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November 3, 2020

Ms. Hillary Salo
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: Proposed Accounting Standards Update, *Franchisors – Revenue from Contracts with Customers (Subtopic 952-606): Practical Expedient (File Reference No. 2020-600)*

Dear Ms. Salo:

We appreciate the opportunity to comment on the proposed ASU, *Franchisors – Revenue from Contracts with Customers (Subtopic 952-606)*. This letter summarizes our key observations. The Appendix provides our detailed responses to the Board's Questions for Respondents.

We support the Board's efforts to develop practical expedients for private entities to help reduce the cost and complexity associated with applying GAAP. However, we do not believe the proposed amendments will achieve those objectives, and generally agree with the alternative views expressed in BC39 – BC46. We believe the proposals would create:

- An exception to GAAP that does not represent a shortcut to the same financial reporting outcome. The treatment of pre-opening services as distinct from the license is inconsistent with the application of ASC 606 by most public company franchisors;
- Financial reporting that is inconsistent with an objective of the converged revenue standard, which was to improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets;
- An industry specific exception when the fact patterns being addressed are economically similar to certain non-franchise arrangements;
- Divergence from IFRS 15 which, in our experience, is used by most private companies applying IFRS in the U.S. as opposed to IFRS Standards for small and medium-sized entities; and
- An exception to GAAP that does not achieve the objective of significantly reducing cost and complexity.

If the Board decides the benefits of providing an exception outweigh the costs, we support limiting an exception to franchisors that are not public business entities. However, we believe the proposals would introduce complexity in applying the allocation and attribution guidance in Steps 4 and 5 of ASC 606, and would require additional guidance, as described in our responses to the Questions for Respondents.

We encourage the Board to reconsider the alternative approach expressed in BC23 and BC44. This approach would provide an option to defer the initial franchise fee and recognize it as revenue on a straight-line basis over the term of the contract. We believe this approach would reduce diversity in practice and significantly reduce cost and complexity on initial adoption of ASC 606 and on an ongoing basis. Although still an exception to ASC 606, we believe it would function as a practical expedient like the Board intends because in most cases it would produce the same outcome as applying the ASC 606 requirements.

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BC23 notes that the Board rejected this approach because it would have exacerbated stakeholders' concerns about the accounting treatment for initial franchise fees. The requirements in paragraphs 606-10-50-13 through 50-16 related to disclosure of transaction price allocated to the remaining performance obligations are optional for non-public entities. Requiring this disclosure in combination with information provided by the statement of cash flows, would provide information to users of the financial statements about the initial franchise fees collected by the franchisor. We believe a disclosure solution is preferable to an exception to GAAP, particularly when the exception may decrease comparability and increase the risk that reported revenue for early stage franchises could be misleading to financial statement users.

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If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at (212) 909-5664 or kbascom@kpmg.com or Meredith Canady at (212) 909-5858 or mcanady@kpmg.com.

Sincerely,

KPMG LLP

KPMG LLP

Appendix – Responses to Questions for Respondents

Question 1:

Do you support introducing guidance for franchisors that are not public business entities to account for pre-opening services provided to a franchisee? Please explain why or why not.

We support the Board's efforts to develop practical expedients for private entities to help reduce the cost and complexity associated with applying GAAP. However, we do not believe the proposed amendments will achieve those objectives. We believe the proposals are inconsistent with one of the primary objectives and outcomes of ASC 606, which was to improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets.

We believe the proposals would create an exception to GAAP, and do not represent a practical expedient to achieve the same financial reporting outcome. The proposals are not consistent with the application of ASC 606 by most public company franchisors. We observe that public company franchisors have generally concluded that most pre-opening services are either administrative or set-up activities that do not represent a promise to the customer or are highly interrelated with, and not distinct from, the franchise license.

We disagree with the assertion made in BC10 that the practical expedient provides financial reporting results that are more consistent with the intent of ASC 606. Example 57 of ASC 606 describes a franchise arrangement in which equipment and a franchise license are identified as distinct performance obligations. Fixed consideration is allocated between the equipment and the franchise license. The fixed fee allocated to the license is similar to an upfront fee that the entity regularly receives in exchange for a franchise license and is recognized over time. Although not specifically addressed in this example, pre-opening services are typical in franchise arrangements and observed by the FASB as evidenced by the legacy accounting guidance in ASC 952-605 related to these services. Therefore, a reasonable inference from Example 57 is that the intent of ASC 606 was for initial franchise fees to be recognized over time. However, we do not believe ASC 606 expresses an intent that is detached from an analysis of the specific facts and circumstances of an arrangement.

