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The New Revenue Recognition Rules: What is the Impact for Franchisors?

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I. Introduction

One of the biggest fears connected with the introduction of the new revenue recognition rules[1] ("NRRR") was that emerging franchisors would be forced to show a lower net worth on their balance sheets and as a result would be required by certain registration states to delay acceptance of initial franchise fee payments until the corresponding outlets were opened. Beyond the issue of cash flow, there was a fear that growth would be hindered because new prospects would be scared off when reviewing a revised balance sheet showing a franchisor with a lower net worth. More mature franchisors were concerned that a lower net worth would cause them to lose registration exemptions in certain states. This paper will give an overview of the NRRR and what is being done to address the fears and concerns of the industry. It will also describe the current lay of the land from the FASB[2] and the accounting industry, and what franchise attorneys can do to help their franchisor clients and their clients' accountants going forward.

The current picture and the current prospects are somewhat murky, and the dust has not settled on how the NRRR will affect the industry. The big four accounting firms[3] (the "Big 4") have thus far taken a conservative approach and have generally advised their clients to recognize 100% of initial franchisee fees over the entire term of the franchise agreement.[4] The IFA has aggressively engaged with the FASB and others on this subject and has achieved tangible results, even if those results have not yet caused the Big 4 to change their guidance. The FASB received a report from its staff during a public meeting on November 29, 2017 regarding the feedback that the FASB staff had received from the franchising industry, and, while the FASB meeting was not a decision-making meeting, the FASB issued a handout[5] (the "Handout") from the meeting stating that franchisors may assess whether any of their pre-opening activities constitute distinct services to the franchisee, and if the franchisors determine that there are indeed distinct services then they may allocate a portion of the overall transaction price[6] to those performance obligations and recognize revenue when (or as) those services are performed.[7] While

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[1] Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, The Financial Accounting Standards Board ("FASB"), adopted May 2014.
[2] The Financial Accounting Standards Board, a non-profit standards-setting body that establishes generally accepted accounting principles ("GAAP") in the United States.
[3] Deloitte, PwC, EY and KPMG.
[4] See, e.g., *Revenue for Franchisors*, KPMG, July 2017, frv.kpmg.us/reference-library/2017/07/revenue-for-franchisors.html.
[5] *Board Meeting Handout, Revenue Recognition Implementation*, FASB, November 29, 2017.
[6] The "transaction price" as used in the NRRR and by the FASB means all revenue received from the franchisee over the entire term of the franchise agreement, including the initial franchisee fee, royalties, advertising fund contributions and other fees from franchisor to franchisee (see Section II, Step 3, infra).
[7] *Handout* at 3-4 (see Section III.A below).

this does not open the door to recognizing 100% of franchise fees upon the opening of the outlet as per historical practice, it does open the door to a (albeit murky) middle ground and sets the stage for further discussion and development in this area. The fact that the current situation is fluid on this subject is unmistakably an improvement from the decidedly dark picture that many franchisors saw immediately after the NRRR were issued.

II. Overview of the New Revenue Recognition Rules

The FASB issued the NRRR in May 2014. The sweeping new rules were followed by five subsequent amendments that are part of the NRRR. The NRRR replace all existing guidance, including voluminous industry-specific guidance, and are meant to provide a principles-based approach for consistency across all industries. Revenue will now be recognized based on the transfer of control of goods or services to a customer in the amount of the consideration the entity expects to be entitled to receive. In other words, revenue can be recognized when a customer can use or benefit from the goods or services provided. This concept may change the amount of revenue recognized, as well as the timing of recognition. Gone are the concepts of risks and rewards, fixed and determinable amounts, and industry-specific norms. In addition, robust quantitative and qualitative disclosures are required. Specifically, the NRRR are causing significant changes to the way in which franchisors recognize revenue. There are five steps outlined in the NRRR, the key provisions of which we include below, followed in each case by comments on how franchisors, their accountants and attorneys may consider applying the FASB's new guidance:

- Step 1 - Identify the Contract with a customer
- Step 2 - Identify the performance obligations in the contract
- Step 3 - Determine the transaction price
- Step 4 - Allocate the Price to the performance obligations
- Step 5 - Recognize Revenue

<u>Step 1 – Identify the Contract with a customer</u>

606-10-25-1 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 (in writing, orally, or in accordance with other customary business practices) 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. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession.

606-25-10-2 A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

Franchisor application – For the franchisor this would seem rather straightforward. We have a franchise agreement that specifies, in writing, the parties, each party's rights and obligations, and the payment terms. No one would doubt that a franchise agreement has commercial substance in that the cash flows of both parties are clearly expected to change as a result of the contract. The franchisor will have to determine the last step related to collectability based upon their credit underwriting of the franchisee.

