Committee on Resources

Subcommittee on National Parks and Public Lands

Testimony

STATEMENT OF DAVID E. JACKSON [(1)]

BEFORE THE SUBCOMMITTEE ON RESOURCES

NATIONAL PARKS AND PUBLIC LANDS

U.S. HOUSE OF REPRESENTATIVES

JULY 1, 1999

Because my firm has served as the outside independent auditors of Fort Sumter Tours, Inc. (FST) since 1995, I was asked to review a Franchise Fee Analysis (FFA) dated February 27, 1992, which had been prepared by the National Park Service (NPS). To formulate a reasonable basis for my opinion, I familiarized myself with the Concession Policy Act, Public Law 89-249 and NPS-48 as they relate to calculating franchise fees. My review revealed that this analysis contains numerous mistakes that fall into three categories of errors which include violations of the NPS's guidelines for the preparation of franchise fee analysis, improper applications of Generally Accepted Accounting Principles (GAAP), and a lack of understanding of how a small family business operates. If these mistakes are not corrected, it will cost FST over $100,000 a year in additional franchise fees because of the faulty conclusions derived from this analysis which served as the basis for a recommended franchise fee increase from 4.25% to 12% of gross revenue from concession operations. This represents a significant sum of money to FST because it is a small family owned business whose average annual gross revenue from its concession operations as calculated by the NPS in this analysis was only $1.4 million a year.

In general, to prepare this analysis, the NPS extracted financial information from the audited financial statements of FST for the five year period 1986 through 1990. From this information, the NPS calculated the average annual profit generated by the company from its concession operations, made certain financial adjustments, and then calculated three financial ratios. These three financial ratios are Return of Gross Revenue (ROG), Return on Equity (ROE) and Return on Assets (ROA). Return is defined as the net profits after income taxes generated by the company from its concession operations. This net income is the numerator in each of the profitability measures utilized by the NPS. The denominators are gross concession revenue for ROG, average equity for ROE, and average assets for ROA. After calculating the financial ratios, the NPS then compares them to some industry standards for similar companies to determine if the operating results fall within an acceptable range. If the ratios are acceptable, no franchise fee increase is warranted. In this instance, because of the erroneous adjustments contained in the analysis, the NPS decided to increase the existing franchise fee rate. In the following paragraphs, I will present examples of the types of mistakes contained in the analysis.

Mistakes/Omissions Which Violate NPS Guidelines

This first mistake made by the NPS in this analysis was the inclusion of non-concession income of $195,603 in the calculation of the profit FST was generating from its concession operations. This income was clearly identified in the analysis as other non-concession income. Its

<u>Mistakes/Omissions Which Violate NPS Guidelines</u> (continued)

inclusion is an indisputable violation of its own guidelines. NPS-48 clearly states that financial reports should reflect only in-park operations and should not include income or expenses of other non-concession operations or business of a concessioner's organization. This error represents almost 50% of the concession profit calculated by the NPS in the analysis. This one mistake completely invalidates the entire ratio analysis comparisons contained in the document because as previously stated "Return" means the net profits from concession operations. It also eliminates the justification for a fee increase because if this error were corrected, the financial ratios of FST would fall within the acceptable industry standards. (See Exhibit 1 for calculations.)

NPS guidelines state that the maximum franchise fee should not be greater than 50 percent of the concessioner's pre-tax and pre-franchise profit. The purpose of this calculation is not to set the fee, but to establish the maximum fee NPS may impose. NPS calculated FST's maximum permissible fee at 15.6% If the above error (including non-concession income in this maximum fee calculation) is corrected, the maximum permissible franchise fee would be 8.7% not the 15.6% fee calculated by NPS. The recommended 12% franchise imposed by the NPS on the company is greater than the correct maximum allowable fee and is another violation of its guidelines . (See Exhibit 1 for calculations.)