The practical expedient would require a franchisor to account for the pre-opening services as a single performance obligation. We believe it is unlikely that a franchisor that is ineligible for the practical expedient could conclude that pre-opening services are distinct from the franchise license but not distinct from one another. Pre-opening services eligible for the practical expedient generally do not customize one another or provide a combined output independent from the franchise license and would likely not be transferred at the same time or necessarily use the same measure of progress. This observation is consistent with the conclusion in Example 1, Case A in which site selection and training are separate performance obligations. Therefore, we do not believe the practical expedient would result in the same accounting when applying ASC 606 without the practical expedient even if certain pre-opening services were determined to be distinct.

We believe that the proposals would not improve GAAP but, rather, would create diversity between public and non-public company franchisors that would be inconsistent with the objectives of ASC 606. Applying the practical expedient would add costs and complexity for private companies that subsequently become public business entities. In addition to diversity between franchisors, the proposals would also create diversity between the accounting for franchise arrangements and other economically similar arrangements in which an entity charges upfront fees to compensate for initial efforts that do not transfer a distinct good or service.

We also note that the proposal would create divergence between ASC 606 and IFRS 15. Paragraph BC37 of the proposed ASU states that there is no significant effect on convergence because IFRS Standards for small and medium-sized entities (SMEs) are not yet converged. However, in our experience, most IFRS reporting entities in the United States apply IFRS 15 and do not apply the IFRS Standards for SMEs. Therefore, we believe this proposal would create divergence from IFRS that did not exist before.

Finally, we believe the proposal would sacrifice comparability and consistent application of ASC 606 while not achieving the Board's goal of reducing cost and complexity. See our response to Question 3.

Question 2:

Should the scope of the amendments in this proposed Update be limited to franchisors that are not public business entities? Alternatively, would it be appropriate for entities in other industries with comparable arrangements that are not within the scope of the proposed Update to analogize to the amendments? Please explain why.

Consistent with our reasons for not supporting an exception to ASC 606 for non-public company franchisors, we also oppose expanding the proposals to include public company franchisors or entities in other industries. Expanding the practical expedient would create further diversity, be potentially disruptive to public companies and result in outcomes that are generally inconsistent with the principles of ASC 606. For these reasons, we agree with the proposal that it would not be appropriate for entities in other industries with comparable arrangements to analogize to the amendments.

Question 3:

Would the proposed amendments to simplify Step 2-identify the performance obligations-reduce the cost and complexity of applying Topic 606 to pre-opening services? Please explain why or why not.

The proposed amendments would reduce the cost and complexity associated with identifying whether pre-opening services are distinct during initial adoption of ASC 606. However, we believe the proposals would increase the cost and complexity of applying the allocation and attribution guidance in Steps 4 and 5 of ASC 606.

The proposed amendments would not eliminate the need to determine the standalone selling prices for a bundle of pre-opening services that the entity may never sell separately and that, in the absence of the practical expedient, may not otherwise have been determined to have value (i.e. be distinct) without the license. An entity would then determine how much of the initial fee is allocated to the pre-opening services. Example 1, Case A allocates the portion of the initial fee that exceeds the standalone selling price of the pre-opening services to the franchise license because of a "customary nonrefundable fee associated with intellectual property". This appears inconsistent with paragraph 952-606-55-4, which notes that the entity regularly provides franchise renewals without a similar fee. We observe that while it may be customary to receive nonrefundable renewal fees, those fees may not equal the amount by which the initial franchise fee exceeds the standalone selling price of the pre-opening services. An entity would consider renewal fees and expected royalties to determine the standalone selling price of the franchise license before it performs a relative selling price allocation. Allocation of transaction price in arrangements with multiple performance obligations and a mixture of fixed and variable consideration is often complex and is performed at the contract level.

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The proposed practical expedient would not require a franchisor to evaluate whether the services would be distinct but, rather, presumes that the pre-opening services are one distinct single performance obligation. As a result, we believe there would be cost and complexity in applying Step 5 of ASC 606. Determining when transfer of control occurs (i.e. when the customer obtains the benefit from the services) is necessarily linked with identifying performance obligations (i.e. whether the services provide benefit before the license is transferred). Therefore, an entity applying the practical expedient would need to determine when the customer obtains the benefits from the pre-opening services. It is unclear how an entity would apply Step 5 of ASC 606 without performing a Step 2 analysis, in view of the relationship between the two steps.