Step 2 - Identify the performance obligations in the contract

606-10-25 -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.

606-10-25-15 A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 606-10-25-27 : to be a performance obligation satisfied over time.
b. In accordance with paragraphs 606-10-25-31 through 25-32 : , the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

606-10-25-16 A contract with a customer generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the promised goods and services identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer also may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a reasonable expectation of the customer that the entity will transfer a good or service to the customer.

606-10-25-17 Promised goods or services do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not promised goods or services in the contract with the customer.

606-10-25-19 Distinct Goods or Services - 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).

606-10-25-20 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.

606-10-25-21 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.

606-10-25-22 If a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

606-10-55-57 When a single performance obligation includes a license (or licenses) of intellectual property and one or more other goods or services, the entity considers the nature of the combined good or service for which the customer has contracted (including whether the license that is part of the single performance obligation provides the customer with a right to use or a right to access intellectual property in accordance with paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A) in determining whether that combined good or service is satisfied over time or at a point in time…. and, if over time, in selecting an appropriate method for measuring progress.

Franchisor application: A performance obligation is a promise to provide goods or services (or a bundle of goods or services) that are capable of being distinct. This is the critical part of the analysis in which franchisors need to look at the package of services they are providing to the franchisee at onset of the franchise agreement to determine if the promises can be identified as distinct. There are a number of promises that a franchisor may include in the franchise agreement such as:

- ***Pre-opening activities***
- ***Site selection***
- ***Training franchisees***
- ***Obtaining equipment***

- ***Establishment of supplier/ vendor relationships***
- ***Ongoing support activities***
- ***Advertising and marketing for the brand***
- ***Renewal terms***
- ***Operations manual***
- ***General business training i e. Accounting, time management***
- ***Architectural plans***

Determining if the service is distinct is a matter of judgment and industry practices. Just because it is broken out separately, with a separate fee, in the FDD and franchise agreement, does not by itself constitute a distinct good or service. However, the identification as a potential distinct service would be supported by having it broken out in the FDD and franchise agreement and making that service optional to the franchises. A key factor is determining if the various promises are highly interdependent or highly interrelated to the franchise right itself. Certain goods and services are directly related to the brand and could not be of value without the franchise right, such as operations manuals, marketing and pre-opening services. However, other services could be of value regardless of the brand with which they are associated. A review of your materials and how they are presented could be helpful in this determination. It is important that your materials and practices be consistent in how they are communicated to your employees, the public and your franchisees and how you conclude this process of determining what is distinct.

The most common examples of goods and services that franchisors have been looking at as possibly being distinct are site selection, certain training and equipment. If a franchisor offers site selection as an option and a franchisee could choose to use the franchisor or an outside service provider that may be an indication that service is distinct. The sale of equipment that would have an alternative use if the franchisee was to discontinue being a franchisee may be another indication that the equipment is a distinct good. Then the waters start to muddy – certain training that would be applicable to any business, meaning not specific to the brand, could be carved out as well. The challenge is the model of franchising. Most franchisors will tell you that what they provide through their brand is unique and proprietary to them. Indeed, this is the basis of the assertion of intellectual property rights that give rise to legal protections and may increase the valuation of franchisor companies. There will potentially be a tension between the desire to claim that services are not unique to the brand (possibly helping with early revenue recognition) and the desire to claim that most of a franchisor's services are proprietary (possibly helping with intellectual property protection and valuation). The point is that consideration has to be made about the goods and services and a presumption that they are a bundled package should be avoided. The impact of this process will be much more significant for emerging franchisors.

In the circumstances of an area developer or a multi-unit agreement, exclusivity may be granted to your franchisee. That exclusivity is not considered a separate performance obligation but is part and parcel to the franchise right.

Step 3 – Determining the transaction price

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.

606-10-32-3 The nature, timing, and amount of consideration promised by a customer affect the estimate of the transaction price. When determining the transaction price, an entity shall consider the effects of all of the following:

a. Variable consideration
b. Constraining estimates of variable consideration
c. The existence of a significant financing component in the contract
d. Noncash consideration
e. Consideration payable to a customer

Franchisor application: The franchisor now needs to make a list of all the revenue streams it has coming into the company. These should be outlined in the franchise agreement. Just because a separate fee is charged for a service does not make it distinct (See Step 2). The transaction price is the amount of funds you will receive and some of these may be received as a onetime up-front fee and others may be received over time. An example of various revenue streams may be:

- ***Initial franchise fee***
- ***Royalties (exception – do not need to estimate future royalties)***
- ***Area development or area representative fees***
    - ***With fees to be paid for additional franchises sold***
- ***Master franchise agreement fees***
    - ***With fees to be paid for sub-franchises sold***
- ***Ad fund fees/contributions***
- ***Renewal fees***
- ***Transfer fees***
- ***Relocation fees***
- ***Product/Equipment sales***
- ***Software license fees***
- ***Loyalty programs***
- ***Rebates***
- ***Gift cards***

There is additional guidance related to determining whether there is a significant financing component. This would be applicable in situations in which the timing of payment is extended or significantly later than when the goods or services are provided. The granting of area development rights or master franchise rights may be subject to this guidance depending on payment terms.

