

Proposed Accounting Standards Update

Issued: September 21, 2020
Comments Due: November 5, 2020

**Franchisors—Revenue from Contracts with
Customers (Subtopic 952-606)**

Practical Expedient

The Board issued this Exposure Draft to solicit public comment on proposed changes to Topic 952 of the *FASB Accounting Standards Codification*[®]. Individuals can submit comments in one of three ways: using the electronic feedback form on the FASB website, emailing comments to director@fasb.org, or sending a letter to “Technical Director, File Reference No. 2020-600, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116.”

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft until November 5, 2020. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at [Exposure Documents Open for Comment](#)
- Emailing comments to director@fasb.org, File Reference No. 2020-600
- Sending a letter to “Technical Director, File Reference No. 2020-600, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116.”

All comments received are part of the FASB’s public file and are available at www.fasb.org.

The *FASB Accounting Standards Codification*[®] is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective. A copy of this Exposure Draft is available at www.fasb.org.

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Proposed Accounting Standards Update

Franchisors—Revenue from Contracts with Customers
(Subtopic 952-606)

Practical Expedient

September 21, 2020

Comment Deadline: November 5, 2020

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Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

On May 28, 2014, the FASB issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. During the implementation of Update 2014-09, private company stakeholders in the franchise industry raised concerns about the cost and complexity of applying Topic 606 to determine the amount and timing of revenue recognition for initial franchise fees, especially for franchisors that are start-ups or that have a small number of franchise units. The initial franchise fee typically is paid in a lump sum to a franchisor in exchange for establishing a franchise relationship, along with the provision of varying levels of pre-opening services. Before the adoption of Topic 606, under the industry-specific guidance in Topic 952, Franchisors, the initial franchise fee typically was recognized when the franchise location opened. Under the guidance in Topic 606, the franchisor is required to determine whether the pre-opening activities contain any separate performance obligations and to analyze the standalone selling prices for those activities to determine the timing and amount of revenue recognition.

The Board decided to undertake this project to address the issues raised by stakeholders who expressed concerns about the level of effort required to account for initial franchise fees by private company franchisors and the accounting outcome of deferring some or all of the initial franchise fee over the franchise license term. The Board also became concerned that some entities that are not public business entities appeared to presume that the initial franchise fee would always be recognized over the license term rather than applying the Topic 606 model to identify performance obligations. The amendments in this proposed Update are intended to reduce the cost and complexity of applying Topic 606 to initial franchise fees for franchisors that are not public business entities by providing a practical expedient for applying Topic 606 to initial franchise fees. Additionally, the Board expects that for nonpublic business entities, applying the practical expedient will result in accounting results generally consistent with the intent of Topic 606 for those entities.

Who Would Be Affected by the Amendments in This Proposed Update?

The amendments in this proposed Update would apply to entities that are not public business entities that are within the scope of Topic 952. The guidance in that Topic applies to all entities that meet the definition of franchisor, that is, the party who grants business rights (the franchise) to the party (the franchisee) who will operate the franchised business.

The timing of an entity's adoption of Topic 606 (that is, whether the entity previously adopted Topic 606 or whether it will apply the deferred effective date) does not affect the applicability of the guidance.

What Are the Main Provisions?

The amendments in this proposed Update would introduce a new practical expedient that would simplify the application of the guidance about identifying performance obligations. The practical expedient would permit franchisors that are not public business entities to account for pre-opening services provided to a franchisee as a single separate performance obligation if the services are consistent with those included in a predefined list within the guidance and they meet certain other conditions.

A franchisor would be required to assess the ongoing fees and the relation of those fees to ongoing services. A franchisor would be precluded from applying the expedient if it is not probable that continuing franchise fees will cover the continuing cost of services plus a reasonable profit.

How Would the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Would They Be an Improvement?

Under the current guidance in Topic 606, franchisors analyze pre-opening activities in their franchise agreements to identify whether those activities represent promised goods or services and, if so, whether they are performance obligations. If the goods or services and the franchise license are determined to be distinct from each other and, therefore, are performance obligations, entities are then required to analyze each performance obligation to determine the standalone selling prices, allocation of the consideration, and timing of revenue recognition.

In applying the proposed practical expedient, pre-opening services that are consistent with those included in a predefined list within the guidance may be accounted for as a single bundled, separate performance obligation, as long as it is probable that the continuing fees in the agreement would be sufficient to cover the franchisor's continuing costs plus a reasonable profit.

Feedback from private company stakeholders indicated that significant cost and complexity are associated with identifying and evaluating performance obligations related to pre-opening services under a franchise agreement. In addition, they noted that some nonpublic business entities appeared to presume that the initial franchise fee would always be recognized over the license term rather than applying the Topic 606 model to identify performance obligations. Accordingly, the

Board expects that applying the practical expedient would achieve accounting results that are generally more consistent with the intent of Topic 606 for those entities. Additionally, the proposed practical expedient would simplify the guidance on identifying performance obligations for franchisors that perform pre-opening services by allowing a franchisor to account for pre-opening services as distinct if they are consistent with those included in a predefined list of pre-opening services. The expedient would not amend other aspects of Topic 606, for example, the guidance on allocating the transaction price and determining standalone selling prices.

When Would the Amendments Be Effective and What Are the Transition Requirements?

If an entity has not yet adopted Topic 606, the existing transition provisions and effective date in paragraph 606-10-65-1 are required. That guidance allows for an option of modified retrospective transition or full retrospective transition and an effective date of annual reporting periods beginning after December 15, 2019, and interim reporting periods within annual reporting periods beginning after December 15, 2020.

