FASB FINANCIAL ACCOUNTING STANDARDS BOARD

MEMO

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Project	**Revenue Recognition**		
Project Stage	**Implementation**		
Issue	**Update on Implementation Activities for Franchise Industry**		

The following includes excerpts from a paper that was prepared for discussion by the Board at its November 29, 2017 Board meeting. It does not purport to represent the views of any individual members of the Board or staff. Comments on the application of GAAP do not purport to set out acceptable or unacceptable application of GAAP.

Memo Purpose

1. At its November 2017 Board meeting, the Board discussed an update on the status of revenue implementation. That meeting was a non-decision-making meeting. During that meeting, the Board discussed the technical inquiry process and key themes coming out of that process. One example that was discussed as part of the technical inquiry update related to implementation of the standard by franchisors. While the vast majority of franchisors that are public business entities have already adopted the new revenue standard as of the date of this memo, nonpublic business entities have until their 2019 annual reporting period to adopt the standard. The staff and Board continue to receive questions from this industry, in particular about the application of Step 2, Identifying Performance Obligations. Therefore, the FASB is making this content available for educational purposes.

Background

2. The FASB staff provides its Technical Inquiry Service to help stakeholders understand FASB standards. The objective of this service is to clarify existing guidance or provisions within the *FASB Accounting Standards Codification*®. While this process is not unique to the revenue project, the staff will describe revenue-related technical inquiries from the franchising industry in this section of the memo.

3. The staff continues to receive questions about areas of the guidance that require the application of 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, the staff has received several inquiries from stakeholders in the franchising industry with different facts and circumstances. This section of the memo summarizes the requirements of the new guidance. These requirements are then illustrated in the next section of the memo.

4. Before the adoption of the new revenue standard, under Topic 952, Franchisors, the initial franchise fee typically is recognized when the location opens. Because of the existence of industry-specific GAAP, franchisors historically have not had to assess whether pre-opening services are a separate deliverable. Under the new guidance, the franchisor determines if the pre-opening activities contain any distinct goods or services. The guidance on identifying performance obligations is included in paragraphs 606-10-25-14 through 25-22. The following is the guidance on determining whether goods or services are distinct.

> **606-10-25-19** A good or service that is promised to a customer is distinct if both of the following criteria are met:
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> 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).

5. The transaction price is then allocated to distinct performance obligations based on standalone selling prices.

> **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.

6. The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. Typically, 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. However, if a standalone selling price is not directly observable, an entity estimates the standalone selling price. The guidance does not prescribe any particular method for estimation but provides the following examples of estimation methods:

(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.

7. A sales-based royalty stream is recognized over time under the new standard, which is consistent with how entities account for sales-based or usage-based royalties today:

> **606-10-55-65** Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:
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> a. The subsequent sale or usage occurs.
> b. 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).

Example

8. Consider the following example:

(a) A franchisee enters into a 10-year arrangement with a franchisor to open a restaurant location. The consideration comprises a $25,000 upfront fee and a royalty of 4 percent of future sales.

(b) The franchise agreement grants the franchisee the right to use the franchisor's intellectual property.

(c) Before opening the restaurant, the franchisor will provide various services related to the opening, such as site selection and training.

Sales-Based Royalty

9. On the basis of the guidance in paragraph 606-10-55-65 (detailed above), the entity in the example does not estimate the royalties for the entire franchise period. The 4 percent royalty is allocated entirely to the license because the variable payment relates specifically to an outcome from the

performance obligation to transfer the license. As such, the entity records revenue related to the 4 percent royalty as the customer's subsequent sales occur.

Identifying Performance Obligations

10. When implementing the new revenue standard, the common question in the fact pattern above has been whether the $25,000 fee relates to a single performance obligation for the license of intellectual property, which must be spread over the 10-year term of the arrangement, or whether the entire $25,000 fee may be allocated to separate performance obligations associated with the activities of the location opening, which would be recognized up front consistent with current GAAP. Because the allocation of revenue depends on determining whether the goods or services are distinct (which some, all, or none may be), as well as determining the standalone selling price for each distinct good or service, the answer may differ from franchisor to franchisor.

11. If the franchisor determines that some or all of the pre-opening services are distinct, then it would recognize revenue when (or as) those services are performed (i.e., typically up front). In this example, the entity determines that the training services are distinct because they are not highly interrelated with the franchise license. In this case, the entity determines that the training is not highly brand specific and consists principally of training that could be relevant to the operations of a similar business or businesses in general. In this example, the entity also determines that the site selection services are distinct from the license because they are not specific to the brand and could be provided by a third party. Next, the entity would need to determine the standalone selling price of the services that are separate performance obligations and allocate the transaction price to them based on the standalone selling prices.

Allocation/Standalone Selling Prices (Scenario 1)

12. As described in the background section of this memo, the guidance does not prescribe a single method to determine standalone selling price. In applying the guidance on standalone selling price, the staff has considered how that analysis might be performed for training if it is considered a distinct performance obligation. The first step is to determine if the standalone selling price is observable (that is, the price charged if the entity provides any training services apart from the franchise license). For example, after the agreement for the franchise license, what would the franchisor charge to train new employees of the franchisee? Does the contract include a component of training for free for a minimal number of employees and then charge for additional employees (for example, free training for the first five employees but $X per additional employee)? If the entity does not have an observable standalone selling price for training, it might consider (a) the price that a third party typically charges for comparable education or (b) the cost of training plus an expected margin.

13. Consider that in this example a portion of the initial franchise fee, rather than the entire fee, is allocated to the pre-opening services (for example, $20,000). In this case, the entity determines that

allocating the fixed consideration related to the standalone selling price of the pre-opening services and allocating a portion of the initial franchise fee and sales-based royalty to the license is consistent with the allocation objective.

Allocation/Standalone Selling Prices (Scenario 2)

14. Assume that the example above is modified so that the standalone selling prices of the pre-opening services is $30,000. Therefore, the standalone selling price of the pre-opening services ($30,000) is greater than the amount of the initial franchise fee ($25,000). In this case, the entity would recognize the entire fee ($25,000) as the pre-opening services are performed because the guidance does not allow pulling forward a portion of the future sales-based royalty (because of the guidance in paragraph 606-10-55-65).

Summary

15. The example above illustrates the following key takeaways in this inquiry when implementing the revenue standard:

    (a) Topic 606 does not include presumptions about the number of performance obligations in an arrangement. For example, an entity may not presume that the initial franchise fee would always be recognized over the license term. The staff observes that this presumption is not included in the guidance.

    (b) When assessing the standard, entities should consider the facts and circumstances of their specific arrangements and not over-generalize. Franchise arrangements vary considerably. Whether pre-opening services are distinct will depend on "what" the franchisor is doing. That is, the franchisor should understand the nature of the services it is performing and whether some, none, or all of those service are distinct in order to come to an appropriate accounting conclusion.