If an entity applying the practical expedient determines that control of the bundle of services is transferred over time, ASC 606 requires the entity to use a single measure of progress to recognize revenue. Determining and applying a single measure of progress is often difficult when a single performance obligation contains multiple promised goods or services whose costs will be incurred over different periods of time or transferred in different patterns. TRG Paper 41 acknowledged the increased judgment required in these situations and noted that in making these judgments it is important to consider the reasons why an entity decided that the goods or services are not distinct and have been bundled into a combined performance obligation. Before the effective date of ASC 606, challenges associated with over time recognition for short-cycle performance obligations (e.g. costs associated with tracking measures of progress) were raised repeatedly by entities and were also discussed with the TRG. The proposed practical expedient creates these complexities for which other entities sought the TRG's guidance.

The complexities the TRG addressed related to determining and applying a single measure of progress generally do not exist when a franchisor concludes the pre-opening services are not distinct from the franchise license. Identifying a single measure of progress in these cases is not difficult because the conclusion reached in Step 2 is that the pre-opening services provide benefit to the customer as the customer receives the benefits from the license. Applying a single measure of progress is generally not difficult because a time-elapsed measure of progress is often appropriate for franchise licenses because the entity is providing access to the license consistently over time. Therefore, the franchise fee is generally recognized on a straight-line basis over the franchise contract term.

However, when the practical expedient is applied, identifying and applying a single measure of progress presents similar challenges to those presented to the TRG. The measure of progress guidance may be difficult to apply because the pre-opening services generally do not customize one another or provide a combined output independent from the franchise license. Bypassing the Step 2 analysis makes it impossible to follow the TRG's guidance to consider why services are bundled together when determining the appropriate measure of progress. Also, applying the measure of progress guidance would be more difficult because the pre-opening services are generally not stand-ready obligations that provide the customer with access to a benefit evenly over time. As a result, an entity applying the practical expedient may experience challenges recognizing revenue as the services are performed (e.g. as costs are incurred).

We believe that the benefits of eliminating the step to identify performance obligations would potentially not outweigh the cost and complexity associated with allocating transaction price and analyzing all of the various promises embedded in the initial services to determine whether they are transferred over time and, if so, what single measure of progress depicts transfer of control. Recognizing revenue over time when these services are not bundled with the license may require tracking performance or costs at a level that previously was not required or would not be required if the practical expedient had not been applied. We also note that the challenges in Step 2 that are avoided by the practical expedient are primarily addressed

in the initial adoption of ASC 606 while the allocation and recognition challenges would create ongoing complexity.

We believe that the Board could provide a simple practical expedient to achieve the goal of reduced cost and complexity. We encourage the Board to reconsider the alternative approach expressed in BC23 and the alternative views expressed in BC44. This approach would provide an option to defer the revenue recognition of all pre-opening services and amortize the deferred amount into revenue on a straight-line basis over the term of the contract. Although still an exception to ASC 606, we believe this approach would reduce diversity in practice and significantly reduce cost and complexity, at initial adoption of ASC 606 and on an ongoing basis.

Question 4:

In paragraph 952-606-25-3, the proposed amendments would reinstate superseded guidance from paragraph 952-605-25-4 as a required criterion for applying the practical expedient. Is this guidance operable? Please explain why or why not.

Reinstating the guidance from paragraph 952-605-25-4 as a required criterion for applying the practical expedient may be misinterpreted or difficult to apply in the context of ASC 606. The proposed amendments require entities applying the practical expedient to also apply the transaction price allocation guidance in ASC 606. The reinstated guidance from Subtopic 952-605 along with the allocation described in Example 1, Case A, may be misinterpreted to imply a simplified residual allocation approach is appropriate. That is, if it is probable that a reasonable profit will be earned during the franchise period, revenue for pre-opening services is recognized in an amount equal to the lesser of the initial franchise fee or the standalone selling price for the pre-opening services. This approach would eliminate some of the complexity associated with the allocation guidance in ASC 606, as described in our response to Question 3. If this simplified approach is what the Board intends, we recommend that the Board clarify this approach if the FASB decides to provide the practical expedient.

Additional guidance related to determining what constitutes continuing ‘franchise fees’ and ‘future services’, may be required. Some entities may interpret future services to mean discrete services provided to a specific franchisee (e.g. franchisee-specific advertising). If these types of future services are not part of the contract, an entity may conclude this guidance does not apply. However, we believe future services is meant to relate primarily to the remaining performance obligation to transfer the franchise license over time (i.e. symbolic intellectual property). Therefore, the ongoing costs to support and maintain the franchise would need to be evaluated. Because these costs generally provide benefit to all franchisees, it may difficult to determine how to apply the guidance to a specific franchise arrangement, particularly if scale is required to recover the costs to maintain the franchise. The guidance may require the franchisor to forecast franchisee sales or even franchise store openings. This may present challenges for start-up franchisors with a limited history or number of franchisees.

