

Audit...no longer a dirty word for franchisors



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The much heralded changes to the *Franchising Code of Conduct* have imposed a number of compliance issues that need to be effectively managed by franchisors. Franchisors wishing to avoid penalties and on going scrutiny now at the very least should be maintaining their own compliance programs regarding to their obligations. Independent internal audits within franchise business have emerged over the last 5 years as a value added activity for franchisors which can complement the need for compliance programs regarding to the Code.

These value-added activities include direct financial benefits of an internal audit activity in terms of:

- royalty and brand protection audits on franchisees;
- process improvement opportunities within the franchisees operations; and
- advice on potential breaches of other legislation such as the *Trade Practices Act*.

No longer is internal audit a back office function limited to large firms. For franchisors the benefits obtained from a strong audit function correlates with a strong and consistent business model. Audit is no longer a dirty word and has now evolved into a “stress reducing” rather than a “stress enhancing” exercise for franchises across a range of industries.

COMPLIANCE AUDITS

The *Franchising Code of Conduct* changes impose stricter requirements of franchisors. Internal audits can provide assurance that these requirements are met by testing pertinent changes to the Code including complaint handling, disclosure and whether conditions in the agreement are satisfactory. As a growing franchisor with a focus on business development, a regular audit function can provide assurance that the requirements are met not just “thought” to be met. Compliance audits can also focus on other areas of legislative or industry compliance. Initial risk assessments conducted by organisations such as the Optimum Assurance Group can provide management with immediate or longer term exposures in this area. The *Franchising Code of Conduct Compliance Manual* issued by the ACCC is available on the FCA website and provides useful instruction on how a franchisor can compile their own internal compliance program www.franchise.org.au.

ROYALTY AUDITS

The most common area of internal audits in the franchise sector internationally is the area of royalty protection audits. Royalty auditing is technically defined as the process of verifying that royalties remitted to the franchisor (which are usually based on a percentage of gross sales) are reported properly. Benefits back to the franchisor in terms of evidencing funds owed by recalcitrant franchisees is generally detected

quickly through ‘data mining’ tools via the audit process. The more significant issue of franchisee/franchisor trust is more complicated to address.

Franchises with strong ERP systems have less of a requirement for royalty audits than those with weaker and older technology. Opportunities tend to exist for franchisees to misreport revenue when automated reporting controls are weak and do not deal with real time information. Sadly, many Australian franchise businesses have outdated ERP systems increasing the risk in this area identifying a need for royalty audits.

BRAND PROTECTION AUDITS

Operational audits of basic marketing and promotional standards on site are an extension of the mystery shopping program and perform similar functions to royalty audits; those players who move outside the brand model are quickly highlighted to protect the image of other franchisees involved in the system.

For franchise businesses, the expertise of franchise audit specialists is invaluable in assisting with local issues such as dealing with internal theft; ensuring strong business controls are maintained around high risk areas and offering recommendations to improve cash flow or eliminating areas of wastage.

Areas covered by brand protection audits include issues surrounding the location and existence of marketing/promotional material, the use of non-preferred suppliers, pricing, staff/business presentation, and local business decisions not complying with franchisor standards.

PROCESS REVIEWS OF A FRANCHISEE'S OPERATIONS

Franchise auditing has progressed to reviewing individual functions within a franchisee's operations. These functions typically include inventory management processes ensuring that common working capital issues associated with carrying too much stock are minimised and incorporating important operational activities such as cash handling, receivables, payables, sales processes, payroll and health and safety. The objective of these types of audits is to provide solutions to areas of common control risk to retail franchise systems. An important example is how franchisees manage cash sale refund controls which is a primary employee theft risk area.

As franchises in Australia grow larger and larger and the demands of franchisors become more taxing in competitive environments, auditing and compliance control will play a stronger part in the management of franchise businesses. Advantages can immediately be had in operations that implement a risk based audit process given the current compliance climate that will only become more stringent.

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