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November 4, 2020

VIA EMAIL TO: director@fasb.org

Technical Director
File Reference No. 2020-600
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-51116

Re: Proposed Accounting Standards Update, *Franchisors—Revenue from Contracts with Customers*
(Subtopic 952-606): *Practical Expedient* (the Proposal)

To Whom It May Concern:

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions.

We are writing to provide comments on the recent proposal by the Financial Accounting Standards Board (FASB) related to the accounting for revenue from contracts with customers (Topic 606) by nonpublic companies in the franchising industry.

We are unable to find any basis to support the FASB's Proposal. We believe the proposed amendment would create an industry-specific exception to the measurement and recognition criteria for revenue from contracts with customers despite the absence of contract terms that are unique either to nonpublic franchisors or to the franchise industry.

In addition, we believe the Proposal understates the magnitude of the differences in accounting that will result when entities apply the optional alternative treatment and obscures the primary objective of the amendment.

File Reference No. 2020-600
November 4, 2020
Page 2

More specifically, in our view:¹

- ***The proposed amendment does not represent a practical expedient.***

We support the identification of practical expedients that lower the cost and complexity of preparing financial statements without materially changing the accounting result. However, we believe the Board's proposal creates an exception to the requirement to determine whether a performance obligation is distinct. The impact of allowing entities to treat pre-opening activities as being distinct from the franchise license promise will likely materially alter the amount and timing of revenue recognized by some franchisors.

We are also concerned that attaching the "practical expedient" label to this exception could potentially mislead stakeholders into thinking that the alternative approach to identifying performance obligations has no effect on the financial statements. In fact, the Basis for Conclusions sends a mixed message. Paragraphs BC10, BC13 and BC15 all state that the "practical expedient will result in accounting results more consistent with the intent of Topic 606." Yet paragraphs BC12, BC26 and BC32 all suggest that the "practical expedient" represents a departure from the accounting results that would otherwise be reported.²

This potential misunderstanding is exacerbated by Example 1³ because it simply aggregates two distinct pre-opening performance obligations into one. The more relevant example would be a fact pattern in which the pre-opening activities are not distinct performance obligations absent the "practical expedient." In our view, that is the more common fact pattern.

Further, the Board's oft-stated conclusion that the practical expedient will result in accounting that is consistent with the intent of Topic 606 contradicts what we understand to be the result of Topic 606 in practice. For example, we note that major franchisors such as McDonald's, Yum, Dunkin' Brands and Marriott recognize revenue from initial franchise fees over the life of the franchise arrangements under Topic 606 because they have concluded that pre-opening services are interrelated with the franchise license. Franchise agreements certainly vary widely. But we believe it is misleading to suggest that the intent of Topic 606 is to treat pre-opening services as distinct.

¹ Our answers to the Questions for Respondents are presented in the Appendix to this letter.

² Paragraphs BC12 (*Benefits and Costs*) and BC32 (*Disclosure*) acknowledge that the proposed change may impose additional costs on users of financial statements by affecting the comparability of financial statements between those franchisors that use the "expedient" and those that do not. If the proposed change were not an exception, there would be no material effect on comparability. Additionally, in paragraph BC26 (*Scope – Entities That Are Not Public Business Entities*), the Board explains that one reason for limiting the amendment to nonpublic entities is to retain convergence with IFRS. If the proposed change were not an exception, convergence would be retained.

³ Paragraphs 952-606-55-1 through 55-8 (*Implementation Guidance and Illustrations – General – Illustrations*) in the Proposal.

File Reference No. 2020-600
November 4, 2020
Page 3

- ***The proposed amendment does not address issues that are unique to nonpublic franchisors.***

We support FASB efforts to consider whether the differential information needs between users of public and nonpublic company financial statements should alter the accounting principles used to prepare general-purpose financial statements. However, concerns regarding the “cost ... and ... potential accounting outcome of deferring some or all of the initial franchise fee over the franchise license term”⁴ do not represent issues that are unique to nonpublic franchisors.

We see no conceptual reason to prohibit public companies from using a practical expedient. If the FASB identifies an approach that reduces cost and complexity without materially changing the accounting result, why limit its use to nonpublic companies?

Further, we are not aware of (and the Proposal does not identify) any aspect of franchise arrangements that is unique to nonpublic franchisors. We thus question the Board’s conclusion that the proposed change “would provide financial results that are more consistent with the intent of Topic 606 *for those entities that are nonpublic.*”⁵ (emphasis added)

In our view, if there are concerns about the accounting outcome for initial franchise fees, any proposed changes that would produce outcomes that are more consistent with the Board’s intent would, by definition, be industry-wide concerns and outcomes that are independent of an individual entity’s capital structure or ownership.

