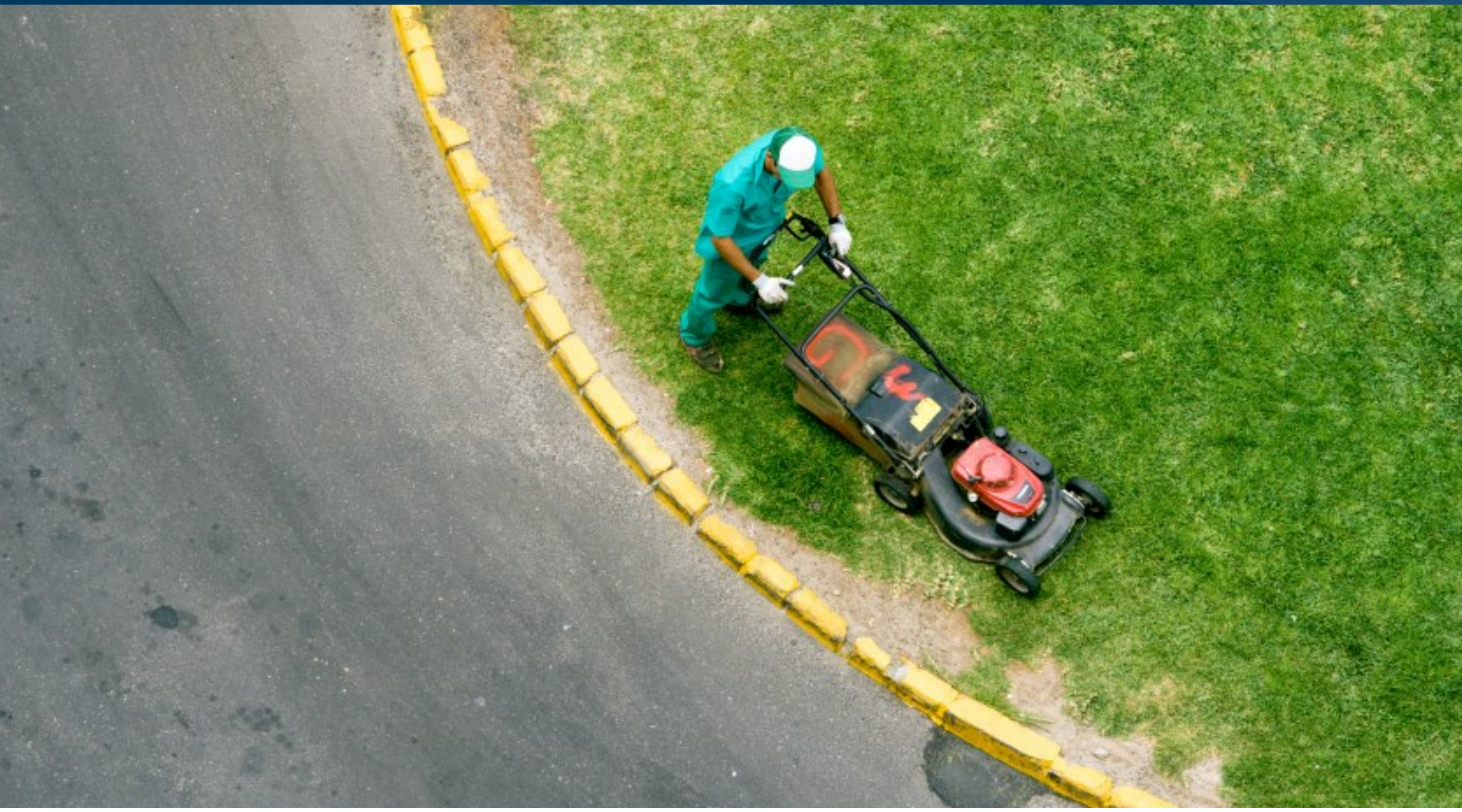
Accounting for Franchises



"Franchises are big business in Australia turning over $81 billion a year. When you buy a franchise you are basically buying someone else's business or brand, along with all the systems, processes and marketing that comes with it. Some describe it as like 'buying a business in a box' but it's not that simple because there are strings and legal red tape attached."

Damian Tornese - Director

Most franchisors charge a significant up front fee that can range from as little as $35,000 for a mowing business to as much as $1 million or more for a McDonald's restaurant. In addition, franchisees are also generally required to pay ongoing fees for support, which may be a fixed monthly amount or calculated as a percentage of gross turnover. Even though franchising is considered to be the most successful form of small business in Australia, a 2008 study suggests that:

- Only 81% of franchisees are profitable
- 58% of franchisees generate a profit of less than $50,000 per annum
- 3% of franchisees generate a loss of more than $50,000

If you need further evidence that buying a franchise doesn't guarantee success or profits, consider these facts. In the space of 24 hours in October 2011 close to 400 Australian franchisees operating under the Refund Home Loans and Tyrecorp brands were hit with the news that both companies had collapsed. The eight year old mortgage broking group Refund Home Loans with around 350 franchisees had been placed in administration while tyre retailer and distributor Tyrecorp 35 franchisees was up for sale after being placed in receivership.

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Clearly it's important to consult with your accountant before starting or buying any business but the substantial up front franchise fee makes it even more important. Remember, product development, production processes, branding and marketing are all there on a platter waiting for you to serve up to the public but tougher lending criteria and reduced risk tolerance from the banks make obtaining finance difficult.