If an entity has already adopted Topic 606, the amendments in this proposed Update would be effective in interim and annual periods beginning after December 15, 2020. Early application would be permitted. For those entities, this proposed guidance would be applied retrospectively to the date Topic 606 was adopted.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Question 1: Do you support introducing guidance for franchisors that are not public business entities to account for pre-opening services provided to a franchisee? Please explain why or why not.

Question 2: Should the scope of the amendments in this proposed Update be limited to franchisors that are not public business entities? Alternatively, would it be appropriate for entities in other industries with comparable arrangements that are not within the scope of the proposed Update to analogize to the amendments? Please explain why.

Question 3: Would the proposed amendments to simplify Step 2—identify the performance obligations—reduce the cost and complexity of applying Topic 606 to pre-opening services? Please explain why or why not.

Question 4: In paragraph 952-606-25-3, the proposed amendments would reinstate superseded guidance from paragraph 952-605-25-4 as a required criterion for applying the practical expedient. Is this guidance operable? Please explain why or why not.

Question 5: Should the scope of the proposed amendments be limited to pre-opening services? If not, please explain why.

Question 6: Is additional guidance about other aspects of applying Topic 606 to pre-opening services needed for the proposed amendments to be operable? If so, what specific guidance is needed?

Question 7: Should entities that elect to apply the practical expedient be required to disclose that fact? Do the proposed amendments provide decision-useful information for users of financial statements? If not, please explain why.

Question 8: Should entities that have not yet adopted Topic 606 be required to apply the transition provisions and effective date in paragraph 606-10-65-1 to the proposed amendments? If not, please explain why.

Question 9: Should entities that have already adopted Topic 606 be required to apply the proposed amendments on a full retrospective basis, including an entity's first reporting period under Topic 606? If not, please explain why.

Question 10: For entities that have already adopted Topic 606, should the proposed amendments be effective for annual reporting periods beginning after December 15, 2020, including interim reporting periods within that period, with early application permitted? If not, please explain why.

Amendments to the *FASB Accounting Standards Codification*[®]

Summary of Proposed Amendments to the Accounting Standards Codification

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2 and 3. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck-out~~.

Addition of Subtopic 952-606

2. Add Subtopic 952-606, Franchisors—Revenue from Contracts with Customers, with a link to transition paragraph 952-606-65-1, as follows:

[For ease of readability, the new Subtopic is not underlined.]

Franchisors—Revenue from Contracts with Customers

Overview and Background

General

952-606-05-1 This Subtopic addresses a practical expedient for revenue recognition for a **franchisor** that is not a **public business entity**.

Scope and Scope Exceptions

General

952-606-15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 952-10-15.

952-606-15-2 Except for the example in paragraphs 952-606-55-1 through 55-4, which is applicable to any entity that is a franchisor, a **public business entity** shall not apply the guidance in this Subtopic.

952-606-15-3 Except as noted in paragraph 952-606-15-2, entities that are not within the scope of this Subtopic shall not apply the guidance in this Subtopic directly or by analogy.

Glossary

Contract

Note: The following definition is Pending Content; see Transition Guidance in 606-10-65-1

An agreement between two or more parties that creates enforceable rights and obligations.

Customer

Note: The following definition is Pending Content; see Transition Guidance in 606-10-65-1

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.

Franchise Agreement

A written business agreement that meets the following principal criteria:

- a. The relation between the franchisor and franchisee is contractual, and an agreement, confirming the rights and responsibilities of each party, is in force for a specified period.
- b. The continuing relation has as its purpose the distribution of a product or service, or an entire business concept, within a particular market area.
- c. Both the franchisor and the franchisee contribute resources for establishing and maintaining the franchise. The franchisor's contribution may be a trademark, a company reputation, products, procedures, manpower, equipment, or a process. The franchisee usually contributes operating capital as well as the managerial and operational resources required for opening and continuing the franchised outlet.
- d. The franchise agreement outlines and describes the specific marketing practices to be followed, specifies the contribution of each party to the operation of the business, and sets forth certain operating procedures that both parties agree to comply with.
- e. The establishment of the franchised outlet creates a business entity that will, in most cases, require and support the full-time business activity of the franchisee. (There are numerous other contractual distribution

arrangements in which a local businessperson becomes the authorized distributor or representative for the sale of a particular good or service, along with many others, but such a sale usually represents only a portion of the person's total business.)

- f. Both the franchisee and the franchisor have a common public identity. This identity is achieved most often through the use of common trade names or trademarks and is frequently reinforced through advertising programs designed to promote the recognition and acceptance of the common identity within the franchisee's market area.

The payment of an initial franchise fee or a continuing royalty fee is not a necessary criterion for an agreement to be considered a franchise agreement.

Franchisor

The party who grants business rights (the franchise) to the party (the franchisee) who will operate the franchised business.

Not-for-Profit Entity

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

- a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- b. Operating purposes other than to provide goods or services at a profit
- c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

- a. All investor-owned entities
- b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

Performance Obligation

Note: The following definition is Pending Content; see Transition Guidance in 606-10-65-1

A promise in a **contract** with a **customer** to transfer to the customer either:

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

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a **not-for-profit entity** nor an employee benefit plan is a business entity.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, **securities** that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

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

Security

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

- a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
- b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
- c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Recognition

General

952-606-25-1 Revenue shall be recognized in accordance with Topic 606, Revenue from Contracts with Customers.