NPS's worksheet found on page 6 of the analysis contains numerous mistakes which affect the conclusions which were supposed to be derived from the information presented. In the column which presents the average amounts with a 4.25% franchise fee, several errors can be found. First, as mentioned above, the reported amounts include other income of $195,603 from non-concession sources. In addition, the income taxes of $36,330 presented in this column is incorrect In the calculation of this average from the information extracted from FST's audited financial statements, NPS failed to consider that no income taxes were included for two out of the five years presented. In 1989, FST elected under allowable Internal Revenue Codes to be taxed as an "S" corporation. Under these regulations, the taxable income of the company is reported on the individual income tax returns of its shareholders. A provision for income taxes should have been included for these two years in the determination of the true net income the company earned from its concession operations. Again, this caused the reported profit to be overstated which would have also caused the financial ratios to be overstated. The titles for the other columns presented are very misleading. The column descriptions contain which new franchise fees are included in its presentation. However, in each instance, the heading amounts did not agree with the actual calculated amount of the franchise fee used in the column. For example, the actual fee rate used in the column designated as including a 12% rate was actually only 10.3%. This misrepresents the results contained in the worksheet and

the conclusions which can be derived from them. As discussed in more detail below, NPS failed to include the effects of a capitalization adjustment relating to a vessel when calculating ROE and ROA in this worksheet. Again, this caused these profitability measures to be overstated. (See Exhibit 2 for calculations.)

NPS guidelines also permit making positive adjustments which might be beneficial to a concessioner. This is a recognition that a mature company is likely to have fully depreciated assets and little debt which would make it appear more profitable in a comparison with a relatively new **<u>Mistakes/Omissions Which Violate NPS Guidelines</u> (continued)** business because its depreciation and interest expense deductions would not be as large. NPS failed to make any adjustments in the calculation of the financial ratios even though FST is a mature company with significant fully depreciated assets and very little debt.

Mistakes in the Application of Generally Accepted Accounting Principles

Material errors were made in a capitalization adjustment by NPS relating to a vessel which was leased to FST by a partnership in which it was a 50% partner. This acquisition is the single largest financial transaction ever undertaken by the company. In addition, the purchase of this boat was the basis for the NPS granting FST a new 15 year contract in 1986. This adjustment should not have been made because this lease had already been recorded and properly reported in accordance with GAAP in the audited financial statements of the company, This incorrect adjustment caused the concession profit to be overstated by $70,000 in the analysis. Again, the "Return" portion of the financial ratio calculations were overstated and the underlying profitability measures were overstated because of this error.

Even if you agree with the premise that the adjustment should be made, and I don't because it is not in accordance with GAAP, NPS incorrectly used a cost of $1 million and debt of $600,000 in the capitalization adjustments. I also prepare the income tax returns for the partnership which owns this vessel and it cost over $1.4 million and the debt incurred in its purchase was $1.3 million. There was no explanation given in the analysis to support the use of the wrong amounts and I can think of no basis under GAAP for the use of incorrect dollar amounts. The use of the wrong amounts caused the concession profit to be overstated by $56,000 because both depreciation and interest expenses would be understated. Once again, the "Return" portion of the financial ratio calculations were overstated and so were the underlying profitability measures. In addition, the company was deprived of the right to earn a return on $400,000 of its assets. To compound this mistake, when the profitability ratios of ROA and ROE were calculated, the related capitalized value and equity were ignored. Again, this caused these two profitability ratios to be overstated (See Exhibit 2 for calculations)

Another mistake in the application of GAAP occurred when NPS assumed away $347,700 of the company's equity. The only reason given in the analysis was that this was done "to approximate industry". Equity and debt are the two primary sources of capital utilized by a company. Capital is the amount invested by the owners of the company and debt is a loan to the company. Neither are free because an owner wants a return on his investment, usually in the form

of a dividend, and interest must be paid on a loan. NPS guidelines recognizes that in setting franchise fees, owners are entitled to a return on their invested capital. As previously mentioned, an adjustment should be made to reflect the fact that a company has low debt because retained capital is being used to finance the operations of the business. I can think of no place in GAAP when you can just assume away equity of a business and that is what was done with this adjustment. By assuming away this equity, the profitability measure of ROE was overstated in the analysis.

Mistakes in the Application of Generally Accepted Accounting Principles (continued)

If you agree with the premise that this adjustment was correct, and I do not, NPS should

have increased the debt of the company by the same $347,700. In addition, an adjustment should have been made to the concession profit for the interest which would be due on this loan. Again, by not making this adjustment, the "Return" in the profitability measures of ROG, ROA and ROE would have been overstated and the resulting calculations incorrect.

Lack of Understanding of How a Small Business Operates

NPS clearly demonstrated a lack of understanding of how a small family owned business operates when officer salaries were reduced by $162,762 without any investigation of what type of duties were being performed by the officers of the company. It is common practice for all family members who work in the business to be named an officer of their company. Their birthright not their actual duties is the reason for them being elected as officers. The officers of FST perform many non-officer duties and are compensated in line with industry pay for these duties. The NPS made no attempt to gain an understanding of the actual duties of the officers and this adjustment should not have been made. Again this resulted in the concession profit to be overstated which caused the "Return" in the profitability ratios to be overstated and invalidates their calculations.

