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What Every Franchisor Must Know About the New Revenue Recognition Rules – Understanding and Navigating ASC 606

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OBJECTIVES FOR TODAY'S SESSION:

- Background of the Revenue Recognition Standard and the IFA's Role
- Understand the Business Impact to Franchising and Why it's Important to you
- Gain a General Understanding of How to Apply
- Discuss Practical Considerations and Next Steps
- Q&A

BACKGROUND ON THE NEW STANDARD

- FASB and IASB - Single, comprehensive revenue recognition model for all contracts with customers will lead to greater consistency in the recognition and presentation of revenue and will improve comparability within industries, across industries, and across capital markets.
- ASC Topic 606 was introduced via ASU 2014-09. The topic and its subsequent amendments and clarifications are over 700 pages long making it the longest standard ever written.
- Some scope exceptions, for example lease contracts are excluded, but franchise licenses are specifically included in the new standard
- Potential for significant impact on timing of revenue recognition for upfront franchise fees

EFFECTIVE DATES

- Public business entities
  - Fiscal years beginning after 12/15/17 (and interim periods within)
- Nonpublic entities
  - Fiscal years beginning after 12/15/18 (and interim periods within, beginning after 12/15/19)
    - Early adoption is permitted

THE FRANCHISE REGULATORY LANDSCAPE

- The Franchise Disclosure Document.
- The requirement for the franchisor’s audited financial statements for the past 3 fiscal years.
  - All financial statements must be prepared in accordance with United States Generally Accepted Accounting Principles (“GAAP”), and audited in accordance with United States Generally Accepted Auditing Standards (“GAAS”), unless you are a start-up franchisor eligible to phase the disclosure of audited financial statements.
- State registration of the FDD and review of the audited financial statements.

STATE REVIEW OF THE AUDITED FINANCIAL STATEMENTS

- State Examiners look at a variety of factors in determining whether a franchisor is sufficiently capitalized, including:
  - Positive net worth (excess of total assets over total liabilities);
  - Positive current ratio (excess of cash and other current assets over liabilities due within the year);
  - Sufficient working capital to cover projected openings;
  - Presence of fixed assets;
  - Income; and
  - History.

STATE REVIEW OF THE AUDITED FINANCIAL STATEMENTS

- **Cash and cash equivalents must at least equal:**

  Current Liabilities

  \+ (cost to establish franchisee x number of projected openings during coming fiscal year)

  \+ (cost to establish franchisee x number of franchisees signed but not yet open as of year end)

- May impose a "financial assurance requirement"
  - Bond, escrow or deferral of initial fees

WHY THE NEW STANDARD MATTERS

- Retrospective – requires restatement of prior years or a cumulative catch-up.
- Financial Statement will likely show lower assets and greater liabilities, resulting in lower equity– particularly affecting emerging brands.
- Cascading effects – impact on loan covenants, etc.
- Increasing likelihood of state imposed financial assurance requirements.
- Potential to scare off prospects concerned, perhaps wrongly, that the franchisor's financial standing has deteriorated or is on shaky ground.

WHY THE NEW STANDARD MATTERS

- Brokers don’t wait for their commissions (and the true cost per sale is likely much higher).
- Taxes likely due on fees received but not yet recognizable.
- Increased administrative and professional costs.
- Accelerates the need for additional capital or financing event.
- Potential claims related to the prior years’ restatement.

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Understanding Revenue Recognition and its Application to Franchisors

THE FIVE STEP MODEL

Core Principle:

Recognize revenue to depict the transfer of 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.

Steps to Apply the Core Principle Are:

STEP 1:	STEP 2:	STEP 3:	STEP 4:	STEP 5:
Identify The Contract	Identify Separate Performance Obligations	Determine Transaction Price	Allocate Transaction Price to Performance Obligations	Recognize Revenue When/As Performance Obligations Satisfied

STEP 2: PERFORMANCE OBLIGATIONS

- A performance obligation is a promise to provide goods or services (or a bundle of goods or services) that are distinct. To qualify as distinct the following criteria must be met:
  - The franchisee can benefit from the good or service either on its own or together with other resources readily available to the franchisee.
  - The promise to transfer the good or service is separately identifiable from other promises in the contract.

Franchisor Considerations

- Generally the various activities to be undertaken to support the brand are considered a single performance obligation (transfer of the franchise license).
- The franchisor **must** assess each of the additional promises in the franchise agreement and FDD to determine whether they are distinct, for example:
  - Assistance in selecting a site and/or in obtaining facilities, including related financing and architectural services.
  - Training of the franchisee's personnel.
  - Equipment necessary to operate the franchise.
  - Establishment of suppliers, and inspection, testing and other quality control programs.

