Everything Old is New Again: Addressing Under-Reporting by Franchisees

In our lifetime, the changes that have impacted national and global franchisors have been driven by a host of factors – wage and hour laws, real estate markets, the rise of the third-party delivery service & ghost kitchens, and the globalization of supply chains. Those changes have been critical; however, they pale in comparison to the technological explosion of the last twenty-five years. Consider this – as recently as 1998 many national and global food service franchisors were still using electronic cash registers (ECR’s) and manually self-reporting their sales to the franchisor!

Certainly, at the time, these devices represented a step up from a dented cash box with its key fastened to the handle with a rubber band; yet, although a technological upgrade, ECRs inadvertently helped enable willful and wanton underreporting of sales to both taxing authorities and franchisors. Today, while there are still a handful of brands using ECR’s, most have moved on to more sophisticated, networked, auto-polled POS systems, along with ACH drafting of royalties. Yet like the cash box or ECR of old, even these systems are far from “bullet-proof,” and under-reporting of sales remains a risk.

Brands need to consistently and purposefully review POS reporting to identify, investigate and resolve “high-risk” transactions, including refunds, voids, and discounts.

Brands need someone with the expertise to deal with the issues unearthed. Investigations are both complex and sensitive; by their nature they demand that they are handled fairly, independently, professionally and with adequate discretion.

Brands need to acknowledge that even with “bullet-proof” POS systems there is no guarantee that all sales are being entered.

To mitigate this risk:

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3. Brands need to acknowledge that even with “bullet-proof” POS systems there is no guarantee that all sales are being entered.

About the Author

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Mike has been a member of the National Restaurant Association’s Internal Audit and Loss Prevention Executive Study Groups, where he has served as past chairman of both groups, the Association of Certified Fraud Examiners and the National Food Service Security Council, where he is a past Board Member.

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The above quote, penned by a French journalist over 170 years ago, still rings true in many facets of our modern lives. Applying it professionally, it is easy to see the connection to the topic of franchise business integrity: In spite of the many changes to the business, methods of under-reporting remain the same. Under-reporting is still most frequently accomplished by:

- Cash or catering sales not being rung through the system
- Outside delivery orders transacted independent of the POS
- Operation of unauthorized branded, co-branded or unbranded off-site locations, typically in kiosks, convenience stores, hotel chains, and/or food trucks.

Thus it begs the question:

**What is a Franchisor to do?**

To start, ensure that internal purchasing, yield/usage, and food & beverage cost reports identify outliers who are buying too much product for the sales they are reporting. While on the surface this may appear obvious, there have been countless discussions at countless franchise industry meetings where high-ranking executives initially scoff at the idea that this could be occurring in their system. This bravado cools when one of their peers quietly shares anecdotes of how “it even happened to them.”

In the pre-COVID era numerous national brand franchisees were found to be in default of their agreements each year simply because they were purchasing their raw materials through wholesale clubs, local suppliers and/or at public open-air markets. Not only do these unauthorized items have the potential to compromise hard-earned, possibly global, brand standards, they run the risk of exposing a corporation to civil liabilities. In a particular case in point an established franchisee was found to be purchasing frequently used mixes outside of corporate supply channels to hide underreported sales and save money; however, the mixes being used contained allergens not identified on corporate provided menu boards or nutrition guides displayed in their stores, thus exposing unknowing consumers to a potential allergic reaction.
The following checklist will help franchisors identify if they meet common under-reporting risk indicators. Ask yourself if your business model includes the following:

- **Limited product mix**, i.e.: baked goods, coffee, pretzels, ice cream, smoothies, pizza, or other models where 75-80% of your menu is one item.

- **Franchisees own small numbers of locations**, typically <5 units.

- **Franchisees and/or their family members** work most open hours.

- **Product is readily transportable and easy to move to outside locations.**

- **Sales are self-reported via a manual process.**

- **Fluctuations in purchasing habits of primary products**: i.e., vanilla and chocolate ice cream orders are dropping, while other flavors remain consistent or rise.

- **Product yield** is outside the averages of comparable stores in a similar DMA or region.

Should you identify any of the above items as areas of concern, it is best to identify a strategic partner early on who can guide you through an appropriate audit and investigative process. At their conclusion, documentation of underreporting typically allow the franchisor to recover lost royalties, audit and investigative expenses, convert previously franchised locations to corporate stores, or reopen an under-performing network to a new franchisee eager to rebuild the brand.
Using a simple yield review with a global baked goods and beverage brand, it was identified that as much as 23% of sales were being underreported. That improved to 12% within the next 16 months, based on intelligence-driven audits and a global awareness campaign.
A national sandwich chain recognized a 15% lift in bread yield the month following initial communication introducing their first audit program to franchisees… these results reflect improvement before a single audit was even conducted! Following the initial spike, you see that the improvements were sustainable.

Certainly, geographic product allocations, franchisee receiving practices, intra-franchisee transfers and other practices can influence these yield numbers, but for a high-level first glance the number of true outliers, and their impact on the brand, is eye opening.
Both case studies, in addition to the obvious royalty assurance implications, call in to question the issues of food safety, brand image, and quality risk mentioned elsewhere in this paper.

Once organizational vulnerabilities have been identified, there are two steps necessary to return to maximum profitability:

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**Implement**

Implement a completely transparent strategy to communicate your plan to your Franchise Advisory Council. This is crucial in gaining franchisee leadership support of your plans to improve results. Following this, communicate regularly with franchisees on current level of yields, high-risk transactions, catering, etc., and let them know your plans for maximizing those results, including implementing audit strategies.

Franchisees buy into your system because they trust you will be good stewards of the brand, and protect their investment through effective brand protection strategies, including audit programs that are designed to ensure integrity. No one wants to pay marketing costs for those who are cheating the system!

**Engage**

IntelliShop is a Brand Protection Advisory Firm which provides guidance on designing an objective, independent and effective Royalty Assurance program. Our practice is comprised of industry professionals who have held senior-level positions with some of America’s most recognized and respected food service and retail brands. Most members of our team hold advanced certifications in the areas of fraud, loss prevention, risk management, security, or accounting.

At IntelliShop we pride ourselves in helping franchisors navigate the complexities of royalty assurance and brand standards investigations. Our industry-leading team has been featured in major news outlets, trade publications, and broadcast media.

Once retained, we typically identify 20-30% of a brand’s franchisee system who fall significantly outside of averages for their market area. That statistic is compelling when considering that we serve well recognized brands with thousands of storefronts domestically and abroad. Our methods help well-informed franchisors to recover hundreds of thousands of under-reported royalty dollars annually.