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[Via e-mail to director @ fasb.org]

TA&I Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Re: File Reference No 1082-300 Paragraph 5a of FIN 46

Ladies and Gentlemen:

As indicated in our letter to the Financial Accounting Standards Board ("FASB") dated November 21, 2003, the International Franchise Association ("IFA") and its members appreciate the efforts being made by FASB and its staff to address their concerns about Financial Accounting Standards Board Interpretation No. 46 ("FIN 46"). However, as also indicated in that letter, the IFA and its members have continuing serious concerns regarding the application of Paragraph 5a of FIN 46 to franchise business systems which are not addressed in either the Exposure Draft dated October 31, 2003 (the "Exposure Draft") or FSP FIN 46-f (FSP 46-f"). In fact, we believe that some of the changes proposed in the Exposure Draft, taken together with FSP 46-f, cause greater confusion regarding Paragraph 5a, as evidenced by inconsistent applications by international public accounting firms.

Background

In the typical franchisor-franchisee relationship, the franchisee designs its own equity and debt structure with no input from the franchisor. Many franchisees borrow funds from commercial lenders, most often secured by a pledge of franchisee assets and are either co-signed or guarantied by one or more equity owners. Some franchisors make available to franchisees as a group equipment financing and facility lease programs, again guarantied by the franchisee's equity owners. Even in those instances where franchisor-sponsored financing is made available, the franchisee designs its own accounting system which most often is not based upon Generally Accepted Accounting Principles (i.e., tax and cash methods of accounting). Most franchisees are more concerned with cash flow before compensation and related party payments than operating profits and, in fact, many franchisees look for opportunities to reduce net income or create losses so as to minimize taxes. Particularly in the case of small, closely held businesses, selling, general and administrative expenses are distorted from GAAP by income tax driven and related party payment decisions made by the franchisee. Furthermore. franchisors are not in a position, contractually or otherwise, to police the infusion and withdrawals of equity from their and related party payment decisions made by the franchisee. Furthermore, franchisors are not in a position, contractually or otherwise, to police the infusion and withdrawals of equity from their

franchisees or to evaluate the impact of asset acquisitions or dispositions by their franchisees. Recognizing these business realities, franchisors are rarely concerned with any operating statement line items below net revenue or gross margin, and therefore do not require from franchisees full financial statements or financial statements based on GAAP. Franchisors most certainly cannot force upon their franchisees GAAP requirements or annual audits.

In summary, franchisors are not involved in the design of the capital structure of franchisees, have no control over franchisee losses or profits, and have no ability to command from franchisees the financial information necessary to make the evaluation required by Paragraph 5a. This would, by default, result in a significant number of franchisees being deemed variable interest entities ("VIEs") as FIN 46 is currently written, merely because of the lack of information to prove otherwise. This appears to contradict the FASB staff's belief, expressed in FAS 46-f. that FASB did not intend for all franchisee arrangements to be considered VIEs.

Owners' Equity Investments

In the Exposure Draft, FASB proposes to make the Paragraph 5a evaluation more qualitative. However, proposed changes make it more difficult for franchisors to avoid VIE classification of franchisees. By extending the possible providers of subordinated financial support to equity owners while not modifying footnote 2 (which provides that equity investments in an entity are interests required to be reported as equity on the entity's financial statements), FASB will be establishing certainty that personal borrowings and equity owner guaranties of entity borrowings and other financial arrangements are excluded from equity and classified as subordinated financial support. Unless remedied, this assures that franchisees who borrow to start their businesses will be VIEs. We believe that substantially all franchisees will fall into this category. To avoid this problem, we suggest that footnote 2 be modified to provide as follows:

"Equity investments in an entity are interests that are required to be reported as equity in that entity's financial statements plus indebtedness for borrowed funds and other entity financing from unaffiliated persons for which the controlling equity owner is personally liable for payment directly or by unconditional guaranty."

This proposed modification puts the evaluation squarely where it belongs – on the creditworthiness and risk absorption of the equity owners.

Loss and Residuals Analyses

Because of the lack of control of franchisors over franchisee losses or profits, if any, we encourage FASB to provide relief from the equity to loss analysis required in Paragraph 5a, as supplemented by Paragraphs 8, 9.A, 9 and 10. In this regard, we are advised by IFA members that a number of international public accounting firms are disregarding the intended presumption that equity equal to or greater than 10% of the entity's total assets is sufficient to avoid VIE classification under Paragraph 5a. Rather, they are requiring franchisors to provide franchisee-by-franchisee equity to loss analysis. Some continue to treat franchisors as decision makers and to include royalties and fees to the franchisor as residual returns in the profits analysis. By doing so, it is practically impossible for franchisees to not be deemed VIEs under Paragraph 5a. If the same tests were applied to landlords, lease rents would also represent residual returns and tenants would be VIEs.