952-606-25-2 As a practical expedient, when applying the guidance in Topic 606, a **franchisor** that enters into a **franchise agreement** may account for the following pre-opening services as a single **performance obligation**:

- a. Assistance in the selection of a site
- b. Assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural, and engineering services, and lease negotiation
- c. Training of the franchisee's personnel or the franchisee
- d. Preparation and distribution of manuals and similar material concerning operations, administration, and record keeping
- e. Bookkeeping, information technology, and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate, and other taxes or about local regulations affecting the franchisee's business
- f. Inspection, testing, and other quality control programs.

952-606-25-3 Sometimes, large initial franchise fees are required but continuing franchise fees are small in relation to future services. If it is probable that the continuing fee will not cover the cost of the continuing services to be provided by the franchisor and a reasonable profit on those continuing services, then the franchisor is precluded from applying the practical expedient in paragraph 952-606-25-2.

952-606-25-4 The practical expedient in paragraph 952-606-25-2 applies only to identifying performance obligations. An entity shall apply this guidance, including the use of any practical expedients, consistently to contracts with similar characteristics and in similar circumstances. If an entity elects not to apply the practical expedient or if the services performed are not included in the list in paragraph 952-606-25-2, the entity shall apply the guidance in Topic 606 on identifying performance obligations. An entity should refer to Topic 606 for guidance on the remaining aspects of recognizing revenue from contracts with customers, including allocating the transaction price and recognizing revenue.

Disclosure

General

952-606-50-1 If an entity elects to use the practical expedient in paragraph 952-606-25-2, the entity shall disclose that fact.

Implementation Guidance and Illustrations

General

> Illustrations

> > Example 1—Identifying Performance Obligations

952-606-55-1 An entity enters into a **contract** with a **customer** and promises to grant a franchise license to open a restaurant location. The franchise license term is 10 years. In addition to the license, the entity also promises to provide two services related to the opening of the franchise location—site selection and training. The entity receives a fixed fee of \$25,000, as well as a sales-based royalty of 5 percent of the customer’s sales for the term of the license. The fixed consideration of \$25,000 is payable on or before the opening of the restaurant location.

> > > Case A: Application of Topic 606 without Using the Practical Expedient

952-606-55-2 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. In this Case, the entity determines that the training services are distinct because they are capable of being distinct and separately identifiable because they are not highly interrelated with the franchise license. In this Case, the entity determines that the training is not highly brand specific and consists principally of training that could be relevant to the operations of a similar business or businesses in general. In this Case, the entity also determines that the site selection services are distinct from the license because they are not specific to the brand and could be provided by a third party. Therefore, the entity determines that it has three performance obligations—a franchise license, a training service, and a site selection service.

952-606-55-3 The entity determines that the transaction price includes fixed consideration of \$25,000 and variable consideration in the form of a sales-based royalty that is equal to 5 percent of the customer’s sales from the franchise location. The standalone selling price of the pre-opening training services is \$15,000, and the standalone selling price of the site selection service is \$5,000.

952-606-55-4 The entity next allocates the transaction price to the three performance obligations—franchise license, training service, and site selection service. The entity determines that the sales-based royalty relates solely to the franchise license because the entity regularly provides franchise renewals in exchange for 5 percent of customer sales without a similar upfront fee. Therefore,

the entity applies the sales-based royalty exception in paragraph 606-10-55-65 to the variable consideration and recognizes revenue as the franchisee's sales occur. Because the initial franchise fee exceeds the standalone selling prices of the pre-opening services, allocating the variable consideration solely to the license while allocating the initial franchise fee based on the standalone selling prices would be consistent with the allocation objective because the transaction price allocated to the performance obligation depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised good or service. In reaching this conclusion, the entity considers that the initial franchise fee is commensurate with its level of effort in providing the pre-opening services plus a customary nonrefundable fee associated with the intellectual property. The entire royalty is allocated to the franchise license. Of the \$25,000 fixed fee, \$15,000 is allocated to the training service, \$5,000 is allocated to the site selection service, and \$5,000 is allocated to the franchise license.

> > > **Case B: Application of Topic 606 Using the Practical Expedient**

952-606-55-5 The entity first assesses whether it is eligible for the practical expedient for identifying **performance obligations** in paragraph 952-606-25-2. The entity determines that it is eligible because it is not a **public business entity**, it is a **franchisor** that is within the scope of Topic 952, and the royalty fee will compensate the entity for the cost of any continuing services, which in this Case is the right to access symbolic intellectual property (the franchise license), plus a reasonable profit.

952-606-55-6 In applying the practical expedient, the entity compares its pre-opening services (training and site selection) to the list of services in paragraph 952-606-25-2 instead of applying the guidance in paragraph 606-10-25-19. The entity determines that those services may be accounted for as a single performance obligation because they are consistent with the list of services in paragraph 952-606-25-2. Therefore, the entity determines that it has two performance obligations—a franchise license and pre-opening services.

952-606-55-7 As described in paragraphs 952-606-55-3 through 55-4, \$20,000 is allocated to the pre-opening services performance obligation, and the remaining fixed and variable payments are allocated to the franchise license performance obligation.

952-606-55-8 The entity discloses its use of the practical expedient in accordance with the disclosure requirement in paragraph 952-606-50-1.

