FRANCHISING
PAM KERSHAW

STATEMENT OF ACCOUNT

Audits are seen as breaching trust between franchisee and franchisor, but they may soon be far more common.

Lawyer Andrea Pane and franchise accountant Richard Angley. Photo: Eddie Jim

Any franchise system that handles cash can be vulnerable to the understating of sales and royalties by franchisees. But those particularly at risk are the relatively new systems where resources are directed to expanding the group, leaving existing franchisees feeling poorly supported by the head office.

Franchisees whose margins are being squeezed by increases in interest rates, fuel costs and rent may also react by understating sales, according to Richard Angley, a partner with accountancy firm McLean Delmo and Partners.

"Franchisees are becoming much more sophisticated in their knowledge of rorting the system and may pass this knowledge on to other franchisees," says Angley, who discovered a reluctance among Australian franchisors to conduct royalty audits, especially compared with their American counterparts.

Angley, who attends the annual International Franchise Association conference in the US, says more than 50 per cent of American franchise groups have some kind of royalty audit system.

A primary audit of sales, income tax returns and financial statements is usually conducted on all franchisees. If discrepancies are suspected, a more detailed audit of the franchisee's financial information is conducted.

"It's an accepted procedure. It maximises royalties, detects fraud and promotes to the franchisees that there are checks and balances in the system," Angley says.

He estimates only five to 10 per cent of Australian franchisors conduct royalty audits, largely because of "cultural reasons" relating to the issue of trust in franchisor/franchisee relationships.

And if franchisors are in the start-up stages with 10 to 20 franchisees, they are often very reluctant to "upset the apple cart", particularly when there is a shortage of good franchisees.

While most franchise groups have sophisticated point-of-sale systems that collect extensive data, Angley says it's essential for franchisors to set up strong reporting systems and key performance indicators, then strictly monitor the outcomes.

"There's no point in the franchisor saying to franchisees that they're going to be looking at their regular reports and KPIs if they don't do it."

Point-of-sale systems allow benchmarking of franchisees' figures, and Angley says discrepancies may be picked up if a franchisee's purchases as a percentage of sales are higher than average. And if there is heavy advertising in a specific area but a franchisee's sales do not fluctuate, this may also indicate that all sales are not being declared.

Andrea Pane, a partner and franchise specialist at Robert James Lawyers, says although franchise agreements give franchisors the right to carry out audits, most are very reluctant to do so.

"It's one thing to have the right in the franchise agreement, but it's another thing to go on the public record and say to their franchisees: 'We make it our practice to go in there and make sure you're not short-changing us,'" Pane says.

"Trust is a big issue in franchisor/franchisee relationships."

Pane says franchise agreements should state that the franchisor has the right to investigate franchisees' records.

And if a discrepancy over a certain amount is found, the franchisee pays the cost of the investigation.

"That's usually used as a deterrent, and a mechanism to ensure franchisees do keep accurate records," she says.

"Franchisors may come to us and say: 'We haven't got a report from these guys for months – what do we do?' The last resort is usually we'd issue a breach notice. But you don't want to damage the relationship if there's some other way to achieve it."

While point-of-sale systems provide comprehensive data, Pane says franchise agreements should give the franchisor access to franchisees' computer system at all times.

Professor Andrew Terry at the School of Business Law and Taxation, University of NSW, believes franchisors should minimise chances of franchise fraud.

"The POS technology is so good these days, but you've got to be satisfied that everything is going through the till."

Using mystery shoppers is one means of checking this, as is the American practice of posting signs that ask shoppers to report transactions where they are not provided with a receipt.

Terry suggests retail franchisors may be better off charging franchisees a flat fee indexed for inflation instead of royalties. Or, if they are the exclusive product supplier to franchisees, they can build the equivalent of a royalty into product prices.

"There's no use in having operational systems with royalties if franchisors are not prepared to do the hard thing and exercise their rights. But a royalty audit is pretty much in our culture – and maybe it shouldn't be – a precursor to termination. It is a sign that a relationship has gone off the rails.

"I think the emphasis of a franchisor should be to try to develop systems and protocols to make royalty evasion difficult, rather than rely on a royalty audit as an instrument of compliance."

Terry believes the differences in attitudes to royalty audits between American and Australian franchisors lie in the fact that franchises are sold in America as a commodity or product. In Australia, buying a franchise means entering a relationship, with more of a "family" feeling.

"Americans are much better at selling franchises than we are, but we're much better at building stronger relationships," Terry says.

WHEN NO ROYALTY LEADS TO LOYALTY

7-Eleven splits gross profits with franchisees rather than charging a royalty fee, but the group still has checks and balances in place to protect both the franchisor and franchisee, according to Sue Owen, 7-Eleven's national operations manager.

"With us, it's very much about driving the sales for both franchisor and franchisee, because we share in the gross profit. So the more profitable sales we make, the better for both the franchisor and the franchisee," Owen says.

7-Eleven invested in a point-of-sale system two years ago, which has put it "streets ahead" in its ability to track sales. "The system enables us to track our data very well. But any system is only as good as the information you put into it," Owen says.

The company has a full-time team that works on ensuring sales information is reported correctly, and that monitors sales and purchases. Owen says 7-Eleven has experienced problems with under-reporting of sales, but she believes this would be common to most franchisors.

"It may not be the franchisee not ringing up sales for the franchisor. It may be the franchisee's staff not ringing up sales, which is therefore hurting the franchisor and franchisee," she says.

Checks and balances ... Sue Owen.