As explained in FSP 46-f, it is not the intention of FASB to capture franchisees under FIN 46. Great strides were made in FSP 46-f to avoid VIE classification under Paragraph 5b. Comparable clarification of FASB's intent is also needed for Paragraph 5a. To provide this clarification, we suggest that:

- The Exposure Draft include illustrations of high-risk activities to provide guidance to the
 accounting profession for going beyond the 10% of total assets analysis and that franchise
 arrangements be distinguished from high risk activities;
- The determination of decision-makers (for fee inclusion) be made in a manner consistent
 with FSP 46-f (as proposed to be modified in our letter of November 21, 2003). By this, we
 mean to imply that if the franchisor's level of decision making is consistent with those
 discussed in FSP 46-f, then the franchisor is not the decision maker for purposes of
 Paragraph 8 of FIN 46 and a calculation of expected residual returns;
- The franchisor's standard royalties, advertising fund, and license fees be excluded from the residual profits analysis;
- Illustrations B.8, B.9 and B.10 of Appendix B to FIN 46 not be deleted as proposed in the Exposure Draft;
- The Exposure draft provide an alternative "loss" analysis that compares equity investment to gross margin, rather than to GAAP losses; and
- The Exposure draft provide certainty as to the number of years that must be included in the loss analyses.

Lack of Information

There are numerous valid business reasons why a franchisor cannot obtain from franchisees the financial statement information required to do the analysis under Paragraphs 5a, 8, and 9. FIN 46 now requires extensive explanation regarding those entities which may be VIEs for which information cannot be obtained. In some instances, the absence of such information is leading auditors to qualify their reports on the financial statements of franchisors. In at least one recent instance, an international accounting firm has refused to issue an audit opinion to one of the country's leading franchisors because of an inability to obtain financial data on franchisees joining the system after February 1, 2003. This has already had, and will continue to have, profoundly adverse implications to franchisors in their efforts to comply with the federal and state laws governing the offer and sale of franchises, and may also seriously impair their commercial finance and capital markets activities.

We strongly suggest that FIN 46 be modified to include a presumption that an entity that has not provided the financial statement information needed by an enterprise to complete a Paragraph 5a analysis is not a potential VIE if: (i) the enterprise is not a related party to the entity; (ii) the equity owner of the entity has represented to the enterprise by questionnaire or agreement that it has adequate equity investment to meet its expected losses, if any, or that its equity investment is equal to or greater than 10% of its total assets; (iii) nothing has come to the attention of the enterprise that leads it to question the representation of the equity owner of the entity; and

(iv) the enterprise has requested, but has not been provided, the entity financial information needed to complete the Paragraph 5a. analysis.

As we discussed in our letter to FASB dated November 21,2003, we believe that the scope exception discussed in the Exposure Draft related to lack of available information should apply to entities created subsequent to the date of the Exposure Draft becoming effective and not January 31, 2003. To continue to apply a January 31, 2003 start date in light of the fact that guidance on the information availability issue is continuing does not give credence to business realities, particularly with respect to franchise relationships and agreements.

Reassessments under Paragraph 7

Finally, we suggest that the staff provide greater guidance on Paragraph 7 of FIN 46 to avoid uncertainty and considerable costs. Franchise arrangements that pre-date FIN 46 are not subject to the paragraph 5a analysis unless one of the paragraph 7 events occurs. Unfortunately, Paragraphs 7b and 7c are so broadly drafted that an owner-operator's withdrawal of cash from a franchisee for whatever purpose might trigger paragraph 7b, and the purchase of a major asset (e.g. an oven or french fry machine) could arguably trigger paragraph 7c for a small franchisee that has expected losses. This could mean that a host of franchisees could be brought back under FIN 46 for reasons that may be inconsequential and upon the occurrence of events that are well outside the scope of involvement, control (and even the knowledge) of the franchisor. This would worsen the burdens noted above in our discussions about 5a.

We ask that the staff make clear that only very significant equity withdrawals, new activities or asset purchases actually known to the enterprise (franchisor) trigger a reassessment under Paragraph 7.

The International Franchise Association and its members appreciate the time and attention that FASB and its staff have given to understanding their concerns regarding FIN 46. Representatives of the International Franchise Association continue to be available to meet with members of FASB and/or its staff to review these comments and those expressed in our letter dated November 21, 2003, as well as the impact of FIN 46 to the franchise business system.

Respectfully submitted,

Matthew R. Shay Executive Vice President

International Franchise Association