Note: Identification of distinct performance obligations is required. A franchisor cannot simply assume that all promises are part of the franchise license.

STEP 2: PERFORMANCE OBLIGATIONS

Area Development Arrangements

- Provides a franchisee with the right to develop multiple locations within a geographic region.
- Exclusivity in and of itself is not considered a performance obligation, but instead is considered an attribute of the franchise right and will be recognized in line with the franchise fee.
- Subfranchise rights provided by master franchise agreements may be considered a distinct performance obligation.

Material Rights

- Discounts
  - If an option for a future purchase provides a material right to the customer, the option itself is a performance obligation, which is satisfied upon exercise.
  - The right must be valued and this portion of the initial fee should be deferred until the right is exercised.
  - An example would be discounted franchising fees for subsequent franchises.

STEP 4: ALLOCATE TRANSACTION PRICE TO PERFORMANCE OBLIGATIONS

- A franchisor allocates/splits the transaction price (determined in Step #3) between its performance obligations (identified in Step #2).
- The allocation is based on the relative ‘standalone selling prices’ of each identified performance obligation, being:
  - ‘The price at which a franchisor would sell a promised good or service separately to a customer’.
  - Use actual standalone selling price if available, estimate using market pricing or cost plus a reasonable margin if not
- Variable consideration (i.e. royalty fees) must also be allocated
  - If items are priced at standalone value, the royalty fee may be allocated solely to the franchise license.
  - If not, the royalty fee will have to be allocated to any other distinct performance obligations as well.

STEP 5: RECOGNIZE REVENUE

- Revenue is recognized as/when a franchisor satisfies each performance obligation:
  - Over time - franchise licenses are considered symbolic IP and are recognized over time.
  - At a point in time – when equipment is delivered.
- Sales/Usage-based fees - 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)
- Effectively, royalties fees will continue to be recognized as they are incurred.
- However, in the event of a lag in reporting of the sales on which

  the royalty fee is based, estimated revenues will be required

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ADOPTION IMPACT AND NEXT STEPS

GENERAL INDUSTRY IMPACT – INITIAL ADOPTION

"We expect adoption of the new revenue recognition standard to <u>materially impact our accounting for advertising fees</u> charged to franchisees and other transactions involving our advertising and gift card funds. Upon the adoption of Topic 606, we expect to present advertising contributions received from franchisees as revenue and to record all expenses of the national advertising fund and therefore expect that this will increase revenues and expenses on our consolidated statements of earnings.

We also expect the adoption of Topic 606 to <u>impact our accounting for initial franchise fees</u>. Currently, we recognize revenue from initial franchise fees upon the opening of a franchised restaurant when we have performed all of our material obligations and initial services. Upon the adoption of Topic 606, we expect to recognize the revenue related to initial franchise fees over the term of the related franchise agreement."

<u>Buffalo Wild Wings Q3 2017</u>

Lower impact

- Mature franchisors
- Growing – historically steady new franchisee additions

Higher impact

- New franchisors
- Growing – sporadic growth

Regardless

- Earnings smoothed over time
- Initial adoption – will take time and effort

OTHER CONSIDERATIONS DURING AND AFTER ADOPTION

- Cannot change performance obligations or transaction price by merely rewording contracts, BUT, for new contacts, consider restructuring payment streams in order to support stand-alone selling price determination and potentially minimize portion of initial fees required to be deferred:
  - Identify distinct performance obligations and spell out in the contract.
  - Specifically state a price for each distinct performance obligation that can reasonably be supported.
- Any resulting changes to accounting can impact more than just the financial statements. Communicate proactively to impacted parties:
  - Investors/Lenders:
    - Net Income/EBITDA
    - Company Valuations
    - Debt Compliance Ratios (ST/LT Deferred Revenue)
  - States and Franchisees
    - FDD Disclosures/FTC Reporting
    - Franchisees/Potential Franchisees
  - Internal stake-holders
    - Compensation benchmarks
    - Key metrics
    - Performance indicators
  - IRS and Other Tax matters
    - Schedule M adjustments
    - Method of Accounting Changes (M-3)

Note: The new standard must be adopted on a retrospective basis, with a cumulative adjustment to retained earnings. Franchisors should consider the impact of this adjustment on state equity requirements.

ASC 606 IMPLEMENTATION TIMELINE

Private Companies (12/31 Year End)

PHASE 1 – SCOPING AND GAP ANALYSIS

Identify revenue streams to be impacted. Prepare a "gap analysis" of ASC 605 vs. ASC 606 for those revenue streams addressing: Transition method/issues; Five steps of ASC 606; Contract costs; Disclosures

PHASE 2 - TECHNICAL ANALYSIS

Determine specific application of issues identified in Phase 1, including method of determining standalone selling price, pricing controls, identifying specific contracts costs to be capitalized, amortization periods and methodologies and lookback periods for revenue contracts and contract costs. Identify broad systems and business process requirements.

