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Via e-mail to director @ fasb.org

Director of Technical Application and Implementation Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk. Connecticut 06856-5116

Re: File Reference No. 1082-300

Ladies and Gentlemen:

We appreciate the opportunity to provide comments on the above referenced Exposure Draft on the Proposed Interpretation, Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46 ("FIN 46"). We find the Exposure Draft to be helpful in addressing some of the interpretive and operational issues relative to FIN 46. We find particularly useful in the Exposure Draft the communication of the intent of the Financial Accounting Standards Board ("FASB" or "Board") when reaching its conclusions. In this letter we highlight three issues addressed in the Exposure Draft as they impact franchisors. Also, given that the FASB and FASB Staff are continuing to issue FASB Staff Positions ("FSPs") and to propose significant modifications to FIN 46, we strongly recommend that the Board provide an additional deferral of the FIN 46 effective date, which should include entities created on or after February 1, 2003 as well as entities created prior to that date.

Access to Information

Paragraph 3(c) of the Exposure Draft would add new paragraph (g) to Paragraph 4 stating an enterprise with an interest in a variable interest entity or potential variable interest entity created before February 1, 2003, is not required to apply FIN 46 subject to the enterprise making continuing exhaustive efforts to obtain the information necessary to apply FIN 46. We appreciate the Board's recognition and attention to instances when adequate financial information is not available to comply with the requirements of FIN 46. However, the language proposed in paragraph 3(c) of the Exposure Draft does not fully acknowledge the issues faced by franchisors.

As was previously communicated by the International Franchise Association ("IFA") in its letter to Mr. Edward Trott in care of Mr. Jeffery Mahoney dated October 21, 2003, the vast majority of franchisors currently do not have the right to impose on their franchisees the requirements necessary to obtain financial and other information needed to apply FIN 46 and consolidate franchisee entities. To do so, existing and new franchise agreements would have to be revised to allow a franchisor to dictate the gathering of necessary timely financial and other information. As a note, revisions of existing agreements can not be made unilaterally by franchisors and can generally occur only by common agreement between the franchisor and franchisee. The letter dated November 21, 2003 from the IFA to Mr. Edward Trott in care of Mr. Jeffery Mahoney discusses in detail the level of control that can be exercised by franchisors.

Changes to franchise agreements to obtain financial and other information needed to comply with FIN 46 would, of necessity, encompass:

- The implications of requiring franchisee financial statements in accordance with 1) United States Generally Accepted Accounting Principles (including for internationally based franchisees), 2) the franchisor's accounting policies, and 3) the franchisor's disclosure procedures, reporting systems and internal controls.
- Particularly for franchisors with public reporting responsibilities, obtaining franchisee
 financial statements and other information in time to meet franchisors' reporting
 deadlines to shareholders, the investment community and the Securities and Exchange
 Commission ("SEC").
- How the franchisor's auditors would include franchisees in the audit scope and who
 would absorb the increased audit costs.
- How to address franchisor Audit Committee risks and responsibilities.
- The significant legal implications associated with requiring CEO and CFO Sarbanes-Oxley (and other) certifications to cover information obtained from franchisees where the franchisor currently has no, or very limited, rights to impose or even be informed of franchisees' internal controls, thus placing franchisor executives in the dilemma of not being able to perform the reviews and evaluations called for in connection with those certifications or else not being able to execute those certifications in the required form.

Although each of the above points is stated generally, we trust the Board and FASB Staff will appreciate that each point is comprised of numerous requirements and specifics that are both complex and detailed. This is particularly true given the current state and timing of financial information for most franchisees today. It is quite possible that, after considering the above issues, a franchisor would decide the best course of action would be for the franchisor to actually perform the accounting for its franchisees. We trust also the FASB and FASB Staff appreciate that obtaining the information necessary to consolidate franchisees would significantly increase the control and involvement a franchisor exercises over the operations of franchisees and would result in greatly expanded franchisor visibility into franchisees' financial results. As a result, the needed changes to franchise agreements to obtain the financial and other information necessary to apply FIN 46 and consolidate franchisees will be met by significant resistance from franchisees and, therefore, would have to be carefully considered by franchisors and not entered into lightly.

