Testimony of

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On behalf of the International Franchise Association

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Chairman Enzi, Senator Dodd, Senator Allard, other members of the Subcommittee, thank you for opportunity to testify before you on the impact the Financial Accounting Standards Board (FASB) has on small business growth.

As you know, my name is Pete Salg. I have worked in franchising since 1968, doing everything from running a restaurant, to running a franchisor with 450 units. Today, I am a small franchisee. My company, QSC Restaurants, Inc. owns five Wendy's restaurants in Colorado.

I will be testifying today on behalf of the International Franchise Association (IFA), which represents franchisees, franchisors, and others in the franchise community. In the 44-year history of the organization, there has been a clear and constant effort to promote entrepreneurship for all sectors of American society.

I'll be focusing my comments on the impact of FASB FIN 46 on the small franchisee, but I also want to make sure you know that the great majority of franchisors are small businesses too. The typical franchisor has less than 200 units and revenues of less than $5 million. I will mention some of the hardships they face as a result of FIN 46 as well.

If FIN 46 goes into effect as written, here is what it could mean to franchisees like me:

- We would have to have audited financial statements. This is not required currently and would be very expensive. It is not required currently because it does not make sense to require it for two reasons: one, Wendy's has no contingent liability, and two, mine is not a public company!
- We might be required to use the same outside auditor as their franchisor. This isn't an explicit requirement of FIN 46, but if my franchisor's auditors say they will only be comfortable if my statements are prepared by their own people, Wendy's is left with little choice and neither am I. This requirement will hit the single-unit franchisees the hardest. Needless to say, not every mom and pop small business can afford PriceWaterhouseCoopers or KPMG.
- We would also be required to adhere to the franchisor's internal accounting standards. Franchisees like me have made enormous investments – enormous at least in relation to *my* business – in the way they have decided how best to create their financials. Wendy's P&L Statement doesn't look like my P&L. We both have good business reasons why they look the way they do and there is no reason they should look the same.
- We would have to develop a system to provide internal control reports to franchisors and adhere to internal control dictates of the franchisor's auditor. I can understand why the franchisor would want this since the CEO and CFO are on the hook for criminal penalties provided for in Sarbanes-Oxley, but why on earth should a small operator have to institute an extensive internal control system? An individual Subway sandwich shop that probably grosses under $400,000 is not the same as IBM and shouldn't be treated as such. This unintended consequence of FIN 46 is pure overkill.

Now let's look at the impact on small franchisors.

Typically, franchisors generate all of their revenue from royalties paid by the franchisee and that royalty is usually around 5% of sales. When you read about a franchise company you often see reports in the media about their system-wide sales figures. For example, if a franchisor with 100% franchises has system-wide sales of $100 million dollars, that sounds impressive. But what it means is that the franchisor probably has an annual income of around $5 million -- five percent of $100 million. Of the 1500 franchisors in the US, probably half have annual incomes of $5 million or less. So it is important to remember that not just franchisee – but also most franchisors – are very small businesses.

This hearing is about the impact on small business growth and it's hard to think of something more stifling to growth than FIN 46.

If you have a successful small business and you are thinking of ways to expand, franchising is a great method for a lot of people. You share your brand and operating plan with others willing to invest their money to start a franchise and you both can profit while your brand takes off.

FIN 46 makes franchising much less appealing. First of all, it just got a lot more expensive to be a franchisee. As I described earlier, you've got to have audited statements done by an expensive firm, acceptable internal controls systems, etc. etc.

Secondly, your freedom to operate your franchise just got more limited. I have chosen to operate my restaurants the Wendy's way – the menu, the appearance of the store, the quality of the food – things like this must be standardized across the system so that you the customer knows what you are going to get when you walk into any Wendy's in the country. This consistency is critical to my success.

On the other hand, I am an independent businessman. I decide how to set up my business. I decide whether it's a company, a partnership, or an S Corp, and I decide who my lawyer and accountant are. I decide on what capital expenditures I make and I decide on product pricing. Furthermore, I decide who to hire and fire, what salaries and benefits to offer, and what pension plan to set up. I make decisions that directly affect the bottom line. There are reasons that some franchises within a system fail and others succeed and the biggest one is the abilities of the franchisee.

So, in deciding whether franchising is the way to go, some prospective franchisees will find the level of intrusion called for in FIN 46 more than they can live with.

