BDO

McAbee, Schwartz, Halliday & Co.
A PROFESSIONAL CORPORATION
CERTIFIED PUBLIC ACCOUNTANT AND CONSULTANTS

JUNE 2017
www.bdo.com

THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

BDO KNOWS: FASB

TOPIC 606, REVENUE FROM CONTRACTS WITH CUSTOMERS – A VIEW FROM THE KITCHEN

Introduction

In 2014, the FASB issued its landmark standard, Revenue from Contracts with Customers[1], which has since been amended by the following updates:

- Accounting Standards Update (ASU) 2015-14, Deferral of the Effective Date
- ASU 2016-08, Principal versus Agent Considerations (Reporting Revenue Gross versus Net)
- ASU 2016-10, Identifying Performance Obligations and Licensing
- ASU 2016-12, Narrow Scope Improvements and Practical Expedients
- ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers.

The new standard is generally converged with equivalent new IFRS guidance and sets out a single and comprehensive framework for revenue recognition. The new

1 ASU 2014-09

CONTENTS

INTRODUCTION 1
OVERVIEW 2
FRANCHISOR ACCOUNTING 2
1. Step One – Identify the contract with a customer 3
2. Step Two – Identify the performance obligations in the contract 3
3. Step Three – Determine the transaction price 5
4. Step Four – Allocate the transaction price to the performance obligations 7
5. Step Five – Recognize revenue when each performance obligation is satisfied 7
Costs to obtain the contract 8
Presentation 9
Disclosures 9
FRANCHISEE/OWNER-OPERATOR ACCOUNTING 10
Coupons and other promotional discounts 10
Gift card sales and related breakage 10
Loyalty Programs 11
CONCLUSION / CONTACT 12
APPENDIX 1 – FRANCHISOR EXAMPLE 13

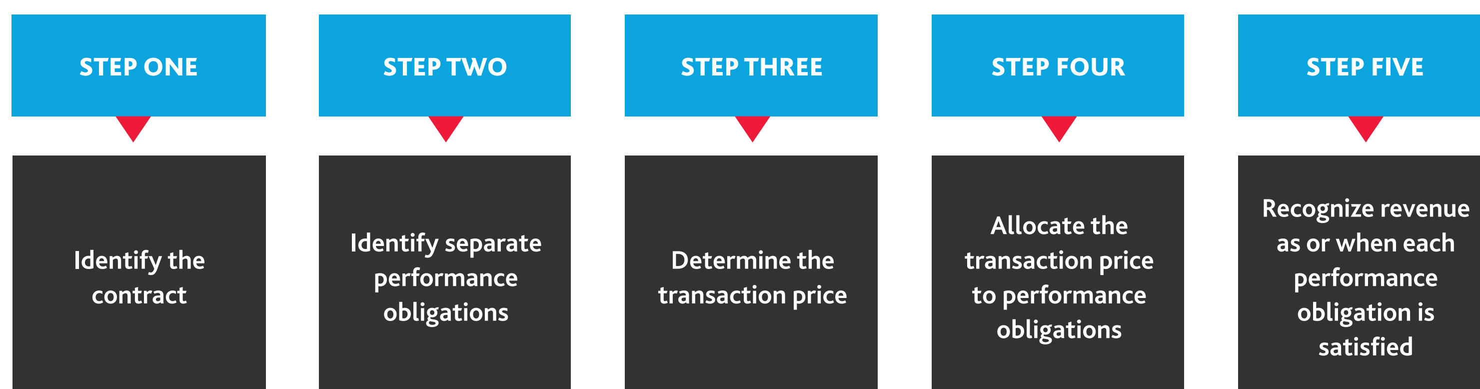
standard also introduces an overall disclosure objective together with significantly enhanced disclosure requirements for revenue recognition. It takes effect in 2018 for public companies and in 2019 for all other companies, and addresses virtually all industries in U.S. GAAP, including those that previously followed industry-specific guidance such as franchisors.

In this newsletter, we will assess the provisions most applicable to companies in the restaurant sector, including franchisors, owner/operators and franchisees. As explained below, franchisors will see significant change in the treatment of upfront franchise and area development fees. Franchisees and owner/operators will also likely experience changes in the accounting for loyalty programs. In addition, all companies will need to provide extensive new footnote disclosures.

Overview

The new standard establishes a single, comprehensive framework which ascertains how much revenue is to be recognized, and when. The core principle is that a vendor should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the vendor expects to be entitled in exchange for those goods or services.

Revenue will now be recognized by a vendor when control over the goods or services is transferred to the customer. The application of the core principle is carried out in five steps:



After identifying the contract(s) with the customer, a vendor separates the contract into what are termed 'performance obligations'. A performance obligation is a promise by a vendor to transfer goods or services to a customer. Each performance obligation is 'distinct', being either a good or service from which the customer can benefit on its own (or in combination with other readily available goods and services); or two or more goods and services (such as the supply of construction material and labor) that are combined if, in reality, they represent one overall performance obligation.

In the third and fourth steps, a vendor determines the transaction price of the entire contract and then allocates the transaction price among the different performance obligations that have been identified.

In the fifth step, a vendor assesses when it satisfies each performance obligation (which may be at a point in time, or over time) and recognizes revenue. The principle is based on the point at which the customer obtains control of the good or service.