- ***The expected benefits of the proposed amendment may not outweigh the expected costs.***

We acknowledge that any cost benefit analysis is necessarily qualitative. However, it appears that the Board’s analysis may have overlooked some potentially significant factors that call the Board’s conclusion into question.

Specifically, the Board’s qualitative assessment of expected benefits mentions simplifying the identification of performance obligations but omits the added complexity of determining the probability that the continuing fee will cover the cost of continuing services plus a reasonable profit.⁶ The Board’s analysis also neglected to consider the fact that any net benefit is unlikely to be significant on an ongoing basis absent a subsequent change in the franchise arrangement. Further, the Board made no attempt to qualitatively weight the expected benefits against the incremental cost to users of franchisor financial statements. In particular, because franchise agreements tend to be consistent across franchisees and accounting periods, the difficult judgments that the practical expedient would eliminate are made infrequently whereas the cost to users of inconsistent financial reporting is ongoing.

⁴ Paragraph BC3 in the *Background Information* section of the Proposal.

⁵ Paragraph BC10 in the *Benefits and Costs* section of the Proposal.

⁶ Even if that analysis is consistent with prior generally accepted accounting principles (GAAP) for franchisors, it is still incremental to the cost of complying with existing requirements of Topic 606.

File Reference No. 2020-600
November 4, 2020
Page 4

- ***There is no reason to carve out an industry-specific, private company exception to the principles of Topic 606.***

One of the principal reasons for the decade-long project to comprehensively overhaul revenue recognition guidance was to dispense with the complexity, cost, and diversity created by industry-specific standards. Yet the Board is creating an industry-specific exception for an industry issue that was fully vetted during the revenue standard's development. This precedent concerns us. Furthermore, other industries have arrangements that are similar to franchise arrangements (i.e., upfront and ongoing services and upfront an ongoing fees). If the Board believes the practical expedient is consistent with the intent of Topic 606, why is the Board limiting the scope of a simplified approach to identifying performance obligations to the franchise industry?

Similarly, we are surprised that the Board would create an alternative revenue recognition model for private companies. If there were one financial statement line item where users of public and private company financial statements would seem to want consistency, it would be in the measurement and recognition of revenue.⁷ Here again, the establishment of a precedent concerns us.

In addition to our concerns with the merits of the proposed practical expedient, we found the Proposal to be written in a way that obscures its purpose and effect.

As we read through the Proposal, here were some of the questions that puzzled us.

- If the proposed change were truly a practical expedient—a lower cost way of obtaining substantially the same result—why would the Board restrict its use to nonpublic companies?
- Given that the proposed change could materially alter the amount of revenue a franchisor would otherwise report under Topic 606, why does the Board assert that the proposed change is a practical expedient that may provide financial reporting results that are “closer to the intent of Topic 606”?⁸
- The practical expedient would change the identification of performance obligations by allowing a company to (i) assume individual pre-opening services are not distinct from each other and (ii) assume that the group of pre-opening services is distinct from the franchise license and ongoing services. Given that second assumption is clearly more consequential than the first, why does the example in the Proposal highlight only the first, thereby portraying the effect of the practical expedient as being far less significant than it actually is?

⁷ The FASB's Private Company Decision Making Framework states that recognition and measurement differences for private companies should be considered only if the difference “increases the relevance of information to the primary users of private company financial statements ... so long as the benefits justify any increase in costs.” The Basis for Conclusions identifies franchise regulators and prospective franchisees as primary users of a nonpublic franchisor's financial statements but makes no mention of how the proposed change would “increase the relevance” of those financial statements. In fact, it states that the proposed change decreases comparability with other franchisors and increases the users' ongoing cost of performing their analyses.

⁸ Paragraphs BC10 in the *Benefits and Costs* section and BC13 and BC15 in the *Basis for Conclusions* section of the Proposal.

File Reference No. 2020-600
November 4, 2020
Page 5

- The Board has been working with nonpublic franchisors for several years to address questions and clarify the guidance in Topic 606. Further, public franchisors raised no issues during their implementation of the guidance. Is the issue facing nonpublic franchisors and their auditors really a lack of understanding?
- Given that other industries have arrangements that are similar to franchise arrangements (i.e., upfront services and upfront fees), why didn't those industries raise similar questions and concerns with the Board?
- If the principal concern of nonpublic franchisors is cost and complexity, why did the Board state that the deferral of the entire initial franchise fee (which would most certainly be simpler and less costly than the proposed amendment) "would have exacerbated stakeholders' concerns about the accounting treatment of initial franchise fees"?
- If the Board concluded that the full deferral approach was "overly conservative" because it would defer revenue for pre-opening services that are in fact distinct, why did it not conclude that its proposed approach to accelerate the recognition of revenue for pre-opening services that are not distinct is "overly aggressive"?

