

NOVEMBER 14, 2018

For more information,
contact:

Kevin E. Manz

+1 212 556 2133

kmanz@kslaw.com

J.C. Boggs

+1 202 626 2383

jboggs@kslaw.com

Justin M. Riess

+1 704 503 2598

jriess@kslaw.com

Michael Urschel

+1 212 556 2285

murschel@kslaw.com

Ryan McNaughton

+1 212 556 2244

rmcnaughton@kslaw.com

Anthony Mechatie

+1 212 556 2104

amechcatie@kslaw.com

King & Spalding

New York

1185 Avenue of the Americas

New York, NY 10036

FASB Clarifies Revenue Recognition of Initial Franchise Fees (ASC 606)

This past Monday, November 5, 2018, the Financial Accounting Standards Board (“FASB”) published much-sought after [guidance](#) regarding the recognition of franchise fees under Accounting Standard Codification 606, *Revenue Recognition* (“ASC 606”). As clarified by the FASB, ASC 606 will not be interpreted to require the amortization of initial franchise fees, provided that such fees are “distinct” from the ongoing franchise license and relate to the activities of opening a new location. Instead, such initial franchise fees may be recognized up-front under GAAP (i.e., in the year in which start-up services are delivered). It is anticipated that this clarification will resolve one of the most prevalent ambiguities regarding the implementation of ASC 606 by franchise companies and present a significant benefit to the franchise restaurant community.

The FASB’s recent clarification is in connection with the broader implementation of ASC 606, which has generally been adopted by public companies during 2018 and will be adopted by private companies in 2019.

RESOLUTION OF ONE OF THE INDUSTRY’S MOST PREVALENT AMBIGUITIES UNDER ASC 606

Prior to this month’s clarification, many audit firms had concluded that ASC 606 required amortization of initial franchise fees over the life of the franchise. This treatment had the undesirable effect of decreasing net income in the first year of a franchise arrangement, despite the significant expenses incurred in connection with site selection, training, equipment and other common start-up expenses. This accounting treatment disproportionately impacted smaller franchisors who were unable to spread the accounting impact over a larger population of franchise arrangements. Further, this accounting treatment made valuation of franchise operations more difficult as the accounting treatment distorted the practical realities of the franchise model.

Under the clarified guidance, franchisors are now permitted to recognize income associated from initial franchise fees if the initial franchise fee is



“distinct” from the franchise license generally. A good or service is distinct if (i) the franchisee can benefit from the good or service either on its own or together with other resources that are readily available and (ii) the entity’s promise to transfer the good or service is separately identifiable from other promises in the contract (ASC 606-10-25-19). Typically within the restaurant franchise industry, a franchisor will charge a new franchisee an initial franchise fee of a set dollar amount and an ongoing royalty payment based on sales volume. At the same time, the franchise company will incur significant up-front expenses in order to prepare the new franchisee for operation. The FASB’s clarified guidance will give accounting effect to the practical realities of this business model and facilitate clearer and more accurate valuation with less accounting noise.

Materials at the FASB’s recent meeting described the ambiguity addressed by this clarifications as “one of the most prevalent questions from the franchising industry”.

FASB ALSO ADVISES CAUTION IN CLARIFICATION

While the FASB clarification memo recognizes that ASC 606 does not require a presumption that initial franchisee fees be amortized over time and identifies common instances in which up-front recognition is appropriate, it also cautions that “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.”

CONCLUSIONS

The FASB’s recent clarification regarding the recognition of revenue associated with initial franchise fees under ASC 606 will correct important misinterpretations of common franchise arrangements and allow franchise companies to present a clearer picture of their operations to investors and other stakeholders.

As with all accounting and legal determinations, care must be taken to apply guidance appropriately to varying facts and circumstances. Certain issues and considerations are beyond the scope of this brief alert; in the event your company requires legal advice on a financing or other corporate matter, please contact our team for additional information and guidance.

ABOUT KING & SPALDING

Celebrating more than 130 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 1,000 lawyers in 20 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality, and dedication to understanding the business and culture of its clients.

This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered “Attorney Advertising.”

ABU DHABI	CHICAGO	HOUSTON	NEW YORK	SILICON VALLEY
ATLANTA	DUBAI	LONDON	PARIS	SINGAPORE
AUSTIN	FRANKFURT	LOS ANGELES	RIYADH	TOKYO
CHARLOTTE	GENEVA	MOSCOW	SAN FRANCISCO	WASHINGTON, D.C.