FRANCHISOR ACCOUNTING

A license establishes a customer's rights to the intellectual property of a vendor, such as a franchise agreement. The new standard categorizes licenses as either functional licenses, which have significant standalone functionality because they can be used in their existing form for performing a specific task, or symbolic licenses, which do not have significant standalone functionality because their value is dependent upon the licensor supporting or maintaining the intellectual property during the license period. Because a symbolic license is received and consumed as the licensor performs its obligation to provide access to the intellectual property, revenue related to symbolic licenses is recognized over time. The new standard specifically identifies franchises as an example of a symbolic license.

BDO OBSERVATION

Currently GAAP[2] allows upfront franchise fees to be recognized in revenue when all material services or conditions relating to the agreement have been substantially performed or otherwise satisfied. This is generally considered to have occurred once the franchised location opens for service, as that is typically when all initial services, such as site selection, training, inspection or testing and other quality control procedures have been completed. Thus the new standard will result in a significant difference in the timing and pattern of revenue recognition for initial franchise fees.

STEP 1: IDENTIFY THE CONTRACT WITH A CUSTOMER

The first step in assessing the appropriate accounting for a franchise agreement involves determining which agreements represent the contract with the customer. A contract with a customer is deemed to exist under ASC 606 when the following five criteria have been met:

- The contract has been approved in writing, orally, or in accordance with other customary business practices and the parties are committed to perform their obligations in the contract;
- Each party's rights and obligations regarding the goods or services to be transferred can be identified;
- The payment terms for the goods or services to be transferred can be identified;
- The contract has commercial substance (i.e., the risk, timing or amount of the vendor's future cash flows is expected to change as a result of the contract); and
- It is probable that the consideration for the exchange of the goods or services that the vendor is entitled to will be collected. For the purposes of this criterion, only the customer's ability and intention to pay amounts when they become due are considered.

In most jurisdictions, franchisors are required to provide prospective franchisees with a Franchise Disclosure Document ("FDD"), which is a legal document that discloses information related to the entity's franchise agreements, including obligations of the franchisor and expectations of the franchisee, including various franchise fees that will be required. Although the FDD is generally not considered binding until and unless a franchise agreement is executed, it is legally considered an adjunct to the franchise agreement, and therefore its terms should be considered when assessing the appropriate accounting under the franchise agreement.

The combination of the franchise agreement and FDD will generally satisfy the first four criteria. In addition, typically during due diligence, the franchisor will have assessed the intent and ability of the potential franchisee to pay all amounts when due, thus meeting the fifth criterion. However, it is important to note that this criterion does not preclude a franchisor from concluding that a contract exists when it is not probable that the franchisee would meet all commitments under the franchise agreement and FDD if the franchisor has the ability to mitigate that credit risk. For example, if the franchisor has the ability to revoke the franchise agreement upon non-payment, then the franchisor may still conclude that it is probable that it will collect substantially all of the consideration promised in exchange for services that are actually transferred to the customer, i.e. for the periods for which the franchise agreement is valid.

STEP 2: IDENTIFY THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

Once the franchisor has determined that a contract is in place, step two of the revenue recognition process is to identify separate performance obligations in the contract. A performance obligation is a promise to a customer to transfer:

- A good or service (or a bundle of goods or services) that is distinct; or
- A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

In order to be distinct, a good or service must meet both of the following two criteria:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct).
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

2 ASC 952-605-25-1 through 25-4 discuss the accounting for initial franchise fees

Typically, a franchise agreement may require a franchisor to perform various services or provide goods necessary for the franchisee to successfully operate the franchise. Examples of the types of goods and services promised are:

- Assistance in selecting a site and/or in obtaining facilities, including related financing and architectural services.
- Training of the franchisee's personnel.
- Establishment of suppliers, and inspection, testing and other quality control programs.
- Equipment necessary to operate the franchise, such as ovens or other proprietary food preparation equipment and/or point of sale systems.
- Access to operating manuals and recipes.

In addition to the above discrete promises is the general promise to maintain the brand via marketing and pricing strategies and continued investment in recipes and operating procedures. As noted in example 57 in the new standard, described in ASC 606-10-55-375 through 55-382, generally the franchisor would conclude that the various activities to be undertaken to support the brand do not directly transfer goods and services to the customer, but instead represent a single performance obligation, which is the transfer of the franchise license. This is the case even if the franchise agreement calls for separate payments related to one or more of the activities, such as an advertising or marketing co-op fee.

The franchisor must assess each of the additional goods and services promised in the franchise agreement and FDD in order to determine whether they are both capable of being distinct and distinct within the context of the contract. In most cases, the promised deliverables are capable of being distinct, as the franchisee could benefit from them either on their own, or in conjunction with other readily available resources. For example, site selection and architectural services could provide benefits regardless of whether the franchisee also obtains the rights to operate a franchised restaurant, as the site could be used to support other brands or other operations outside of the restaurant industry. Likewise, food preparation equipment and point of sale equipment could either be used in operations or resold for a value greater than scrap. In addition, training services and access to operating manuals and recipes provide benefit to the franchisee in conjunction with the rights to operate a franchise location.