In some circumstances, franchisors will accept payment in services instead of cash for the initial franchise fee. These non-cash services must be valued as part of the transaction price at the inception of the agreement.

Step 4 – Allocating the Price to the performance obligations

606-10-32-28 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.

606-10-32-29 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.

606-10-32-31 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.

606-10-32 -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.

606-10-32-33 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.

606-10-32-34 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 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).

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.

***Franchisor application:* So, here is where the rubber meets the road for the franchisor and its accountant. Time to determine the debits and credits for entry into the books and records of the company. Back in Step 2 we had to determine if the franchisor has distinct goods and services. If only one performance obligation was determined to be present, then the recognition is very simple - the initial franchise fee is allocated to that one performance obligation and recognized over the term of the franchise agreement.**

However, if during Step 2 separate performance obligations were identified, then the franchisor applies the guidance above to determine the relative stand-alone values of the various performance obligations. This activity is performed at the inception of the agreement. The franchise agreement or FDD may reflect separate

amounts for the separately identified performance obligation, which may represent the stand-alone value, but you cannot presume that is the case. Observable data points are needed to determine the stand-alone value. This is a management estimate (that will need to auditable).

As an example – a franchisor has in initial franchise fee of $50,000 and a 6% royalty. Separate performance obligations have been identified for the equipment, site selection and the franchise right. Based upon market data, the franchisor determines that site selection value is $10,000 and the equipment is valued at $60,000. The franchise should be able to sustain $500,000 of sales annually for the 10 years of the agreement. Royalty expectations would then be $200,000 over the contract. The franchisor could allocate the variable consideration to the franchise right and the up-front fee to the performance obligations for the equipment and site selection -

Site selection – $10,000/$370,000 * $50,000 = $1,351
Equipment - $60,000/$370,000 * $50,000 = $8, 108
Intellectual property - $300,000/$370,000 * $50,000 = $40,541

However, if the allocation would have resulted in the allocation to the site selection and equipment in excess of their value, then there would need to be an allocation to the franchise right resulting in a small amount of up-front recognition for the site selection and equipment and a large deferral to be recognized over the life of the contract.

<u>Step 5 – Recognize Revenue</u>

606-10-25-23 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.

606-10-25-24 For each performance obligation identified… 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.

606-10-25-27 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.
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.

c. The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

606-10-25-30 If a performance obligation is not satisfied over time…., 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….
b. The customer has legal title to the asset….
c. The entity has transferred physical possession of the asset…..
d. The customer has the significant risks and rewards of ownership of the asset….
e. The customer has accepted the asset…..

Franchisor application: Now that we know the transaction price, the franchisor has to determine if the goods and services exchanged are done over time or at a point in time. Revenue is recognized when the goods and services are transferred to the customer and the customer has control of them.

The new standard does categorize the franchise right as a symbolic license (606-10-55-60). 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.

The royalties have a carve-out exception as sales-based royalties (606-10-55-65) and therefore the franchisor continues to recognize royalties as the underlying sales occur. However, the franchisor does need to accrue for royalties earned but not yet received. <u>The practice of recognizing royalties in arrears is prohibited.</u>

If additional performance obligations were identified, then the process of determining if the good or service is delivered over time ensues. If it is determined that the goods or services are not provided over time, then they are deemed to be provided at a point in time. Recognition occurs when the goods or services are in control of the recipient as defined above.

Another concept covered within the new guidance is principal vs. agent transactions. This is applicable to franchisors in recognizing the transactions associated with an ad fund/national marketing fund, and the franchisor must consider the control provisions discussed. If the franchisor controls how the funds are to be spent (within the restrictions of the franchise agreement), the monies collected for these funds are recognized as revenue in a manner similar to

royalties. There may be an exception to this if the marketing is very specific to a single franchisee. Generally, advertising costs are expensed as incurred. This is the applicable guidance going forward. This results in a presentation different than we've historically seen, such that revenues and expenses are not matched.

