

(Securities Act Release No. 5218)
(Securities Exchange Act Release No. 9425)

ADMINISTRATIVE PROCEEDING
FILE NO. 3-2968

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
December 20, 1971

In the Matter of

PERFORMANCE SYSTEMS, INC.
2708 Franklin Road
Nashville, Tennessee
Files Nos. 2-28347, 2-32924, 0-3571

Securities Act of 1933 - Section 8(d)
Securities Exchange Act of 1934 - Section 15(c)(4)

FINDINGS, OPINION AND ORDER

STOP ORDER PROCEEDING
COMPLIANCE PROCEEDING

Material Deficiencies

Financial Statements
Overstatement of Income and Retained Earnings
Interest of Officers and Directors in Transactions
Description of Business

Withdrawal of Registration Statement

Where registration statement filed under Securities Act of 1933 and annual report filed pursuant to Section 13(a) of Securities Exchange Act of 1934 overstated issuer's net income and retained earnings, as a result of improper recognition of revenue on installment notes which were received by issuer in connection with sale of undeveloped franchises and collectibility of which could not reasonably be evaluated, and failed to disclose material interests of officers and directors in transactions to which issuer was party, and registration statement failed to disclose material facts relating to issuer's business, held, filings materially misleading.

Where issuer agrees to findings of facts by Commission and to make distribution of Commission's findings and opinion to stockholders, consents to entry of stop order with respect to registration statement found to be misleading but pursuant to which no securities have been sold, and files correcting amendments to cure deficiencies in annual report, held, consistent with public interest to issue stop order, permit withdrawal of registration statement and dismiss compliance proceeding respecting annual report.

APPEARANCES:

Richard H. Rowe, William Gleeson, John S. Bernas and Theodore A. Doremus, Jr., for the Division of Corporation Finance.

Lewis D. Lowenfels of Goldfeld, Charak, Tolins & Lowenfels, for Performance Systems, Inc.

These are consolidated proceedings pursuant to Section 8(d) of the Securities Act of 1933 ("Securities Act") and Section 15(c) (4) of the Securities Exchange Act of 1934 ("Exchange Act"). The proceeding under Section 8(d) was instituted to determine whether a stop order should issue with respect to a registration statement filed by Performance Systems, Inc. ("PSI") on May 2, 1969, covering a proposed public offering of \$15,000,000 of debentures and an undetermined amount of common stock to be sold by shareholders of PSI. The registration statement has not become effective and no securities thereunder have been sold. The proceeding under Section 15(c) (4) of the Exchange Act 1/ relates to an annual report on Form 10-K for the fiscal year 1968 ("1968 report") under Section 13(a) of the Exchange Act 2/ filed by PSI on April 30, 1969.

PSI submitted an offer of settlement, pursuant to which it waived hearings and post-hearing procedures and, solely for purposes of these proceedings and without admitting or denying the allegations in the orders for proceedings, consented to findings that the registration statement and the 1968 report contained certain misleading statements of material facts as alleged. It also consented to the imposition of a stop order, undertook to file corrective amendments to the report and to distribute copies of our Findings and Opinion herein to its shareholders, and requested leave to withdraw the registration statement. Upon the recommendation of our Division of Corporation Finance we have determined to accept the offer of settlement. On the basis of the consent contained in the offer of settlement, we make the following findings.