Unfortunately, given the ongoing interpretative issues involving FIN 46, the February 1, 2003 date proposed in paragraph 3(c) of the Exposure Draft essentially implies that from the January 2003 issuance of FIN 46 to February 1, 2003, each franchisor should have 1) worked through all the necessary franchisee reporting requirements and specifics, 2) changed franchise agreements and business practices for hundreds or thousands of new franchise businesses starting since February 1, 2003, and 3) then only later, through subsequent interpretive guidance and modifications provided by the FASB, determined that most if not all of the new franchisee entities created after February 1, 2003 are not required to be consolidated by the franchisor. This is the only approach a franchisor could have taken to comply with the proposed February 1, 2003 date in paragraph 3(c) of the Exposure Draft because franchisors and their public accounting firms could not have, in a single month, performed and concluded on the expected loss and expected residual return computations and resolved the other interpretive issues related to FIN 46 in order to determine which, if any, franchisces should be consolidated. Indeed, a number of these interpretive issues remain unresolved ten months after FIN 46 was issued.

As the FASB and FASB Staff are aware, some of the ongoing FIN 46 interpretative issues for franchisors include 1) as originally written, FIN 46 defined most franchisors and franchisees as de facto agents - the current Exposure Draft effectively states most franchisors and franchisees are not de facto agents, 2) significant debate as to whether a franchisee lacks the characteristic of paragraph 5(b)(1) of FIN 46 (an issue currently being addressed by proposed FSP FIN 46-f), 3) identifying what is and is not a variable interest and how variable interests are to be applied in the primary beneficiary test (this point is discussed further below), and 4) the proposed expansion in paragraphs 5 and 10 of the Exposure Draft describing when an enterprise should reconsider whether it is the primary beneficiary of an entity. All four of these issues are currently being addressed by the FASB but, as of the date of this letter, none have been finalized. In addition, there were significant changes between the original June, 2002 FIN 46 Exposure Draft as it affected franchise relationships and the final Interpretation - resulting in little advance notice or preparation for franchisors.

As an illustration, prior to the FIN 46 FSPs, interpretations and modifications, some believed that a franchisor charging a 5% royalty might be required to consolidate its franchisees because a) the royalty is a variable interest, b) the franchisees lacked adequate decision making as contemplated in paragraph 5(b)(1), c) the franchisor and franchisee were de facto agents, and d) the activities of the franchisee entity were most closely associated with the franchisor. Intuitively this did not make sense, but a franchisor could not have made the correct interpretive determinations by February 1, 2003.

The only way, then, that a franchisor could comply with the proposed February 1, 2003 date in paragraph 3(c) of the Exposure Draft would have been to change <u>all</u> of its franchise agreements in an unrealistic, if not impossible, one month time frame. Changing all new franchise agreements would have been necessary because a franchisor would not have been able to address all of the FIN 46 interpretative issues by February 1, 2003 in order to determine which, if any, franchisees should be consolidated under FIN 46.

As a practical matter, a one month time frame would have been impossible to meet in order to implement the significant changes allowing a franchisor to dictate requirements necessary to obtain financial and other information needed to address FIN 46. Most likely, franchisors would have had to temporarily halt the execution of new franchise agreements to address the significant business and control issues. Then later, as the interpretive issues related to FIN 46 were clarified, franchisors would discontinue requiring most, if not all, franchisees to submit the stipulated financial and other information. Certainly, this scenario is not the expectation of the Board.