There is a change in terminology used on the face of the financial statements as well. The title – deferred revenue – is now to be identified as contract liability.

Below is a table that summarizes the old GAAP recognition vs. recognition under 606:

Area	Current U.S. GAAP	New Standard
Initial Franchise Fees *	When all material services are performed (gen. when unit opens)	Over the term of the franchise agreement – if one performance obligation
Royalties	As earned (sometimes with a lag)	As earned (no lag allowed – must estimate)
Area Developer Agreements	Over time or units	If finite number of units, as each franchise agreement is executed
Master Agreements	Up front or over time	Over time assuming unlimited number of units

*must determine if additional performance obligations exist at the inception of the contract

Area	Current U.S. GAAP	New Standard
Ad Fund Revenues	Gross vs. Net Recognize revenue to the extent of costs incurred	Recognize revenue as earned (same as royalties)
Ad Fund Costs	Expensed as incurred (some netted revenue with expenses)	Expensed as incurred – gross presentation *
Renewal Fees	When signed	Over new term of contract (assume Renewal fee is immaterial to the overall contract)
Transfer Fees	When signed	over remaining term of contract (assume transfer fee is immaterial to the overall contract)

Area	Current U.S. GAAP	New Standard
Loyalty Programs	Balance sheet only - net presentation	Defer at expected redemption rate – value of points probability
Gift Cards	Liability – revenue as used or net to franchisee	Contract liability – revenue as earned; must include breakage
Vendor Rebates	Passed through to franchisee (net) or Ad Fund (net)	Typically will reduce revenue (may adjust COGS)
Equipment / Product Sales	When delivered – gross vs. net	If in Franchisor control – then gross when delivered; otherwise net

<u>Contract costs</u>

340-40-25-1 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.

340-40-25-2 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).

340-40-25-3 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.

Franchisor application: It is common practice to utilize the services of a franchise broker or pay bonuses/commissions to employees related to getting a new franchisee. These are the types of costs that are considered incremental costs to obtain a contract and therefore they are to be capitalized and recognized over the period of the contract. These are referred to as deferred costs on the balance sheet.

Disclosures

The standard requires additional disclosures that are focused on providing the user of the financial statements to have sufficient information to enable them to understand the nature, amount, timing and uncertainty of revenue and cash flows. Therefore, the footnotes need to disclose qualitative and quantitative information about:

a. Its contracts with customers
b. The significant judgments, and changes in the judgments, made in applying the guidance in Topic 606 to those contracts
c. Any assets recognized from the costs to obtain or fulfill a contract with a customer

These disclosures should contain enough detail as to meet the disclosure objective. The information needs to be presented on a disaggregated level, in categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

Additionally, the financial statement footnotes need to obtain the following contract balances:

a. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed
b. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period.

Related to disclosures applicable to the performance obligations, an entity shall explain how the timing of satisfaction of its performance obligations relates to the typical timing of payment and the effect that those factors have on the contract asset and the contract liability balances. The explanation provided may use qualitative information.

606-10-50-12 An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following:

a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement
b. The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained
c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)
d. Obligations for returns, refunds, and other similar obligations
e. Types of warranties and related obligations.

606-10-50-13 An entity shall disclose the following information about its remaining performance obligations:

a. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period
b. An explanation of when the entity expects to recognize as revenue the amount disclosed in accordance with (previous) paragraph, which the entity shall disclose in either of the following ways:
    1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations
    2. By using qualitative information.

606-10-50-18 For performance obligations that an entity satisfies over time, an entity shall disclose both of the following:

a. The methods used to recognize revenue (for example, a description of the output methods or input methods used and how those methods are applied)
b. An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

606-10-50-19 For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when a customer obtains control of promised goods or services.

606-10-50-20 An entity shall disclose information about the methods, inputs, and assumptions used for all of the following:

a. Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration.
b. Assessing whether an estimate of variable consideration is constrained
c. Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable)
d. Measuring obligations for returns, refunds, and other similar obligations.

Franchisor application: As you can see, there are considerably more disclosures required in the audited financial statements that will be included in Item 21 of your FDD. The spirit of these requirements is to provide insight into management's judgments included in recognizing revenue. As franchisors and their accountants have done in the past, royalties should be recognized separately from initial franchise fees. If the franchisor determines there is more than one performance obligation, additional disclosures around that process will need to be made.

<u>Effective date and adoption</u>

The effective date for adopting this guidance was January 1, 2018 for public companies and January 1, 2019 for private companies (assuming calendar year end). There are 2 transition methods that the franchisor can select. The full retrospective approach allows the franchisor to push the adoption back to the earliest year presented. In other words, you would effectively restate your financial statements for all 3 years presented. The other option is to adopt on a modified basis, meaning you have an adjustment to your retained earnings on the date of adoption, January 1, 2018. If you use the modified approach, there are additional disclosures required to provide comparative information in the footnotes.