The Board states that it undertook this project to "address the issues raised by stakeholders who expressed concerns about the level of effort required to account for initial franchise fees ... and the accounting outcome of deferring some or all of the initial franchise fee over the franchise license term."⁹ But the language of the Proposal focuses only on the required level of effort. The significance of the Proposal's effect on the accounting outcome—an outcome that is substantially equivalent to the superseded revenue recognition guidance for the franchise industry—receives no mention. These discrepancies suggest that the principal purpose of the Proposal is resolving nonpublic franchisors' concerns about the accounting outcome of deferring initial franchise fees.

We believe the Board owes it to its constituents to be transparent in explaining the objectives, consequences and reasons for its standards.

If you have any questions regarding our comments, please contact either Scott Taub (312-345-9105) or Amy Ripepi (312-345-9103).

Sincerely,



Financial Reporting Advisors, LLC

⁹ Refer to the section entitled "Why Is the FASB Issuing This Proposed Accounting Standards Update?"

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 do not. We believe the proposed amendment would create an industry-specific exception to the measurement and recognition criteria for revenue from contracts with customers despite the absence of contract terms that are unique either to nonpublic franchisors or to the franchise industry. Please refer to the body of our letter for a more detailed discussion.

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.

We do not believe it is appropriate to create industry-specific exceptions to the measurement and recognition criteria for revenue recognition. We also do not believe it is appropriate to create private company accounting alternatives for the measurement and recognition of revenue from contracts with customers.

Having said that, we are surprised that the FASB would limit a practical expedient that it believes would be “more consistent with the intent” of Topic 606 to nonpublic franchisors. We are equally surprised that the FASB would limit such a practical expedient to a specific industry when there are any number of contracts in other industries that involve an initial fee that covers both pre-opening services and ongoing license rights. Please refer to the body of our letter for a more detailed discussion.

Question 3: Would the proposed amendments to simplify Step 2—identify the performance obligations—reduce the cost and complexity of applying Topic 606 to the pre-opening services? Please explain why or why not.

We are skeptical that the *net* effect of eliminating some judgments and adding others will significantly reduce the cost and complexity of applying Topic 606.

More importantly, we are skeptical that any benefits to preparers would be outweighed by the costs to users of nonpublic franchisor financial statements. Please refer to the body of our letter and our response to Question 7 for more discussion.

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.

We are aware of no reason that it would not be operable.

Question 5: Should the scope of the proposed amendments be limited to pre-opening services? If not, please explain why.

We remain confused as to why pre-opening services have caused such significant concerns and issues for nonpublic franchisors but not for their public company counterparts or other industries with similar contractual arrangements. Conceptually, there appears to be nothing unique about the identification of pre-opening services as performance obligations. Please refer to the body of our letter for a more detailed discussion.

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?

As noted in our response to Question 5, we remain confused as to why pre-opening services have caused such significant concerns and issues for nonpublic franchisors but not for others. Thus we have no basis to comment on whether additional guidance might be useful.

We are, however, concerned that referring to the proposed amendment as a “practical expedient” could mislead preparers, auditors, franchise regulators, prospective franchisees and other stakeholders into thinking that the alternative approach to identifying performance obligations has no effect on the financial statements. As discussed further in the body of our letter, this potential misunderstanding is exacerbated by Example 1.

Question 7: Should entities that elect to apply the practical expedient be required to disclose that fact? Do the proposed amendments provide decision-useful information for users of financial statements? If not, please explain why.

In our view, the proposed amendment represents an alternative accounting principle. Longstanding GAAP requires companies to disclose the election of accounting principles.

Although our client base typically does not include users of financial statements, we frequently find ourselves using and analyzing financial statements to obtain information about individual companies and selected industries. That experience suggests to us that the proposed amendment could significantly hamper a user’s ability to obtain decision-useful information about franchisors.

Given that the proposed amendment could result in a significant acceleration of revenue and thus dramatically affect the comparability of both revenue and pretax income among franchisors, we believe it is imperative that the FASB obtain input from a cross-section of primary financial statement users before finalizing this Proposal.

Questions 8 through 10: (Transition and effective date)

We have no insights to offer on transition and effective date issues.