This is a very serious threat to franchising. I was an employee of a franchisor for decades, but I chose to become a franchisee because of the freedom to be an independent businessman and to build my family's future security through owning my own business. My restaurants do better than other restaurants because they are mine. My success is the direct result of my ability to run my operation as I see fit. If FIN 46 had been in effect when I made my decision to become a franchisee, I don't think I would have made the leap. That is another problem with FIN 46. When and if I want to sell my business one day, there will be fewer prospective buyers and that will lower the value of my business.

Looking at another example, suppose you are a publicly traded company with hundreds of units. First of all, you have the flip side of all the problems facing franchisees I mentioned earlier. For example, you have to convince hundreds of independent businesspeople to hire expensive firms to audit your financials and develop internal controls, and you have to convince them to give you a lot of financial information they haven't had to. You also have the Sarbanes-Oxley problem I mentioned earlier. You may want to sell out just to avoid the headaches.

I know that the mission of FASB is to improve financial reporting so that the public is protected and I know that FIN 46 is supposed to prevent shady Enron-style arrangements. The entire franchise community supports this vital goal.

But I can not understand how FASB could come to the conclusion that the only way to prevent another Enron is to hobble a way of doing business so important to our economy and job creation. To make matters worse, I don't think FIN 46 even accomplishes FASB's goal of improved financial reporting when it comes to franchising. If FIN 46 results in a franchisor consolidating the financial results of its franchisees, FIN 46 may reduce financial statement transparency and clarity, as well as confuse investors who aren't familiar with how franchisors and franchisees work together and how real it is that a franchisor's financial results are not one and the same with its franchisee's results.

For example, for the income statement, this means no longer including franchise royalty revenue, but instead essentially grossing-up the franchisor's income statement for the franchisee's results of operations and then eliminating their combined impact on the franchisor's income statement through an adjustment to "minority interest".

For the balance sheet, this means consolidating a franchisee's assets and liabilities, including, as an example, the franchisees' debt, even though the franchisor has no legal obligations associated with the debt. Amounts owed to the franchisor would be eliminated in consolidation.

Additional disclosure would be needed to explain the consolidated financial results – disclosure necessary not to provide better information, but necessary to provide clarity to allow financial statement users to understand the consolidated financial statements presented and distinguish between the economic benefits and risks inuring to the franchisor and those not.

Due to the different business models of franchisors and franchisees, the transparency of the franchisor's financial position and results of operations often can be dramatically altered. Consider the example of a 100% franchised system that collects a 5% royalty from franchisees. If the franchisees were to be consolidated, the franchisor would report a twenty-fold increase in sales (net of eliminated royalty income) materially distorting the franchisor's revenues, gross margin and expenses. Further, note that while the franchisor would gross up the income statement revenue and expenses by a factor of twenty, the franchisee net income would be entirely eliminated as minority interest such that the franchisor's net income would be the same before and after consolidation. A reader of the financial statements might ask whether this results in greater clarity and understanding of the operations of the franchisor.

In fact, there has been a longstanding concern expressed by the Securities and Exchange Commission (SEC) staff, about the use of "system wide sales" information (i.e., combining franchisee sales with franchisor company sales) in "selected financial data" and "management's discussion and analysis" as being potentially misleading.

In other words, FIN 46 is going to make me and a lot of other people in the franchising world jump through a lot of hoops and pay a lot of money with zero benefit to the public.

Clearly, FASB has not sufficiently understood the implication of their proposal. They apparently have not been listening to small business concerns, or to big business concerns for that matter.

I was surprised to see FASB acknowledge in the October 31 exposure draft that, "[t]he Board's assessment of the benefits and costs of clarifying and modifying Interpretation 46 was based on discussions with preparers and auditors of financial statements and on consideration of the needs of users for more consistent application of that Interpretation."
It does not seem that real businesspeople like me were consulted on the costs as well.

In conclusion, thank you for holding this hearing. This experience has been a real eye opener for me. I am certain there are not very many small franchisees like me that would ever have thought that FASB could do something like this that could have such a devastating impact on our businesses. I consider myself to be a pretty sophisticated franchisee, but I don't think I would have heard of FIN 46 in time had it not been for the International Franchise Association.

FASB needs to better understand that the rules they set are not just academic exercises. Those rules have real life consequences and FASB needs to understand what those consequences are and take them into account before they act.

IFA and its 30,000 members stand steadfast in their opposition to the current iteration of FIN 46 and urge the Subcommittee to take appropriate action.

I would be happy to answer any questions you have.

Thank You.