Franchisor application: This is a dual edge decision for the franchisor. The FDD requires 3 years to be provided as part of the document. Providing comparative information for all 3 years simplifies the explanation that would be required to a prospective franchisee on the financial statements. However, the franchisor will be presenting different results for prior years. That could provide some exposure to the company or at least a lot of explanation. On the other hand, depending on the maturity of the franchise system, if the franchisor selects the modified approach, it will have numbers that on their face are not comparative but prior year's results would not be impacted. The franchisor should have a discussion with its legal counsel and accountant as to these alternatives.

III. Recent Developments from the FASB and Accounting Industry

A. FASB Board Meeting Handout of November 29, 2017

We alluded to the Handout in the Introduction, and it contains the only written commentary directly from the FASB on the key issue covered in this paper of what part of initial fees may be recognized early rather than over the term of the franchise agreement. The commentary is only three paragraphs long and does not constitute official guidance from the FASB or an amendment to the NRRR. It is particularly useful to look at the exact language of that commentary now in light of the detailed discussion above regarding the NRRR. Here is the exact language from pages 3 and 4 of the Handout:

> 8. While the nature of the technical questions has narrowed over time, the staff has noticed some trends in the consultations. In particular, the staff continues to receive questions about areas of the guidance that require applying judgment, for example, identifying performance obligations. The staff observes that the accounting outcomes in those scenarios depend on the facts and circumstances of the arrangement, such as the contractual terms. That is, there are no presumptions in the guidance on how many performance obligations are included in certain arrangements. For example, since the last Board meeting in May, the staff has received several inquiries from stakeholders in the franchising industry.
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> 9. One of the most prevalent questions from the franchising industry involves determining whether or not pre-opening activities constitute a distinct performance obligation. Under current GAAP, franchisors generally recognize the initial fee when the location opens and recognize the subsequent royalty stream over time. Because industry-specific GAAP exists, franchisors historically have not had to assess whether the pre-opening services are a separate deliverable. In making this determination under the new standard, the first step for the franchisor is to determine if the pre-opening activities contain any distinct services. If none of the pre-opening services are distinct, then the initial fee would be part of the transaction price for the combined performance obligation of the license and services and, thus, recognized over the entire license period. If the franchisor determines that some or all of the pre-opening services are distinct, then it would allocate a portion of the transaction price to that performance obligation and recognize revenue when (or as) those services are performed.
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> 10. The franchisor scenario illustrates the following key takeaways when implementing the revenue standard:
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>> (a) Topic 606 does not include presumptions about how many performance obligations are in an arrangement.
>>
>> (b) When assessing the standard, an entity should review the specific facts and circumstances of the arrangement and not over-generalize.

As you can see, the FASB emphasizes that franchisors need to determine what pre-opening activities are distinct, and that the NRRR do not contain any presumptions in that regard. The difficulty is that, as we discuss above in Step 2 of Section II, making that determination is far from easy, and the determination can have an impact on other aspects of the franchisor's business. That fact brings us back to, and also helps to explain, the conservative approach that has been taken thus far by the Big 4.

B. Current Approach of the Big 4 to the NRRR

While there has not (to the authors' knowledge) been a full survey of annual reports of publicly-traded franchisor companies that have been audited by the Big 4 and how they plan to address recognition of initial franchise fees under the NRRR, anecdotal information supports the view that the Big 4 and the companies they audit have thus far taken a conservative approach. We look at four of the major, publicly traded restaurant franchisors below and what they and their Big 4 auditors have said in their public filings. Namely, we look at McDonald's (audited by EY), Restaurant Brands International (parent of Burger King, Tim Hortons and Popeye's, and audited by KPMG), Dine Brands (parent of Applebee's and IHOP, and audited by EY), and Dominos (audited by PwC).

McDonald's, with guidance from EY, stated the following in its 10-K for the year ending December 31, 2017:

> In accordance with the new guidance, the initial franchise services are not distinct from the continuing rights or services offered during the term of the franchise agreement, and will therefore be treated as a single performance obligation. As such, beginning in January 2018, initial fees received will be recognized over the franchise term, which is generally 20 years.[8]

There was no indication in the McDonald's 10-K that it intends to assess what services are distinct, even though in Item 11 of its 2017 FDD it lists 4 separate "pre-opening obligations".[9]

Restaurant Brands International, with guidance from KPMG, stated the following in its 10-K for the year ending December 31, 2017:

> Under current accounting guidance, we recognize initial franchise fees when we have performed all material obligations and services, which generally occurs when the franchise restaurant opens. Under the new

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[8] *Form 10-K of McDonald's Corporation*, as filed with the U.S. Securities and Exchange Commission and dated February 23, 2018, page 37.
[9] Per copy of 2017 FDD downloaded from the Minnesota Commerce Department website.

