

Financial Reporting Center – Revenue Recognition

Working Draft: Hospitality Revenue Recognition Implementation Issue



Issue #7-1 – Franchise Fees

Expected Overall Level of Impact to Industry Accounting:
Significant

Wording to be Included in the Revenue Recognition Guide:

Introduction

1. This paper will address the accounting for Franchise Fees included in Hotel Franchise Trademark and License Agreements (“the Agreement”) under the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 606, Revenue from Contracts with Customers.
2. In a standard Agreement, the Franchisor provides the Franchisee a license to the entity’s hotel intellectual property. The intellectual property is considered the comprehensive system for providing guest hotel facility services under the trademarks, service marks, logos, commercial symbols, etc. The Franchisor also performs various upfront, Pre-Opening Services as well as ongoing marketing and reservation activities.
3. The Franchisee is responsible for paying the Franchisor various fees over the course of the Agreement. Upon execution of the Agreement, the Franchisor performs certain activities to facilitate the pre-opening and opening of the property, which are considered to be included in the one-time up-front fee, generally referred to as the “Initial Fee”. The “Recurring Fees” generally consist of a Royalty Fee and Marketing and Reservation Fee, which may or may not be combined into a System Assessment Fee, and are generally payable each month of the term.
4. Although the fees discussed below are limited to Royalty Fees, Initial Fees, and System Assessment Fees, other fees in the Agreement not specifically addressed in this paper, including but not limited to, application fees, termination fees, audit fees, training fees, etc., should also be considered. The guidance in FASB ASC 606-10-25-14 through 25-22 should also be considered when assessing if these promised services represent separate performance obligations.

Application of the Five Step Revenue Recognition Model

Step 1: Identify the Contract with a Customer

5. Under FASB ASC 606, the entity is required to determine if a contract exists and if that contract is with a customer. FASB ASC 606-10-25-1 states that an entity shall account for a contract with a customer that is within the scope of this Topic only if all of certain criteria are met.
6. Each franchise agreement should be assessed in order to determine whether all of the criteria in FASB ASC 606-10-25-1 are met, however FinREC believes that generally the Agreement is a contract with a customer that meets the criteria in FASB ASC 606-10-25-1, and the Franchisor's customer is the Franchisee:

- a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.

This is typically evidenced by formal approval of agreements in writing. Where agreements are not formally approved in writing, entities should consider if the criterion is still met (e.g., evidenced by oral approval or other accepted business practices).

- b. The entity can identify each party's rights regarding the goods or services to be transferred.

The Franchisor provides the Franchisee a license to its intellectual property over the life of the agreement. The Franchisor and Franchisee rights and obligations are typically documented in writing throughout the Agreement.

- c. The entity can identify the payment terms for the goods or services to be transferred.

The payment terms are typically documented in writing within the Agreement or adjoining appendices and annexes.

- d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).

Franchise agreements are negotiated at arm's length between a franchisor and franchisee. As such, the terms of a negotiated franchise agreement have a direct impact on the risk, timing and magnitude of cash flows and therefore are deemed to have commercial substance.

- e. It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (see paragraphs FASB ASC 606-10-55-3A through 55-3C). In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph FASB ASC 606-10-32-7).

During contract negotiation, the Franchisor typically works closely with the Franchisee to negotiate contract terms and has made the determination that the customer has the intention and ability to pay. As part of the application process, it is standard to analyze the customer's ability to pay by performing due diligence and checks of customer credit, net worth, and liquidity. In accordance with FASB ASC 606-10-25-2, if the customer's ability to pay the consideration significantly deteriorates, the Franchisor should reassess whether it is probable that the entity will collect the consideration to which the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer. As such, the accounts receivable balances for each customer should be closely monitored to ensure that collectability is probable. This criterion will need to be assessed on a contract by contract basis.

The implications of any price concessions on collectability should also be considered.

7. FASB ASC 606-10-25-9 states:

An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

- a. The contracts are negotiated as a package with a single commercial objective.
- b. The amount of consideration to be paid in one contract depends on the price of performance of the other contract.

