

Stacey Sutay

Subject: FW: FIN 46 and the application to franchise companies

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From: Tony Verbeten [mailto:TVerbeten@Capistar.com]

Sent: Thursday, November 20, 2003 3:45 PM

To: Director - FASB

Cc: Jeff Elgin

Subject: FIN 46 and the application to franchise companies

When the Financial Accounting Standards Board (FASB) issued Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46) in January 2003, it was issued as a further step in ensuring meaningful and accurate financial reporting to regulators, the market and investors. I applaud those efforts. As it is currently written though, it appears that there is the potential that FIN 46 will impose an unnecessary hardship on franchise businesses, add complexity and confusion to the reporting process and actually make the financial statements of franchise businesses less accurate and harder to read. The following points represent examples related to the franchise industry where it doesn't appear that the intended result of more meaningful and accurate financial reporting would be achieved if FIN 46 was adopted as currently written:

- If a franchisor would be required to consolidate the assets and liabilities of franchisees, situations would arise where a franchisor is recording a liability for long-term debt even though the franchisor has no legal obligation related to that debt or recording assets for which the franchisor has no legal ownership rights.
- If the franchisor would be required to consolidate the revenue and expenses of franchisees, while having no impact on the ultimate bottom line of the franchisor, the result would be a gross-up of revenue and expenses related to the franchise company. This would result in the franchisor recording as revenue "system-wide" sales information. The SEC has previously expressed concern that the use of such revenue information by franchisors would be potentially misleading.
- The end result would appear that the financial statements would not reflect economic reality. Additional footnote disclosure would be required, not to provide better financial information, but to provide clarity to allow the financial statement user to understand the financial statements.

In addition to the concerns that I have over the accuracy of the franchisor financial statements, it would appear that application of FIN 46 would require a significant cost to both franchisees and franchise companies. Since the majority of franchisees and franchisors are relatively small entities, this additional cost could have a major impact on the economic growth of this vital industry. Specifically, additional costs would be incurred in applying the provisions of FIN 46 as discussed below:

- If franchisors would be required to consolidate franchisee financial statements, the franchisor would need to gather timely GAAP financial information from franchisees that they may not have the legal right to obtain and which the franchisee may not even maintain.
- The franchisor's auditors would have to include franchisees in the audit scope, increasing the audit costs and potentially resulting in modifications to the auditors report when auditors are not able to obtain the required information.
- All franchisees would be required to provide internal control reports and to adhere to internal control dictates of the franchisor.

Since Capistar is a privately-held company, I have not discussed the specific concerns of publicly-held franchise companies, including the significant additional requirements that would be necessary in order to comply with Sarbanes-Oxley.

I ask that the FASB provide clarification to the franchise industry on the applicability of FIN 46 where the franchisor has no equity ownership in the franchisee and its only continuing interest in the franchisee is a fixed-rate royalty fee that it receives in connection with the franchise agreement. Clearly, the economic reality of this situation would not call for franchisee/franchisor consolidation. This fact should be specifically addressed in FIN 46.

I appreciate your attention to this matter.

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