Conclusion

In my opinion, this analysis contains mistakes totaling over $428,000 in the determination of FST's concession profits. These errors represent almost one third of the average gross revenue of $1.4 million it derived from its concession operations. These mistakes invalidate the financial ratio comparisons contained in the analysis and eliminates the NPS's basis for the fee increase.

This concludes my prepared testimony. I will be happy to answer any questions from the Sub-committee.

Fort Sumter Tours, Inc.

Franchise Fee Worksheets 3 & 4

Exhibit 1

The purpose of Exhibit 1 is to compare the profitability ratios computed by NPS in the analysis with the returns which would have been reported if the non-concession income of $195,603 had not been incorrectly included in the calculation of the profit earned by FST from its concession operations. The exhibit also presents the correct amounts of Equity and Assets which should have been used in the ratio calculations of ROE & ROA. NPS had failed to include the effect of its vessel capitalization adjustment in the totals used for these calculations.

One of the conclusions that can be derived from this comparison is that the maximum franchise fee allowable under NPS guidelines should be 8.7%, not the 15.6% reported by NPS in the analysis.

Another conclusion that can be derived from this exhibit is that these corrections drastically reduce the financial returns of FST and eliminate the justification for a fee increase.

Fort Sumter Tours, Inc.

Franchise Fee Worksheet #3 & #4 Comparison Without Non-Concession Income (NCI)

Exhibit I

As Without

Originally NCI

Reported Of $195,603

Franchise Fee

Worksheet 3: Reported Statistics and Adjustments

IIIa Adjustments To Income

Officer Salaries 162,742 162,742

Vessel Rent 173,812 173,812

Depreciation (55,556) (55,556)

Interest (48,000) (48,000)

Total 232,998 232,998

IIIb Adjustment to Equity (347,700) (347,700)

IIIc Adjustment to Assets 17,924 17,924

Worksheet 4: Fee Determination

I. Adjusted Income

Ave % Franchise Fee 58,368 58,368 **Correct**

Ave Income Before Taxes 150,504 (45,099) **Return**

Income Adjustments From W/S # 3 232,998 232,998 **Calculations**

Total Income Before Taxes & FF 441,870 246,267 246,267

Less Franchise Fee (58,368)

Income Before Taxes 187,899

Estimated Income Taxes (183,011) (102,004) (77,828)

Adjusted Income After Taxes 258,859 144,263 110,071

New Returns (Before Franchise Fees)

On Gross Receipts 18.3% 10.2% 7.8% Gross = 1,416,766

On Equity 41.5% 23.1% 17.6% Equity = 624,000

On Assets 20.8% 11.6% 8.8% Assets = 1,244,000

Returns Based on Net Income After Taxes Adjusted For Vessel Capitalization

On Equity 25.3% 14.1% 10.7% Equity = 1,024,000

On Assets 12.5% 6.9% 5.3% Assets = 2,077,332

Maximum Fee Guideline (½ of Income Before Taxes and Franchise Fee Divided By Gross Receipts)

II. Maximum Fee Guideline 15.6% 8.7%

III. Fee Determination: Based on Comparison With Industry Returns (Statistical Quartiles)

As Originally Reported

Gross -0.50 3.2 8.70 X

Equity -13.3 5.7 35.0 X

Assets -2.9 4.7 11.6 X

As Corrected For Removal Of Non-Concession Income And After Taxes

Gross -0.50 3.2 X 8.70

Equity -13.3 5.7 X 35.0

Assets -2.9 4.7 X 11.6

Fort Sumter Tours, Inc.

Financial Summary-With New Fees Inserted-For Comparison With Industry Statistics

Exhibit 2

The main purpose of Exhibit 2 is to demonstrate that the profitability measures of ROE and ROA at various franchise fee rates were incorrectly calculated by NPS in the analysis because of the failure to consider the effects on Equity and Assets produced in the vessel capitalization adjustment.

Another purpose of Exhibit 2 is to disclose the misleading nature of the franchise fee amounts contained in the heading of the various columns.

The main conclusion derived from Exhibit 2 is that the profitability ratios of ROE and ROA presented in the analysis were incorrect and greatly overstated.