Determining whether the promised goods and services are distinct within the context of the contract requires significant judgment. ASC 606-10-25-21 notes that in performing this assessment, the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of the goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that a vendor's promise to transfer two or more goods or services to the customer are not separately identifiable include:

- The vendor provides a significant service of integrating the goods or services with other goods or services promised in the contract as a bundle which represents a combined output or outputs for which the customer has contracted (i.e., the vendor is using the good or service as an input to produce the combined output specified by the customer);
- One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, another good or service promised in the contract; and
- The goods or services are highly interdependent or highly interrelated. That is, each of the goods or services is significantly affected by one or more of the other promised goods or services in the contract.

Generally, the factor that is most relevant to the goods and services promised in a franchise agreement is whether the goods or services are highly interdependent or highly interrelated with the franchise right itself. For example, it is likely that the franchisee could not operate the franchised location in compliance with the franchise agreement without access to operating manuals and recipes, which would indicate that the access is highly interdependent with the franchise agreement and thus not distinct in the context of the contract. Alternatively, site selection services may be deemed distinct within the contract if successful operation of the brand is not highly interdependent with the site selected, and the sale of food preparation and point of sale equipment may not be highly interrelated with the franchise rights unless successful operation of the brand is reliant upon the use of specific equipment. For example certain fast casual pizza concepts require the use of a specific type of oven.

Other promised goods and services may require further consideration, such as training. If the operating procedures of the brand are so specialized and/or complex that the franchisee could not successfully operate the franchised location absent training, then the franchisor would likely conclude that training services are highly interrelated with the franchise rights and thus not distinct in the context of the contract. Alternatively, if the operating procedures are relatively simplistic and consistent with those employed by similar brands in the industry, or if the training procedures focus primarily on food safety rather than compliance with the brand operating procedures, then the training services may not be interdependent. Likewise, the determination of whether assistance in establishing suppliers and instituting

inspection and other quality control procedures is distinct in the context of the contract will likely hinge on how complex and specialized the recipes and operating procedures are. While the fact that third parties may provide similar services is not determinative, it may be relevant when evaluating whether the promised goods or services are distinct in the context of the contract.

In certain instances, a franchise agreement, or area development agreement, which provides a franchisee with the right to develop multiple locations within a geographic region, will provide rights on an exclusive basis. Exclusivity in and of itself is not considered a performance obligation, but instead is considered an attribute of the franchise right. In addition, it is unlikely that an area development agreement would be distinct from the franchise agreements required to be signed each time a restaurant is opened, as the area development agreement typically does not provide for the transfer of additional goods or services to the franchisee.

A franchise agreement can also transfer a material right to a franchisee in certain circumstances. A material right is a benefit related to future purchases of additional goods or services that the customer would not receive without entering into the initial contract. One example of a material right is a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market. If an option for a future purchase provides a material right to the customer, the customer in effect pays in advance for the future goods or services, and the related revenue must be deferred until those future goods or services are transferred. That is, the option itself is a performance obligation, which is satisfied upon exercise. As it relates to a franchise agreement, a franchisor may grant a material right if the fee to be paid upon renewal of the franchise agreement is less than the initial franchise fee. Another example might be a situation in which subsequent franchise fees for additional locations are assessed at a lower amount than the first initial franchise fee paid. In both situations, the franchisee receives a discount on the future purchase of an additional franchise right that would not be available to another franchisee that had not already entered into a franchise agreement. As such, they would represent material rights that must be accounted for as separate performance obligations.

STEP 3: DETERMINE THE TRANSACTION PRICE

The transaction price is the amount of consideration that a vendor expects to be entitled to in exchange for the goods or services promised in the contract. This will often be the amount specified in the contract. However, the vendor is also required to consider its customary business practices (e.g., price concessions) and to adjust the expected amount of consideration if these indicate that a lower amount will be accepted.

Although a number of estimates about the future may need to be made when determining the transaction price, these are based on the goods and services to be transferred in accordance with the existing contract. They do not take into account expectations about whether the contract will be cancelled, renewed or modified.

When estimating the transaction price, a vendor needs to consider the effects of the following:

- Variable consideration;
- Constraining estimates of variable consideration;
- The existence of a significant financing component in the contract;
- Non-cash consideration; and
- Consideration payable to a customer.

A typical franchise agreement may contain multiple different payment streams. The most common include an initial franchise fee, typically due at signing, and a royalty fee expressed as a percentage of sales. In addition, a franchise agreement may require payment of a separate advertising fee. If the franchisee also signed an area development agreement, that agreement may require an additional upfront fee, as well as a commitment to open a specified number of restaurants during the term, each of which will require payment of an initial franchise fee.

When determining the transaction price under the contract, the franchisor must estimate all fees to be paid, including variable consideration. As an exception to the principle requiring entities to estimate variable consideration, a sales-based or usage-based royalty for a license of intellectual property is only recognized as revenue when (or as) the later of the following (i.e., the “royalty constraint”):

- The subsequent sale or usage occurs; and
- The performance obligation to which some or all of the sales- or usage-based royalty has been allocated has been satisfied (or partially satisfied).

