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October 22, 2018

Ms. Susan M. Cosper, CPA
Technical Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: Questions Related to ASC Topic 606; Request for Guidance

Dear Ms. Cosper:

We appreciate the opportunity to engage in dialogue and, most importantly, to seek your guidance on issues of importance to private companies in the franchise sector of the economy.

Introduction

We are especially concerned that private companies, which must start to comply with ASC 606 starting with their annual reporting periods beginning after December 15, 2018, may not have an accurate understanding as to the FASB's full range of policies. As you will recall from our previous communications, a substantial number of start-up, small, and mid-sized franchisors are private companies.

For most of these companies, there is significant uncertainty surrounding how ASC 606 is to be applied. In particular, the uncertainty centers around addressing separate performance obligations. Further, some large publicly-traded franchisors did not separate out individual performance obligations and assign a value to each (as well as assessing the value attributable to the "generic" and brand-specific aspects of the performance obligations). Rather, some of those publicly-traded franchisors followed the earlier publicly-available guidance and simply concluded that the entire initial franchise fee should be recognized ratably over the course of the term of their franchise agreements. As you may recall, in our meeting held at your offices on October 9, 2017, Board Member Christine Botosan said that:

> *It would be just as wrong to recognize over time revenue that should be recognized immediately as it would be to recognize immediately revenue that should be recognized over time.*

We do not know whether those large publicly traded companies merely concluded that it is not permissible to break the pre-opening services down into separate performance obligations, or whether they determined that doing so would not be material to their results. Whatever the reasoning, private companies are left with serious concerns about how 606 will be implemented in their next audit cycle.

Additionally, we have learned that some professionals are still unaware of the FASB's adoption of the sales and usage-based royalty exception (ASC 606-10-55-65) in 2016.

Taken together, we have an obvious and justifiable concern that the full range of the FASB's plans for ASC 606 will be ignored in favor of a flawed understanding and interpretation of those rules (e.g., that there is no room for separate performance obligations and that Step 3 of the analysis requires assessment of the projected royalty stream throughout the life of a franchise agreement).

Thus far, our members that have explained the FASB conclusions announced at its November 29, 2017 meeting (whether with or without the video and meeting notes) have been met with a basic request: *where does it say that in writing?*

Proposal

For the reasons explained above, we respectfully seek additional written guidance from the FASB and ask the FASB or its staff to issue clear information on this point, especially because the text of Example 57 – in which a $1.0 million initial fee is addressed – doesn't relate to the franchise fees that we have seen in practice in the U.S. economy.* Additionally, Example 57 addresses performance obligations that relate solely to those activities that support the underlying brand name on a continuing basis and certain tangible equipment and omits inclusion of other pre-opening services and obligation which are standard and customary in the prototypical franchise agreement. Accordingly, Example 57 does not address the practical circumstances present in typical franchise arrangements, where franchisors in fact do undertake and deliver distinct performance obligations to new franchisees.

As you will recall from our discussion at the October 2017 meeting, our research of publicly-available franchise disclosure documents reveals that the average initial franchise fee for established franchisors is $36,000 (for start-up franchisors, that average figure is $35,000).

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* A good deal of the uncertainty with respect to addressing initial fees appears to arise from Example 57 of ASC 606 and some of the interpretations that were issued based on that example. Among others, we note that although the AICPA Revenue Recognition Guide concluded that although a franchisor's pre-opening services should be considered as distinct and separate performance obligations, the Guide mistakenly dismissed the possibility that there are separate performance obligations ("*FinREC believes the promised goods or services in a typical franchise agreement (the license, the system assessment services, and the non-distinct pre-opening services) should generally be combined together as a single performance obligation….")* (Guide at Ch. 17.6.34). Although the Guide also theorizes in Ch. 17.6.34 that if "certain pre-opening services are distinct, then they would be accounted for separately following the model in FASB ASC 606," the Guide mistakenly did not actually account for that crucial reality. In practice, franchisors routinely perform more obligations than merely conferring the license, system assessment services, and certain un-mentioned "non-distinct pre-opening services."