> guidance, we will defer the initial and renewal franchise fees and recognize revenue over the term of the related franchise agreement.[10]

The company stated that it will defer initial and renewal franchise fees and recognize the revenue over the term of its franchise agreements for all of its three brands, despite the fact that the 2017 FDDs for all three brands list several pre-opening obligations under Item 11, including initial training.[11]

Dine Brands is an interesting case study because their IHOP division earns a significant amount of its revenue from the sale of proprietary products to its franchisees, primarily pancake and waffle dry-mixes.[12] The company, with guidance from EY, states the following in its 10-K for the year ending December 31, 2017:

> This new revenue guidance supersedes nearly all of the existing general revenue recognition guidance under U.S. GAAP as well as most industry-specific revenue recognition guidance, including guidance with respect to revenue recognition by franchisors. The Company believes the recognition of the majority of its revenues, including franchise royalty revenues, sales of IHOP pancake and waffle dry mix and retail sales at company-operated restaurants will not be affected by the new guidance. Additionally, lease rental revenues are not within the scope of the new guidance.
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> The Company has determined the new revenue guidance will impact the timing of recognition of franchise and development fees. Under existing guidance, these fees are typically recognized upon the opening of restaurants. Under the new guidance, the Company has determined the fees will have to be deferred and recognized as revenue over the term of the individual franchise agreements. However, the effect of the required deferral of fees received in a given year will be mitigated by the recognition of revenue from fees retrospectively deferred from prior years. The Company presently expects to use the retrospective method of adoption when the new guidance is adopted in the first fiscal quarter of 2018. Upon adoption, the Company will recognize the deferral on its balance sheet of approximately $85 million in revenue from franchise and development fees and will reduce its receivables by approximately $7 million. As a result of adoption, the Company's accumulated deficit will increase by $60 million, net of deferred taxes of $32 million.[13]

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[10] *Form 10-K of Restaurant Brands International Inc.*, as filed with the U.S. Securities and Exchange Commission and dated February 23, 2018, page 65.

[11] Per copies of 2017 FDDs for each brand downloaded from the Minnesota Commerce Department website.

[12] *Form 10-K of Dine Brands Global, Inc.*, as filed with the U.S. Securities and Exchange Commission and dated February 20, 2018, page 8.

[13] *Form 10-K of Dine Brands Global, Inc.*, as filed with the U.S. Securities and Exchange Commission and dated February 20, 2018, page 71.

The company makes clear that the majority of its revenue and how it is recognized in its financial statements going forward will not be affected by the NRRR, and they specifically state that the majority of their revenues come from royalties, sales of dry-mix and company store sales. They do take the conservative approach with respect to franchisee and development fees by recognizing all of such income over the term of the franchise agreements, similar to the other companies discussed above, and based on guidance from EY. The example of Dine Brands shows that the impact on franchisors will depend in part on the business model, such as whether there are significant sales of proprietary products to franchisees.

Interestingly, Dominos, with guidance from PwC, describes the NRRR in more detail in its 10-K for the year ending December 31, 2017 than the other brands do, and it seems to be withholding judgment on how it will recognize revenue from initial franchise fees for U.S. based franchises since it is notably silent on the issue, in contrast to the other brands discussed above that already have decided to defer franchise fees over the term:

> The Company has considered all new accounting pronouncements issued by the FASB and concluded the following accounting pronouncements may have a material impact on our consolidated financial statements, or represent accounting pronouncements for which the Company has not yet completed its assessment.
>
> In May 2014, the FASB issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606), or Accounting Standards Codification 606 (“ASC 606”). This guidance outlines a single, comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance issued by the FASB, including industry specific guidance. Under the new revenue recognition standard, entities apply a five-step model that depicts 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. Specifically, companies identify the performance obligations within their contracts with customers, allocate the transaction price received from customers to each performance obligation identified within their contracts, and recognize revenue as the performance obligations are satisfied. During 2015, 2016, and 2017, the FASB issued various amendments which provide additional clarification and implementation guidance on ASC 606. Specifically, these amendments clarify how an entity should identify the specified good or service for the principal versus agent evaluation and how it should apply the control principle to certain types of arrangements, clarify how an entity should identify performance obligations and licensing implementation guidance, as well as account for shipping and handling fees and freight service, assess collectability, present sales tax, treat non-cash consideration, and account for completed and modified contracts at the time

of transition. The new guidance requires enhanced disclosures, including revenue recognition policies to identify performance obligations to customers and significant judgments in measurement and recognition. The effective date and transition requirements for ASC 606 and amendments is for fiscal years, and for interim periods within those years, beginning after December 15, 2017, and the Company will adopt this guidance using the modified retrospective approach effective January 1, 2018.