Fort Sumter Tours, Inc Exhibit 2

Financial Summary -With New Fees Inserted - For Comparison With Industry Statistics

Reported Franchise Fee 4.25% 8.00% 9.00% 10.00% 11.00% 12.00%

Actual Franchise Fee % 4.25% 6.90% 7.80% 8.60% 9.50% 10.30%

	As Reported	**Adjusted**	**Adjusted**	**Adjusted**	**Adjusted**	**Adjusted**
Gross Receipts	1,416,766	1,416,766	1,416,766	1,416,766	1,416,766	1,416,766
Cost of Sales	112,346	112,346	112,346	112,346	112,346	112,346
Gross Profit	1,304,420	1,304,420	1,304,420	1,304,420	1,304,420	1,304,420
Direct Salaries	245,200	245,200	245,200	245,200	245,200	245,200
Operating Supplies	22,402	22,402	22,402	22,402	22,402	22,402
Repairs & Maint	60,257	60,257	60,257	60,257	60,257	60,257
Utilities	0	0	0	0	0	0
Vehicle Expense	42,210	42,210	42,210	42,210	42,210	42,210
Commissions	0	0	0	0	0	0
Other Direct	188,886	15,074	15,074	15,074	15,074	15,074
Total Direct	558,955	385,143	385,143	385,143	385,143	385,143
Officers' Salaries	304,419	141,677	141,677	141,677	141,677	141,677
Other Salaries	110,005	110,005	110,005	110,005	110,005	110,005
Advertising	54,231	54,231	54,231	54,231	54,231	54,231
Auditing Fee	11,507	11,507	11,507	11,507	11,507	11,507
Profit Sharing	18,760	18,760	18,760	18,760	18,760	18,760
Travel	9,780	9,780	9,780	9,780	9,780	9,780
Other Admin	128,674	128,674	128,674	128,674	128,674	128,674
Total Admin	637,376	474,634	474,634	474,634	474,634	474,634
Insurance	14,160	14,160	14,160	14,160	14,160	14,160
Depreciation	44,559	100,114	100,114	100,114	100,114	100,114
Interest	1,839	49,839	49,839	49,839	49,839	49,839
Other Fixed	33,369	33,369	33,369	33,369	33,369	33,369
Total Fixed	93,927	197,482	197,482	197,482	197,482	197,482
Building Use Fee	894	894	894	894	894	894
Percentage Fee	58,368	97,721	109,936	122,152	134,367	146,582
Total Franchise Fee	59,262	98,615	110,830	123,046	135,261	147,476
Other Income	195,603	0	0	0	0	0

Income Before Taxes 150,503 148,546 136,331 124,115 111,900 99,685

Income Taxes 36,330 48,081 42,462 36,843 31,224 25,624

Net Income 114,173 100,465 93,869 87,272 80,676 74,061

Return Calculations as Originally Reported

Return on Equity 11.7% 16.1% 15.0% 14.0% 12.9% 11.9%

Return on Assets 9.3% 8.1% 7.5% 7.0% 6.5% 6.0%

Equity = 971,700 624,000 624,000 624,000 624,000 624,000

Assets = 1,226,076 1,244,000 1,244,000 1,244,000 1,244,000 1,244,000

Return on Gross 8.1% 7.1% 6.6% 6.2% 5.7% 5.2%

Return Calculations Adjusted For Vessel Capitalization

Return on Equity 9.8% 9.2% 8.5% 7.9% 7.2%

Return on Assets 4.8% 4.5% 4.2% 3.9% 3.6%

Equity = 1,024,000 1,024,000 1,024,000 1,024,000 1,024,000

Assets = 2,077,332 2,077,332 2,077,332 2,077,332 2,077,332

Fort Sumter Tours, Inc.

Financial Fee Summary With New Franchise Fees Inserted

Exhibit 3

The purpose of Exhibit 3 is to present profitability measures for franchise fee rates ranging from 4.25% to 5.5%.

The conclusion that can be derived from Exhibit 3 is that the profitability measures are within the acceptable range even with the disputed financial adjustments made by NPS.