Accordingly, we believe that the analysis in the Guide is fundamentally inconsistent with commercial reality. The Guide – together with the $1.0 million fee posited in Example 57 – leaves practitioners and franchisors without practical guidance to apply to understand when it would be appropriate to separate real-world pre-opening services as separate performance obligations. Indeed, those statements make it difficult to overcome the presumption implicit in the Guide that pre-opening activities "generally" are not distinct.

In the example that we propose, a hypothetical franchisor (which we will call "Franchisor X") charges a $35,000 initial franchise fee. The five-step analysis is as follows:

- Step One: Franchisor X signs one contract – the franchise agreement – with its new franchisee. The franchise agreement has a ten-year term. Franchisor X determines that that franchise agreement is a valid contract for the purpose of the Step One analysis.

- Step Two: Franchisor X determines that there are four distinct separate performance obligations that it would render before the franchisee opens: (1) training; (2) site selection services; (3) license of intellectual property and (4) the delivery of equipment.

  In reaching this conclusion, a critical element considered by Franchisor X is determining which performance obligations are highly interdependent or highly interrelated to the right to access the intellectual property (that is, the franchise brand name). Certain activities are directly related to the brand and could not be of value without the license, including parts of the brand standards manuals and marketing materials. Other activities would have value regardless of the brand with which they are associated; that is, those services are predominately not brand-specific. Franchisor X determined that the site selection services provided were not predominately specific to the brand and that the equipment has alternative uses that are not specific to the brand. Training consists of individual units of time (e.g., hours, days, etc.), which include general training that is not brand-specific as well as training that is specific to the brand requirements. Franchisor X considered that the training services should be broken down into its individual units (e.g., 100 hours, of which 75 are not brand-specific) and those that are not brand-specific would be considered distinct within the context of the franchise agreement.

- Step Three: Franchisor X determines that the transaction price is $35,000. Franchisor X follows the sales and usage-based royalty exception and therefore does not consider future royalty payments.

- Step Four: Franchisor X determines the standalone selling price of each distinct performance obligation based on one of the methods outlined in ASC 606. In doing so, Franchisor X determines the standalone selling price for each of the distinct performance obligations is as follows:

Transaction price (initial franchise fee only):	$35,000
Site selection services (estimated standalone selling price):	($5,000)
General training program (non-brand specific portions only):	($15,000)
Equipment (not brand specific):	($6,000)
Residual = estimated standalone selling price of franchise right:	$9,000

  Franchisor X concludes that the standalone selling price of the franchise right is highly uncertain as the total transaction price is attributable to ongoing sales-based royalties which are payable over a long period of time. It should be noted that if Franchisor X determined that the aggregate stand-alone selling prices of the performance obligations,

other than the right to access its intellectual property, exceed the initial franchise fee, the entire initial franchise fee may be allocated to the training, site selection, and equipment on the basis of their relative stand-alone selling prices. In reaching such a conclusion, Franchisor X also considers that the sales-based royalty represents variable consideration for which the criteria to allocate solely to the right to access the intellectual property were met. Franchisor X considered that in reaching such a determination that relative stand-alone selling prices were not necessary to conclude that allocating the variable consideration solely to the license is consistent with the general allocation objectives.

- Step Five: Franchisor X recognizes the revenue for the site selection services when the franchisee signs the lease for the franchised business, recognizes the revenue attributable to training when the franchisee completes the various elements of the initial training program and recognizes the revenue for the equipment when it is delivered to the franchisee. The revenue for the franchise right is to be recognized, ratably, over the 10-year term of the franchise agreement.

Conclusion

We believe that this example, showing the process and the manner of handling the five steps, would be appropriate and – if the FASB and its staff were to confirm this (or a similar example) in writing – that would be extremely helpful to franchisors and to their audit professionals. We would be pleased to discuss our proposed example or educational release with you at our meeting on Wednesday, October 24th.

Sincerely,

The IFA FASB Task Force