- c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs FASB ASC 606-10-25-14 through 25-22.
8. FinREC believes that the promises in the franchise agreement which are also disclosed in Franchise Disclosure Documents (“FDDs”) should be combined and accounted for as a single contract as the franchise agreement typically references the FDD for additional details.
 9. The guidance on contract modifications in FASB ASC 606-10-25-10 through 25-13 should be considered when accounting for agreement amendments.

Step 2: Identify the Performance Obligations in the Contract

10. As noted in FASB ASC 606-10-25-14, at contract inception, the Franchisor should assess the goods or services promised in a contract with a customer, to identify if the goods or services are distinct performance obligations.
11. A standard Agreement contains the following promised goods or services:
 - a. License to the Franchisor’s intellectual property (“the License”)

Through the Agreement, the good or service that is being transferred is the license to the Franchisor’s intellectual property. Upon entering into an Agreement with a Franchisee, the Franchisor has the exclusive right to franchise the distinctive brand to the Franchisee for providing transient guest hotel services. The agreement also provides the franchisee an area of protection in which the Franchisor is precluded from owning, operating or licensing a specific brand hotel within a pre-defined territory. This allows the Franchisee to operate the Hotel under a Trademark until the end of the term. The Trademark is considered a license that establishes the Franchisee’s right to the intellectual property of the Franchisor. The franchise agreement is effective on the hotel opening date and ends on the earlier of the term’s expiration or termination.

- b. System Assessment Services

The Franchisor engages in marketing and reservation activities funded by the System Assessment Fee. The Franchisor is contractually obligated to spend the amounts collected in their entirety on marketing and reservation activities.

- c. Pre-Opening Services

- i. In a standard Agreement, the Franchisor is responsible for performing upfront, Pre-Opening Services which may include, but are not limited to:
 1. Property inspection, testing, and other quality control programs
 2. Assistance in obtaining facilities, including financing
 3. Architectural and design services
 4. Installation of reservation systems
 5. Assistance in the selection of a site
 6. Training the Franchisee’s personnel to operate the hotel as the brand under the license
 7. Other services during the pre-opening phase

License to the Franchisor’s Intellectual Property

12. FASB ASC 606-10-55-54(c) explains that licenses of intellectual property may include licenses of franchises. FASB ASC 606-10-55-55 further explains that as with other types of contracts, when a contract with customer includes a promise to grant a license (or licenses) in addition to other promised goods or services, an entity should apply FASB ASC 606-10-25-14 through 25-22 to identify each of the performance obligations in the contract.
13. FASB ASC 606-10-25-19 states that a good or service that is promised to a customer is distinct if both of the following criteria are met:
 - a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).
 - b. The entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

14. FinREC believes that the License is capable of being distinct since the Franchisee can benefit from the license either on its own or together with other resources that are readily available to the Franchisee. However, since most contracts will include other promised goods or services that are highly interdependent on, or highly interrelated to the License, the License would not be considered separately identifiable from the other promised goods or services. As a result, the License will be combined with other promised goods or services as a single performance obligation as further explained in paragraph 21 below.
15. In accordance with FASB ASC 606-10-55-59, when determining whether the Franchisor's promise to grant a License provides the customer with a right to access or a right to use the Franchisor's intellectual property, the Franchisor should consider the nature of the intellectual property to which the customer will have rights. As explained in FASB ASC 606-10-55-59, intellectual property is either functional or symbolic.
16. FinREC believes the IP subject to the franchise license is symbolic intellectual property, as it does not have significant standalone functionality, and substantially all of the utility is derived from its association with the entity's past or ongoing activities. Consequently, the nature of the entity's promise in granting the license is to provide the customer with access to its symbolic intellectual property over the term of the license.
17. As noted in FASB ASC 606-10-55-60 and further explained in FASB ASC 606-10-55-380:

A customer's ability to derive benefit from a license to symbolic intellectual property depends on the entity continuing to support or maintain the intellectual property. Therefore, a license to symbolic intellectual property grants the customer a right to access the entity's intellectual property, which is satisfied over time (see paragraphs FASB ASC 606-10-55-58A and 55-58C) as the entity fulfills its promise to both:

 - a. Grant the customer rights to use and benefit from the entity's intellectual property.
 - b. Support or maintain the intellectual property. An entity generally supports or maintains symbolic intellectual property by continuing to undertake those activities from which the utility of the intellectual property is derived and/or refraining from activities or other actions that would significantly degrade the utility of the intellectual property.
18. FASB ASC 606-10-55-58A explains that an entity should apply FASB ASC 606-10-25-31 through 25-37 to select an appropriate method to measure its progress toward complete satisfaction of that performance obligation to provide access to its intellectual property.