In this context, an entity should not split a sales-based or usage-based royalty into a portion subject to the royalty constraint and a portion that is not subject to that guidance. In other words, a royalty is either subject to the royalty constraint, or it is not. The constraint applies whenever the predominant item to which the royalty relates is a license. For example, a license may be the predominant item to which the royalty relates when the entity reasonably expects that its customer places significantly more value on the license (e.g., a franchise right) rather than other related goods and services (e.g., site selection and training).

Although that exception exempts the franchisor from recognizing royalty fees and other sales-based revenues until the subsequent sale occurs, a franchisor must still include its best estimate of the royalty fees in order to determine the total transaction price for purposes of allocating that transaction price to the various performance obligations. However, as discussed below, the franchisor may conclude in certain circumstances that allocating the variable consideration solely to the franchise license is consistent with the overall objective of the new standard.

As part of determining the transaction price, the franchisor must also determine whether the arrangement includes a significant financing component. The objective of including adjustments for significant financing components is to reflect the amount that would have been paid if the customer had paid for the goods or services at the point at which they are supplied (that is, when control transfers to the customer). Otherwise, excluding the effects of financing could result in two economically similar transactions giving rise to substantially different amounts of revenue. Typically all franchise arrangements include an upfront franchise fee. In addition, if the franchisee has also entered into an area development agreement with an additional upfront fee, that fee may be paid up to five or ten years prior to the last franchise location being opened. Therefore, a franchisor should consider whether the franchise agreement contains a significant financing component.

In some cases, although there may be a difference between the timing of the goods or services and payment, this is not regarded as giving rise to a significant financing component. This is the case in any of the following circumstances:

- A customer has paid in advance and maintains discretion over when the good or service is transferred (such as a prepaid gift card);
- A substantial amount of consideration payable by the customer is variable, and the amount or timing of that consideration will be determined by future events that are not substantially within the control of either the vendor or the customer (such as a sales-based royalty);
- The timing of payment in comparison with the timing of supply of goods or services is for a reason other than financing (such as to provide the customer with protection that the vendor has or will adequately complete its obligations – such as post completion remedial work on a building).

The Transition Resource Group [3] ("TRG") addressed the question of how broadly to interpret the third factor noted above, that the difference between the timing of payment in comparison with the timing of supply of goods or services is for a reason other than financing, at its March 30, 2015 meeting. In that discussion, the TRG concluded that "there is no presumption in the standard that a significant financing component exists or does not exist when there is a difference in the timing between when goods and services are transferred and when the promised consideration is paid. An entity will need to apply judgment to determine whether the payment terms are providing financing or are for another reason." Therefore, a franchisor must assess whether the upfront franchise fee or area development fee is for a different and substantive business purpose other than for the franchisee to provide financing to the franchisor. For example, a franchisor might consider the fact that it is customary in the restaurant industry to charge upfront fees when granting area development agreements in order to ensure that the franchisee will follow through on its commitments to open multiple franchise locations in the market. However, a franchisor will also need to consider the value of the area development fee in relation to the entire consideration to be earned under the related franchise agreements. The larger the area development fee, the more likely that the fee represents either a financing for the franchisor or a prepayment of future revenues due to a low credit quality franchisee. In those instances, the franchisor must determine an appropriate interest rate and calculate the value of the significant financing component.

It would be unusual for a franchise agreement to include non-cash consideration. However, if a franchisee provides stock in lieu of cash in payment of the initial franchise fee or area development fee, the stock is included in the total consideration under the contract [4]. In this situation, the new standard requires the non-cash consideration to be valued at contract inception. Any future changes in the value of that consideration will be accounted for under other standards. For example, if a franchisee grants 100 shares of stock to the franchisor as payment of the initial franchise fee, the franchisor must value the shares at contract inception. That value will be allocated to the

3 The Transition Resource Group was convened shortly after the issuance of ASU 2014-09 in order to address various issues related to adoption and application of the new standard.

4 If a franchisee provides stock in lieu of cash as a payment, the franchisor should consider whether the existence of the ownership in the franchisee represents a variable interest in a variable interest entity that would require consolidation of the franchisee. A franchisor in this situation should consider the applicability of this guidance including the scope exception provided by ASC 810-10-15-17(d), which exempts entities determined to be a business from the variable interest entity consolidation guidance.

performance obligations, as further discussed below. Any change in that value over the term of the agreement will be accounted for under other GAAP such as Topic 320, Investments.

Likewise, franchisors do not typically make payments to franchisees in the normal course of business. However, to the extent that a franchisor makes payments on behalf of the franchisee, or provides a loan or lease guarantee or other support, the franchisor should consider whether this should be considered a reduction in the transaction price.

STEP 4: ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS

The transaction price reflects the consideration to which a vendor expects to be entitled in exchange for transferring the related goods or services to the customer. The starting point for allocating the transaction price to each performance obligation is its standalone selling price. At contract inception a vendor is required to determine the standalone selling price of the good or service underlying each performance obligation and then allocate the transaction price proportionately based on these standalone selling prices. The 'standalone selling price' is the price at which a vendor would sell a good or service separately to a customer. The best evidence of a standalone selling price is the observable price of a good or service sold in similar circumstances and to similar customers. Although a contractually stated price or a list price for a good or service may represent the standalone selling price, this is not presumed to be the case.

