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Franchisors: Be Aware of How New Revenue Recognition Standards Affect Your Business

In May 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued converging guidance on revenue in contracts with customers. In the U.S., the FASB issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The IASB's standard was issued as IFRS 15. Superseding virtually all existing revenue recognition guidance in U.S. GAAP, the new revenue recognition standard establishes an underlying core principle under which an entity recognizes 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.

One of the more significant developments from the changing accounting standards is the greater impact on emerging franchisors' net worth because of several state periodic registration requirements. Upfront consideration received that may not be immediately recognizable as revenue under the new standard will result in unearned revenue, a liability, which directly impacts the equity on the franchisor's balance sheet.

Which Areas of the New Revenue Recognition Standard Will Most Impact Franchisors?

The new standard has broad implications which can impact many areas of a franchisor's business, including expansion, how agreements are structured, financial regulatory reporting, and financial covenant compliance. Conversion to the new standard will present challenges to franchisors that are unique from other industries. This means that franchisors must take steps to identify and arrange the right resources to address the necessary changes under the new standard.

One of the most significant changes of Topic 606 relates to how a franchisor accounts for upfront or initial franchise fees. A customer's ability to derive benefit from a license of intellectual property depends on the entity continuing to maintain and support the intellectual property. Within a franchise agreement that includes the right to use the

franchisor's intellectual property (i.e., the license) is usually also included other promised goods or services that are highly interdependent on, or highly interrelated to, the license. As a result, under Topic 606, the license may need to be combined with other performance obligations that are associated with the upfront or initial franchise fees, and the franchisor would need to determine if the combined performance obligation is satisfied over time or at a point in time. Under Topic 606, if the customer simultaneously receives and consumes the benefit of a performance obligation as it is being delivered, then the performance obligation is delivered over time. Therefore, applying the new revenue recognition standard may result in a franchisor being required to recognize revenue over longer periods, such as the term of the franchise agreement. Under current practice, franchisors generally recognize revenue from upfront or initial franchise fees when the franchisor's initial obligations to the franchisee are met. This is typically when a franchisee's unit is opened.

Changing the recognition period for upfront fees may directly impact regulatory requirements when filing the Franchisor's Disclosure Document (FDD). As a result of the liability created from having more initial unearned revenue from upfront fees, lower working capital and net worth may impede the ability of an emerging franchisor to meet thresholds required by state agencies, which may result in the franchisor needing to fund additional working capital or have upfront fees impounded by the state in escrow. Those funds might then be unavailable for expenses associated with delivering the promises in the franchise agreement.

Recognizing revenue from marketing fees may also see significant changes under the new standards. There is currently diversity in practice in principal versus agent determination (gross versus net) in the receiving and spending of funds for marketing activities on behalf of franchisees. Using the criteria described by Topic 606 for determining if the franchisor is a principal or an agent, the franchisor would likely conclude that it is a principal, because the franchisor is primarily responsible

for providing the specified service (even if it directs a third party to fulfil on its behalf), and the franchisor is responsible for establishing the prices in the contract. Revenue from marketing fees would generally be recognized on a gross basis, rather than as an offset to advertising expenses.

Incremental Direct Costs to Enter Into a Franchise Agreement and Fulfill Such Agreement

Accounting Standards Update (ASU) 2014-09 also codified a new sub-topic in the accounting guidance for incremental direct costs of obtaining a contract (franchising agreement). These costs should be recognized as an asset if they would not have been incurred if the agreement was not executed. For franchisors, these costs to obtain a contract typically would include broker or sales commissions.

Certain costs incurred to fulfill a contract should be recognized as an asset under the new guidance if all of the following criteria are met:

- The costs relate directly to a contract or anticipated contract and can be specifically identified
- Costs generate or enhance resources that will be used in satisfying future obligations under the contract
- Costs are expected to be recovered

Examples might include payroll or materials that can be directly tied to fulfilling the agreement with the franchisee. Costs to obtain a contract and costs to fulfill a contract should 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. This would likely be over the term of the franchise agreement, commensurate with how the revenue is recognized.

Adoption

Assuming a calendar year end, a public company reporting under U.S. GAAP will be required to adopt on January 1, 2018. A non-public company will be required to adopt on January 1, 2019.

In the year of adoption, companies can select from the following two transition methods of reporting:

- **Full Retrospective Method:** Under this transition method, the new standard would be applied retrospectively to each prior reporting period presented with the cumulative effect of the change recorded in retained earnings as of the first day of the earliest period presented.
- **Modified Retrospective Method:** The new standard is applied under this transition method to all existing contracts as of the effective date or the adoption date and to all future contracts. The cumulative effect of initially applying the new standard is recognized in opening retained earnings in the year of adoption. Under this transition method, companies only need to consider the effects of applying the new standard to contracts that are not completed as of the new standard's effective date. Further, revenue for periods prior to the date the new standard is adopted will be presented under legacy U.S. GAAP.

Contact

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To discuss preparation for the new standard and how it may impact your business, please contact:

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