System Assessment Services

19. The promised goods and services are to engage in marketing and reservation activities funded by the System Assessment Fee. Marketing activities include various forms of advertising, including promotion through the media, online, sponsorships, market research, training, and public relations. Reservation activities include providing, maintaining, and developing a computerized reservation system directly or indirectly through another party. Marketing and advertising activities are performed at the brand level and therefore, although the customer will benefit from the marketing activities, the benefit may not be received directly or proportionately on an individual hotel basis. The System Assessment Fee is treated as a Fund that the Franchisor administers and spends on both marketing and reservation activities at its discretion.
20. FinREC believes the promise of marketing and reservation activities associated with the System Assessment Services is not distinct as the criteria in FASB ASC 606-10-25-19(b) is not met as the marketing and reservation activities do not relate to the individual hotel (franchisee):
 - a. The customer can benefit from the promised service either on its own or together with the other goods and services that are readily available (resources the Franchisee has already obtained from the Franchisor through the License Agreement). The Franchisor benefits from marketing and reservation activities because these activities are undertaken to support the overall brand. Marketing and reservation dollars are not spent at the individual hotel level, but as the franchisee licenses the brand they will benefit from the brand marketing activities as the marketing dollars are spent. The marketing and reservation promises support the overall brand network and maximize the general public recognition, acceptance and use of the brand, hence driving value to the Franchisees.
 - b. The promise to perform marketing and reservation activities and administer the funds are not separately identifiable from other promises in the individual franchisee contract. The marketing and reservation activities are highly dependent on and highly interrelated with the License. As a result, the marketing and reservation activities alone do not have distinct value to a Franchisee.
21. In accordance with FASB ASC 606-10-25-22, since the System Assessment Services are not distinct, the System Assessment Services should be combined and bundled with other services until the entity identifies a bundle of

services that is distinct. FinREC believes the promise to perform System Assessment Services is highly dependent on and highly interrelated with the License because these activities only transfer a good or service to the Franchisee by enhancing the value of the intellectual property. Therefore, FinREC believes System Assessment Services should be combined with the promise to provide the License to create a single performance obligation in accordance with FASB ASC 606-10-25-22.

Series of Distinct Goods or Services

22. As noted in FASB ASC 606-10-25-14, a performance obligation is “either:
 - a. a good or service (or a bundle of goods or services) that is distinct; or
 - b. a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.”
23. Therefore, the Franchisor should determine whether the promise to provide the License in combination with any other non-distinct goods or services represents a separate performance obligation.
24. Paragraph 14 of FASB / IASB TRG Agenda Ref. 39, *Application of the Series Provision and Allocation of Variable Consideration*, discusses Topic 1: *In order to apply the series provision, how should entities consider whether the performance obligation consists of distinct goods or services that are substantially the same?*, and states that in order to be considered a series, there must be more than one good or service that is distinct and each distinct good or service must also be substantially the same. As noted in paragraph 33 of FASB/IASB TRG Agenda Ref. 44: *July 2015 Meeting - Summary of Issues Discussed and Next Steps*:

TRG members agreed with the staff view that the first step is to determine the nature of the entity’s promise in providing the services to the customer. For example, in some cases, an entity might need to determine whether the nature of the promise is the actual delivery of a specified quantity of goods or services or the act of standing ready to perform. If the nature of the promise is the delivery of a specified quantity of a service, then the evaluation should consider whether each service is distinct and substantially the same. If the nature of the entity’s promise is the act of standing ready or providing a single service for a period of time (that is, because there is an unspecified quantity of various activities to be performed to fulfil the service), the evaluation likely would focus on whether each time increment, rather than the underlying activities, are distinct and substantially the same. This evaluation will require judgment.