When a standalone selling price is not directly observable, it must be estimated. This is achieved by using all available information including market conditions, vendor-specific factors and information about the customer or class of customers. In all cases, the use of observable inputs is required to be maximized to the extent possible. In determining the standalone selling price, an entity may use an expected cost plus margin approach, an adjusted market assessment, or in certain limited situations, a residual approach.

Variable consideration may be attributable either to the entire contract, or to specific part(s) of the contract, such as:

- One or more, but not all, performance obligations. For example, a bonus may be contingent on the vendor transferring a good or service within a specified period of time.
- One or more, but not all, of the distinct goods or services of a single performance obligation. This would apply if, for example, the consideration promised for the second year of a two-year maintenance service will increase based on changes in a consumer price index.

A variable amount of consideration (and subsequent changes to that amount) is allocated entirely to a performance obligation (or a distinct good or service that forms part of a single performance obligation to transfer a series of distinct goods or services that are substantially the same) if both:

- The terms of a variable payment relate specifically to the vendor's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service); and
- The allocation of the variable amount in its entirety to a performance obligation or distinct good or service is consistent with the objective that the transaction price is allocated to each performance obligation in order to reflect the consideration to which the vendor expects to be entitled in exchange for the good or service.

Example 57 in the new standard (paragraph 606-10-55-375 through 55-382) illustrates how to allocate arrangement consideration. In that case, consideration consists of $150,000 and a 5% royalty fee for a franchise license and equipment necessary to operate the franchise store. Specifically, in paragraph 606-10-55-379, the entity concludes that the franchise royalty should be allocated solely to the franchise license, and the $150,000 upfront fee solely to the equipment. This conclusion is based on the fact that the royalty relates to the franchise fee, and allocating the royalty solely to the franchise fee, and the upfront fee solely to the equipment, would be consistent with an allocation based on the entity's standalone selling prices in similar contracts.

In many situations, the number of performance obligations identified, and the amount and type of arrangement consideration, may result in a more complex analysis than that considered in Example 57 of the new standard, as illustrated in the Appendix. However, the concepts are still applicable.

STEP 5: RECOGNIZE REVENUE WHEN EACH PERFORMANCE OBLIGATION IS SATISFIED

Revenue is recognized when (or as) goods or services are transferred to a customer. A vendor satisfies each of its performance obligations (that is, it fulfills its promises to the customer) by transferring control of the promised good or service underlying that performance obligation to the customer. Control in the context of Topic 606 is the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. It includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

For each performance obligation, a vendor determines at contract inception whether control of that good or service is transferred over time or at a point in time. If it is determined that a vendor does not satisfy a performance obligation over time, the performance obligation is deemed to be satisfied at a point in time.

As noted earlier, the new standard categorized licenses of intellectual property as either functional or symbolic licenses, and specifically identifies franchise rights as an example of a symbolic license. A symbolic license does not have significant standalone functionality. It represents a promise to both (a) grant the customer rights to use and benefit from the intellectual property and (b) support or maintain the intellectual property during the license period (or over the remaining economic life, if shorter). This type of license is satisfied over time because the customer simultaneously receives and consumes the benefit as the entity performs its obligation to provide access.

If a performance obligation is not satisfied over time, a vendor satisfies the performance obligation at a point in time. A vendor considers indicators of the transfer of control, which include the following:

- A present obligation to pay;
- Physical possession of the asset(s);
- Legal title;
- Risks and rewards of ownership;
- Accepted the asset(s).

As noted earlier, as an exception to the principle requiring entities to estimate variable consideration, a sales-based or usage-based royalty for a license of intellectual property is only recognized as revenue when (or as) the later of the following (i.e., the "royalty constraint"):

- The subsequent sale or usage occurs; and
- The performance obligation to which some or all of the sales- or usage-based royalty has been allocated has been satisfied (or partially satisfied).

Returning to Example 57 in the new standard, the 5% royalty fee was allocated solely to the franchise right, and thus the entity applies the constraint for sales-based or usage-based royalty for a license of intellectual property. The revenue is recognized when the subsequent sale occurs. If sales are reported by the franchisee on a lag, the franchisor will be required to estimate sales in order to comply with the standard. Conversely, the $150,000 upfront consideration was wholly allocated to the sale of equipment, and the related revenue would be recognized at the point in time in which control of the equipment transfers to the franchisee, typically upon delivery and transfer of title.

COSTS TO OBTAIN THE CONTRACT

The new standard requires that incremental costs incurred in obtaining a contract that would not have been incurred had that individual contract not been obtained must be recognized as an asset and then amortized on a basis that reflects the transfer of goods or services to the customer. Any ongoing costs of operating the business will be expensed as incurred, as will any costs that will be incurred regardless of whether the contract is obtained, such as legal fees related to reviewing the contract or compensation and related travel costs associated with contract negotiation. The only exception is when costs are explicitly charged to a customer regardless of whether a contract is obtained.

Many franchisors utilize brokers to identify new franchisees. Commissions paid to those brokers upon successful completion of the franchise agreement will be deferred and recognized over the franchise term. In addition, commissions or other bonuses paid to employees upon successful completion of the franchise agreement will also be deferred and recognized over the franchise term. However, any other costs associated with the negotiations, including legal or accounting fees associated with reviewing the franchise agreement or updating the FDD and generally travel costs must be expensed as incurred.