The Company has substantially completed its assessment of ASC 606, and the adoption of this guidance is not expected to have a material impact on its recognition of sales from Company-owned stores, ongoing royalty fees which are based on a percentage of franchise sales, revenues from its supply chain centers, development fees or technology fees.

The Company has determined that the store opening fees received from international franchisees do not contain separate and distinct performance obligations from the franchise right and those upfront fees will therefore be recognized as revenue over the term of each respective franchise agreement. Currently, we recognize such fees as revenue when received. The Company does not expect this to have a material impact on its international franchise revenues. However, an adjustment to beginning retained earnings and a corresponding contract liability of approximately $15 million will be established on the date of adoption associated with the fees received through December 31, 2017 that would have been deferred and recognized over the term of each respective franchise agreement if the new guidance had been applied in the past.[14]

As you can see, the company does take a position on "store opening fees" for international franchisees, saying that those fees do not contain separate and distinct performance obligations from the franchise right and that they will be recognized over the term of the franchise agreements. It takes no similar position with respect to U.S. based franchisees. It is worth observing that they state in Item 5 of their 2017 U.S. FDD that their initial fee is merely an "initial franchise application processing fee" of between $0 and $25,000.[15] It will be interesting to see how they and their Big 4 auditor address this issue going forward.

IV. Initial Franchise Fees in FDDs and Franchise Agreements after the NRRR

Franchise attorneys spend a great deal of time with their franchisor clients in preparing initial and renewal FDDs, and in preparing and updating their franchise agreement forms. Prior to the release of the NRRR, franchisors and their attorneys sometimes decided to break up initial fees into separate parts, such as an initial franchise fee (arguably just for

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[14] *Form 10-K of Domino's Pizza, Inc.*, as filed with the U.S. Securities and Exchange Commission and dated February 20, 2018, pages 38-39.

[15] Per copy of 2017 FDD downloaded from the Minnesota Commerce Department website.

the franchise right itself), initial training, grand opening assistance and other pre-opening services, and sometimes they just decided to include one initial franchise fee, along with a description of the pre-opening assistance to be provided by franchisor, without breaking up initial fees in any way. While legal documents will not be dispositive in terms of how a franchisor's auditor will decide when revenue can be recognized under the NRRR, franchise attorneys must, at a minimum, understand which pre-opening services their clients and their clients' auditors view as distinct. Franchise attorneys should then review the FDD and franchise agreement form with their clients to ensure that those distinct services are adequately described and should consider modifications if they are not. While this exercise will be the starting point for franchise attorneys, it will not be the ending point, as our discussion of the NRRR above makes clear.

A. Initial Franchise Fees in New Franchise Agreements

A new franchise agreement for a new franchised outlet, as distinguished from a renewal (sometimes called a successor or subsequent) franchise agreement, seems to be the situation that the FASB most clearly had in mind in its brief comments in the Handout. The most common elements of pre-opening franchisor assistance that we think of can be present with each new franchised outlet, such as site-selection, design assistance, project management, training of employees, initial marketing assistance and grand opening assistance. These are the exact services that franchisors and their auditors may decide are distinct and, thus, potentially eligible for revenue recognition after the services are performed.

Emerging franchisors deal almost exclusively with new franchise agreements since the term of franchise agreements tend to be ten years or longer, and most new agreements are signed in connection with new outlets (as opposed to the re-franchising of a company-owned outlet, for example, even though that is not entirely uncommon for emerging franchisors). The NRRR have been of particular concern to emerging franchisors because an improving balance sheet is key to convincing certain registration states that the emerging franchisors should be able to accept payment of initial fees before an outlet opens. Certain registration states may require newer franchisors with a low net-worth to defer the acceptance of initial fees until after an outlet has opened.[16] The purpose of this is to ensure that a franchisee does not lose money to a franchisor who is not able to fulfill all of its pre-opening obligations. This concern on the part of the states has merit, but the NRRR have potentially created a much longer period that emerging franchisors must do this, and the delayed cash flow that could result might cause certain systems to falter or fail, or perhaps never even get off the ground because cash flow expectations will have to be adjusted for those investing in start-up brands.

