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Franchisor Revenue Recognition Simplified

By Christopher F. Terrigino

In January 2021, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2021-02, *Franchisors – Revenue from Contracts with Customers Practical Expedient*. The purpose of this update is to simplify the application of ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, as it is applied to initial franchise fees paid by a franchisee to a franchisor. Let's explore the details and what this means for your franchisor company.

Before we look at the effect of the changes from ASU No. 2021-02, we need to understand the current accounting requirements. In 2014, FASB issued *Topic 606*, which became effective over time depending on the entity type, but was effective for all organizations by fiscal year 2019, which was meant to:

1. Remove inconsistencies and weaknesses in revenue requirements.
2. Provide a more robust framework for addressing revenue issues.
3. Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
4. Provide more useful information to users of financial statements through improved disclosure requirements.
5. Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

The requirements of *Topic 606* affect all entities that enter into contracts with customers to transfer goods, service, or non-financial assets (unless the contracts fall within the scope of other FASB standards). Implementing *Topic 606* requires an organization to recognize revenue to represent the transfer of goods or services in an amount that reflects the value the organization is entitled to. An analysis of the revenue is performed for each contract by applying the following procedures:

Step 1: Identify the contract(s) with a customer.

Step 2: Identify the performance obligations in the contract.

Step 3: Determine the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

The above steps would apply to the initial franchise fees paid to a franchisor. Following *Topic 606* would require the franchisor to determine whether the pre-opening activities contain any separate performance obligations and to analyze the standalone selling prices for those performance obligations to determine the timing and amount of revenue recognition. Since initial franchise fees are typically paid upfront to the franchisor and cover a wide variety of included services and rights, allocating the costs among the performance obligations could be a costly and time-consuming process.

ASU No. 2021-02 was issued to reduce the cost and complexity of implementing revenue recognition guidance under *Topic 606* to the pre-opening services provided by a franchisor. This was accomplished by the distinct provisions included in ASU No. 2021-02.

Exception

Before we explore further, it is important to understand that ASU No. 2021-02 does not apply to public business entities. A public business entity is defined as follows under FASB:

1. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

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2. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

3. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

4. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

5. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Application of ASU No. 2021-02

The first key provision of ASU No. 2021-02 allows a franchisor to adopt a practical expedient (i.e., shortcut) when following revenue recognition standards that allows for certain pre-opening services to be accounted for as distinct from the franchise license in a franchise agreement. These services are:

1. Assistance in the selection of a site.

2. Assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural, and engineering services, and lease negotiation.

3. Training of the franchisee's personnel or the franchisee.

4. Preparation and distribution of manuals and similar material concerning operations, administration, and recordkeeping.

5. Bookkeeping, information technology, and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate, and other taxes or about regulations affecting the franchisee's business.

6. Inspection, testing, and other quality control programs.

Being a franchisor, defined in ASC 952-10-20 as the party who grants business rights (the franchise) to the party (the franchisee) who will operate the franchised business, is required to qualify for use of the practical expedient.

The second key provision allows the franchisor to make an accounting policy election to treat the pre-opening services as a single performance obligation. This will result in all pre-opening costs being combined and recognized as revenue at the same time based on the franchisor recognition policy. An organization will now have only two performance obligations to consider: the franchise license and the pre-opening costs.

Implementation Example

A company enters a contract with a customer to grant a franchise license to open and operate a franchise store. The franchise license term is for 10 years. Additionally, under the contract terms, the company is responsible for assisting the customer in finding a store location, assisting in preparing the facilities, and training personnel. The company receives a payment of $50,000 from the customer when the contract is signed, plus the right to receive 6% of the customer's sales over the term of the agreement.

The first step would be to determine if the company is eligible to use the practical expedient for identifying the performance obligations. In our example, a franchise agreement was developed, the company is not a public business entity, and it qualifies as a franchisor, as defined earlier. At this point, the company qualifies to adopt the practical expedient.

Now the company needs to analyze its pre-opening activities and services and compare them to the list of services detailed in ASU No. 2021-02 above. In our example, all pre-opening services are considered to fall within the scope. Now the company must make an election to treat those services as distinct from the franchise license and as a single performance obligation. At this point, there are two identified performance obligations, and the initial fee of $50,000 would be allocated between them, based on the requirements of Topic 606 - Revenue from Contracts with Customers. The company determined that the pre-opening activities represent $40,000 of the initial fees received, which cover their costs, and are recognized when the new store opens. The remaining $10,000 was allocated to the license agreement and will be recognized over 10 years.

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If the initial contract offered a franchise agreement which covered multiple stores opening over a period of time, the application of ASU No. 2021-02 would be the same. The company will need to determine whether the initial fee related only to the first store opening or whether it covered all or a portion of the future stores. Additional fees may be received by the company as the store development begins. The allocation of the upfront fees to the performance obligations may change with a multiple store agreement, as there could be a reduction in pre-opening activities (such as training personnel) for stores opened after the first. This might result in a greater percentage of the fees being allocated to the license agreement.

Disclosure Requirements

The franchisor is required to disclose when they have elected to use the practical expedient and the accounting policy election to recognize the pre-opening activities as a single performance obligation. These disclosures would be made in the company's notes to their financial statements.

Conclusion

The amendments in ASU No. 2019-02 are effective in interim and annual periods beginning after December 15, 2020, and early application is permitted. If multiple periods are presented, these changes should be applied on a retrospective basis. It is expected that adoption of these changes will make the recordkeeping easier for nonpublic franchisors.

Are you a franchisor? One of your most important duties is to hire a qualified independent public accountant with the necessary experience and expertise to ensure that your company is getting the best advice available. Rivero, Gordimer & Company has been assisting organizations with their tax and accounting needs for over 35 years, and we want to assist you, too. For further information or assistance, contact Christopher F. Terrigino, call our office at 813-875-7774 to schedule a meeting, or visit our website.

About the Author:

Christopher F. Terrigino, CPA, Shareholder, Audit Team, has worked in public accounting since 1997 and has provided accounting, assurance, consulting, and litigation support services to clients in the technology, not-for-profit, construction, retail, and healthcare industries. Mr. Terrigino has also worked with many clients experiencing transitions such as significant growth and management turnover.

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