PRESENTATION

When a vendor transfers control over goods or services to a customer before the customer pays consideration, the vendor presents the contract as either a contract asset or a receivable. A contract asset is a vendor's right to consideration in exchange for goods or services that the vendor has transferred to a customer, when that right is conditional on the vendor's future performance such as the delivery of an additional good or service. A receivable is a vendor's unconditional right to consideration, and is accounted for in accordance with Topic 310—Receivables.

When a customer pays consideration in advance, or an amount of consideration is due contractually before a vendor performs by transferring a good or service, the vendor presents the amount received in advance as a contract liability.

In its statement of financial position, a vendor is required separately to present contract assets, contract liabilities and receivables due from customers. Alternative descriptions are permitted to be used for these line items.

As a result of the accounting discussed above, franchisors will typically present contract liabilities representing the unrecognized portion of any upfront franchise or area development fees. In addition, franchisors will typically present receivables for unpaid royalty fees. Because the unpaid royalty fee receivable represents a present right to payment, it should be reported separately from any contract liability related to that franchise agreement.

DISCLOSURES

Topic 606 includes an overall disclosure objective, which is for the disclosures to include sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. This is accompanied by comprehensive disclosure requirements about a vendor's:

- Contracts with customers;
- Significant judgments, and changes in the judgments, made in applying Topic 606 to those contracts; and
- Assets recognized in respect of costs of obtaining contracts, and in fulfilling contracts.

Topic 606 notes specifically that consideration is to be given to the level of detail that is necessary to satisfy the disclosure objective, and to the emphasis to be placed on each disclosure requirement. The purpose is to ensure that the information that users will find useful is not obscured by a large amount of insignificant detail, with items with sufficiently different characteristics being disaggregated and presented separately.

These requirements expand significantly the amount and type of information that must be disclosed in the footnotes, particularly the requirement to provide disaggregated revenue information. Franchisors should review their current franchise agreements and consider what information will be necessary in order to comply with the disclosure requirements.

Franchisee/Owner-Operator Accounting

For most restaurant operators, whether a franchisee or the brand owner, the new standard is not expected to result in a change in the amount or timing of most revenue to be recognized. Control of the promised good, i.e. food and beverages, occurs simultaneously with receipt of the arrangement consideration, which is usually cash or a credit card, the accounting for which should be straightforward. However, the adoption of ASC 606 may require significant efforts to apply the guidance to existing revenue streams in order to conclude that no change is required. In addition, companies may need to revisit their internal control structure, as the new standard may require additional or different controls. Finally, as previously noted, the new standard requires significant additional disclosures.

COUPONS AND OTHER PROMOTIONAL DISCOUNTS

The new standard retains much of the existing guidance in ASC 605-50, which requires companies to recognize coupons and other discounts, including promotional cards, provided to a customer as a reduction in revenue. Specifically, the new standard notes that consideration payable to a customer includes cash amounts that a vendor pays, or expects to pay, to a customer, credits or other items such as coupons or vouchers that can be applied against amounts owed to the vendor. Alternatively, the payment to the customer may be in return for the supply of goods or services. Consideration payable to a customer is accounted for as a reduction of the transaction price (and hence, a reduction of revenue), unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the vendor.

When the consideration payable to a customer is treated as a reduction of the transaction price, the reduction of revenue is recognized when (or as) the later of either of the following occurs:

(i) The vendor recognizes revenue for the transfer of the related goods or services to the customer.

(ii) The vendor pays, or promises to pay, the consideration, even if the payment is conditional on a future event. Such a promise may be implied by the vendor's customary business practices.

Therefore, coupons and other discounts provided to customers will continue to be recognized at the point of sale as a reduction of revenue to the extent that they are broadly distributed as a marketing offer.

However, if an owner/operator grants a coupon to a customer at the time of sale such that the customer would not obtain the coupon without making the related purchase, then the coupon is considered a material right, and the arrangement consideration must be allocated between the good being purchased and the coupon, with any amount allocated to the coupon deferred as a contract liability until the coupon is redeemed or expires. See "Loyalty Programs" below for further discussion of the applicable accounting.

GIFT CARD SALES AND RELATED BREAKAGE

Accounting for the initial sale and subsequent redemption of gift cards will also remain substantially unchanged under the new standard. Under step 5 of the revenue recognition model, revenue cannot be recognized until control of the promised good or service is transferred to the customer. Therefore any consideration received in exchange for a gift card must be deferred as a contract liability until redeemed in the restaurant, at which time it is recognized in revenue.

The new standard does, however, provide a new model for accounting for breakage. In addition, the FASB issued ASU 2016-04[5] to exempt prepaid stored-value products from the guidance on extinguishing liabilities, and instead makes them subject to the breakage accounting in Topic 606. However, the exemption only applies to breakage liabilities that are not subject to unclaimed property laws or that are attached to segregated bank accounts, such as consumer debit cards.