25. FinREC believes the promise to provide the License represents a series of distinct services which is the Franchisor’s promise to provide daily access to the License over a period of time, and not a specified amount of services or access. While the Franchisor’s underlying activities associated with the License will vary both within a day and day to day, FinREC believes that the license is accessed over time and that the customer simultaneously receives and consumes the benefit from the Franchisor’s performance of providing access (including other related activities). Furthermore, each day of access is deemed distinct and substantially the same based on the following factors:
 - a. The Franchisee is able to benefit from each day’s right to access;
 - b. There is no significant integration service provided between the days of access provided;
 - c. No single day of access modifies or customizes another; and
 - d. The individual days of access are not highly interdependent or interrelated as the Franchisor can fulfill its promise to grant one day of access independent from its promise to grant another day of access.
26. In accordance with FASB ASC 606-10-25-14 and 15, a series of distinct services should be accounted for as a single performance obligation if they have the same pattern of transfer to the customer. To determine the number of performance obligations within a series the Franchisor should determine if the distinct goods or services have the same pattern of transfer to the customer.
27. As noted in FASB ASC 606-10-25-15, A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:
 - a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph FASB ASC 606-10-25-27 to be a performance obligation satisfied over time.
 - b. In accordance with paragraphs FASB 606-10-25-31 through 25-32, the same method would be used to measure the entity’s progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.
28. As noted in FASB ASC 606-10-25-27, an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:

- a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs FASB ASC 606-10-55-5 through 55-6).
 - b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph FASB ASC 606-10-55-7).
 - c. The entity's performance does not create an asset with an alternative use to the entity (see paragraph FASB ASC 606-10-25-28), and the entity has an enforceable right to payment for performance completed to date (see paragraph FASB ASC 606-10-25-29).
29. FinREC believes that the promise to provide the License is a series of distinct services that represents a single performance obligation:
- a. In accordance with FASB ASC 606-10-55-381, the Franchisor concludes that the promise to transfer the License is a performance obligation satisfied over time because the License provides a right to access. Therefore, FinREC believes the License meets the criterion of FASB ASC 606-10-25-15(a).
 - b. The same measure of progress (a daily time based increment) would be used to measure the Franchisor's progress toward complete satisfaction of the performance obligation to provide the daily right to access the License. Therefore, FinREC believes the License meets the criterion of FASB ASC 606-10-25-15(b).

Pre-Opening Services

30. In accordance with FASB ASC 606-10-25-14, the Franchisor should determine whether the Pre-Opening Services promise a service to the customer that is distinct from the License. The determination will require judgment and may vary based on the individual contract needs and the Franchisor's customary business practices.
31. FinREC believes that in some instances the promise of Pre-Opening Services is not distinct as both criteria in FASB ASC 606-10-25-19 are not met:
- a. In certain instances the upfront, Pre-Opening Services are initial fulfillment activities that the Franchisor must undertake to fulfill the contract and do not provide a benefit to the Franchisee as the tasks are performed without the License. In this situation, the Franchisee generally only benefits from the Pre-Opening Services together with the License that is made available through the Agreement, thus the customer cannot benefit from the pre-opening service on its own and therefore it would not represent a separate performance obligation. Nonetheless, Franchisors will need to individually assess whether an initial activity transfers a promised good or service to a customer or if it represents a fulfillment activity.
 - b. Based on FASB ASC 606-10-55-51, as these activities on their own do not result in a transfer of a promised good or service to the Franchisee, the upfront fee is deemed an advance payment for services and becomes a portion of the overall transaction price.
32. The Pre-Opening Services are primarily related to operating a hotel and the benefits begin being realized once the hotel is open and operating under the License. Such Pre-Opening Services are not distinct goods or services when they do not transfer a benefit to the Franchisee directly without use of the License. For example, signage with the hotel brand name and logo or would not benefit a franchisee without the use of the License. Another example is the property inspection, which differs based on the hotel brand based on quality control and brand specific features, and therefore, does not transfer a benefit to the customer without the use of the License and is also performed for the benefit of the Franchisor. In these instances, as explained in paragraph 28 the Pre-Opening Services are not distinct, and in accordance with FASB ASC 606-10-25-22, need to be bundled with the License in order to form a distinct performance obligation.
33. However, if there are Pre-Opening Services that do transfer a benefit to the Franchisee directly without use of the License (e.g., architectural and design services, hotel management training or a property improvement plan), the entity should review the criteria in FASB ASC 606-10-25-19 to determine if the services are distinct. If both of the criteria in FASB ASC 606-10-25-19 are met, the allocated amount of total transaction fees based on relative stand-alone selling prices for the related Pre-Opening Service is recognized as revenue when the performance obligation is satisfied.
34. 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, that are a series of distinct goods or services in accordance with FASB ASC 606-10-25-14, however, if it is concluded that certain pre-opening services are distinct, then they would be accounted for separately following the model in FASB ASC 606.

