

Client Alert

Business Information for
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Shumaker, Loop & Kendrick, LLP

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Business Owners - Did you really earn that revenue? The Authorities say "Not so FASB."

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Thanks to a new revenue recognition standard implemented by the Financial Accounting Standards Board (FASB)¹, formally titled "ASC 606, Revenue from Contracts with Customers" ("ASC 606"), the ability of business owners to recognize certain payments and/or other revenue generated by the business owner sooner than later has been modified. While this new revenue recognition standard is applicable to many businesses and industries, for purposes of this article, we will focus on franchisors.

Pursuant to prior financial standards, a franchisor was generally able to recognize initial franchise fees as earned revenue when the franchisor substantially performed or otherwise met its material obligations to a new franchisee. This typically occurred when the franchisee opened for business. However, the objective of ASC 606 is to "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 or services." Translated, what that means is that revenue is to be recognized after the "actual" performance of a specific obligation. While in some cases that would be on or before the time a franchisee opens for business, that is not always the case. In some cases, the performance continues throughout the franchise term. The most common referred-to example is the intellectual property licensed from the franchisor to the franchisee. This includes not only the core license to use the trademark, but also other "technology" of the franchise system. The result of applying ASC 606 is that franchisors will be required to defer recognition of some portions of the initial franchise fee, even beyond the franchisee's opening date and/or full performance by the franchisor of all of its pre-opening obligations to the franchisee. In some cases, that could mean "spreading" the recognition of the revenue over the entire term of the franchise agreement.

FASB has provided the following five-step process for revenue recognition standard application for contracts:

- Step 1: Identify the contract(s) with a customer.
- Step 2: Identify the performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price to the performance obligations in the contract.
- Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

FASB provides additional guidance for each of these steps in its May 2014 Accounting Standards Update entitled "[Revenue from Contracts with Customers \(Topic 606\)](#)."

Franchisors (and other business owners providing services over the course of a contract term) need to take a deeper dive into the components of the goods and services provided to their franchisees to properly recognize such revenue on their financial statements.

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¹FASB is the independent, private-sector, not-for-profit organization that establishes financial accounting and reporting standards for public and private companies and not-for-profit organizations that follow Generally Accepted Accounting Principles (GAAP)."

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