5 Recognition of Breakage for Certain Prepaid Stored-Value Products (a consensus of the Emerging Issues Task Force)

BDO OBSERVATION

Determining whether breakage liabilities are subject to unclaimed property laws is a legal question, and may require judgment as the laws often vary by state. As a result, a company could have multiple breakage liabilities that are accounted for differently. As such, entities may need to consult with unclaimed property specialists. Separately, this guidance does not address the accounting for dormancy or other fees charged to holders of unused stored-value products.

The guidance in the new revenue standard provides that if an entity expects to be entitled to breakage, it should derecognize the amount of the liability in proportion to the pattern of rights expected to be exercised by the product holder. In addition, breakage should only be recognized to the extent that it is probable that a significant reversal of the recognized breakage amount will not subsequently occur. Entities must update their estimates of breakage at the end of each reporting period, with changes accounted for as a change in accounting estimate.

EXAMPLE

Bobby's Burgers sells gift cards which are redeemable at any of its ten locations, and which expire after two years. The restaurants all operate in jurisdictions in which the gift cards are not subject to escheatment. During 20X7, Bobby's sells gift cards totaling $100,000. Based on historical experience, Bobby's expects approximately 10% of the gift cards to go unredeemed.

During 20x8, Bobby's customers redeem 60% of the gift cards, which represents 2/3rd of the total gift cards expected to be redeemed ($60,000 out of $90,000 expected to be redeemed). Therefore, Bobby's recognizes breakage revenue during 20x8 of $6,667, or 2/3rd of the total expected breakage of $10,000. During 20x9, the remaining 30% is redeemed, and Bobby's recognizes the remaining 1/3rd of the cards that expire, or $3,333 as breakage revenue.

BDO OBSERVATION

The new model for recognizing gift card breakage requires tracking gift card redemptions based on when the cards were sold in order to recognize the breakage "in proportion to the pattern of rights expected to be exercised." Restaurant operators should proactively work with their gift card program manager to ensure that the manager will be able to provide adequate tracking and related reporting in order support the operator's recognition of breakage.

LOYALTY PROGRAMS

Many restaurant brands sponsor loyalty programs in which repeat customers can earn points from qualifying purchases that may be redeemed for free or discounted merchandise. Under step 2 of the new revenue recognition model, the operator must assess the promises in the contract with the customer, including material rights as discussed previously. As noted by the TRG at its October 2014 meeting, rights that accumulate (for example, loyalty points) may be considered a material right that represents a discrete performance obligation that must be accounted for separately. As a result, the arrangement consideration must be allocated under step 4 of the revenue recognition model between the performance obligations.

Example 52[6] in the new standard illustrates how to account for loyalty points earned by a customer under a contract. In that example, an entity has a customer loyalty program that rewards a customer with 1 customer loyalty point for every $10 of purchases. Each point is redeemable for a $1 discount on any future purchases of the entity's products. Sales totaling $100,000 are made during a given reporting period result in the accumulation of 10,000 loyalty points. If the entity expects 95% of the points to be redeemed, it estimates a standalone selling price of $0.95 per point, for a total of $9,500, based on a likelihood of redemption.

6 ASC 606-10-55-353 through 55-356

Because the points are deemed to represent a material right that the customer would not have received absent entering into the contract, the entity concludes that the promise to grant points is a performance obligation. Under step 4 of the model, the entity allocates the arrangement consideration of $100,000 to the two performance obligations (loyalty points and goods sold) on a relative standalone selling price basis, resulting in the following:

Goods: $100,000 x ($100,000 ÷ ($100,000 + $9,500)) = $91,324

Points: $100,000 x ($9,500 ÷ ($100,000 + $9,500)) = $8,676

Therefore, the entity recognizes revenue of $91,324, and a contract liability of $8,676. Revenue related to the loyalty points is recognized as the points are redeemed by customers. If the loyalty program allows customers to redeem points for goods or services provided by other entities, the plan sponsor must assess whether they serve as the principal or the agent in the redemption transaction. See BDO's newsletter, Topic 606, Revenue from Contracts with Customers, for more information on assessing whether an entity serves as the principal or agent in a transaction.

Conclusion

The new revenue standard will result in a significant change in the accounting for upfront franchise fees and area development fees charged by franchisors. Franchisors should begin now assessing the impact of the new standard on their accounting and reporting, including assessing how to gather the additional information needed to comply with the new disclosure requirements.

While franchisees and other owner/operators are not expected to experience the same far-reaching changes from implementing the new standard, some of the changes, in particular those related to the treatment of loyalty programs, may require system changes. Franchisees and other owner/operators should assess their current programs, and any planned changes, and perform a system review to ensure that the appropriate information will be available.

For additional information, or to learn more about BDO's restaurant and franchise industry practice, please contact:

ANGELA NEWELL
National Assurance Partner
214-689-5669 / ajnewell@bdo.com

DUSTIN MINTON
Assurance Partner and Co-Leader of BDO's National Restaurant Practice
513 587-3285 / dminton@bdo.com

JAY DUKE
Managing Partner and Leader of BDO's National Franchise Practice
214-665-0607 / jduke@bdo.com

ALAN STEVENS
Assurance Partner
214-665-0786 / astevens@bdo.com

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 60 offices and over 500 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 67,700 people working out of 1,400 offices across 158 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.

