



Revenue for franchisors

New standard.
New challenges.

US GAAP

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Revenue viewed through a new lens

Again and again, we are asked what's changed under the new standard: what do I need to tweak in my existing accounting policies for revenue? It's just not that simple.

The new standard introduces a core principle that requires companies to evaluate their transactions in a new way. It requires more judgment and estimation than today's accounting and provides new guidance to determine the units of account in a customer contract. The transfer of control of the goods or services to the customer drives the amount

and pattern of revenue recognition; this is a change from the existing risks and rewards model. As a result, there will be circumstances in which there will be a change in the amount and timing of revenue recognition.

Less has been said about disclosures, but the new standard requires extensive new disclosures.

Read this to understand *some* of the most significant issues for franchisors.

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Franchise right

A franchise arrangement is the license of symbolic intellectual property. Consideration other than sales-based royalties is usually recognized on a straight-line basis over the term of the arrangement.

The new standard supersedes the existing revenue guidance for franchisors in Subtopic 952-605 and introduces an entirely new accounting model.

The primary good or service transferred in a franchise agreement is usually the franchise right. The franchise right typically includes use of the name, trademarks and proprietary methods. Under the new standard, franchise rights are considered symbolic IP. Revenue from licenses of symbolic IP is recognized over time using a measure of progress that reflects the franchisor's pattern of performance (see [Licensing of intellectual property](#)).

In general, the franchisor's performance occurs evenly over the term of the contract, meaning that revenue attributed to the franchise right is usually recognized on a straight-line basis, except for:

- sales-based royalties, because of the sales-based royalty exception (see [Sales-based royalties](#)); and
- revenue allocated to goods and services distinct from the franchise right (see [Performance obligations](#)).

Sales-based royalties

Sales-based royalties are recognized when franchisee sales occur. Royalty reporting on a lag basis is not permissible.

Franchisors typically earn sales-based royalties as part of the consideration for the franchise right. The new revenue standard requires variable consideration to be estimated (see [Step 3](#)). There is however an exception to this requirement for sales-based royalties related to licenses of IP.

For sales-based royalties, a franchisor recognizes revenue at the later of:

- when the subsequent sales occur; or
- on the satisfaction or partial satisfaction of the performance obligation to which the royalty relates.

In most circumstances, sales-based royalties are recognized as earned, similar to current practice. However, exceptions may arise, for example, if the royalty is also promised in exchange for other goods or services (see [Allocating the transaction price](#)). In addition, any guaranteed royalties (e.g. a fixed minimum amount) are recognized in the same manner as any other fixed consideration in the contract (see [Franchise right](#)).

Determining if the sales-based royalty exception applies

The sales-based royalty exception applies either when the royalties relate only to a distinct license of IP or when the license is the predominant item to which the royalty relates.

When the franchise right is *not* the only performance obligation (see [Performance obligations](#)) in the arrangement, we expect most franchisors to conclude that the franchise right is the predominant item to which the royalty relates. This is because the franchisee would ascribe significantly more value to the franchise right than to the other goods or services to which the royalty relates. In this case, the exception would still apply to the entire sales-based royalty.

Royalty reporting on a lag is not permissible

Under current US GAAP, some franchisors recognize sales-based royalties on a lag basis – i.e. they recognize revenue in the period subsequent to that in which the sales occur. This is because they do not receive reporting about the royalties that the franchisee owes until the subsequent period.

Under the new standard, lag reporting is not permitted. If the franchise location sales are not known at the reporting period close, they need to be estimated using a most-likely-amount or expected-value method; that amount is recognized as revenue for the period. The franchisor trues up the difference between the estimate and actual royalties earned in the subsequent period.

Performance obligations



The unit of account in a franchise arrangement may differ from that under current US GAAP.

Under the new standard, a franchisor accounts for the performance obligations in the contract – i.e. the performance obligation is the unit of account for revenue recognition. Franchisors often provide to their franchisees goods or services ancillary to the franchise right, and may charge for those separately.

Generally, advertising services are not separate performance obligations (see [Advertising funds](#)). Other goods or services – e.g. pre-opening activities (see [Up-front fees, activities and costs](#)), training, ongoing support services, purchasing services or sale of equipment (see [Other franchise support activities](#)) – require specific analysis in order to reach a conclusion as to whether they represent separate performance obligations.

Assessing whether these goods or services are performance obligations is key

If the goods or services are separate performance obligations, the franchisor allocates revenue among those and the franchise right (see [Allocating the transaction price](#)). This may affect the timing of recognition, presentation and disclosures.

If the goods or services are not separate performance obligations, any amount charged for those goods or services is deemed to relate to the franchise right. This means that related revenue will likely be recognized on a straight-line basis unless it is in the form of a sales-based royalty.

Identifying performance obligations

To determine the performance obligations in a contract, a franchisor first identifies the promised goods or services in the contract. It then determines whether they are distinct.

Promised goods or services do not include administrative or other activities that a franchisor undertakes to set up a contract; for example, certain pre-opening activities might not transfer a promised good or service to the customer. Judgment is required in some cases to distinguish promised goods or services from administrative tasks (see [Up-front fees, activities and costs](#)).

Under the new standard, two or more goods or services (e.g. the franchise right and equipment sold to the franchisee) are distinct from each other, and therefore separate performance obligations, when they are not in effect inputs to a single combined item that is the output of the contract.

In making this determination, a franchisor considers factors such as whether:

- it is providing a significant integration service – i.e. using its expertise to create a combined output using the promised goods or services as inputs;
- one good or service significantly modifies or customizes the other; and/or
- the goods or services are highly dependent on, or highly interrelated with, each other.

Among the factors to consider, the following may indicate that a good or service is distinct from a franchise right (although not a requirement):

- the good or service is optional; and
- the good or service could be purchased from a third party.

The practical consequences of applying these separation criteria to franchise agreements are further explored in the following sections.

Up-front fees, activities and costs



Most up-front activities are not distinct from the franchise right. Up-front fees will generally be recognized on a straight-line basis over the contract duration. Up-front costs will generally be expensed as incurred.

Individual franchise sales

Franchisors often perform pre-opening activities related to a new franchise location. These include assistance with and approval of site selection, providing access to a copy of approved architectural plans and to the franchisor's operating manual, training for a limited number of the franchisee's employees, and on-site pre-opening assistance from franchisor personnel. Franchisors commonly charge a nonrefundable up-front fee for each new franchise location in addition to the ongoing sales-based royalties received over the term of the franchise agreement.

Under current US GAAP, the up-front franchise fee is recognized as revenue when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor. This is often when the location commences operations.

Under the new standard, up-front payments are part of the consideration received for the contract with the franchisee. In order to determine the pattern and timing of revenue recognition, franchisors need to evaluate whether each pre-opening activity represents a performance obligation (see [Performance obligations](#)) to which some portion of the transaction price should be allocated. We expect that most pre-opening activities are either administrative activities or services highly interrelated with the franchise right. In such cases, a significant portion or all of the up-front fee will usually be recognized as revenue on a straight-line basis over the term of the franchise agreement.