Step 3: Determine the Transaction Price

35. In accordance with FASB ASC 606-10-32-2, the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to the customer. The contractual transaction price in a standard Agreement consists of Royalty Fees, System Assessment Fees, and the Initial Fee.
36. The Royalty Fees and System Assessment Fees are typically calculated as a percentage of Gross Room Revenues (“GRR”) of the hotel accruing during a calendar month, and accrue from the hotel opening date until the end of the term. The Royalty Fees and System Assessment Fees are variable as the fees are contingent on the occurrence of a future event, which is the amount of GRR. In accordance with FASB ASC 606-10-32-17b, FinREC does not believe there is a significant financing component because the consideration promised by the Franchisee is variable, determined monthly based on the GRR, which is substantially outside the control of the Franchisor and Franchisee.
37. As discussed in paragraph 45, the License to the Franchisor’s intellectual property is the predominant deliverable in the combined performance obligation. The Royalty Fees and System Assessment Fees are determinable at the end of each reporting period (i.e., month end) as and when the underlying sales (GRR) occur in accordance with FASB ASC 606-10-55-65. Such guidance clarifies that a Franchisor should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs: (a) the subsequent sale or usage occurs or (b) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). Therefore, FinREC believes the Franchisor is precluded from recognizing an estimate of the associated transaction price for future periods.
38. The Initial Fee is typically comprised of a non-refundable fixed fee of cash consideration, due to the Franchisor upon signing of the Agreement. Although the Initial Fee is typically due in advance of services rendered, in accordance with FASB ASC 606-10-32-17(C), FinREC does not believe there is a significant financing component because the timing of the payment does not arise for the reason of provision of finance to the entity. The difference arises to protect the entity from the Franchisee in the event the Franchisee fails to complete its obligations under the contract (e.g., the franchised hotel does not open, but initial services and an area of protection were provided up through that point).
39. While not typical, if the contract includes refund liabilities, variable consideration or other non-cash consideration the relevant guidance in FASB ASC 606-10-32-5 through 32-27 should be evaluated in order to determine the impact on the transaction price.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

40. FASB ASC 606-10-32-28 states “The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.”

Allocation of the Fixed Fees to the Separate Performance Obligations

41. In accordance with FASB ASC 606-10-32-28 and 29, if, based on the specific facts and circumstances, there is more than one distinct performance obligation identified, the fixed fee component of the transaction price should be allocated to the performance obligations to which they pertain on a relative standalone selling price (“SSP”) basis. Per FASB ASC 606-10-32-32 and 32-33, the SSP may be directly observable or may need to be estimated. In situations where observable prices for certain services are not available on a stand-alone basis, FinREC believes the adjusted market assessment approach, which is a suitable method for estimating SSP per FASB ASC 606-10-32-34, should be used to estimate the SSP by evaluating what a Franchisee would be willing to pay for similar services. In a standard Agreement the Initial Fee is a fixed fee, which is typically the SSP for Pre-Opening Services. In addition, based on the guidance set forth in ASC 606-10-55-58C, FinREC believes that a franchisee would be able to use and benefit from its right to access the symbolic intellectual property provided by the license only after the hotel opening.