APPENDIX 1: FRANCHISOR EXAMPLE

A franchisor enters into a franchise agreement with a new franchisee. Under the terms of the franchise agreement, the franchisee pays an upfront fee of $100,000 at the time of signing the agreement and agrees to remit royalty fees of 4.0% of sales plus advertising fees of 1% of sales on a monthly basis. In return, the franchisor promises to provide limited use of the franchisor's brand name and logo, supported by marketing activities, and ongoing access to a continually updated operating procedures manual and recipes for a period of 10 years, as well as initial training on those operating procedures. In addition, the franchisor agrees to provide site selection services to help the franchisee identify an appropriate location for the franchise store, as well as access to brand-specific architectural designs (which must be used by the franchisee when constructing the franchise store). Finally, the agreement provides for the provision of point-of-sale equipment to be used in the franchise location. While the agreement requires the franchisee to utilize one of three approved food suppliers, it does not provide any support for the franchisee related to obtaining services from any of those suppliers.

After assessing the guidance in ASC 606-10-25-19, the franchisor concludes the use of brand name and logo and ongoing access to the operating procedures manual and recipes represent the core components of the franchise license. In addition, the franchisor concludes that the initial training services plus the brand-specific architectural designs are not distinct performance obligations. While both are capable of being distinct, both are highly interrelated with the franchise agreement. Specifically, the training focuses on how to perform the brand operating procedures and prepare the recipes, and thus is necessary in order for the operating manual and recipes to have value to the franchisee. In addition, the architectural designs result in a distinctive façade that is critical to the overall brand design and logo, and thus significantly affect the value of the franchise agreement.

Conversely, the franchisor notes that the site selection services are not brand-specific, but could benefit any owner-operator or franchisee, and the point-of-sale equipment is not required in order to appropriately prepare the brand recipes. Therefore, the franchisor concludes that the franchise agreement includes the following distinct performance obligations:

- Franchise license
- Site selection services
- Point-of-sale equipment

While the franchisor does not typically enter into new franchise arrangements that do not include the site selection services and point-of-sale equipment, it does frequently renew existing franchise agreements without those items. In those situations, the franchisor typically requires a renewal fee of $20,000, a monthly royalty fee of 4% of sales and a monthly advertising fee of 1% of sales. In addition, the franchisor determines that the standalone selling price of the point-of-sale equipment is $75,000, based on the prices charged in the market by the manufacturer of the equipment. Finally, the franchisor concludes that the standalone selling price of the site selection services is $5,000, based on the franchisor's cost to provide the services, plus a reasonable profit margin.

The franchisor first considers whether the royalty fee and advertising fee, which represents variable consideration, can be allocated solely to the franchise license and the upfront fee to the site selection service and equipment. Based on its experience with other franchisees, the franchisor estimates that the franchisee can obtain average monthly sales of $500,000 over the 10-year term of the agreement. Therefore, the franchisee estimates the variable consideration to be $3,000,000 (5% of $500,000 per month for ten years). Allocating the variable consideration solely to the franchise license and the upfront payment solely to site selection and equipment would result in the following:

Franchise license	**$3,000,000**
Site selection	**6,250**[7]
Point-of-sale equipment	**93,750**[8]

However, the franchisor concludes that this allocation is not consistent with the objective that the transaction price is allocated to each performance obligation in order to reflect the consideration to which the franchisor expects to be entitled in exchange for the good or

7 Calculated as $5,000 ÷ ($75,000 + $5,000) x $100,000
8 Calculated as $75,000 ÷ ($75,000 + $5,000) x $100,000

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

© 2017 BDO USA, LLP. All rights reserved.

service, as it allocated substantially more consideration to the site selection services and equipment than their standalone selling prices. Therefore, the franchisor concludes that it cannot allocate the upfront consideration solely to the site selection services and equipment and variable consideration solely to the franchise license. Instead, it must allocate both upfront and variable consideration to the three performance obligations on a relative standalone selling price basis.

Therefore, the franchisor allocates the upfront payment on a prorata basis between the three performance obligations, resulting in the deferral of $97,419[9] related to the franchise license, recognition of $162[10] upon performance of the site selection services and recognition of $2,419[11] upon delivery of the point-of-sale equipment. Note, because the revenue resulting from the royalty and advertising fees cannot be recognized until the related sales are generated, the franchisor will not recognize a receivable for the remainder of the arrangement consideration allocated to the site selection and point-of-sale equipment, despite the fact that both have been delivered to the franchisor. However, there is no ability to defer any portion of the related costs, resulting in a net loss on the provision of those goods and services upon delivery.

In this example, had the upfront fee been only $80,000, which directly corresponds with the standalone value of site selection services and the equipment, then the franchisor would have been able to allocate the royalty fee solely to the franchise fee deliverable, and the upfront fee solely to the site selection services and equipment. Therefore, in this revised scenario, the franchisor would have been able to recognize the full $80,000 upon transfer of control of the site selection services and equipment, rather than having to defer the majority.

9 Calculated as value of license of $3,020,000 ÷ ($3,020,000 + $75,000 + $5,000) x $100,000
10 Calculated as $5,000 ÷ ($3,020,000 + $75,000 + $5,000) x $100,000
11 Calculated as $75,000 ÷ ($3,020,000 + $75,000 + $5,000) x $100,000

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

© 2017 BDO USA, LLP. All rights reserved.