Some judgment may be required to determine the point from which the franchisee can begin to use and benefit from the license depending on the facts and circumstances, which include the specific terms of the contract. Generally, we would expect this date to be the date when the store commences operations, but franchisors may also need to consider alternatives, such as the date the contract is signed or the date a restaurant is ready for use (if different from the commencement of operations).

Example – Pre-opening activities

Franchisor enters into a 20-year franchise agreement with Franchisee, its customer. Franchisor charges Franchisee a nonrefundable up-front fee of \$20,000. Pre-opening activities by Franchisor include providing Franchisee with copies of architectural plans and access to the operating manual, and on-site pre-opening assistance from Franchisor's personnel.

Franchisor determines that the pre-opening activities do not represent distinct goods or services transferred to Franchisee. These activities are inputs to a combined output that Franchisee is contracting to receive (ability to operate a franchise location).

For example, copies of architectural plans and operating manual are part of Franchisor's IP, and cannot legally or practically be used without access to the trade name and logo contained in the franchise right. Operational assistance is unique to Franchisor's business model and standards, and is therefore highly interrelated with the franchise brand.

Consequently, Franchisor concludes that the \$20,000 up-front fee should be recognized as revenue over the term of the franchise agreement (i.e. straight-line over 20 years).

Area Development Agreements

Some franchisors enter into arrangements within a new territory or country, commonly called Area Development Agreements or Master Franchise Agreements (collectively referred to as ADAs). An ADA typically:

- grants rights to one franchisee, the master franchisee, to open locations in a defined area;
- requires a minimum number of openings, and may specify their timing;
- defines the exclusivity period, during which no other franchisee can operate in that area;
- requires the master franchisee to pay a nonrefundable up-front fee upon signing the ADA;

- may authorize the master franchisee to sub-franchise the opening and operation of the franchise locations in the area.

For each individual location opened under the ADA, a separate franchise agreement is then executed and up-front fees and pre-opening services may be similar to other non-ADA locations (see [Individual franchise sales](#)).

Under current US GAAP, area development fees are typically allocated on a pro rata basis over the number of locations required or estimated in the ADA, and recognized as revenue as those locations commence operations.

Under the new standard, franchisors need to identify what goods or services are promised to the customer (the master franchisee) and how the customer benefits from those goods or services. This evaluation is key to determining the pattern and timing of revenue recognition for the ADA fee. The nature of the performance obligation can also vary, depending on facts and circumstances.

A franchisor may determine that the ADA transfers a license of symbolic IP to the master franchisee upon entering into the ADA. This may be the case, for example, if the master franchisee has an exclusive right to sub-franchise the opening and operation of an unlimited number of locations in the area. This may indicate that, upon entering into the ADA, the master franchisee can use and benefit from the symbolic license that has been transferred. In this scenario, the franchisor would likely recognize the up-front fee on a straight-line basis over the term of the ADA agreement. More judgment may be required if the exclusivity period is shorter than the ADA duration.

In other circumstances, a franchisor may determine that the master franchisee cannot benefit from the exclusivity on its own, until a location opens. Rather, the agreement conveys rights to open a certain number of locations. Because the exclusivity prevents other franchisees from operating in a particular geographic area, it may affect the value of those rights. In this scenario, the up-front fee would be allocated to each material right to open a location. The right is exercised when the individual franchise agreement is executed, for each location. The exercise of each right may be treated as:

- **a continuation of the original contract.** The amount allocated to the material right would be added to the transaction price for the individual franchise agreement. It is then recognized over the term of that agreement, similar to individual franchise up-front fees, unless the franchise agreement includes other distinct performance obligations to which some transaction price should be allocated; or
- **a contract modification** (see [Franchise contract modifications](#)). The franchisor would then assess whether the additional goods and services are distinct and priced at their stand-alone selling price. This could potentially result in reallocating the transaction price in the contract to the remaining performance obligations.

The particular facts and circumstances of the arrangement have to be considered in arriving at an accounting treatment.

Example – Area Development Agreement

Franchisor enters into an ADA with Franchisee, its customer, with the following terms.

- Exclusivity to a defined area for 10 years.
- Franchisee must open 200 locations within 10 years.
- Nonrefundable up-front fee of \$2 million.

The ADA states that each location will be opened with the standard franchise agreement used at all franchise locations, which includes a franchise right for 20 years, a sales-based royalty fee, a separate up-front fee of \$20,000 and certain pre-opening activities by Franchisor.

Franchisor does not identify any goods or services provided to Franchisee that are distinct from the franchise right.

Franchisor analyzes that Franchisee does not benefit from the ADA until a location is open. Each of the 200 franchise locations is a contract for the license of IP (a franchise right). The exclusivity provided by the ADA represents an attribute of each franchise right. The ADA is not a contract under the new standard because no goods or services are committed by Franchisor. The nonrefundable up-front area development fee of \$2 million is allocated to the 200 locations. Assuming all rights have the same stand-alone selling price, this means \$10,000 is allocated to each location.

Because the franchise right is determined to be the only performance obligation in each franchise agreement, the total up-front fee of \$30,000 (\$10,000 + \$20,000) for each location is recognized over the term of each franchise agreement.

Up-front costs

Up-front costs are those incurred by the franchisor at the commencement of the franchise relationship to establish and prepare to service the relationship on an ongoing basis.

Under current US GAAP, up-front costs are generally expensed as incurred, which is not expected to change under the new standard.

The new standard requires costs incurred to fulfill a contract (or anticipated contract) with a customer to be recognized as an asset and amortized when certain criteria are met (see [Contract costs](#)).

However, this new guidance only applies to those costs that are not already in the scope of other guidance. Also, general and administrative costs are not eligible for capitalization, unless explicitly chargeable under the contract.

We expect that many up-front costs incurred by franchisors will be either administrative in nature or in the scope of Subtopic 720-15. Subtopic 720-15 requires costs relating to start-up activities, such as pre-opening costs related to a new facility, to be expensed as incurred.

Advertising funds



Franchisors will generally present advertising contributions from franchisees as revenue. The recognition of contributions and advertising expenditures may also be affected.

Franchisors usually control brand marketing and advertising for all locations (company-owned and franchise), with the franchisor holding final decision-making authority on the timing and nature of spending. Often a separate legal entity or fund is established (advertising fund) to handle contributions and spending and is consolidated by the franchisor. Franchise agreements typically require franchisees to contribute a percentage of their sales to the fund and the franchisor to spend all amounts collected for the specified purpose (i.e. advertising).

Under current US GAAP, franchisors report advertising contributions collected from franchisees as a net reduction to advertising expenses. This is because the arrangement is considered similar to an agency relationship under which the contribution is required to be used for a specified purpose. It also follows that many franchisors do not report income or expense when the advertising fund is under- or over-spent at the reporting date.

Under the new standard, advertising contributions are reported gross as part of revenue. This is because amounts paid to the advertising fund are usually not for distinct goods and services that can be separated from the symbolic IP franchise right, thereby changing the accounting for contributions received and amounts paid.

The following discussion assumes that the advertising fund is consolidated by the franchisor.

Evaluating whether advertising is a separate performance obligation

Franchisors first need to determine whether advertising services are separable from the franchise right (see [Performance obligations](#)).