Duc to the impracticality of the February 1, 2003 date proposed in paragraph 3(c) of the Exposure Draft, we recommend the February 1, 2003 date be changed to a practical date after all significant interpretive issues related to FIN 46 are resolved. It is only with the resolution of the outstanding significant interpretive issues that franchisors will be able to determine which franchise entities are intended to be consolidated by FIN 46. Once the interpretive issues are concluded, a reasonable period of time should be provided to consider their implications and make the necessary changes to the appropriate franchise agreements, systems and controls where consolidation of franchisees is required.

We also ask the FASB for clarification on what is intended by continuing "exhaustive efforts" as described in paragraph A11 of the Exposure Draft. For example, under existing franchise agreements, a franchisor could incur liability under common law and various state, federal and foreign regulations for demanding under its franchise agreements the necessary financial and other information required to apply FIN 46. One question is whether a franchisor would be expected to take legal action to obtain the timely financial and other information in order to meet the exhaustive efforts standard.

As stated earlier, franchisors are unable to change unilaterally franchise agreements and the changes necessary to comply with FIN 46 will be resisted by franchisees who believe they operate their own businesses. Given contractual and legal restrictions, we believe instances of franchisors not able to obtain the financial and other information necessary to comply with FIN 46 will be more than infrequent. Generally, based on franchisors' assessments of their exposure, franchisors have not found it necessary to receive franchisee financial information necessary to comply with FIN 46 requirements. Certainly, today, this information is not received in time to meet reporting deadlines to shareholders, the investment community and the SEC.

We understand the Board's concern involving an inability to obtain information may relate to potential "engineering" by some enterprises to avoid consolidating variable interest entities. However, franchisors can point to historical, wide spread and readily observable contractual, legal and business practices over a number of decades that show franchisors have not had the timely information necessary to apply FIN 46 or consolidate franchisces. As such, franchisors, franchisees and others whose basic business practices are potentially affected should be provided more time to address the ongoing FIN 46 interpretive issues and the very real operational issues related to obtaining the financial and other information necessary to comply with FIN 46.

Variable Interests

We are very concerned by the proposal in paragraph 19 of the Exposure Draft to delete ten of the twelve examples in Appendix B of FIN 46, which describes examples of variable interests. Of greater concern, however, is that the Exposure Draft provides nothing to replace the ten paragraphs to be deleted. Board considerations on this matter provided in paragraph A41 of the Exposure Draft do not provide guidance that would allow public companies and their accounting firms to determine whether they are applying the variable interest concept properly and in accordance with the intention of the FASB.

Variable interests and how they are treated in the primary beneficiary test are obviously critical to the application of FIN 46. We and others do not understand why the Board has proposed to delete the ten paragraphs. Many are left to speculate what information within the ten paragraphs proposed to be deleted is either wrong or fails to provide the proper context to make a determination.

Two arrangements of concern in this area for franchisors are royalties and real estate leases and how they should be considered and applied in the expected loss and expected residual return computations. Paragraph B10 of FIN 46 (proposed to be deleted) had introduced the concept of "market terms" and that under certain circumstances long term leases at market terms are not considered in determining the primary beneficiary. A number of franchisors enter into long term real estate lease arrangements to lease land and/or buildings to their franchisees. These leases may require either a minimum fixed lease rent payment or, if greater, a lease rent payment computed as a percent of franchisee sales. Also, franchisors generally charge a royalty as a percent of franchisee sales, sometimes with a minimum royalty payment required to be paid. Royalty payments represent compensation for services to a franchisor in return for agreeing to license its brand, operating system and a valuable established business concept and to provide ongoing support of the brand and to franchisees. In many instances franchisors can demonstrate royalties charged are at market terms. The question is, how should these arrangements be applied under FIN 46?

Mathematically, if a franchisor charged its franchisees fixed amounts for royalties and lease rents (rather than as a percent of sales), the expected losses and expected residual returns calculation would often result in minimal variability for these amounts. Some would argue then, that for franchisees considered variable interest entities, that the franchisor may never be considered the primary beneficiary if fixed royalties and lease rents were the only financial interest the franchisor had in its franchisees.

