



In This Issue

- [Background](#)
- [Key Provisions of ASU 2021-02](#)
- [Effective Date and Transition](#)
- [Appendix — Definitions](#)

FASB Provides a Practical Expedient for Private-Company Franchisors on the Identification of Performance Obligations Under ASC 606

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On January 28, 2021, the FASB issued [ASU 2021-02](#),¹ which allows a [franchisor](#) that is not a [public business entity](#) (“private-company franchisor”) to use a practical expedient when identifying performance obligations in its contracts with customers (i.e., franchisees) under ASC 606.² When using the practical expedient, a private-company franchisor that has entered into a [franchise agreement](#) would treat certain preopening services provided to its franchisee as distinct from the franchise license. The practical expedient is intended to reduce the cost and complexity of applying ASC 606 to preopening services associated with initial franchise fees.

Background

ASC 606 requires entities to identify whether the goods or services promised in a contract with a customer are distinct performance obligations. Franchisors applying the revenue guidance in ASC 606 may need to exercise significant judgment to determine whether preopening services provided to franchisees (e.g., site selection assistance, training, and other services) are distinct from one another, the franchise license, and any other goods or services promised in the contract. This determination will affect the timing of revenue recognition related to the franchisee’s payment of initial franchise fees to the franchisor.

¹ FASB Accounting Standards Update (ASU) No. 2021-02, *Franchisors — Revenue From Contracts With Customers (Subtopic 952-606): Practical Expedient*.

² For titles of FASB Accounting Standards Codification (ASC or the “Codification”) references, see Deloitte’s [“Titles of Topics and Subtopics in the FASB Accounting Standards Codification.”](#)

Private-company franchisors expressed concerns about the cost and complexity of applying ASC 606, particularly with respect to the accounting for initial franchise fees. Many franchise agreements include an up-front payment (i.e., the initial franchise fee) plus a royalty paid to a franchisor throughout the term of the arrangement. Under legacy industry guidance in ASC 952-605-25-1, the initial franchise fee is generally recognized “when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor” (typically, upon the opening of the franchise location). However, under ASC 606, some franchisors may be required to defer revenue recognition related to some or all of the initial franchise fee over the term of the franchise license.

In June 2020, the FASB issued [ASU 2020-05](#),³ which permits certain private entities⁴ that have not yet issued their financial statements or made financial statements available for issuance as of June 3, 2020, to adopt ASC 606 for annual reporting periods beginning after December 15, 2019, and for interim reporting periods within annual reporting periods beginning after December 15, 2020. This deferral of the effective date was provided, in part, to enable the Board to evaluate whether it could reduce the costs of applying ASC 606 to initial franchise fees.

Key Provisions of ASU 2021-02

ASU 2021-02 adds a new Codification subtopic, ASC 952-606,⁵ to provide a practical expedient that allows a private-company franchisor that has entered into a franchise agreement to treat certain preopening services provided to a franchisee as distinct from the franchise license. Those preopening services consist of the following activities:

- “Assistance in the selection of a site.”
- “Assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural, and engineering services, and lease negotiation.”
- “Training of the franchisee’s personnel or the franchisee.”
- “Preparation and distribution of manuals and similar material concerning operations, administration, and record keeping.”
- “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 regulations affecting the franchisee’s business.”
- “Inspection, testing, and other quality control programs.”

If a private-company franchisor applies the practical expedient, it must disclose that fact.

If a private-company franchisor does not elect to use the practical expedient, or if its contracts with customers include other promised goods or services that are not consistent with the activities in the above list, the entity must apply the guidance in ASC 606 on identifying performance obligations.⁶ In addition, a private-company franchisor that applies the practical expedient must make a policy election to either (1) apply the guidance in ASC 606⁷ to determine whether the preopening services that are subject to the practical expedient are distinct from one another or (2) account for those preopening services as a single performance obligation. A private-company franchisor that elects to account for those preopening services as a single performance obligation is required to disclose this accounting

³ FASB Accounting Standards Update No. 2020-05, *Revenue From Contracts With Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*.

⁴ The deferral does not apply to public business entities, public not-for-profit entities, and employee benefit plans that file or furnish financial statements with or to the SEC.

⁵ FASB Accounting Standards Codification Subtopic 952-606, *Franchisors: Revenue From Contracts With Customers*.

⁶ See ASC 606-10-25-19 through 25-22.

⁷ See footnote 6.

policy. Further, an entity that applies the guidance in ASU 2021-02 should apply it consistently to contracts with similar characteristics and in similar circumstances.

Although the practical expedient simplifies step 2 of ASC 606 (i.e., identifying the performance obligations), entities are still required to apply the rest of the guidance in ASC 606, including the guidance on (1) identifying other performance obligations (e.g., equipment sales), (2) determining the stand-alone selling prices of the performance obligations, (3) allocating the transaction price to the performance obligations, and (4) determining the timing of revenue recognition. Further, ASU 2021-02 applies only to certain preopening services provided by private-company franchisors, and entities not within the scope of the ASU's guidance are precluded from applying the ASU directly or by analogy.

Effective Date and Transition

If an entity has not yet adopted ASC 606, the existing effective dates and transition requirements of ASC 606 are applicable to the amendments in ASU 2021-02. If an entity has already adopted ASC 606, the amendments are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. Early adoption is permitted. For those entities that have already adopted ASC 606, the amendments must be applied retrospectively as of the date of initial application of ASC 606, with a cumulative-effect adjustment to opening retained earnings. For entities that have already adopted ASC 606, the following transition disclosures are required in the period of adoption of the ASU:

- “The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle.”
- “The method of applying the change.”
- “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 [ASU 2021-02] is applied.”
- “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 [ASU 2021-02] is applied.”

Appendix — Definitions

ASC Master Glossary

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.

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.

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