Advertising services that promote the brand (rather than an individual location), such as national advertising campaigns, are not separable between different franchise agreements or franchisees, and not distinct because the services and franchise right are highly dependent and interrelated with each other.

Other advertising services may be separable and distinct from the franchise right if the advertising provides a distinct benefit to an individual franchisee and is not highly interdependent on or interrelated to the franchise right. For example, location or regional advertising that is exclusive to one franchisee under an ADA may be separate and distinct.

Franchisors need to exercise judgment to determine what advertising campaigns may be considered a separate service to the franchisee. In general, we would expect most advertising activities to support the brand rather than individual franchisee locations.

Accounting for advertising contributions when advertising is not a separate performance obligation

If advertising services are not distinct, the advertising contributions are considered part of the transaction price for the franchise right. It follows that advertising contributions and expenditures are presented gross in the income statement. The timing of revenue recognition depends on the nature of the fee.

- **Fixed advertising fee.** Because the franchise right is a license of symbolic IP with an over-time recognition model, fixed fees will likely be recognized on a straight-line basis over the franchise duration (see [Franchise right](#)).
- **Sales-based advertising fee.** The sales-based royalty exception applies and contributions are recognized as the underlying sales occur, unless the royalty does not reflect performance (see [Sales-based royalties](#)).

Example – Advertising fund

Franchisor enters into a franchise agreement with Franchisee to operate a location for 20 years. The franchise agreement includes the following terms related to sales-based royalties and advertising.

- Royalty of 5% of gross monthly sales for use of Franchisor’s trademark.
- Advertising contribution of 2% of gross monthly sales.
- Franchisor must use the advertising contribution for market research, developing advertising and sales promotions, public relations and/or the delivery of advertising or promotional messages.

Franchisor has a separate Advertising Fund, which is controlled by Franchisor and consolidated in its financial statements, to handle receipts and spending.

Because Franchisor performs marketing and advertising activities for the benefit of all franchisees, it is not performing a service for an individual franchisee in the context of an individual franchise agreement.

Therefore, Franchisor determines that the marketing and advertising activities do not represent a separate performance obligation, but are part of the overall obligation to undertake activities to enhance the franchise brand.

Assuming no other distinct performance obligations are identified, Franchisor records revenue on the entire 7% sales-based royalty in accordance with the royalty exception (when the franchisee sales occur), regardless of the stated purpose or contractual use of those amounts.

Franchisor recognizes marketing and advertising expenses in accordance with Subtopic 720-35, as further explained here.

Matching of advertising contributions and expenses

At any point in time, the advertising fund may be over-spent (advertising expenses exceed related contributions) or underspent (advertising contributions exceed related expenses).

Under current US GAAP, most franchisors do not recognize the effects of this mismatch in income and expense.

The new standard supports neither accelerating revenue to match expenses incurred, nor deferring revenue until advertising costs are recognized. Franchisors therefore need to determine if their accounting for the related costs allows or requires accruing or deferring advertising expenses up to contributions received.

The guidance on interim reporting may support a policy where advertising expenses are accrued based on the annual budgeted spend (i.e. a percentage of sales) or deferred beyond the interim period in which the expenditure is made.

In the annual financial statements, however, the general guidance on advertising costs applies. Advertising costs are expensed either as incurred or the first time the advertising takes place. Therefore:

- When the advertising fund is over-spent at year-end, advertising expenses are reported in the income statement in an amount that is greater than the revenue recorded for advertising contributions. In other words, advertising expenses cannot be deferred beyond the date the advertising first appears or beyond the date the costs are incurred depending on the franchisor’s accounting policy.
- Conversely, when the fund is under-spent at year-end, advertising costs incurred are less than the revenue recorded for advertising contributions. When the franchisor is contractually required to spend on advertising costs within the scope of ASC Subtopic 720-35, we believe franchisors can either (1) apply the guidance on cooperative advertising¹ by analogy to accrue those costs, or (2) expense the advertising costs in accordance with their normal policy. However, the analogy to cooperative advertising does not apply when the franchisor has discretion on its spending such that it may be able to spend some of the funds on costs that are not in the scope of ASC Subtopic 720-35.

Franchisors may also need to rethink how they account for advertising contributions committed to the fund and expenses incurred on behalf of company-owned locations, particularly those where the contractual requirements as to the type of costs to be funded by the advertising fund are broad or not clear.

1. The guidance on cooperative advertising was formerly in SOP 93-7, paragraph 27. Once ASU 2016-19, *Technical Corrections and Improvements*, becomes effective together with the new revenue standard, this guidance will be codified in paragraph 720-35-25-1A.

Other franchise support activities



Some franchise support activities, even at a zero profit margin, may need to be reported as revenue.

In addition to marketing and advertising, franchisors often provide other ongoing support activities to franchisees, including payroll, vendor selection, centralized systems (such as point-of-sale or reservations systems), equipment and/or inventory procurement. Some franchise agreements require the franchisee to pay separate fees for these goods or services, which may be optional or mandatory purchases under the terms of the agreement.

Under current US GAAP, revenues for these activities are generally recognized when earned. Zero or low margin activities are often presented net, considering this characteristic to indicate that the franchisor is acting as an agent on behalf of the franchisee.

Assessing if the activity is a performance obligation

Under the new standard, the first step in the analysis is to determine if the support activities are separate performance obligations (see [Performance obligations](#)). The analysis is based on the same guidance used to analyze whether pre-opening services are separate performance obligations (see [Up-front fees, activities and costs](#)).

Support activities may be offered by the franchisor at low or zero profit. This characteristic is not relevant to determine whether the activity is distinct from the franchise right. However, when concluding that the activity is distinct, this may further complicate the allocation of the transaction price between the franchise right and the activity. For example, a franchisor providing inventory procurement at zero margin would need to determine the stand-alone selling price for that service. This may require allocating revenue from the

franchise right to other revenue streams, potentially affecting the presentation and/or timing of revenue recognition (see [Allocating the transaction price](#)).

Principal vs. agent considerations

In certain franchise support activities, such as inventory or equipment procurement, a third party may be involved in providing the goods or services to the franchisee. If these activities represent a distinct performance obligation of the franchisor, the franchisor also applies the principal versus agent guidance in the new standard to determine if the performance obligations should be presented gross or net.

Current US GAAP (paragraph 925-605-25-16) requires net reporting by a franchisor acting as an agent for franchisees by placing orders for inventory and equipment and selling those items to franchisees at no profit. The usual principal versus agent indicators in Subtopic 605-45 are not relevant.

This guidance is superseded by the new standard and all such transactions are subject to the principal versus agent analysis. The new guidance emphasizes the transfer of control such that if the franchisor controls the use of the specified goods or services before their transfer to the franchisee, the franchisor qualifies as principal. This may further complicate the allocation of the transaction price if the contract contains multiple performance obligations, for some of which (e.g. the license of IP) the franchisor is the principal and for others (e.g. purchasing services) an agent.

Example – Inventory procurement

Franchisor uses a standard franchise agreement that includes the following terms related to inventory procurement.

Franchisor...