Transition and Open Effective Date Information

General

> Transition Related to Accounting Standards Update No. 202X-XX, Franchisors—Revenue from Contracts with Customers (Subtopic 952-606): Practical Expedient

952-606-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 202X-XX, *Franchisors—Revenue from Contracts with Customers (Subtopic 952-606): Practical Expedient*:

- a. An entity that has not yet adopted the pending content that links to paragraph 606-10-65-1 shall apply the pending content that links to this paragraph when it first applies the pending content that links to paragraph 606-10-65-1 and shall apply the same transition requirements for the pending content that links to paragraph 606-10-65-1.
- b. An entity that has adopted the pending content that links to paragraph 606-10-65-1 shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. Early application is permitted.
- c. An entity that adopts the pending content that links to this paragraph in accordance with (b) shall apply the pending content that links to this paragraph by means of a cumulative-effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the pending content that links to paragraph 606-10-65-1 was applied.
- d. An entity that adopts the pending content that links to this paragraph in accordance with (b) shall disclose the following in the period that the entity adopts the pending content that links to this paragraph:
 1. The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle
 2. The method of applying the change
 3. The effect of the adoption on any line item in the statement of financial position as of the beginning of the first period for which the pending content that links to this paragraph is applied
 4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the pending content that links to this paragraph is applied.

Amendments to Topic 606

3. Add paragraphs 606-10-25-18C and 606-10-55-150L and its related heading, with a link to transition paragraph 952-606-65-1, as follows:

Revenue from Contracts with Customers—Overall

Recognition

> Identifying Performance Obligations

> > Promises in Contracts with Customers

606-10-25-18C See Subtopic 952-606, Franchisors—Revenue from Contracts with Customers, for additional guidance and a practical expedient for entities within the scope of that guidance.

Implementation Guidance and Illustrations

> Illustrations

> > Identifying Performance Obligations

> > > Franchisor Example

606-10-55-150L See paragraphs 952-606-55-1 through 55-4 for an additional example of identifying performance obligations for a franchisor.

The amendments in this proposed Update were approved for publication by four members of the Financial Accounting Standards Board. Ms. Botosan and Messrs. Buesser and Schroeder voted against publication of the amendments. Their alternative views are set out at the end of the basis for conclusions.

Members of the Financial Accounting Standards Board:

Richard R. Jones, *Chairman*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Gary R. Buesser
Susan M. Cospers
Marsha L. Hunt
R. Harold Schroeder

Background Information, Basis for Conclusions, and Alternative Views

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. The Board decided to undertake this project to address issues raised by stakeholders in accounting for initial franchise fees by private company franchisors.

Background Information

BC3. On May 28, 2014, the FASB issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. During the implementation of Update 2014-09, private company stakeholders in the franchise industry raised concerns about the cost and complexity of applying Topic 606 to determine the amount and timing of revenue recognition for initial franchise fees, especially for franchisors that are start-ups or that have a small number of franchise units. The initial franchise fee is a fee paid to a franchisor in exchange for establishing a franchise relationship, along with the provision of varying levels of pre-opening services. Before the adoption of Topic 606, under the industry-specific guidance in Topic 952, Franchisors, the initial franchise fee typically was recognized when the franchise location opened. Under the current guidance in Topic 606, franchisors are required to analyze pre-opening activities in their franchise agreements to identify whether the goods and services provided are distinct from the franchise license and, therefore, are performance obligations. If the goods or services are determined to be performance obligations, entities are then required to analyze each performance obligation to determine the standalone selling prices, allocation of the consideration, and timing of revenue recognition. Nonpublic franchisors expressed concern about the cost and complexity of applying the Topic 606 guidance to initial franchise fees and about the potential accounting outcome of deferring some or all of the initial franchise fee over the franchise license term.

BC4. The Board discussed this issue at a public Board meeting in November 2017, in which the Board explained that Topic 606 does not include presumptions about the number of performance obligations in an arrangement. The Board also shared its views that when assessing the standard, an entity should consider the facts and circumstances of its specific arrangements and not overgeneralize. The

handout for the Board meeting and a recording of the Board meeting were posted to the FASB's revenue implementation website. In November 2018, the FASB staff drafted an educational paper, including an example of the application of Topic 606 to initial franchise fees, and a short educational video, which also were posted to the revenue implementation website.

BC5. In early 2020, nonpublic stakeholders in the franchise industry again raised concerns regarding Topic 606 adoption. At the time, nonpublic franchisors had begun the audits of their 2019 annual financial statements, and they observed that it was costly and complex to justify not deferring initial franchise fees, despite analyses performed by some franchisors that were intended to support their view that a portion of pre-opening services is distinct from the franchise license. Additionally, some entities that are not public business entities appeared to presume that the initial franchise fee would always be recognized over the license term rather than applying the Topic 606 model to identify performance obligations. Accordingly, the Board decided to add a research project to its agenda to evaluate how to reduce the costs and complexity related to applying Topic 606 to initial franchise fees and how to improve the application of the guidance to achieve accounting results more consistent with the objective of Topic 606. In July 2020, the Board decided to move the project from the research agenda to its technical agenda and to pursue a private company practical expedient.

