



Is your franchise business leaking revenue?

Royalty payments are the lifeblood of franchisors – are yours slipping away?

It's no secret that the three main revenue streams in franchising are royalties, rebates and franchise fees.

A large amount of time and effort is required to set up a franchise operation, attract franchisees and negotiate contracts. You'd think the first thing a franchisor would do in managing the ongoing business would be to ensure the revenue streams they have negotiated are actually received and are correct. In practice, this is not always the case.

Revenue leakage to franchisors can occur in a variety of ways:

- Deliberate or accidental under-reporting of sales by franchisees, resulting in reduced royalty payments to franchisors;
- Deliberate or accidental misclassification of sales, again potentially impacting on royalty payments;
- Incorrect treatment of discounts, promotional offers, credit notes, trade-ins, warranty claims, refunds etc.;
- Use of non approved suppliers;
- Internal fraud by staff at a franchise operation, which impact not only the franchisee, but also potentially the revenue stream of the franchisor.

Franchisee Audit Program

A structured franchisee audit program can help identify and control areas of revenue leakage.

Specific tasks may include:

- Analysis of the franchisee revenue base that is being used to calculate royalty payments;



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- Review of the tools and collection methods used to calculate revenue, including testing of spreadsheet models used for calculations and controls in point of sale systems;
- Identification of excluded revenue and the reasons this revenue has been excluded from royalty calculations;
- Testing franchisee revenue calculations against tax returns (particularly BAS), banking records, point-of-sale records, invoices, work orders, and stock usage records;
- Analysis of franchisee purchasing to ensure purchases are made via approved vendors, and are compliant with contractually agreed product sourcing percentages (where applicable).

Revenue verification forms only part of the overall audit process. At franchisee level, audits may also focus on areas such as rebate calculation, process reviews, operational controls (e.g. inventory management), and even on contractual operational requirements such as opening hours and outlet branding. Compliance with any administrative controls documented in the franchise agreement is also reviewed. At a franchisor level, the audit may cover areas such as the entire 'purchase to payables' cycle, which may detect control weakness that enable duplicate payments and or incorrect pricing from vendors – all areas for 'cash' leakage

Whatever the specifics, a well-designed audit program will review business processes, IT systems and internal control mechanisms at both franchisor and franchisee level, and provide recommendations that management can use to help address any shortcomings identified. This will provide long-term benefits to the entire franchise system and network.

An audit may reveal the need for additional training, either at an individual location or across the entire network. In some cases, the franchise training program may be heavily geared towards operational issues, with little attention to administrative necessities such as bank reconciliations and BAS returns.



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Keeping it professional

Many franchisors are reluctant to enforce the audit clauses contained within their franchise agreements. They may be concerned that subjecting a franchisee to an audit will signify a lack of trust, and may hinder the development of a healthy and productive commercial relationship.

An audit initiative that is properly planned, communicated and executed can help dispel the franchisor/franchisee trust issue. One benefit of the process is that it puts a third party between the franchisor and individual franchisees, helping set the correct tone in dealing with potentially emotional issues in a professional and commercial manner.

Audit initiatives help create a level playing field by ensuring that all franchisees are complying with their financial obligations. As such, compliant franchisees should support the concept, as it will help weed out those franchisees that are cheating the system and therefore not paying their way. Compliant franchisees may also receive direct benefits from an audit program, via the identification of issues such as poor internal controls and internal theft, and the benchmarking of operational indicators such as sales margins and operating costs.

Transparency is the key

The audit process should be as transparent as possible in order to allay the fears and suspicions of franchisees. Although most franchisors would be able to identify 'problem' franchisees within their network as candidates for audit visits, it is important to ensure the method for choosing audit targets can withstand scrutiny for fairness. The selection method should ensure that a fair cross-section of franchisees is chosen. This may include consideration of geographic location, size, length of relationship, and multi-franchise versus single franchise outlets. Risk modeling of KPIs and benchmarks can also be used in this process.

Ideally the franchise agreement will provide guidance on audit-related issues such as frequency, notice period required, and what documents the franchisee is obligated to provide as part of the audit. These terms should be complied with at all times, firstly as a



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matter of commercial ethics and best practice, and secondly to ensure that any audit breaches detected can be remedied through the appropriate channels if required.

It is recommended that franchisees be notified of a forthcoming audit in writing, and that requests for information and documentation also be provided in writing. The same general process should be adopted for all audits to ensure consistency of approach and avoid any allegations of prejudice.

Can you afford not to?

Many Australian businesses are feeling the pinch as a result of the ongoing Global Financial Crisis. Cost-cutting and downsizing of operations is now the norm – but it seems a no-brainer that the first step a business should take when reviewing its operations is to ensure that all revenue due to it is in fact being received.

Give it some attention over the forthcoming weeks. You may be pleasantly surprised at the results.

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Other Resources

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