- Negotiates a master purchase agreement (MPA) with a third-party vendor to provide certain inventory items to all company-owned and franchise locations of the brand.
- Centrally controls ordering inventory under the MPA and manages the shipping and handling.
- Takes legal title of the inventory, holds it at company-owned or third-party storage facilities (typically for a few days), and contracts with a logistics company to have it delivered from storage facilities to store locations as needed.
- Charges Franchisee its cost per the MPA, plus direct storage, shipping and handling costs, plus a nominal amount (about 0.5% of cost) to cover part of the overhead costs of administering the central purchasing program.
- Bears the risk of loss or damage while inventory is in its possession.
- Is responsible for negotiating resolution of any inventory quality issues directly with the vendor. Franchisee compensation is limited to what Franchisor can obtain from the vendor.

Franchisee...

- Is required to purchase inventory through the MPA.
- Has no contractual relationship with the vendor and does not receive invoices from the vendor.
- Submits a forecast of volume needs each month to assist in determining purchase orders to be submitted for the brand.
- Can be charged for forecasted volume in excess of actual orders based on a formula in the contract, if there is excess inventory that cannot be redirected to other locations. However, the shelf life of these inventory items is much longer than the normal inventory turnover cycle and this happens very rarely.

Franchisor assesses the inventory procurement service to be distinct from the franchise right and any other performance obligations in the contract. This is because Franchisee could contract with a third party to perform these activities, could benefit from them on their own, the activities are not customized or modified by any other goods or services in the contract (or vice versa), and the activities are not highly interdependent or interrelated with the franchise right or any other goods or services in the contract.

Franchisor applies the principal versus agent guidance in the new revenue standard and determines that it controls the inventory items before control transfers to Franchisee. This is because Franchisor can direct the use of the items – e.g. it can direct to which franchisee the items will be shipped.

This is further confirmed by the following indicators:

- Franchisor has discretion to establish prices for the inventory because the vendor has not dictated in the MPA what Franchisor can charge Franchisee.
- Franchisor has inventory risk because it takes legal title and physical possession of the inventory before selling it on to Franchisee. The provision for charging Franchisee for excess inventory and limiting compensation for quality problems is merely Franchisor's method for mitigating that inventory risk.
- Franchisor has primary responsibility to provide the inventory to Franchisee because it holds the contractual relationship with the vendor and a separate contractual obligation to provide inventory to Franchisee.

Franchisor therefore determines it is a principal in the inventory transactions and presents the amount allocated to this performance obligation (which could be different from the payments received from Franchisee) as revenue, gross of the costs incurred.

In addition to the principal versus agent considerations, Franchisor will need to consider whether the contract contains a material right (to acquire goods at favorable pricing) to which a portion of the up-front fee must be allocated. For further discussion on transaction price allocation consequences, see [Allocating the transaction price](#).

Allocating the transaction price

price



Sales-based royalties may need to be allocated between the franchise right and other performance obligations in the contract for disclosure purposes.

Under the new standard, the transaction price is allocated to the performance obligations in a contract based on their relative stand-alone selling price. Given the typical sales-based royalty structure of franchise arrangements, applying the allocation guidance can be challenging when the contract contains goods and services that are distinct from the franchise right.

First, the franchisor needs to assess whether the franchise right is the predominant item in the arrangement.

— **The franchise right is the predominant item.** We believe this is the most common scenario. In this case, the sales-based royalty exception applies and the royalty does not need to be estimated at contract inception. However, an allocation exercise may be subsequently required, as the royalty is earned, either for recognition or disclosure purposes.

For example, if the franchisor transfers up-front goods or services distinct from the franchise right, the amount of revenue allocated to the up-front performance obligations is initially limited to any up-front fee received by the franchisor. As the sales-based royalty is being earned, an allocation between the franchise right and other goods or services may be needed to disclose disaggregated revenue by nature.

Alternatively, if the franchisor transfers goods or services distinct from the franchise right later in the contract, those performance obligations may be satisfied after the sales-based royalty is earned. This situation may require that a portion of the sales-based royalty be deferred and recognized when control of the distinct performance obligation is transferred.

— **The franchise right is not the predominant item.** The total transaction price for the franchise agreement is estimated using the variable consideration guidance and allocated between the franchise right and any other distinct good or service, at contract inception.

The franchisor should not split a royalty into a portion that needs to be estimated and one that does not.

Next, the franchisor estimates the stand-alone selling price of the distinct good or service and of the franchise right. When a distinct good or service is separately priced in the franchise arrangement, it should not be assumed that the stated price is necessarily reflective of the stand-alone selling price of that good or service. However, if this is the case, and the franchise royalty rate is also reflective of the stand-alone selling price terms, then the stated price can generally be entirely allocated to the distinct good or service.

Similarly, judgment is required to estimate the stand-alone selling price of the franchise right. For example, it may be acceptable to charge a lower royalty rate in a geographical zone where the franchise brand name is starting to develop compared to another zone where it is well established. Conversely, a franchise arrangement where no sales-based royalty is charged would likely indicate that the franchise right is not priced at stand-alone selling price. This may be the case, for example, when the franchisor derives compensation for the franchise right through other means such as charging a higher fee for procurement services to franchisees.

Example – Allocation of transaction price to up-front services

Franchisor enters into a 10-year franchise agreement with Franchisee, its customer. Franchisor charges Franchisee the following.

- A sales-based royalty of 3%; this rate is comparable to that charged to other locations in this region.
- An up-front fee of \$10,000 for providing a three-day accounting training to Franchisee's personnel; this fee is comparable to what Franchisor charges other franchisees for similar services. Franchisor has determined that the training services are distinct from the franchise right because Franchisee can opt out from those services, the accounting training is proposed by Franchisor to all franchisees twice a year and could be provided by a third party, and it does not transform the franchise right.

Franchisor determines that the franchise right is the predominant item in the arrangement because Franchisee would ascribe significantly more value to the franchise right than to the training services. Therefore, the royalty does not need to be estimated and allocated to the training services at contract inception.

Because both the franchise right and the training services are priced at their stand-alone selling price, Franchisor recognizes the \$10,000 up-front fee as the training services transfer to Franchisee.

Example – Allocation of transaction price to procurement services

This example continues the inventory procurement example on [page 9](#).

Franchisor provides inventory procurement services and product sales at cost plus a minimal margin to Franchisee. The margin is designed to cover overhead costs rather than create a profit for Franchisor.

Franchisor has concluded that the inventory procurement services and product sales are distinct from the franchise right and that the related revenue forms part of the total contract transaction price and should be presented on a gross basis in the income statement. Therefore, Franchisor needs to allocate the transaction price to the performance obligations in the contract.

Franchisor first determines that the franchise right is the predominant item in the arrangement. This is because Franchisee would ascribe significantly more value to the franchise right than to the procurement service and product sales.

Franchisor can observe stand-alone wholesaler-to-retailer selling prices for the inventory, which are higher than the pricing charged to franchisees given the minimal margin.

In this case, Franchisor concludes that the ability to purchase goods at favorable pricing creates a material right, to which a portion of the up-front fee must be allocated. Franchisor also concludes that the pattern of usage of that material right is substantially the same as the pattern of usage of the franchise right; accordingly, the amount allocated to the material right is recognized in the same manner as the amount allocated to the franchise right.

