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# FASB Issues Revenue Recognition Clarity

## Understanding a five-step process to the new requirements.

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In November 2018, the Financial Accounting Standards Board (FASB) released additional educational examples that will assist franchisors in understanding and applying the new revenue recognition standard. These examples came about after considerable consultation and discussions between the FASB and a task force led by IFA.

Every franchisor, when preparing its franchise disclosure document (FDD), must include financial statements that are prepared in accordance with U.S. GAAP (Generally Accepted Accounting Principles). Because U.S. GAAP is derived from FASB accounting standards, the new revenue recognition standard is of paramount importance to franchisors. The new revenue recognition standard is known as Accounting Standards Codification Topic 606 (ASC 606). For publicly traded companies, ASC 606 became effective for their fiscal years beginning after Dec. 15, 2017. For all other entities, the new standard becomes effective after Dec. 15, 2018. For a typical non-public franchisor with a Dec. 31 fiscal year end, the standard is effective with the fiscal year that begins on Jan. 1, 2019. Before the adoption of ASC 606, franchisors applied an industry-specific standard to determine the appropriate timing for recognizing revenue related to initial franchise fees (IFF). In prior practice, IFF revenues were typically recognized when the associated franchise location was opened.

## FIVE-STEP PROCESS

The adoption of ASC 606 changes how and when IFF revenues may be recognized. Instead of the previous industry-specific approach, ASC 606 provides a single comprehensive revenue recognition model, which in franchising will be applied to all contracts with a franchisor's franchisees. Franchisors must follow a five-step process to apply ASC 606, which includes:

- **Step 1:** Determining the contracts to be included in the evaluation;
- **Step 2:** Determining if there are separate performance obligations (SPO's) that the franchisor provides to its franchisees and, if so, identifying those;
- **Step 3:** Determining the total amount paid to the franchisor;
- **Step 4:** Allocating the total consideration attributable to the SPO's based upon a determination of the value of the SPO's; and
- **Step 5:** Determining when to recognize the revenue attributable to the SPO's.

Working together with the FASB and its professional staff, the IFA-led task force proposed, and the FASB agreed to release, additional educational examples. In the FASB's Nov. 5, 2018 media release accompanying the new examples, FASB Chairman Russ Golden said that "[t]he FASB staff paper is one of many examples of how we're continually monitoring and supporting the successful implementation of our standards. These efforts are made possible by the valuable input provided by organizations like the International Franchise Association and its members, and we thank them for their assistance in ensuring our standards are, in fact, 'standards that work.'"

The new examples illustrate, among other things, how a franchisor may use its judgement in identifying SPO's under the ASC 606 five-step model. For example:


Left to right, IFA's Matt Haller and Suzanne Beall, Esq., with FASB Task Force members Lee Plave, CFE, Aaron Chaitovsky, CFE, and Joseph Turkewitz. According to FRANdata estimates, without the new FASB guidance, 1.1 million jobs would be lost, 930 franchise brands would close within 3 years, and 104,098 franchised businesses would go bankrupt or close.

- A franchisor may (and should) properly identify the promised goods or services provided in exchange for the IFF. Examples include services and goods such as training, site selection and equiment.
- Next, determine if some or all the pre-opening services are distinct (that is, that they should be allocated a portion of the IFF to be recognized as revenue when (or as) those services are satisfied).
- Then, each of the distinct SPO's should be evaluated to determine the standalone selling price.
- The portion of the IFF attributable to the SPO (for example, a service that the franchisee might be able use outside the franchise system, without taking into account that non-competition and confidentiality covenants apply) will likely be recognized when those services are rendered to the franchisee (e.g., upon completion of training).
- The standalone selling price method for valuing services can include fair market replacement value (e.g., the cost of buying the same service from another party, such as training courses from a university), cost-plus-a-reasonable markup (helpful where the cost is actually known), or the residual approach (applied to the balance that remains; typically this is the portion that is amortized throughout the rest of the agreement term).

The FASB staff paper provides educational examples to illustrate the application of the new revenue recognition standard to a typical franchise arrangement commonly found in practice. In simple terms, there are no presumptions in the new standard. Proper application of the new five-step revenue recognition model, based on the facts and circumstances presented in the FASB staff paper, may in fact result in the recognition of all or a portion of the IFF when the franchisor's obligations associated with pre-opening services are satisfied. There are nuances to understanding and applying ASC 606. Franchisors will need to consult with their auditors to determine how they can approach these issues in the context of transactions such as new sales, terminations, transfers, renewals, and multi-unit agreements.

Franchisors should carefully evaluate their own facts and circumstances to determine the appropriate application of the new standard to franchise agreements, development agreements, master franchise agreements, and the like. Some franchisors may still determine that deferral and recognition of the IFF over the term of the franchise agreement is appropriate (e.g., if the impact of applying the five-step process would not be material to their financial reporting or the pre-opening services are determined to not be distinct from the franchise license).

Jim Kroeker, Vice Chairman of FASB, commented that "as the newest FASB staff guidance suggests, there is no one-size-fits-all standard for applying the five-step procedure set out in ASC 606 – and therefore each franchisor's circumstances should be evaluated on its own merits."



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