Instead, franchisors have chosen to link their compensation to the value of the brands they license. Accordingly, royalties and lease rents charged by franchisors are often computed as a percent of franchisee sales. Unlike the previous fixed fee scenario, if a franchisor charges royalties and lease rents computed at 5% and 9% of a franchisee's sales, respectively, some will conclude that, for franchisees considered variable interest entities, the franchisor is the primary beneficiary. This primary beneficiary conclusion is based on assuming the full variability of the combined 14% is treated as a variable interest that is obligated to absorb expected losses and receive expected residual returns of the franchisee entity.

The view by some that a franchisor is considered the primary beneficiary if royalties and lease rents are charged as a percent of sales and not considered the primary beneficiary if these amounts are charged at a fixed rate simply based on how "the math" comes out is perplexing. Intuitively, it does not seem that the primary beneficiary answer should change depending only on the basis of how payments to a franchisor are calculated. In addition, potential franchisor exposures related to royalties and leases are already recognized and disclosed by franchisors under accounting pronouncements other than FIN 46.

To address this issue, we suggest that market rate amounts charged by service providers as a percent of sales for entities comprised primarily of non-financial assets should not be considered variable interests for purposes of determining the primary beneficiary. For franchisees, a change in sales may only indirectly translate to a change in franchisee net asset values subject to market valuations at the time the business licensing the franchise is ultimately sold. In some cases, an increase in franchisee sales driven by price discounting can have a negative impact on franchisee cash flows. Also, whether or not something is a "market rate" should be verifiable by observable transactions between unrelated willing parties. To the extent financial arrangements are not at a market rate, they could be considered and treated as variable interests.

We request a clear expression of what variable interests are and how those interests should be applied to expected loss and expected residual return computations for purposes of evaluating equity at risk and determining the primary beneficiary. Given the Board's proposal to delete paragraph B10 of FIN 46, we request clarification as to how and to what extent terms above or below market and fixed payments should be considered. Providing examples for substantive operating entities, like franchises, would be very useful in helping to clarify the Board's intent in this area. Without clearer guidance, franchisors may reach different conclusions with respect to these matters - resulting in less comparable financial statements between franchisors. We question how FIN 46 can be implemented given the current lack of guidance on these matters.

Variable Interest Entities

We appreciate the FASB clearly emphasizing that qualitative factors are important considerations when determining whether the equity at risk is adequate to permit an entity to finance its activities. In paragraph A21 of the Exposure Draft, one of the qualitative factors considered in determining whether an entity is a variable interest entity is the life of the entity. We are uncertain as to why the life of an entity is an important consideration in determining whether an entity is a variable interest entity and request clarification.

Given that the FASB and FASB Staff are issuing FSPs and proposing modifications to FIN 46 that significantly affect franchisors, we join with positions expressed in letters from the McDonalds Corporation, the International Franchise Association, the three Board members and others to strongly recommend the Board provide an additional deferral of the FIN 46 effective date. The deferral should include entities created on or after February 1, 2003 as well as entities created prior to that date. The ongoing interpretive and operational issues faced by franchisors since FIN 46 was issued are real and significant and apply to entities created both before and after February 1, 2003. The ongoing discussions between the FASB, the SEC, franchisors and the public accounting firms demonstrate that the issues are real. Public companies today operate in a post Enron and Sarbanes-Oxley world where the perceived level of risk is affecting interpretations, actions and advice being offered absent clear expressions of intent from the FASB concerning these matters. Until the outstanding FIN 46 issues are resolved and understood with adequate time provided to those preparing and issuing financial statements, we believe the risk of financial statement errors and inconsistencies is unacceptably high.

We appreciate the opportunity to express our views and concerns on this important topic and would be happy to supplement this expression in writing or discussion at your request.

Respectfully submitted,

Kenni B. Anderson

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Executive Vice President and
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cc: International Franchise Association