand specific
    - Site selection
    - Sale of equipment

5 Step Model – Step 1

Step 1: Identify the contract with the customer

- Define the contract and the duration of the contract
- Consider the probability of collecting the amounts in the contract
- Determine how to treat multiple contracts entered into at or near the same time and contract modifications

5 Step Model – Step 2

Step 2: Identify the separate performance obligations in the contract

- Identify the goods or services provided to the customer
- Determine if the good or service **should be accounted for separately** (e.g., separate from the IP license)

Example: Applying the 5 step model

Does the $25,000 fee relate to :

- *A **single** performance obligation for the license and pre-opening services*
- ***Multiple** performance obligations associated with the activities of the location opening and the license*

Example: Applying the 5 step model

In this example, the entity determines that the following activities are separate from the franchise license:

- **Training services** –*the portion that are not brand specific*
- **Site selection services** –*not specific to the brand and could be provided by a third party*

5 Step Model – Step 3

Step 3: Determine the transaction price

- Identify the types of consideration to be paid to the FR (e.g., fixed payments, variable payments, royalties)

- Estimate variable payments (but not license-related royalties based on sales or usage)

    FASB: sales and usage-based royalties exception

Example: Applying the 5 step model

In this example, the transaction price includes the following:

- Fixed consideration – $25,000 upfront fee

- Variable consideration – Royalty of 4% of future sales
  - FR does not need to estimate the expected royalties as they are based on *future sales*

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5 Step Model – Step 4

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

- Determine the standalone selling price for each separate performance obligation
    - No specific method is required

- Allocate transaction price in proportion to standalone selling price of each performance obligation
    Exception for certain variable payments

Example: Applying the 5 step model

The FR needs to determine the **standalone selling price** of the services that are separate performance obligations and allocate the transaction price to them based on standalone selling prices

- No specific method is required
- Consider if the standalone selling price is observable

5 Step Model – Step 5

Franchise Fee Revenue –
For amounts allocated to the license of "symbolic intellectual property" (e.g., the TMs, the brand), recognize the revenue over term of the license period

For amounts allocated to separate performance obligations (e.g., pre-opening services, equipment), the FR should recognize the revenue when the performance obligation is satisfied

Royalties are separately analyzed –

Intertwined with the TM license –

Recognized **when underlying sale or usage occurs**

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Example: Applying the 5 step model

- *NOTE (as clarified by the FASB)*

In a case where amounts allocated to separate performance obligations of pre-opening services is greater than the Initial Franchise Fee, the Franchisor would recognize the entire initial fee as the pre-opening services are performed

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Thank you!

Questions?