The good news for emerging franchisors is that, as noted above, there are more services provided by franchisors with respect to new franchise agreements for new outlets that

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[16] Some registration states may require fee deferral by statute while others may offer it as an alternative to another option that is allowed by statute, such as establishing an escrow or posting a surety bond.

can be considered distinct than is the case for renewal franchise agreements, or franchise agreements that are signed as a result of a transfer or re-franchising. Franchise attorneys should look carefully at the wording of FDDs and franchise agreement forms and assess how they currently distinguish between franchisor activities associated with new outlets and franchisor activities that occur with every franchise agreement. It is likely that franchisors and their auditors will conclude that most of the distinct services that may be eligible for revenue recognition are associated with new outlets. Indeed, even if an initial franchisee fee is the same for a new outlet as it is for a franchise agreement signed in connection with a re-franchising, auditors may conclude that a larger portion of the initial franchise fee may be allocated to specific services in the case of a new outlet (site-selection services, for example) than in the case of a re-franchising. Franchise attorneys should consider modifying FDDs and franchise agreements to better describe the distinct activities of their franchisor clients in connection with new franchised outlets in order to bolster the position their clients' auditors have taken or seem inclined to take going forward under the NRRR.

B. Renewal Franchise Fees / Transfers of Franchise Agreements

As discussed above, franchisors will be far less likely to find distinct performance obligations connected with renewals of existing franchise agreements. That reason alone makes it more likely that the only alternative will be to recognize a renewal franchise fee over the entire renewal term. Moreover, the renewal fee is such a small part of the overall transaction price (which includes all royalties paid over the term) that it will not be considered material to the overall contract, which also argues in favor of recognizing the fee over the entire renewal term.

Similarly, transfers are unlikely to involve distinct performance obligations on the part of franchisors, and are typically in amounts that will be a very small percentage of the overall transaction price. Unless there are unique attributes to renewals and transfers in a franchisor's system, it is likely that they will conclude that renewals and transfers do not involve distinct performance obligations or material rights, so franchisors and their attorneys will likely not make revisions to the FDD or franchise agreement form in these areas.

V. Financial Impact to Other Agreements of Franchisor

As part of the adoption of the NRRR, a franchisor company needs to consider the impact to other financial arrangements of the company. If the franchisor has a line of credit with a bank, it may include covenants. The new presentation will change equity and revenue, as well as potentially costs and GAAP net income. Leasing arrangements may also be impacted.

There should be consideration also to management bonus or incentive plans as these agreements typically include a linkage to net income.

Although GAAP is changing there is no change to how revenue is recognized from a tax perspective. Therefore, proper planning is needed. In addition, for C-corporations, the recognition of deferred income taxes will need to be addressed.

As the adoption has taken place for public company franchisors, it is becoming evident that the new accounting system is occurring in large part through the use of Excel spreadsheets. Franchisors should seek systems upgrades or changes to deal with this new accounting. Excel is helpful, but not a good alternative, especially from an internal controls perspective.

VI. Conclusion

The NRRR are going to require the attention of franchisors and their accountants and attorneys for years to come. The new rules are lengthy and complex, and they require numerous judgment calls on everyone's part. Public companies have already been forced to make some of these judgments and reveal them in their public filings. For private franchisor companies, the important thing is to begin thinking about the transition now.

The process must necessarily start with franchisor companies and their accountants. They must apply the NRRR to the franchise system and decide which goods or services provided by the franchisor are distinct and separable from the grant of the franchise right. The franchisor and its accountant must then put in place better systems to monitor and track the provision of these goods and services. In addition, prior to or immediately after the end of the fiscal year for which a franchisor must present its financial statements pursuant to the new rules, franchisors and their accountants must decide how they will present their financials for the previous two fiscal years (assuming a company has been operating that long).

At this stage the franchisor's attorneys should review the findings of its client and their accountants and then review the FDD, franchise agreement form, area development agreement form and other documents with those findings in mind. If the client and its accountants have concluded that some performance obligations of the franchisor are distinct within the meaning of the NRRR, the attorneys should consider revisions to the FDD and agreement forms to better describe those performance obligations. Caution is warranted, however, as we have discussed above. Describing performance obligations as wholly distinct may run the risk of implying that they do not consist of material that is proprietary to the franchisor.

It may be that franchisors and their auditors conclude that some pre-opening obligations consist of both distinct, non-proprietary aspects and some proprietary aspects that are part of the franchise right. For example, a franchisor may conclude that some parts of training (like janitorial procedures) are distinct and non-proprietary, while other parts of training involving trade secrets of the franchisor and are part of the franchise right. These analyses and judgment calls will not be easy, and the sooner that franchisors and their accountants and attorneys begin attacking them, the better.