BC6. The guidance in Update 2014-09 was effective for calendar-year-end public business entities on January 1, 2018. For all other entities with calendar year-ends, the guidance was set to be effective as of January 1, 2019, for annual reporting periods (and interim reporting periods in 2020). At the April 8, 2020 Board meeting, the Board decided to delay the effective date of Topic 606 for all nonpublic entities that had not yet issued financial statements, including franchisors that are not public business entities, to provide the Board with time to identify a cost-effective solution for the initial franchise fee issue. The effective date deferral was finalized in June 2020 when the Board issued Accounting Standards Update No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, which deferred the effective date for nonpublic entities to annual reporting periods beginning after December 15, 2019, for entities that had not issued financial statements (or made financial statements available for issuance) as of June 3, 2020 (the date the Update was issued). The Board observes that some franchisors had adopted the guidance in Topic 606 before the deferral of the effective date. The timing of an entity's adoption of Topic 606 (that is, whether the entity previously adopted Topic 606 or whether it will be applying the deferred effective date) does not affect the applicability of the guidance.

Benefits and Costs

BC7. The FASB's *Rules of Procedure* states:

The mission of the FASB is to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports.

BC8. In fulfilling that mission, the Board follows certain precepts, including issuing standards only when the expected benefits of the resulting information justify the expected costs. The Board strives to determine that a standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. The Board's assessment of the costs and the benefits of applying new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC9. Paragraph OB2 of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting, Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information*, states the following:

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit. [Footnote reference omitted.]

BC10. Because the amendments in this proposed Update would introduce a practical expedient for applying Topic 606 to initial franchise fees, the Board believes that the proposed amendments would provide the benefit of reducing the cost and complexity of applying Topic 606 for franchisors and their auditors as well as providing financial reporting results that are more consistent with the intent of Topic 606 for those entities that are nonpublic business entities. The expedient

would allow nonpublic franchisors to apply a simplified Step 2, Identify the Performance Obligations in the Contract, of the five-step revenue recognition model, which would eliminate some of the judgment required in applying Topic 606.

BC11. The Board has been working for several years with nonpublic stakeholders in the franchising industry on the issue of the cost and complexity of revenue recognition for initial franchise fees. In response to the issue, the FASB communicated with industry stakeholder groups, discussed the topic at a public Board meeting, and published educational materials on the subject. Despite the FASB's efforts to clarify the purpose of the guidance in Topic 606 and to reduce the cost and complexity associated with applying the guidance to initial franchise fees, the issue has not been resolved. Furthermore, the issue seems to be pervasive among nonpublic franchisors. Therefore, the Board believes that it is appropriate to resolve the issue through standard setting and that developing a limited-scope solution that would result in narrow-scope changes to GAAP would be appropriate to address the issue.

BC12. The Board acknowledges that there will be a cost for financial statement users in analyzing the financial statements affected by amendments in this proposed Update. The primary users of nonpublic franchisor financial statements are regulators and franchisees (both current and prospective). Because application of the practical expedient is optional, the users may incur some ongoing costs to assess the financial statements of both franchisors that choose to apply the practical expedient and franchisors that do not. Additionally, because the practical expedient is not applicable to public business entities, there may be an ongoing cost of comparing financial statements between public business entities and nonpublic entities.

Basis for Conclusions

Practical Expedient

BC13. Nonpublic stakeholder feedback indicated that significant cost and complexity for nonpublic franchisors were associated with identifying performance obligations related to pre-opening services under a franchise agreement. In response to this feedback, the Board decided to propose a practical expedient to allow nonpublic franchisors to account for pre-opening services provided to a franchisee as a single separate performance obligation if the services are consistent with those included in a predefined list within the guidance. Additionally, the Board expects that, for nonpublic business entities, applying the practical expedient will result in accounting results more consistent with the intent of Topic 606.

BC14. The Board believes that the proposed amendments in this Update represent a practical expedient to the application of the guidance in Topic 606 rather than an exception or an accounting alternative. An exception or accounting alternative allows an entity to forgo applying certain accounting guidance or allows different guidance to be applied, leading to a different accounting outcome. An example of an existing accounting exception in Topic 606 is the sales-based or usage-based royalty exception to the general revenue recognition principles in paragraph 606-10-55-65.

BC15. As defined in the Private Company Decision-Making Framework, a practical expedient is a more cost-effective way of achieving the same or a similar accounting or reporting objective. Nonpublic franchisors may use the proposed practical expedient to simplify the determination of whether the promise of pre-opening services is distinct from the intellectual property performance obligation in a franchise agreement. Those entities will then need to apply the existing allocation model in Topic 606 to allocate the consideration in the contract among the license, pre-opening services, and any other goods or services in the arrangement (for example, equipment). Identifying performance obligations and allocating consideration in the contract are two objectives of Topic 606. Therefore, the Board believes that the proposed guidance will simplify the achievement of those objectives. The Board observes that the revenue recognition outcome of applying Topic 606 without the expedient may differ in some cases from the outcome of applying Topic 606 with the expedient. However, the Board believes that the expedient has the same objectives as Topic 606 and that in many cases application of the practical expedient may provide a result closer to the intent of Topic 606. The Board observed that, as with the other practical expedients in Topic 606, an entity should apply the practical expedient consistently to similar contracts in similar circumstances.

BC16. The proposed practical expedient would simplify the guidance on identifying performance obligations for franchisors that perform pre-opening services. Rather than evaluating each promise to perform a pre-opening service to determine whether it is both capable of being distinct from the franchise license promise and distinct in the context of the contract, the practical expedient would allow a franchisor to account for pre-opening services as distinct if they are consistent with those included in a predefined list of pre-opening services. That list of services in the proposed expedient was developed by leveraging the definition of *initial services* that currently exists in the Master Glossary of Topic 952 (which was superseded by Topic 606). That definition has been updated to reflect stakeholders' feedback and the Board's views about which services should be included.