Deficiencies

The registration statement and the 1968 report of PSI, which was organized under the laws of Tennessee in 1967 and until recently was engaged in the business of franchising and operating various businesses, primarily chicken and roast beef fast food outlets, were materially deficient in several aspects.

a. Financial Statements

The financial statements in the registration statement and 1968 report contained material overstatements of net income and retained earnings as a result of PSI's failure to follow generally accepted accounting principles with respect to a series of transactions involving sales of roast beef and chicken fast food franchises in multi-unit blocks ranging from 20 to 100 franchises. Under the terms of the sales, the franchisees paid a portion of their initial franchise fees in cash and the remainder in notes payable in installments over a period of two to four years, usually beginning one year after their issuance. The sales in question were made to seven companies, all of which were newly formed for the purpose of acquiring the franchises. Under the item "sales of franchises" in its 1968 Consolidated Statement of Income and Retained Earnings, PSI included revenues of \$3,190,000, representing initial franchise fees paid by the seven franchisees, of which \$2,378,500, or over 70%, represented the full face amount of notes issued to PSI by those companies in connection with the sales. The principal deficiency stems from the inclusion of revenue related to the notes.

The facts surrounding the franchise sale transactions indicate that there was no reasonable basis for estimating the degree of collectibility of the notes received by PSI. The capital of the franchisee companies, which in some instances consisted in part of personal notes of stockholders, was insufficient both to develop the franchises and to pay the notes issued to PSI, even assuming that the franchisees were able to successfully carry out plans they had to lease land and buildings for development of the franchises. With the possible exception of one company (Minnie Pearl of Canada, Ltd.), none of the franchisees had plans for further financing, and none had firm commitments for such financing. Some were in default on the construction schedule of the franchised units, and PSI had not enforced forfeiture provisions in the franchise contracts in certain of the instances where it had a right to do so. PSI had only limited experience in chicken franchise operations and little in roast beef franchises ^{3/} and that experience had been unprofitable, and the franchise companies had no significant operating history.

In view of the impossibility under those circumstances of estimating the collectibility of the notes, revenue recognition related to them in the 1968 PSI financial statements was inappropriate and resulted in an overstatement of the related items. As stated in Accounting Principles Board Opinion No. 10 issued by the American Institute of Certified Public Accountants, while revenue should ordinarily be accounted for at the time a sale transaction is completed, with appropriate provision for uncollectible accounts, where there is no reasonable basis for estimating the degree of collectibility, it is inappropriate to recognize revenue at the time of the transaction and either the installment basis or the cost recovery method of accounting may be used. And in our Accounting Series Release No. 95, ^{4/} we stated that, under generally accepted accounting principles, the recognition of profit at the time of sale is appropriate if it is reasonable to conclude, in light of all the circumstances, that a profit has been realized; that such conclusion is not warranted where the circumstances are such that the collection of the

sale price is not reasonably assured; and that recognition of profit is appropriate only to the extent that the consideration received in the transaction can be reasonably evaluated.

Partly as a result of the questions raised by the practices by PSI and other franchisors in accounting for initial franchise fees, generally accepted accounting principles were revised in that initial franchise fee revenue could not be recognized earlier than approximately the time the operating unit had been completed and the franchisee had started operations. 5/ The rationale for such deferral of recognition is that until that time the transaction is still executory in that the franchisor and franchisee have not yet substantially performed all the obligations related to the sale of the franchise. Substantial performance is attained when the franchisor has no remaining obligation -- by agreement or trade practice -- to refund any cash already received or to excuse nonpayment of notes as a result of cancellation or surrender of the franchise by the franchisee, and substantially all of the services to be rendered by both the franchisor and the franchisee have been provided. 6/ Thus under this test any valuation of notes received in the sale of the franchise and recognition of revenue are deferred until the operating unit is opened, at which time the accounting and evaluation principles referred to above relating to estimating collectibility are to be applied.

As part of the settlement of the compliance proceeding under Section 15(c)(4), PSI amended its annual report on Form 10-K for the fiscal year ended December 31, 1968, and it restated the financial statements on the unit opening basis, which eliminated the initial franchise fee revenue in question from the income statement. The restatement showed Deferred Revenue totaling \$10,300,000, consisting of \$8,098,000 applicable to notes and \$2,202,000 of cash received for franchises where the operating unit had not been opened at the end of 1968. As a result, PSI's reported 1968 net income of \$3,156,691, or 67¢ per share of common stock, was changed to a loss of \$1,269,000, or 27¢ per share. In 1969, when some of the units began to open, PSI set up an appropriate provision for uncollectible accounts with respect to almost all of the franchise sale transactions in question.

b. Other Deficiencies

In addition to containing inaccurate financial statements, both the registration statement and 1968 report on Form 10-K were deficient and misleading in several other respects.