The only other performance obligation is the franchise right for which a sales-based royalty is charged. Therefore, part of the royalty is determined to relate to the inventory procurement service performance obligation.

In this example, because the franchise right is the predominant item to which the royalty relates, Franchisor can continue to apply the sales-based royalty exception to estimating variable consideration. However, for income statement classification and/or disclosure purposes, Franchisor may need to allocate a portion of royalties received each period to the inventory sales to report an amount that represents its allocated stand-alone selling price.

End customer sales incentives

Revenue typically needs to be deferred for loyalty programs and gift cards. Franchisors acting as incentive program administrators may face additional accounting issues.

Loyalty programs

Many franchisors administer system-wide loyalty programs whereby points and/or discounts may be earned and redeemed by end customers at any combination of company-owned and franchise locations. Franchisees typically remit cash to the franchisor as the points are earned at the franchise location, and report redemptions each period for reimbursement by the franchisor. Some franchisors may also charge separate fees for administering the program.

Loyalty programs provide the end customer with a material right via the promise of a future good or service or discount that the customer would not have received had they not entered into the contract (i.e. the sales transaction). Therefore, the loyalty program creates a performance obligation separate from the initial sale. Revenue should be allocated to the material right and recognized when the points/discounts are redeemed or expire. For purposes of allocating the transaction price, the stand-alone selling price of the material right must be estimated. This estimate is usually calculated as the value of the points/discount multiplied by the probability of redemption.

Gift card programs

Many franchise systems sell gift cards to end customers, which may be purchased and redeemed at any combination of company-owned and franchise locations. The program

is administered by the franchisor, and the proceeds and obligations belong to the franchisor. Franchisees remit cash received for sale of gift cards as they are activated, and report redemptions each period for reimbursement by the franchisor.

Certain gift card obligations are financial liabilities outside the scope of the new revenue standard because they are redeemed at a third-party merchant (franchise location). However, these cards would be in the scope of ASU 2016-04², which prescribes the same recognition for breakage as the new revenue standard. Therefore, franchisors track and recognize gift card breakage the same regardless of where a gift card is sold or redeemed within the franchise system.

Presentation in the income statement

Fees earned from administering incentives programs for the system, either directly (fees paid by the franchisees) or indirectly (unredeemed points or gift card breakage), are presented as revenue.

In some arrangements, gift card breakage may need to be contributed to the advertising fund (either by contractual obligation or standard practice). However, when the fund is consolidated by the franchisor, this additional contribution should not be recorded as a reduction of advertising expense, for the same reasons discussed in the [Advertising funds](#) section.

2. ASU 2016-04, *Recognition of Breakage for Certain Prepaid Stored-Value Products* (a consensus of the FASB Emerging Issues Task Force).

Franchise contract modifications

Franchise renewals and transfers may impact the accounting of the unamortized portion of the initial up-front fee.

Franchise arrangements are frequently modified, for example renewed or transferred to another franchisee.



Under current US GAAP, these modifications are accounted for prospectively with no immediate accounting consequences.

The new standard defines a contract modification as a change in price or scope. One general accounting framework applies to all contract modifications. In franchise arrangements, goods and services before the modification are usually distinct from those transferred after. Therefore, franchise contract modifications are usually treated prospectively, similar to current US GAAP. However, because franchise up-front fees are typically deferred under the new standard (see [Up-front fees, activities and costs](#)), their initial accounting may be affected by the modification. Franchisors need to carefully analyze their facts and circumstances in order to determine the appropriate accounting treatment of the unamortized up-front fee – e.g. immediate recognition in revenue, prospective revision of the amortization period or continuation of previous accounting.

Some typical franchise arrangements modifications are further explored here.

Change of contract terms with the same franchisee

Franchise contract modifications may increase the scope of the contract by adding distinct goods or services – e.g. extension of the franchise term with or without a renewal fee, additional locations added to an ADA. These modifications are accounted for prospectively in one of two ways, depending on whether the additional goods or services are priced at their stand-alone selling price.

| Additional goods or services priced at their stand-alone selling price? | Modification treated as: | Accounting consequences |
|---|--|--|
|  | Creation of a new contract | <p>The accounting for the existing contract is untouched. The initial up-front fee amortization pattern is not modified.</p> <p>The added goods or services are treated as a new contract.</p> |
|  | Termination of the existing contract and creation of a new contract | <p>The existing contract is terminated. Any unamortized up-front fee at that point is rolled into the transaction price of the new contract and allocated to the performance obligations under the new contract.</p> |

Example – Single location franchise contract term extension

In Year 1, Franchisor enters into a franchise agreement with Franchisee to operate a location for 20 years, with no rights of renewal (contractual or implied). Franchisee pays an up-front fee of \$20,000 and a sales-based royalty of 4%, which is comparable to other similar franchise arrangements in this market. Annual sales of the location are expected to average \$1,000,000.

At the end of Year 15, Franchisor and Franchisee enter into negotiations and agree to extend the term of the agreement to 25 years total (i.e. the modification adds 5 years). No fee is charged at the modification date. Royalties for the extended contract are at 4%, similar to other franchise arrangements in this market at that point.

The contract has been modified by extending its duration (change in scope) for an increase in price (additional royalties). Franchisor analyzes whether the additional years of license are priced at their stand-alone selling price by comparing the royalty and renewal fee to similar transactions. Franchisee pays no renewal fee, although an up-front fee of \$20,000 would typically be charged for a first 20-year franchise contract. However, Franchisor determines that the fee is minimal compared to the transaction price because it represents only 2.5%¹ of the expected royalty payments. Franchisor therefore concludes that the added license years are priced within a reasonable range – i.e. at their stand-alone selling price.

The modification is treated as a new franchise agreement for 5 years (Years 21 to 25). The accounting for the existing contract is unchanged, meaning the initial up-front fee remains amortized over 20 years.

If a renewal fee had been paid in this example and Franchisor still concluded that the additional goods or services were priced at their stand-alone selling price, its amortization would start from Year 21, when Franchisee starts benefiting from the new license.

Note 1:

$$2.5\% = \$20,000 / (\$1,000,000 \times 20 \text{ years} \times 4\%).$$

Transfer of existing contract to another franchisee

Franchise arrangements can also be transferred between franchisees, usually with the franchisor's approval. Upon transfer, a one-time fee may be paid by the previous franchisee to the franchisor or by the new franchisee to the franchisor or the previous franchisee.

We believe the transfer should be treated in one of the following ways, depending on facts and circumstances.

- **Continuation of the existing license.** The accounting for the existing contract is untouched. The initial up-front fee amortization pattern is not modified.
- **Termination of the existing license and creation of a new one.** The existing contract is terminated. Any unamortized up-front fee at that point is immediately recognized in revenue.

Relevant facts and circumstances may include to what extent the rights and obligations of the existing license have been modified and whether the transfer triggers substantial change in the projected future cash flows.

Example – Single location franchise contract transfer

In Year 1, Franchisor enters into a franchise agreement with Franchisee F1 to operate a location for 20 years. Franchisee F1 pays an up-front fee of \$20,000 and a sales-based royalty of 4%, which is comparable to other similar franchise arrangements in this market. Annual sales of the location are expected to average \$1,000,000.