Fort Sumter Tours, Inc. Exhibit 3

Financial Fee Summary With New Franchise Fees Inserted

Franchise Fee % 4.25% 4.25% 4.50% 5.00% 5.50%

As Reported Adjusted Adjusted Adjusted Adjusted

Gross Receipts 1,416,766 1,416,766 1,416,766 1,416,766 1,416,766

Cost of Sales 112,346 112,346 112,346 112,346 112,346

Gross Profit 1,304,420 1,304,420 1,304,420 1,304,420 1,304,420

Direct Salaries 245,200 245,200 245,200 245,200 245,200

Operating Supplies 22,402 22,402 22,402 22,402 22,402

Repairs & Maint 60,257 60,257 60,257 60,257 60,257

Utilities 0 0 0 0 0

Vehicle Expense 42,210 42,210 42,210 42,210 42,210

Commissions 0 0 0 0 0

Other Direct 188,886 15,074 15,074 15,074 15,074

Total Direct 558,955 385,143 385,143 385,143 385,143

Officers' Salaries 304,419 141,677 141,677 141,677 141,677

Other Salaries 110,005 110,005 110,005 110,005 110,005

Advertising 54,231 54,231 54,231 54,231 54,231

Auditing Fee 11,507 11,507 11,507 11,507 11,507

Profit Sharing 18,760 18,760 18,760 18,760 18,760

Travel 9,780 9,780 9,780 9,780 9,780

Other Admin 128,674 128,674 128,674 128,674 128,674

Total Admin 637,376 474,634 474,634 474,634 474,634

Insurance 14,160 14,160 14,160 14,160 14,160

Depreciation 44,559 100,114 100,114 100,114 100,114

Interest 1,839 49,839 49,839 49,839 49,839

Other Fixed 33,369 33,369 33,369 33,369 33,369

Total Fixed 93,927 197,482 197,482 197,482 197,482

Building Use Fee 894 894 894 894 894

Percentage Fee 58,368 60,213 63,754 70,838 77,922

Total Franchise Fee 59,262 61,107 64,648 71,732 78,816

Other Income 195,603 0 0 0 0

Income Before Taxes 150,503 186,054 182,513 175,429 168,345

Income Taxes 36,330 61,486 59,997 57,018 54,039

Net Income 114,173 124,568 122,516 118,411 114,306

Return on Equity 11.7% 12.2% 12.0% 11.6% 11.2%

Return on Assets 9.3% 6.0% 5.9% 5.7% 5.5%

Equity = 971,700 1,024,000 1,024,000 1,024,000 1,024,000

Assets = 1,226,076 2,077,332 2,077,332 2,077,332 2,077,332

Return on Gross Receipts 8.1% 8.8% 8.6% 8.4% 8.1%

Fort Sumter Tours, Inc.

Financial Fee Summary With New Franchise Fees Inserted

Exhibit 4

The purpose of Exhibit 4 is to present a comparison between the financial results if the disputed financial adjustments are included with the results which would occur if no adjustments were made and a 12% franchise fee is employed.

The conclusion derived from Exhibit 4 is that if the disputed adjustments are eliminated, a 12% franchise fee would produce disastrous financial results for FST.

Fort Sumter Tours, Inc. Exhibit 4

Financial Fee Summary With New Franchise Fees Inserted

Franchise Fee % 12.0% 12.0%

Adjusted No Adjustments

Gross Receipts 1,416,766 1,416,766

Cost of Sales 112,346 112,346

Gross Profit 1,304,420 1,304,420

Direct Salaries 245,200 245,200

Operating Supplies 22,402 22,402

Repairs & Maint 60,257 60,257

Utilities 0 0

Vehicle Expense 42,210 42,210

Commissions 0 0

Other Direct 15,074 188,886

Total Direct 385,143 558,955

Officers' Salaries 141,677 304,419

Other Salaries 110,005 110,005

Advertising 54,231 54,231

Auditing Fee 11,507 11,507

Profit Sharing 18,760 18,760

Travel 9,780 9,780

Other Admin 128,674 128,674

Total Admin 474,634 637,376

Insurance 14,160 14,160

Depreciation 100,114 44,559

Interest 49,839 1,839

Other Fixed 33,369 33,369

Total Fixed 197,482 93,927

Building Use Fee 894 894

Percentage Fee 170,012 170,012

Total Franchise Fee 170,906 170,906

Other Income 0 0

Income Before Taxes 76,255 (156,744)

Income Taxes 16,924 0

Net Income (Loss) 59,331 (156,774)

Return on Equity 9.5% -16.1%

Return on Assets 4.8% -12.8%

Equity = 624,000 971,700

Assets = 1,244,000 1,226,076

Return on Gross Receipts 4.2% -11.1%