The registration statement and report failed to make required disclosure of material interests of members of PSI's management in two transactions. 7/ In connection with the formation of one of the franchisee companies, Mahalia Jackson's Chicken Systems, Inc., contributions to its capital were made by PSI in the amount of \$250,000 and by three individuals in the amount of about \$200,000. The individuals obtained their funds through bank loans which were guaranteed by John Jay Hooker, Jr., Chairman of the Board of Directors of PSI, but such guaranty was not disclosed in the PSI filings. Similarly, at the formation of another franchisee, West America Foods, Inc. which purchased 110 franchises from PSI on or about October 31, 1968, that company's president and chairman each contributed \$100,000 which together constituted one-third

of the total capital, obtaining the funds through bank loans which were guaranteed by the Union Street Investment Company, a partnership composed of John Jay Hooker, Jr. and Henry Hooker, Vice Chairman of PSI. However, those facts also were not disclosed in PSI's filings.

The registration statement also was materially misleading in its description of PSI's business. It did not disclose that companies which purchased franchises were formed for that purpose and did not have sufficient assets to both pay the initial franchise fees and develop the franchises into operating units, that a substantial number of chicken franchises had not been profitable in 1968, and that the franchise chicken operations for the first three months of 1969 were below the assumed break-even point for such franchises.

Conclusions

The publication of this Findings and Opinion, and its distribution by PSI to its shareholders prior to its next annual meeting which PSI has agreed to effect, will inform those shareholders and potential investors concerning the matters set forth above. Under the circumstances, it is consistent with the public interest and with the protection of investors to issue a stop order suspending the effectiveness of the registration statement and to grant PSI's request to withdraw such statement. In addition, in light of PSI's curative amendments to the 1968 annual report filed pursuant to the offer of settlement, we consider it appropriate to dismiss the proceeding instituted under Section 15(c)(4) of the Exchange Act.

Accordingly, IT IS ORDERED that the effectiveness of the registration statement under the Securities Act of 1933 filed by Performance Systems, Inc. with respect to a proposed offering of its securities be, and hereby is, suspended; that the company's request to withdraw such registration statement be, and hereby is, granted; and that the proceeding instituted under Section 15(c) (4) of the Securities Exchange Act of 1934 with respect to that company's annual report for fiscal year 1968 be, and hereby is, dismissed, subject to the condition that the company distribute to its shareholders copies of this Findings and Opinion.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

Ronald F. Hunt
Secretary

1/ Section 15(c) (4) of the Exchange Act provides that if we find that any person has failed to comply with the reporting requirements of Section 13 and the rules and regulations thereunder, we may publish our findings and issue an order requiring compliance upon such terms and conditions and within such time as we may specify.

2/ Section 13(a) of the Exchange Act provides in relevant part that issuers with a class of securities registered pursuant to Section 12(g) shall file such annual reports as we may prescribe. PSI registered a class of equity securities under Section 12(g) on April 30, 1968.

3/ The franchises purchased by six of the franchisee companies were for roast beef outlets. Only three roast beef franchise units were in operation during 1968.

4/ Securities Act Release No. 4566, Securities Exchange Act Release No. 6982, December 22, 1968.

5/ See "Accounting for Initial Franchise Fee Revenue," Archibald E. McKay Journal of Accountancy, January 1970, page 70.

6/ Ibid.

7/ Both Form S-1 and Form 10-K require disclosure of the approximate amount of any material interest, direct or indirect, within a specified period, of, among others, any officer or director in any material transactions to which the registrant or any of its subsidiaries was a party.