At the end of Year 5, Franchisee F1 negotiates with Franchisee F2, a third party, for Franchisee F2 to take over the franchise agreement. Franchisor agrees to the transfer and charges Franchisee F2 an up-front fee of \$5,000. The terms of the original contract are otherwise unchanged.

Franchisor determines that the terms of the original arrangement are unchanged (e.g. duration, royalties). Approval of the new franchisee comprises standard due diligence and credit check procedures. Franchisor has a practice of accepting transfers at the initiative of franchisees, as long as the new franchisee meets the pre-specified criteria in the franchise arrangement. Further, Franchisor assesses that the transfer fee of \$5,000 is administrative in nature and is minimal in the context of the royalty payment. The fee represents only 0.8%¹ of the remaining expected royalty payments.

Franchisor therefore concludes that the transfer should be accounted for as a continuation of the existing contract. The initial up-front fee remains amortized over 20 years. The transfer fee is amortized over the 15 remaining years.

Note 1:

$$0.8\% = \$5,000 / (\$1,000,000 \times 15 \text{ years} \times 4\%).$$

Substantial judgment may be required to conclude on the accounting for transfers of franchise rights between franchisees. Franchisors may for example consider the following, in addition to any other factors that are relevant in the particular circumstances.

| Factor | Example | Potential indication of: | |
|---|--|--------------------------|-------------|
| | | Continuation | Termination |
| Transferability of the existing license | The existing contract specifies that the franchise right is transferrable with no or only perfunctory restrictions. | ✓ | |
| Customary business practices | It is rare that the franchisor denies the transfer right: this may indicate that any approval rights contained in the contract are nonsubstantive. | ✓ | |
| Transfer fee paid to the franchisor | Payment of a de minimis transfer fee. | ✓ | |
| | Payment of a substantial transfer fee. | | ✓ |
| Change in credit risk of the customer | Significant change in the credit risk of the franchisee acquiring the franchise right as compared to the existing franchisee. | | ✓ |
| Extension or reduction of the franchise term | Extension of the franchise agreement beyond the existing franchise term. | | ✓ |
| Change in royalty rate or other terms and conditions | Increase in the royalty rate to reflect market conditions at the date of transfer. | | ✓ |

Transition

Up-front fee revenue already recognized under current US GAAP may need to be deferred on transition, for recognition in future years.

An entity can elect to adopt the new standard in a variety of ways, either:

- retrospectively with or without optional practical expedients (full retrospective method); or
- retrospectively with no restatement of comparative periods – i.e. the cumulative effect of applying the new standard is recognized at the date of initial application (cumulative effect method). Some optional practical expedients are also offered under this method. Entities that elect the cumulative effect method are required to disclose the changes between the reported results of the new standard and those that would have been reported under current US GAAP in the period of adoption.

Practical expedients for completed contracts

Several transition practical expedients aim at simplifying implementation of the new standard for completed contracts. A completed contract is a contract for which an entity has recognized all (or substantially all) of the revenue under current US GAAP. Because of the sales-based royalty stream, most franchise agreements do not meet this definition and therefore are not eligible for the practical expedients for completed contracts.

Applying the new standard retrospectively to open franchise agreements may require franchisors to reverse and defer some

revenue from up-front fees that had previously been recognized at the beginning of the franchise agreement under current US GAAP (see [Up-front fees, activities and costs](#)).

Franchisors should consider the potential accounting and practical complexities as well as internal control implications involved with calculating the opening retained earnings adjustment and the recast of comparative periods (if any) when planning their implementation.

Practical expedient for modified contracts

Franchisors may choose to apply the contract modification practical expedient. If so, franchisors need not separately evaluate the effects of each contract modification, such as past changes in the amount of up-front fees or number of locations in ADA, past transfers of franchise rights, etc.

Instead, franchisors may reflect the aggregate effect of all the modifications (on a contract-by-contract basis) that occur before:

- the beginning of the earliest reporting period presented – e.g. January 1, 2016 for a calendar year-end public business entity, under the full retrospective method; or
- the date of initial application – e.g. January 1, 2018 for a calendar year-end public business entity, under the cumulative effect method.

Some other considerations

Some services to the franchisee may be out of scope of the revenue standard

Franchisors often assist their franchisee to obtain facilities. Facilities may be purchased or leased by the franchisee. The franchisor may lease the facility to the franchisee or may guarantee lease payments for a franchisee.

Leases and guarantees, other than product and service guarantees, are scoped out of the new revenue standard. Therefore, franchisors must look to the lease guidance (Topics 840 or 842) and the guarantees guidance (Topic 460) to account for those components of the contract. If the other accounting guidance specifies how to account for one or more parts of a contract, then an entity first applies those requirements. Otherwise, a franchisor applies the new standard to account for the contract.

Up-front fees may create a material right

The new standard defines a material right as an option to acquire additional goods or services at a discount. That option is a performance obligation (the unit of account for revenue recognition) under the contract. This results in revenue being allocated to the option and deferred until the option is exercised or expires, which may result in the up-front fee being recognized over a period longer than the original franchise term.

Franchisors typically charge a lower or no fee upon renewing franchise arrangements, compared to the initial up-front fee. This practice, whether explicit in the franchise contract or implicit, may create a material right. Therefore, franchisors need to assess the renewal discount – i.e. the difference between a first-time up-front fee and a renewal fee and determine whether this discount is quantitatively and qualitatively material to the franchise arrangement.

Up-front fees may create a significant financing component

Under the new standard, a significant financing component may exist in a contract when payment is received significantly before or after the transfer of goods or services. This could result in an adjustment to the transaction price to impute interest income/expense.

Franchisors may need to assess whether up-front fees create a significant financing component, given the typical long-term duration of franchise arrangements.

Vendor rebates

Franchisors may negotiate pricing with large vendors on a system-wide basis, and receive commissions or volume rebates from those vendors, based on the volume of purchases by company-owned and franchise locations. In

some arrangements, franchisors may distribute rebates proportionally to franchisees based on their purchase volume. In other arrangements, vendor rebates may be contributed to the advertising fund (either by contractual obligation or standard practice).

Franchisors need to carefully consider the substance of these arrangements to determine the appropriate presentation of vendor rebates received, as a reduction of the cost of goods sold to which the rebates relate or as revenue. Further, any amount remitted to franchisees or committed to an advertising fund, by the franchisor, may need to be recorded as a reduction of revenue.

Up-front fees and business combinations

Each company-owned or franchise location may meet the definition of a business.³ If so, when a franchisor acquires a location from an existing franchisee, the acquisition is a business combination. Because the franchise agreement is terminated by the transaction, the franchisor applies the guidance addressing the effective settlement of a preexisting relationship between the acquirer and acquiree in a business combination. After adoption of the new revenue standard, in addition to the reacquired franchise right that is often recognized in these situations, this analysis needs to consider the unamortized portion of any up-front fee associated with the location(s) being acquired. Specifically, the acquirer needs to consider how this unamortized deferred revenue amount affects the gain or loss, if any, recognized on effective settlement of the preexisting relationship.