BC17. The proposed amendments in this Update would identify the bundle of pre-opening services as one separate performance obligation. By considering the pre-opening services as a single performance obligation, the Board believes that

it will be simpler to determine one standalone selling price for the bundle as opposed to each individual service.

BC18. The proposed amendments in this Update would simplify the process of identifying performance obligations but would not amend the guidance on allocating the transaction price and determining standalone selling prices as well as recognizing revenue. The Board believes that retaining this guidance is important to maintain a close link to the existing Topic 606 guidance. The Board believes that retaining the requirement to apply the allocation guidance in Topic 606 ensures that the revenue recognized correlates to the services provided and will aid in preventing abuse. For example, if an entity charges a large initial franchise fee but the services provided are minimal, then the standalone selling price should naturally provide a ceiling for how much revenue could be recognized. After allocating the transaction price, an entity would apply the guidance in Topic 606 to determine when to recognize revenue. Under that guidance, an entity would evaluate whether revenue should be recognized over time (paragraph 606-10-25-27) or at a point in time (paragraph 606-10-25-30).

BC19. The Board believes that another advantage of this approach is that it leverages concepts in another area of the guidance in Topic 606. Paragraph 606-10-25-18A addresses shipping and handling activities and provides an election about when shipping and handling is not a promised good or service. This expedient would be similar to that election but would address it differently, that is, by identifying when certain services are a performance obligation.

BC20. A franchisor would be required to assess the ongoing fees and the relationship of those fees to ongoing services to determine whether it is eligible to apply the practical expedient. The Board decided that if it is not probable that continuing franchise fees will cover the continuing cost of services plus a reasonable profit, a franchisor would be precluded from applying the expedient because a contract may require a large initial franchise fee while the continuing franchise fee is small. Those continuing fees may or may not cover the cost of the continuing services to be provided under the franchise agreement. This requirement is similar to the superseded guidance in paragraph 952-605-25-4, which required that a franchisor defer a portion of the initial franchise fee in an amount sufficient to cover the estimated cost in excess of continuing franchise fees plus a reasonable profit for the continuing services when it was probable that continuing franchise fees would not cover the cost of the continuing services plus a reasonable profit. In those situations, the structure of the payments may not reflect the economics of the transaction, and the Board believes that entities should apply the full guidance in Topic 606 to recognize those transactions. Because this criterion was developed using existing guidance in Subtopic 952-605 that has been effective for franchisors for years, the Board expects that it would result in similar application as in current practice.

Alternative Approaches Considered but Dismissed by the Board

BC21. The Board considered three alternative approaches that would have significantly amended Topic 606 as compared with the amendments in this proposed Update. These approaches are discussed in detail below. The Board ultimately dismissed those approaches because it concluded that the benefits would not justify the costs.

BC22. The first alternative that the Board considered would have allowed a franchisor to presume that an initial franchise fee can be recognized, in its entirety, when an entity has transferred control of the goods or services to which the consideration that has been received relates, unless certain conditions are met. Those conditions are that (a) the sales-based or usage-based royalty does not reflect the standalone selling price of the franchise license, (b) the initial franchise fee relates to multiple franchise units, or (c) the costs incurred by the franchisor in opening the franchise location are significantly less than the initial franchise fee. If any of those conditions are met, an entity would be precluded from applying the practical expedient. That alternative leveraged the existing expedient in paragraph 606-10-55-18, which allows an entity to recognize revenue if the consideration received corresponds directly to the value to the customer of the entity's performance to date. The Board ultimately rejected this alternative because it disregards the requirement in Topic 606 to identify performance obligations and to allocate the transaction price based on the standalone selling prices of those performance obligations.

BC23. The second alternative that the Board considered would have required the deferral of the entire initial franchise fee, which would be recognized as revenue ratably over the license term. That approach would have eliminated the need to evaluate and document whether each good or service is distinct, as well as the need to estimate the standalone selling price for the services, both of which seem to be a point of difficulty for nonpublic franchisors. However, the Board rejected this approach because it would have exacerbated stakeholders' concerns about the accounting treatment of initial franchise fees. Additionally, the Board considered this approach to be overly conservative because it would defer revenue for pre-opening services that may have been considered separate performance obligations if Topic 606 were applied.

BC24. The third alternative considered would have allowed a predetermined percentage of the initial franchise fee to be recognized upon completion of the pre-opening services. The Board had concerns about drawing an arbitrary threshold and that such an approach would require ongoing maintenance of the guidance (for example, periodically reevaluating the threshold). The Board rejected this alternative because it believes that it is inconsistent with the objectives of Topic 606.

Scope

Entities That Are Not Public Business Entities

BC25. Nonpublic franchisors voiced concerns about the cost and complexity of applying Topic 606 to initial franchise fees. On the basis of outreach with stakeholders, the Board understands that initial franchise fees are typically a more significant portion of revenue for nonpublic franchisors than for public franchisors, generally because nonpublic franchisors are more likely than public franchisors to be in a start-up or growth phase. Additionally, the Board understands that nonpublic franchisors are experiencing more difficulty in applying the guidance on identifying performance obligations as compared with public franchisors.

BC26. The Board observes that public business entities have previously adopted Topic 606 and is unaware of questions being raised recently about the application of Topic 606 by public franchisors. Furthermore, limiting the amendments to entities that are not public business entities substantially retains convergence between GAAP and IFRS Standards, as described further in paragraphs BC35–BC37. For those reasons, the Board decided to limit the applicability of the practical expedient to entities that are not public business entities.