Allocation of the Variable Fees within the Agreement to the Separate Performance Obligations and/or to the Distinct Good(s) or Services that Form Part of a Single Performance Obligation

42. As noted in FASB ASC 606-10-32-40, a Franchisor should allocate variable fees entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation if both of the following criteria are met:

- a. The terms of the variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service); and
 - b. The allocation of the variable amount to the performance obligation or the distinct good or services is consistent with the allocation objective when considering all the performance obligations and payment terms in the contract.
43. The structure of the Agreements typically separates the fees so that the compensation aligns with the related services being provided. For example, the license Royalty and System Assessment Fees are typically related to a specific outcome from satisfying the License obligation for the period. If the Franchisor has concluded the performance obligation is a series of daily services for which the uncertainty regarding the consideration is resolved on a daily basis, FinREC believes the allocation of the monthly variable Royalty and System Assessment Fees to the daily services provided during the month they are billable would meet the allocation objective in FASB ASC 606-10-32-28 for each month. In addition, as noted in FASB ASC 606-10-55-18, as a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date, the entity may recognize revenue in the amount to which the entity has a right to invoice. As a result, the Franchisor will recognize revenues as and when the underlying sales (i.e., gross room revenues) occur. This issue was also addressed in FASB/IASB TRG Agenda Ref 39: *Application of the Series Provision and Allocation of Variable Consideration*.

Step 5: Recognize Revenue When (or As) the Entity Satisfies a Performance Obligation

44. As concluded above, the promises to perform System Assessment Services and non-distinct pre-opening services should be bundled with the License to form a single performance obligation. Under FASB ASC 606-10-55-65, the revenues related to the License performance obligation will be recognized when the later of the following events occur:
- a. The subsequent sales or usage occur; and
 - b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).
45. As the performance obligation represents a series of distinct services, FinREC believes the Franchisor will identify the predominant deliverable of the combined performance obligation and assess the best measure of progress for satisfying its performance obligation and will recognize the revenues allocated to the distinct services provided to the Franchisee on that basis. FinREC believes that providing access to the License is the predominant deliverable and when Franchisors use time as its measure of progress they will recognize the revenues allocated to the distinct services provided to the Franchisee through the end of the period. Therefore, the monthly variable Royalty and System Assessment Fees will be recognized as revenue in the month the fees are billable as discussed above.
46. The Franchisor should evaluate the remaining "ad-hoc" services in the Agreement (if applicable) to determine the appropriate revenue recognition for these services.
47. Example - The following example is meant to be illustrative, and the actual application of the guidance in FASB ASC 606 should be based on the facts and circumstances of an entity's specific situation.

A Franchisor enters into a Hotel Franchise Trademark and License Agreement on January 1, 20X1 with a new Franchisee for one of the Franchisor's brands. The term of the Agreement expires 10 years from the opening date of the hotel. On the Agreement signing date the Franchisee is in the process of building a new construction hotel which the Franchisee plans to open under the hotel franchise trademark after construction completion. The Franchisor promises to provide Pre-Opening Services, which include signage and installation of the franchise reservation system. The Franchisor promises not to own, operate, lease, manage, or license any party but the Franchisee to operate a chain hotel within a pre-defined territory while the Agreement is in effect. The Franchisor charges the Franchisee a non-refundable upfront fee of \$12,600 for signing the Agreement and performing the Pre-Opening Services.

Assume the hotel opening date is January 1, 20X2. Upon opening, the Franchisee agrees to pay the Franchisor Recurring Fees consisting of:

- a. a fixed Royalty Fee of 5% of hotel GRR over the entire term of the contract and accruing during the calendar month; and
- b. a System Assessment Fee, which is comprised of a fixed Marketing Fee and a fixed Reservation Fee of 2.5% and 1.3% of hotel GRR, respectively, over the entire term of the contract and accruing during the calendar month.

Step 1 - Identify the contract(s) with a customer

The contract is the Hotel Franchise Trademark and License Agreement and the customer is the Franchisee.

Step 2 - Identify the performance obligations in the contract

There is a series of distinct services that shall be accounted for as a single distinct performance obligation in the contract comprised as follows:

A bundle of the three promises ("Bundled Services"):

- 1) provide the Hotel Franchise Trademark License,
- 2) perform marketing and reservation activities funded by the Marketing Fee and Reservation Fee, and
- 3) provide Pre-Opening Services consisting of the temporary signage and installation of the franchise reservation system.