Conversely, a franchisor may sell an existing company-owned location to a franchisee. In this case, the franchisor evaluates the consideration received from the franchisee to determine which portion of the consideration is attributable to the franchise arrangement separately from the business. If the franchisor has an established practice or policy to charge an up-front fee for each new franchise arrangement, we generally expect that some portion of the consideration transferred would be allocated to the franchise right. This amount would then be recognized as revenue over the term of the franchise arrangement entered into to govern the subsequent operation of the location. However, deferring an amount equal to the standard franchise up-front fee may not always be appropriate. Rather, the allocation of the consideration should be made on a relative stand-alone selling price basis, consistent with the new standard. When estimating the stand-alone selling price of the franchise right, the franchisor needs to consider all relevant factors, including whether any royalty amount is at a market rate.

3. ASU 2017-01, *Clarifying the Definition of a Business*, becomes effective generally for the same periods as the new revenue standard. It changes the definition of a business, and will generally result in fewer transactions involving 'businesses'. For a summary, see KPMG's [Defining Issues](#).

Applicable to all industries

Expanded disclosures

The new standard contains both qualitative and quantitative disclosure requirements for annual and interim periods. The objective of the disclosures is to provide sufficient information to enable users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Specifically, the new standard includes disclosure requirements for:

- disaggregation of revenue;
- contract balances, including changes during the period;
- performance obligations;
- significant judgments; and
- assets recognized to obtain or fulfill a contract, including changes during the period.

An entity should review these new disclosure requirements to evaluate whether data necessary to comply with the disclosure requirements are currently being captured and whether system modifications are needed to accumulate the data.

Internal controls necessary to ensure the completeness and accuracy of the new disclosures should be considered – especially if the required data was not previously collected, or was collected for purposes other than financial reporting.

Also, SEC guidance requires registrants to disclose the potential effects that recently issued accounting standards will have on their financial statements when adopted⁴. The SEC expects the level and specificity of these transition disclosures to increase as registrants progress in their implementation plans. The SEC has also stated, when the effect is not known or reasonably estimated, that a registrant should describe its progress in implementing the new standard and the significant implementation matters that it still needs to address.

Transition

An entity can elect to adopt the new standard in a variety of ways, including retrospectively with or without optional practical expedients, or from the beginning of the year of initial application with no restatement of comparative periods (cumulative effect method).

Entities that elect the cumulative effect method are required to disclose the changes between the reported results of the new standard and those that would have been reported under current US GAAP in the period of adoption.

For transition purposes, the new standard introduces a new term – completed contract. A completed contract is a contract for which an entity has recognized all or substantially all of the revenue under current US GAAP as of the date of adoption of the new standard. The concept of a completed contract is used when applying:

- certain practical expedients available during transition under the retrospective method; and
- the cumulative effect method coupled with the election to initially apply the guidance only to those contracts that are not complete.

This will require careful analysis particularly where there is trailing revenue after delivery has occurred (e.g. revenue was not fixed or determinable, collectibility was not reasonably assured, royalty arrangements). In those circumstances, the contract would not be considered complete if substantially all of the revenue had not been recognized before adoption. Applying the standard to these types of contracts at transition may result in revenue being pulled into the opening retained earnings adjustment.

Entities should consider the potential complexities involved with calculating the opening retained earnings adjustment and the recast of comparative periods (if any) when planning their implementation. It may be prudent for entities to perform transition calculations before the adoption date to ensure all potential complexities are identified.

Effective dates

| Type of entity | Annual reporting periods after |
|--|---|
| Public business entities and not-for-profit entities that are conduit bond obligors | December 15, 2017 including interim reporting periods within that reporting period. Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. |
| All other US GAAP entities, including SEC registrants that are Emerging Growth Companies | December 15, 2018 and interim reporting periods within annual reporting periods beginning after December 15, 2019. Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period or interim reporting periods within the annual period subsequent to the initial application. |

4. Staff Accounting Bulletin Topic 11.M.

Some basic reminders

Scope

The guidance applies to all contracts with customers unless the customer contract is specifically within the scope of other guidance – e.g. Topic 944 (insurance), Topic 460 (guarantees).

The new standard applies to contracts to deliver goods or services to a customer. A ‘customer’ is a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.

The new standard will be applied to part of a contract when only some elements are in the scope of other guidance.



Step 1: Identify the contract

Contracts can be written, oral or implied by an entity’s customary business practices, but must be enforceable by law. This may require legal analysis on a jurisdictional level to determine when a contract exists and the terms of that contract’s enforceability.

A contract with a customer is in the scope of the new standard when the contract is legally enforceable and all of the following criteria are met:

- the contract has commercial substance;
- rights to goods or services can be identified;
- payment terms can be identified;
- the consideration the entity expects to be entitled to is probable of collection; and
- the contract is approved and the parties are committed to their obligations.

If the criteria are not met, any consideration received from the customer is generally recognized as a deposit (liability).



Step 2: Identify the performance obligations

Performance obligations do not have to be legally enforceable; they exist if the customer has a reasonable expectation that the good or service will be provided. A promise can be implied by customary business practices, policies or statements.

Performance obligations are the unit of account under the new standard and generally represent the distinct goods or services that are promised to the customer.

Promises to the customer are separated into performance obligations, and are accounted for separately if they are both (1) capable of being distinct and (2) distinct in the context of the contract.

An exception exists if the performance obligations represent a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer over time. A series is accounted for as a single performance obligation.



Step 3: Determine the transaction price

Estimating variable consideration will represent a significant departure from current accounting for many entities.

When determining the transaction price, an entity uses the legally enforceable contract term. It does not take into consideration the possibility of a contract being cancelled, renewed or modified.

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. some sales taxes. This consideration can include fixed and variable amounts, and is determined at inception of the contract and updated each reporting period for any changes in circumstances.

The transaction price determination also considers:

- **Variable consideration**, which is estimated at contract inception and is updated at each reporting date for any changes in circumstances. The amount of estimated variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.
- **Noncash consideration** received from a customer is measured at fair value at contract inception.
- **Consideration payable to a customer** represents a reduction of the transaction price unless it is a payment for distinct goods or services it receives from the customer.
- **Significant financing components** may exist in a contract when payment is received significantly before or after the transfer of goods or services. This could result in an adjustment to the transaction price to impute interest income/expense.



Step 4: Allocate the transaction price

A contractually stated price or list price is not presumed to be the stand-alone selling price of that good or service.

The transaction price is allocated at contract inception to each performance obligation to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. Observable stand-alone prices are used when they are available. If not available, an entity is required to estimate the price using other techniques – even if the entity never sells the performance obligation separately.



Step 5: Recognize revenue

An entity must first determine whether a performance obligation meets the criteria to recognize revenue over time.

If none of the over-time criteria are met, revenue for the performance obligation is recognized at the point in time that the customer obtains control of the goods or services.

Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from the goods or services – or prevent others from doing so.

An entity recognizes revenue when it satisfies its obligation by transferring control of the good or service to the customer.