BC27. The Board observes that a private company practical expedient is allowable under the Private Company Decision-Making Framework, which states that if the guidance provides relevant information, the Board should consider whether using one or more practical expedients could satisfy the needs of the users of private company financial statements while reducing the cost for preparers of those financial statements.

BC28. The Private Company Decision-Making Framework provides that effective dates for private companies should be deferred as compared with the effective dates for public companies because private companies require additional time to effectively and efficiently implement new guidance and because many private companies and/or their public accountants acquire valuable knowledge and become efficient from observing the earlier implementation experiences of public companies. The Board observes that a longer implementation period has provided private companies with the time necessary to identify the issues in applying Topic 606 to initial franchise fees and has provided insights into how to become efficient in adopting the guidance through the introduction of a new practical expedient.

Entities That Are Franchisors

BC29. In undertaking this project, the Board decided to limit the applicability of the guidance to entities that are franchisors. The Master Glossary defines a

franchisor as “the party who grants business rights (the franchise) to the party (the franchisee) who will operate the franchised business.”

BC30. Because the intent of the amendments in this proposed Update is to limit the use of the practical expedient to entities that are franchisors, the Board decided to create a new Subtopic, Subtopic 952-606, Franchisors—Revenue from Contracts with Customers, to reduce the costs of applying the guidance by clarifying the scope for stakeholders. The Board determined that the Topic 606 application issue and the need for a practical expedient are unique to franchisors. While the Board acknowledged that other industries may provide upfront services or collect upfront fees, the Board decided not to expand the scope of the amendments to other entities. Therefore, the amendments specify that the guidance would not be applied directly or by analogy by entities that are not within scope of Subtopic 952-606.

Types of Fees

BC31. The amendments in this proposed Update apply to pre-opening services. During outreach, stakeholders highlighted that there are other fees that a franchisor collects that may be similar to an initial franchise fee that a franchisor collects in exchange for performing pre-opening services, such as area franchise fees, renewal fees, and transfer fees. The Board decided to limit the scope of the proposed amendments to pre-opening services because the stakeholders' concerns relate to initial franchise fees. Additionally, the Board has not received feedback indicating a need for clarification or an expedient relating to other fees. Also, initial franchise fees are well defined and share a certain level of commonality among franchisors and transactions that other types of fees may lack. For example, area arrangement fees are typically unique and may have complex structuring, and the accounting for a renewal depends on applying the contract modification framework and, therefore, the applicability of an expedient may depend on the structure of the renewal.

Disclosure

BC32. Paragraph 606-10-50-22 of Topic 606 currently includes a disclosure requirement about the use of practical expedients. The Board believes that this disclosure would be important to the users of franchisor financial statements (a) because of the potential effect on comparability between those franchisors that apply the expedient and those that do not and (b) to ensure that the financial statements provide transparency for the primary users of franchisor financial statements, franchise regulators, and prospective franchisees about an expedient being applied. Accordingly, the Board included this disclosure requirement in Subtopic 952-606.

Implementation Guidance

BC33. The amendments in this proposed Update would add implementation guidance to Subtopic 952-606 on how to apply Topic 606 as issued and Topic 606 using the new practical expedient. The educational example illustrating the application of Topic 606 to pre-opening services that was previously developed by the staff was well received by stakeholders. However, the primary shortcoming of the previous example is that it is included in educational materials posted to the FASB website and is not included in the Codification.

BC34. The amendments in this proposed Update would elevate the example to authoritative guidance and increase the accessibility of the example by including it within the Codification, which should aid with the dissemination of the information. Codifying the example is intended to improve the accessibility of the information and it is not intended to call into question an entity's prior adoption of Topic 606. The Board also decided to include a proposed example that illustrates the application of the proposed practical expedient.

International Financial Reporting Standards

BC35. On May 28, 2014, the FASB and the International Accounting Standards Board (IASB) jointly issued converged guidance on the recognition of revenue from contracts with customers. The guidance on revenue recognition for intellectual property (IP) has substantially converged, although there are some differences because GAAP includes evaluation of symbolic IP and functional IP to determine whether a license may be recognized over time or at a point in time, which does not exist in IFRS Standards. Despite those differences, the Board would expect that franchise licenses would be recognized over time under both GAAP and IFRS Standards. Additionally, the guidance about identifying performance obligations and allocating the transaction price (and standalone selling price guidance) has converged.

BC36. While IFRS 15, *Revenue from Contracts with Customers*, and Topic 606 have substantially converged, there is a significant difference between GAAP and IFRS Standards when it comes to the guidance for nonpublic entities. Under GAAP, both nonpublic entities and public business entities follow the same guidance. Private companies may elect to apply private company accounting alternatives, but largely they follow the same GAAP as public companies. Accordingly, the revenue guidance under GAAP for public and private companies is the same (except for some disclosure differences).

BC37. The IFRS Standards differ from GAAP because under IFRS Standards nonpublic entities may use the IFRS Standards for small and medium-sized entities (SMEs), although some nonpublic entities may apply IFRS. The revenue section of the IFRS Standards for SMEs has not yet been updated to apply IFRS 15 principles. Accordingly, while the revenue guidance for public business entities

has largely converged, revenue guidance for nonpublic entities that apply IFRS Standards for SMEs has not converged between GAAP and IFRS Standards. Accordingly, because the proposed amendments in this Update are applicable only to entities that are not public business entities, no significant effect on the convergence of Topic 606 and IFRS 15 is expected.