PHASE 3 – SYSTEMS CONFIGURATION AND BUSINESS PROCESSES

Reconfigure systems and business processes based on Phase 2 findings.

PHASE 4 – TESTING/TRANSACTION AUDITING INTERNAL CONTROLS

Run historical transactions through parallel systems and business processes reconfigured for ASC 606. Auditors to perform detail transaction testing.

PHASE 5 – FINANCIAL REPORTING AND DISCLOSURES

Assess results of Phase 4 and record ASC 606 adoption entries and develop disclosures including contract liability rollforwards, summary of remaining performance obligations, etc.

Timeline

- Sept 2017 - April 2018
- April-Sept 2018
- Oct-Dec 2018
- Jan-March 2019

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OTHER IMPACTS

OTHER POTENTIAL AREAS OF REVENUE IMPACT

- Advertising Funds
  - New standard reinforces fact that all amounts received from customers are potentially revenue
  - If franchisor controls ad placement, even if that control is delegated to franchisees, ad funds will generally be recorded as revenues
  - As a result, timing of expenses may not match
- Loyalty Programs – Performance obligation
  - Rights that accumulate (i.e. loyalty points) typically are considered a material right that must be accounted for as a separate performance obligation
  - Must defer a portion of the sales price to reflect the value of the loyalty points earned
- Gift cards – New breakage guidance, <u>only applicable to cards not subject to escheatment</u>
  - Recognize breakage in proportion to the pattern of rights expected to be exercised by the cardholder, only to the extent it is probable that a significant reversal of breakage will not occur
  - Results in earlier recognition of breakage, but requires significant tracking and reporting capabilities

CONTRACT COSTS

- 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 amortized on a basis that reflects the transfer of goods or services to the customer.
- Many franchisors utilize brokers to identify new franchisees.
- Commissions paid to those brokers (or internal sales employees) upon successful completion of the franchise agreement will be deferred and recognized over time.
- Other fees associated with reviewing the franchise agreement or updating the FDD must be expensed as incurred.
- Other specifically identifiable costs directly attributable to fulfilling the contract, such as site selection brokers and training, should be deferred and recognized as the related performance obligation is satisfied.

RESOURCES & REFERENCE AIDES

BDO Revenue Recognition Resource Center
https://www.bdo.com/services/assurance/revenue-recognition/news-resources

BDO FASB Newsletter – Topic 606, Revenue From Contracts with Customers – A View From the Kitchen
https://www.bdo.com/getattachment/f939de25-c626-4736-b7a4-588ab5c502e2/attachment.aspx?BDO-Knows-FASB-Topic-606_June-2017-FINAL.pdf

FASB Transition Resource Group Agenda Papers
http://www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176164066683

AICPA Revenue Recognition Center
http://www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/RevenueRecognition/Pages/default.aspx

CAQ Tool: Preparing for the New Revenue Recognition Standard
http://www.thecaq.org/preparing-new-revenue-recognition-standard-tool-audit-committees

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A PRACTICAL APPLICATION OF THE REVENUE RECOGNITION STANDARD

IMPLEMENTATION PITFALLS

- Time to gather franchise agreements and identify various obligations in each
- Availability of information on incremental costs to be capitalized
- Valuation of renewal rights

POTENTIAL PROCESS CHANGES

- Changes to franchisor obligations spelled out in the FDD
- Tracking time/value of training franchisees
- Franchise development incentive structures

LEGAL AND REGULATORY IMPACTS

- Potential impact on book equity and ability for owners of smaller franchisors to take cash out of the business while maintaining FTC exemptions

M&A CONSIDERATIONS

Businesses are still valued on cash but

- You will need to be able to cleanly remove the impacts of 606 from financial statements so buyers can understand cash flows
- Know the impact now if you’re being acquired by a public company
- Even non public companies will need to understand the impacts on their business for purposes of setting go forward debt covenants

CHANGES TO STAKEHOLDER COMMUNICATIONS

- Impact on go forward lender compliance
  - Amendments to existing credit facilities to modify definitions of net worth, interest coverage and leverage convent calculations
- Changes to internal and external reporting?

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WHAT TO DO NOW

ACTIONS TO TAKE TODAY

- Engage early with your auditors (DO IT NOW).
  - What will YOUR auditors require you to demonstrate?
- Track and value your pre-opening obligations.
- Consider whether a capital infusion is necessary.
- Changes to your FDD?
  - Modifications to Form B of the state registration materials.
- Renegotiation of other contracts?

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