A performance obligation is satisfied **over time** if one of the following criteria are met:

- the customer simultaneously receives and consumes the benefits as the entity performs;
- the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
- the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

If control transfers **over time**, an entity selects a method to measure progress that is consistent with the objective of depicting its performance.

If control transfers at a **point in time**, the following are some indicators that an entity considers to determine when control has passed. The customer has:

- a present obligation to pay;
- physical possession;
- legal title;
- risks and rewards or ownership; and
- accepted the asset.

Customer options

Customer options may be accounted for as performance obligations, resulting in more revenue deferral than under current GAAP.

Revenue is allocated to a customer option to acquire additional goods or services, and is deferred until (1) those future goods or services are transferred or (2) the option expires when it represents a material right. A material right exists if the customer is only able to obtain the option by entering into the sale agreement and the option provides the customer with the ability to obtain the additional goods or services at a price below stand-alone selling prices.

Licensing of intellectual property

The new standard includes a framework for determining whether there is a license of IP, and the category into which it falls.

As a result, the pattern of revenue recognition for licenses could differ from legacy US GAAP.

How an entity recognizes license revenue depends on the nature of the license. There are two categories of licenses of IP.

- **Functional IP.** IP is functional if the customer derives a substantial portion of the overall benefit from the IP's stand-alone functionality – e.g. software, biological compounds, films and television shows. Revenue is generally recognized at the point in time that control of the license transfers to the customer.
- **Symbolic IP.** IP is symbolic if it does not have significant stand-alone functionality, and substantially all of the customer's benefit is derived from its association with the licensor's ongoing activities – e.g. brands, trade names and franchise rights. Revenue is generally recognized over the license period using a measure of progress that reflects the licensor's progress toward completion of its performance obligation.

There is an exception to the general revenue model on variable consideration for sales- or usage-based royalties related to licenses of IP. Such a sales- or usage-based royalty is recognized as revenue at the later of:

- when the sales or usage occurs; or
- on the satisfaction or partial satisfaction of the performance obligation to which the royalty has been allocated.

Principal vs. agent

The new standard changes the guidance used to evaluate whether an entity is a principal or an agent.

Credit risk is no longer an indicator that an entity is a principal.

An entity identifies each specified good or service to be transferred to the customer, and determines whether it is acting as a principal or agent for each one. In a contract to transfer multiple goods or services, an entity may be a principal for some goods and services and an agent for others.

An entity is a principal if it controls the specified good or service that is promised to the customer before it is transferred to the customer.

Indicators that an entity has obtained control of a good or service before it is transferred to the customer are having primary responsibility to provide specified goods or services, assuming inventory risk, and having discretion to establish prices for the specified goods or services.

Contract modifications

A general accounting framework replaces specific contract modification guidance for long-term construction- and production-type contracts. However, outside of these arrangements, an entity will find more guidance in the new standard than under current GAAP.

The new standard requires an entity to account for modifications either on a cumulative catch-up basis (when the additional goods or services are not distinct) or a prospective basis (when the additional goods or services are distinct).

If any additional distinct goods or services are not priced at their stand-alone selling prices, the remaining transaction price is required to be reallocated to all unsatisfied performance obligations, including those from the original contract.

Contract costs

More costs are expected to be capitalized under the new standard.

An entity cannot elect to expense or capitalize. Capitalization is required when the criteria are met.

The new standard provides guidance on the following costs related to a contract with a customer that are in the scope of the new standard:

- incremental costs to obtain a contract; and
- costs incurred in fulfilling a contract that are not in the scope of other guidance.

Incremental costs to obtain a contract with a customer (e.g. sales commissions) are required to be capitalized if an entity expects to recover those costs – unless the amortization period, which may include anticipated contracts or renewals, is less than 12 months.

Fulfillment costs that are not in the scope of other guidance – e.g. inventory, intangibles, or property, plant, and equipment – are capitalized if the fulfillment costs:

- relate directly to an existing contract or specific anticipated contract;
- generate or enhance resources that will be used to satisfy performance obligations in the future; and
- are expected to be recovered.

An entity amortizes the assets recognized for the costs to obtain and fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates.

The impact on your organization

Implementation of the new standard is not just an accounting exercise.

New revenue recognition standard and corresponding accounting changes

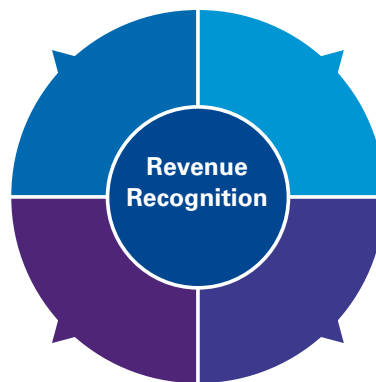
- Impact of new revenue recognition standard and mapping to new accounting requirements
- New accounting policies – historical results and transition
- Reporting differences and disclosures
- Tax reporting/planning

Revenue recognition automation and ERP upgrades

- Automation and customization of ERP environment
- Impact on ERP systems
- General ledger, sub-ledgers and reporting packages
- Peripheral revenue systems and interfaces

Financial and operational process changes

- Revenue process allocation and management
- Budget and management reporting
- Communication with financial markets
- Covenant compliance
- Opportunity to rethink business practices
- Coordination with other strategic initiatives



Governance and change

- Governance organization and changes
- Impact on internal resources
- Project management
- Training (accounting, sales, etc.)
- Revenue change management team
- Multinational locations

As noted in the chart, the new standard could have far-reaching effects. The standard may not only change the amount and timing of revenue, but potentially requires changes in the core systems and processes used to account for revenue and certain costs. Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, estimates

and disclosures. The implementation of the new standard will involve a diverse group of parties (e.g. Tax, IT, Legal, Financial Planning, Investor Relations, etc.) and entities should have a governance structure in place to identify and manage the required change. For more information about implementation challenges and considerations, see chapter 14 of KPMG's [Revenue: Issues In-Depth](#).

KPMG Financial Reporting View



Insights for financial reporting professionals

As you evaluate the implications of new financial reporting standards on your company, KPMG Financial Reporting View is ready to inform your decision-making.

Visit kpmg.com/us/frv for news and analysis of significant decisions, proposals, and final standards and regulations.

FRV focuses on major new standards (including revenue recognition, leases and financial instruments) – and also covers existing US GAAP, IFRS, SEC matters, broad transactions and more.



US news & views



CPE



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Insights for financial reporting professionals

Here are some of our resources dealing with revenue recognition under the new standard.

| | |
|---------------------------------|---|
| Handbook | Assists you in gaining an in-depth understanding of the new five-step revenue model by answering the questions that we are encountering in practice, providing examples to explain key concepts and highlighting the changes from legacy US GAAP. |
| Issues In-Depth | Provides you with an in-depth analysis of the new standard under both US GAAP <i>and</i> IFRS, and highlights the key differences in application of the new standard. Additionally, chapter 14 provides implementation considerations. |
| Illustrative disclosures | We show how one fictitious company has navigated the complexities of the revenue disclosure requirements. |
| Transition options | Assists you in identifying the optimal transition method. |
| Industry guidance | See our other industry guidance. |

Contacts

KPMG is able to assist companies with franchise operations as they navigate the adoption of the new standard.

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