If a franchisor (e.g. an early stage franchisor) does not have sufficient evidence to conclude that it is probable that its future royalties will provide a reasonable profit on future services, it would be precluded from applying the practical expedient. For these entities the cost and complexity of applying ASC 606 would not be avoided. The alternative practical expedient expressed in BC23 to recognize the initial franchise fees on a straight-line basis over the term of the contract would reduce cost and complexity for these entities.

Question 5:

Should the scope of the proposed amendments be limited to pre-opening services? If not, please explain why.

Yes. We agree with the Board that the scope of the proposed amendments should be limited to pre-opening services. As noted in our response to Question 1, we believe the proposal represents an exception to GAAP. Therefore, limiting its application would be most beneficial to users of financial statements. We also believe that if the FASB decides to provide the practical expedient, the guidance should explicitly state whether an entity applies the guidance to all of the pre-opening services identified in the proposals or whether it can select the pre-opening services to which it would apply the practical expedient.

Question 6:

Is additional guidance about other aspects of applying Topic 606 to pre-opening services needed for the proposed amendments to be operable? If so, what specific guidance is needed?

Yes. As discussed in our response to Question 3, we believe additional guidance is needed to clarify how an entity determines when and how control of the pre-opening services transfers to the customer when the practical expedient to bypass Step 2 is elected. Because determining when control transfers is necessarily linked to identifying performance obligations, we believe this additional guidance is needed for the amendments to be operable, achieve their intended objective of reduced cost and complexity, and limit further diversity.

Services are typically transferred over time but it may be difficult to determine a single measure of progress for different types of initial services that are bundled together based on a practical expedient rather than an evaluation of whether the services are distinct. Under ASC 952-605, revenue related to these pre-opening services was recognized at a point in time, generally on the opening of the franchise location. Some entities may conclude this point-in-time recognition is also appropriate when applying the practical expedient. This conclusion would be based on a determination that the services provide benefit to the customer only after store opening which may be contrary to a conclusion that the services are distinct from the franchise license.

As discussed in our response to Question 3, we believe that the least costly and complex alternative would be to provide an option to defer and recognize initial franchise fees on a straight-line basis over the term of the contract. We believe this would result in an operable practical expedient that is more closely aligned with predominant practice by public company franchisors.

Question 7:

Should entities that elect to apply the practical expedient be required to disclose the fact? Do the proposed amendments provide decision-useful information for users of financial statements? If not, please explain why.

Yes. We believe that adopting the practical expedient would create diversity in the accounting for similar transactions. Therefore, entities that elect to apply the practical expedient should be required to disclose that fact. We note that a disclosure requirement would be consistent with the disclosure requirements

under ASC 606 when an entity elects other practical expedients (e.g. significant financing component or costs to obtain a customer).

We believe financial statement users are best positioned to comment on the decision-usefulness of the proposed amendments. However, we believe this disclosure would be more useful to financial statement users if Example 1, Case A was replaced with an example of an entity that concludes pre-opening services are not distinct from the license. As noted previously, we believe this conclusion is more typical under ASC 606 based on the arrangements that are prevalent in the industry, therefore, an example illustrating this predominant practice would better highlight the accounting difference the practical expedient may have on the financial statements.

Question 8:

Should entities that have not yet adopted Topic 606 be required to apply the transition provisions and effective date in paragraph 606-10-65-1 to the proposed amendments? If not, please explain why.

Yes. We agree with the Board that entities that have not yet adopted ASC 606 should be required to apply the transition provisions and effective date in paragraph 606-10-65-1 to the proposed amendments.

Question 9:

Should entities that have already adopted Topic 606 be required to apply the proposed amendments on a full retrospective basis, including an entity's first reporting period under Topic 606? If not, please explain why.

Yes. We agree with the Board that entities that have already adopted ASC 606 should be required to apply the proposed amendments on a full retrospective basis, including an entity's first reporting period under ASC 606. We believe this approach would preserve comparability between financial reporting periods and eliminate distortion in revenue trends caused by this change.

Question 10:

For entities that have already adopted Topic 606, should the proposed amendments be effective for annual reporting periods beginning after December 15, 2020, including interim reporting periods within that period, with early application permitted? If not, please explain why.

We agree that if the Board proceeds with the proposed changes, early application should be permitted, and we agree with the proposed date of annual and interim period adoption for entities that have already adopted ASC 606.