Step 3 - Determine the transaction price

The transaction price includes fixed consideration of \$12,600 and variable consideration of 8.8% of GRR (5% + 2.5% + 1.3%).

Step 4 - Allocate the transaction price to the performance obligations in the contract

The transaction price is allocated to the performance obligation as follows:

- Promise to provide the Hotel Franchise Trademark License – Variable consideration of 8.8% GRR and fixed consideration of \$12,600 in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods and services.
- Promise to provide Pre-Opening Services- Since combined with the Promise to provide the Hotel Franchise Trademark License as a single performance obligation any consideration received will be allocated to the combined performance obligation.

Step 5 - Recognize revenue when (or as) the entity satisfies a performance obligation

The revenue for the performance obligations will be recognized as follows:

- Bundled Services
 - Promise to provide the Hotel Franchise Trademark License At the end of Month 1, the Franchisor will recognize \$985 as revenue. Beginning at hotel opening through the end of the term, the Franchisor will calculate the revenue based on the variable and fixed consideration and record monthly.
 - Revenue \$985 = (8.8% * \$10,000 GRR) + (\$12,600 / 10 years / 12 months)
 - Promise to provide Pre-Opening Services-Will be combined with the promise to provide the Hotel Franchise Trademark License as a single performance obligation and as a result any consideration received for pre-opening services will be allocated to the combined performance obligation.

The journal entries through the first two months of the Agreement would be as follows:

1/1/20X1

Receipt of Initial Fee Payment

| | | |
|---------------------|----------|----------|
| DR Cash | \$12,600 | |
| CR Deferred Revenue | | \$12,600 |

1/1/20X2

Hotel Opening

No entry required

1/31/20X2

Recognize deferred revenue for Initial Fee as the right to access the License is provided

| | | |
|---------------------|--------|-------|
| DR Deferred Revenue | \$105* | |
| CR Revenue | | \$105 |

* \$12,600 /120 months = \$105

Recognize revenue for the promise to provide the License

| | | |
|------------------------------|---------|-------|
| DR Accounts Receivable/ Cash | \$880** | |
| CR Revenue | | \$880 |

** \$10,000 GRR x 8.8% Royalty rate

Please note that if the royalty or system assessment fee percentages varied at any point over the term of the contract, further analysis of transaction price allocation may be required.

Presentation – Principal versus Agent Considerations

48. In accordance with FASB ASC 606-10-55-36, for each specified good or services promised to the customer, the Franchisor should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself, as a principal, or to arrange for those goods or services to be provided by the other party, as an agent.

49. As noted in FASB ASC 606-10-55-37:

An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is principal may satisfy its performance obligations to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligations on its behalf.

50. FASB ASC 606-10-55-37B notes that when (or as) an entity that is a principal satisfies a performance obligation, the entity recognizes revenue in the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred.

51. FASB ASC 606-10-55-37 notes that an entity is a principal if it controls the specified good or service before it is transferred to a customer. This may even be the case if the entity does not fulfill the promise itself but directs a third party to fulfill the obligation on its behalf. In order to assess whether it is acting as a principal, a Franchisor should consider the indicators in FASB ASC 606-10-55-39 as follows:

- a. The Franchisor is primarily responsible for fulfilling the promise to provide the specified service, as it is responsible for licensing the brand intellectual property to the Franchisee, performing Pre-Opening Services, and performing the System Assessment Services.
- b. There is no general inventory risk associated with the License, Pre-Opening Services, or System Assessment Services.
- c. The Franchisor is responsible for determining all prices established in the contract.

52. Based on assessment of the indicators in FASB ASC 606-10-55-39, FinREC believes the Franchisor is the principal of the combined performance obligation that includes the License to its intellectual property in the Franchise Agreement and therefore, should recognize revenue on a gross basis.

Comments should be received by June 1, 2017, and sent by electronic mail to Kim Kushmerick at kim.kushmerick@aicpa-cima.com, or you can send them by mail to Kim Kushmerick, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.

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