

Financial Services

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FASB Proposes New "Practical Expedient" to Recognition of Initial Franchise Fees (ASC 606)

SUMMARY

On September 21, 2020, the Financial Accounting Standards Board ("FASB") announced a proposed Accounting Standards Update ("ASU"), that if enacted, would provide a "practical expedient", simplifying the analysis supporting the recognition of up-front franchise fee revenue under Accounting Standard Codification 606, Revenue Recognition ("ASC 606"). The new guidance would allow franchisors (other than public companies) to recognize revenue associated with up-front franchise fees, provided that the franchisor can demonstrate that such franchise fees relate to a pre-determined list of pre-opening services and such franchise fees are sufficient to cover the expenses of the pre-opening services plus a reasonable profit. The new guidance, if enacted, would reduce ambiguity around the appropriate accounting treatment of franchise fee revenue and will likely encourage earlier revenue recognition of up-front franchise fees.

BACKGROUND

Under current guidance, franchisors can declare revenue from start-up related franchise fees in the first year of the franchise if these costs are "distinct" from the franchise license itself. For a franchise fee to meet this definition, the franchisor must determine if any pre-opening activities in its franchise agreement constitute promised goods and services. They must then determine whether any of these goods and services qualify as a current performance obligation. Any current performance obligations may be accounted for up front, rather than over the life of the franchise license.

Such guidance has been criticized as requiring a costly and complex analysis, particularly for private start-up franchisors that are unable to spread the accounting impact over a larger population of franchise arrangements. Rather than engage in such analysis and invite ambiguity into their revenue recognition regimes, many advisors interpreted ASC 606 to require de facto amortization of initial franchise fee revenue over the life of the franchise. This has historically resulted in decreased net income



with respect in the first year of franchise arrangements, despite the significant expenses incurred in connection with start-up.

In the proposed September 2020 guidance, the FASB seeks to streamline the complicated ASC 606 analysis by introducing a new “practical expedient” that would simplify the process of identifying performance obligations. The practical expedient would permit non-public, privately held franchisors to label qualifying pre-opening services as a single performance obligation so long as (i) the services fall within a predefined list and (ii) it is probable that the continuing fees in the licensing arrangement are sufficient to cover the franchisor’s continuing costs plus a reasonable profit. The result allows private franchisors to account for certain pre-opening services up front while avoiding the unnecessary expenses involved with making these determinations.

Under the proposed guidance, the predefined list of pre-opening services includes:

- Assistance in the selection of a site;
- Assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural, and engineering services, and lease negotiation;
- Training of the franchisee’s personnel or the franchisee;
- Preparation and distribution of manuals and similar material concerning operations, administration, and record keeping;
- 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 local regulations affecting the franchisee’s business;
- Inspection, testing, and other quality control programs.

The proposed guidance would not be applied to public companies. The FASB chose to limit its guidance as public companies previously adopted ASC 606 without issue and have not raised any questions about its application to date.

TIMING AND MORE INFORMATION

The FASB is inviting comments on the proposed amendment until November 5, 2020

For more information on the proposed amendment and a complete list of questions for respondents, please visit the [following link](#). King & Spalding will continue to monitor developments in ASC 606 and their impact on our current and prospective clients.



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