Effective Date and Transition

BC38. The Board is providing the following two sets of transition guidance for entities that have not yet adopted Topic 606 and entities that have previously adopted Topic 606:

- a. If an entity has not yet adopted Topic 606, the existing transition provisions and effective date in paragraph 606-10-65-1 would be required. That guidance allows for an option of modified retrospective transition or full retrospective transition and an effective date of annual reporting periods beginning after December 15, 2019, and interim reporting periods within annual reporting periods beginning after December 15, 2020.
- b. If an entity has already adopted Topic 606, the proposed amendments would be effective in interim and annual periods beginning after December 15, 2020. Early application would be permitted. The Board believes that the proposed effective date would provide sufficient time for entities and their auditors to analyze the effect of the proposed amendments on their application of Topic 606. For those entities, those proposed amendments would be applied retrospectively to the date Topic 606 was adopted. The Board decided that a full retrospective approach would be necessary to preserve comparability between periods and data about historical revenue trends.

Alternative Views

BC39. Ms. Botosan and Messrs. Buesser and Schroeder do not support this proposed Update's practical expedient to account for initial franchise fees (IFFs) by franchisors that are not public business entities. They believe that applying such a one-size-fits-all approach violates the core principle of Topic 606 in paragraph 606-10-10-2, which states that "an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services" provided by the entity. Therefore, they believe that the amendments in this proposed Update would not improve GAAP. Additionally, they believe that the expected benefits would not justify the costs.

BC40. Ms. Botosan and Messrs. Buesser and Schroeder observe that a main advantage of Topic 606 was that it eliminated a vast body of industry-specific revenue recognition guidance that suffered from internal inconsistencies. In their view, the amendments in this proposed Update would simply reintroduce industry-specific guidance. Compounding their concern is that adding industry-specific guidance for franchisors that are not public business entities will open the door to additional requests from others for their own unique guidance. Those Board members believe that the purpose of those requests would likely not be to achieve more faithful representation of performance, but rather to achieve more preferred revenue recognition outcomes.

BC41. The amendments in this proposed Update would allow franchisors that are not public business entities to account for certain pre-opening services that are consistent with a codified list as a separate performance obligation, regardless of the nature of those services within the context of the arrangement. Adding that guidance to a principles-based standard would override Topic 606's inherent application of judgment in determining the accounting for revenue. They believe that judgment is critical to best reflect the economics of an entity's often unique contracts with its customers that evolve over time.

BC42. Furthermore, Ms. Botosan and Messrs. Buesser and Schroeder are concerned that introducing such a pre-defined list would increase cost and complexity. They believe that higher costs are a likely consequence because questions inevitably will arise about the items included in the list, the ongoing maintenance of the list (as the nature of arrangements evolve over time), and the applicability of the list to an entity's unique facts and circumstances. As one outreach participant noted, there are approximately 220 sectors within franchising. Therefore, it would be difficult for the Board to develop and maintain a list applicable to all franchisors that would result in the same or similar outcome to one resulting from the application of the five-step model in Topic 606.

BC43. Rather than introducing a practical expedient, Ms. Botosan and Messrs. Buesser and Schroeder believe that the amendments in this proposed Update are an exception to the Topic 606 model. A practical expedient is intended to be a more cost-effective way of achieving the same or similar accounting or reporting outcome. They believe that using judgment inherent in applying Topic 606 often results in outcomes that are materially different from that resulting from applying the proposed one-size-fits-all approach.

BC44. In addition, Ms. Botosan and Messrs. Buesser and Schroeder question the efficacy of the proposed practical expedient. If cost reduction is the primary concern, the least costly alternative would be to provide an option to defer the revenue recognition of all IFFs and amortize the deferred amount into revenue on a straight-line basis over the term of the contract. They believe that their preferred alternative would be far less costly than the proposed practical expedient. It also

would offer a more faithful representation of those franchise arrangements that they believe are more typical, that is, arrangements that do not convey high-value, distinct pre-opening services to franchisees.

BC45. Ms. Botosan and Messrs. Buesser and Schroeder also are concerned about the difficulty in limiting the scope of the proposed Update to only franchisors that are not public business entities because entities in other industries face similar economic circumstances. There is nothing unique about IFFs compared with initial fees charged in a variety of other industries. Therefore, they believe that the amendments in this proposed Update would open the door to analogizing by entities in other industries who can reasonably argue that they face similar economic circumstances.

BC46. Finally, Ms. Botosan and Messrs. Buesser and Schroeder conclude that the expected benefits would not justify the expected costs of the amendments in this proposed Update. They believe that the amendments would be more costly for preparers than their preferred alternative to defer and amortize all IFFs. Furthermore, they believe that it would impose greater cost on the collective financial reporting system by reintroducing industry-specific revenue recognition rules into the principles-based guidance designed to apply to all industries, which is guidance that has largely converged with IFRS 15. Included in their assessment of system-wide costs are those that would be imposed on financial statement users who would receive less comparable and, in some cases, less relevant information about an entity's revenue. Moreover, they are concerned that such costs will likely grow if other industries similarly urge the Board to address their specific concerns.

Amendments to the XBRL Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would not require improvements to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). Any stakeholders who believe that improvements to the Taxonomy are required should provide their comments and suggested improvements at xbrled@fasb.org.