

Highlights of Revenue Changes for Franchisors

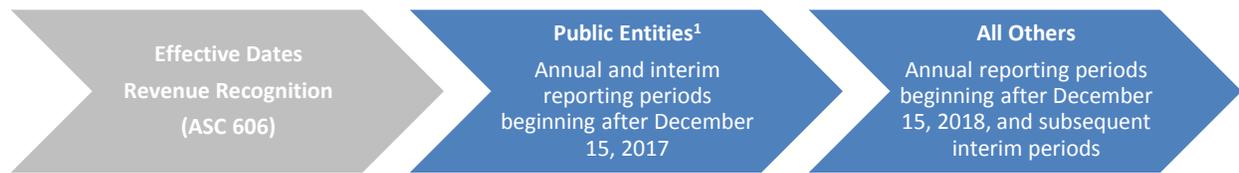
Revenue recognition will change with the adoption of Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which supersedes most industry-specific guidance and adds significant disclosures. The standard is now effective for public entities.¹ Implementation is a significant undertaking for entities across all industries. Franchisors face additional challenges due to the variety of revenue streams and extent of changes to current guidance and practice. The effect on each company will vary depending on existing income streams, customer base and current estimation methodologies and accounting elections. Even if timing of revenue recognition does not change, disclosure and internal controls and systems will. The following items will have the greatest effect on franchisors:

- **Initial franchise fees.** Under Accounting Standards Codification (ASC) 606, these will now be recognized over the term of the agreement rather than upfront on opening or when a renewal agreement becomes effective.
- **Incentive management fees.** Currently, many companies recognize the amount that would be due if the management contract was canceled at the end of the reporting period. Under ASC 606, incentive management fees would be recognized to the extent that it is probable a significant reversal will not occur, which could be later than current practice. This is likely to primarily affect interim reporting.
- **Contract assets and liabilities.** This is a new concept for most industries other than construction. Under ASC 606, reclassification from a contract asset to a receivable is contingent on fulfilling performance obligations—not on invoicing a client. As a result, the point at which a contract asset is reclassified as a receivable may be different than the time of invoicing.
- **Advertising fund contributions.** Many franchisors recognize these amounts as a reduction to advertising expenses. Under ASC 606, franchisors may be required to recognize the funds on a gross basis, with advertising fund fees included in revenue and the related advertising expense included in operating expenses.
- **Loyalty programs.** Many programs currently recognize points or benefits on a gross basis at issuance along with an accrual of the expected future cost. Under ASC 606, benefits are recognized at redemption, net of any reimbursement to a third party. Fees received in excess of the estimated liability for loyalty programs may be considered a contract liability.
- **Contract acquisition costs.** Depending on current practice, certain costs related to management and franchise contracts may be recognized over the term of the contracts as a reduction to revenue, instead of as amortization expense.
- **Breakage.** For companies that issue gift cards, the timing of when a company can derecognize a contract liability and recognize revenue may change depending on current accounting practice.
- **Presentation of sales taxes.** The standard creates a new accounting policy election to present sales taxes collected from customers on a net basis. In general this is current practice for most companies; however, to continue under ASC 606, an entity must make this accounting policy election.
- **Additional disclosures.** These are needed around the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

¹ A public entity is defined as any one of these:

- A public business entity
- A not-for-profit entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market
- An employee benefit plan that files or furnishes financial statements to the U.S. Securities and Exchange Commission

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For a more detailed look at any of the above issues, see BKD's comprehensive white paper [Revenue Changes for Franchisors](#).

BKD can help educate your team, provide implementation tools and assist with analysis and documentation. If you would like assistance complying with the new revenue recognition standard, contact your trusted BKD advisor. BKD has prepared a library of **BKD Thoughtware**® on revenue recognition issues. Visit our [revenue recognition](#) page to learn more.

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