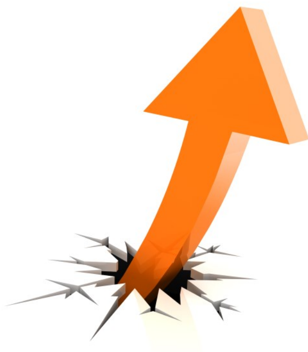
What is a Franchise?

A franchise is an agreement or license between two parties where the franchisee (which can be a person or group) is given the rights to market a product or service using the trademark of the franchisor. For the rights to market the product or service in Australia the franchisee is obliged to pay the franchisor certain fees and royalties. In return, the franchisor has the obligation to provide these rights and generally support the franchisee. Therefore, the franchisor and franchisee have a strong vested interest in the success of the brand.

How much does a franchise cost?

In terms of valuing a business or franchise there are some basic valuation guidelines. Business values are generally based on an EBIT (Earnings before Interest and Tax) of 25% after providing the business owner with a fair salary. To illustrate this point, lets assume your business earnings (before interest and tax) is $100,000 before paying you a salary. If a fair salary for the business operator is $60,000 per annum then the business has an EBIT (after your salary) of $40,000. If you are looking for a 25% return on your investment then a fair price for the business is $160,000 (because a 25% return on a $160,000 purchase is $40,000 per annum).

Clearly these are just broad guidelines because we see businesses bought and sold with much lower EBIT's (particularly for lower cost businesses) and sold with EBIT's above 30%. Factors that will influence the potential return and the price of the franchise include:



- How long the franchise has been established and operating
- Whether you are buying an existing franchise or opening a brand new franchise
- The risk associated with the industry the franchise operates in
- The total price being paid for the franchise business

The Traps

The number one question that prospective franchisees want to know is, "How much will I earn?" It's a fundamental part of the buying equation and some smart franchisors now offer income guarantees, particularly in the service franchises. Given these types of franchises generally attract first-time business owners moving from a salaried employment position with a regular income to the uncertain world of self employment, the income guarantee can be very appealing. These income guarantees are often stated as '$1,000 a week for the first ten weeks' to reassure the franchisee and reduce the perceived risk of investing.

While income guarantees might provide short term peace of mind for new franchisees, they expire and buyers need to look beyond income guarantees when assessing a franchise. What if the operator is not suited to the type of work or has no marketing skills? Generally speaking, most people looking to buy a franchise will look at (at least) two different franchises before making a decision. You need to look at the total package including the price, training, equipment, marketing support, ongoing fees and income guarantees when assessing the offering. Don't make your decision based on one part of the offering because in some instances the income guarantee is really just a recruitment incentive.

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"There are numerous issues to consider when buying into a franchise operation. There is no substitute for professional advice and over the years we have helped many franchisees and several franchisors work through the process. Contact us today about your franchise idea or purchase and we'll help you make an informed business decision."

Damian Tornese - Director

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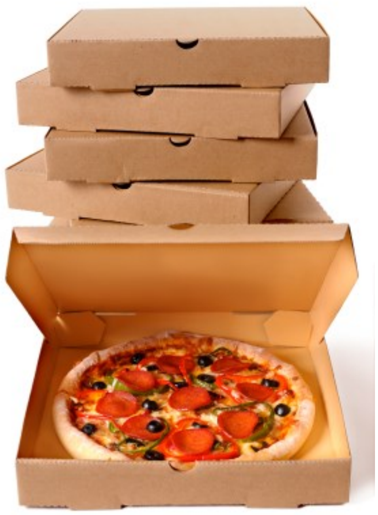

GET ADVICE!

Damian Tornese, says franchise agreements need to be perused by a professional, preferably a lawyer and an accountant. This ensures the franchisee understands what they are signing up for. Damian says, "So many franchisees don't really understand what they are buying into and I have seen people up in arms when they realize that apart from the upfront joining fee there are ongoing monthly franchise costs for advertising and marketing. While these are clearly spelt out in the agreement, the franchisee was so eager to buy they ignored the fine print in the contract. The whole relationship starts on the wrong foot and it's hard to transfuse bad blood".

- Start-Up Business Advice for a Franchisee or Franchisor
- Advice regarding the Purchase or Sale of a Franchise
- Tools including the Start-Up Expense Checklist and Templates for a Business Plan, Cash Flow Budget, Letterhead and Business Card
- Advice and Establishment of Your Business Structure
- Tax Registrations including ABN, TFN, GST, WorkCover etc.
- Preparation of Business Plans, Cash Flows, Profit Projections
- Accounting Software Selection and Training – Bookkeeping, Invoicing, Quotes & Payroll
- Preparation and Analysis of Financial Statements
- Preparation of Finance Applications
- Bookkeeping and Payroll Services
- Tax Planning Strategies
- Assistance with your Website Development, Content and SEO
- Wealth Creation Strategies and Financial Planning Services
- Industry Benchmarking and KPI Management
- Vehicle & Equipment Finance (Chattel Mortgage & Lease)
- Monitoring and Controlling Labour and Sub-Contractor Costs
- Advice regarding Pricing and Claiming Car Expenses
- Recession Survival Strategies
- Advice regarding Employee Relations and Workplace Laws
- Business Succession Planning

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