

underreporting, and that the franchisor has adopted an effective sales integrity program that it will follow religiously.

**B. How Do Franchisors Investigate And Confirm Franchisee Underreporting of Sales?**

*1. Common Signs of Underreporting*

If franchisors are unanimous in their view that underreporting is a problem that must be dealt with, they are just as united in their belief that there is little they can do to detect and prove that it is occurring at their franchisees. In fact, to the contrary, there are several indicia of underreporting that can be found by paying attention to a number of items that are already in the operations files.

The first place to look is in the franchisee's profit and loss statements. While most franchise agreements *require* the franchisee to submit P&Ls on a monthly and annual basis, it is often the case that compliance with this requirement is spotty. The key to starting a strong underreporting program is enforcement of the P&L requirement. Leaving aside underreporting for the moment, the P&L is the essential document that gives a snapshot of the franchisee's business, and it is a necessary tool for providing the business advice for which the franchisee pays royalties. If the franchisor's field staff does not have up-to-date profit and loss statements in hand, it is hard to imagine how they are dispensing meaningful business advice to the franchisees. Obtaining the P&Ls is essential.

Once the P&Ls have been collected, they are a great source for screening underreporting targets. First and foremost, many franchisees are quite willing to claim, on their P&Ls and tax returns as well, that they make literally no money from the business. A franchisee who shows a net loss for the year, and whose P&Ls say that the owner takes no money from the business should be begging for help. If this franchisee is begging for another unit, it is a sign of underreporting.

The P&Ls contain certain cost information that can indicate whether sales are reported accurately. Every franchisor knows that if a unit is run in accordance with standards, then the franchisee's cost of goods sold should be within a particular acceptable range of percentages of gross sales. In your business, perhaps the cost of goods sold should be in the range of twenty-five to thirty percent of gross sales. This can be refined even further to look at the core ingredients that go into the products the franchisees sell. If your business is selling hamburgers, then you will know that purchases of meat should be twenty-two percent of gross sales. When the franchisee's records show ratios that are not within acceptable parameters, this is a sign of underreporting. Usually, the percentage will be too high, meaning the franchisee is concealing only his sales, but not his purchases. If the percentage is too low, the franchisee may well be buying supplies off the books.

Another cost area that bears close scrutiny is labor. Again, salaries and wages should be a given percentage of gross sales. Payroll figures that are either too high or too low may signal a problem. If too high, it may mean that the franchisee is concealing sales but not labor costs. If too low, the franchisee may be paying employees off the books with the excess cash generated by unreported sales. A growing problem area is the employment of illegal aliens, which may draw attention from the Immigration and Naturalization Service. As noted above, underreporting to the franchisor often goes hand-in-hand with tax fraud. Therefore, a shortcut to termination can be a violation of the obey-all-laws clause, discussed below.

Even if the franchisor does not collect P&Ls, it should receive weekly (or, less preferable, monthly) sales reports. Sales trends are useful in the underreporting analysis. A "flatliner" -- a franchisee whose reported sales are flat year in and year out -- is more likely to be an underreporter. This information is particularly telling when it is compared to the other franchisees in the market. If everyone's sales are rising but one franchisee's sales are flat, the reason could be underreporting. Look at reported sales in light of particular events, such as a new product promotion, or a large sporting event or college graduation that usually generates increased sales in the market. If the franchisee's sales show no response to these events, further investigation is warranted.

A business within the business is a common form of underreporting sales, although it is more commonly viewed as a violation of the covenant not to compete. Franchisees have been known to operate a competing business, under a different name, right on the franchise premises! The operation comes complete with separate invoices, a separate phone line, and its own delivery route. Even without such elaborate preparations, an easily segregated portion of the business is ripe for underreporting. In the retail food industry, unreported wholesale or catering sales is a frequent vehicle for intentional underreporting. Detecting this type of behavior can be easy. For example, a district manager may conduct an unannounced inspection, find unmarked boxes of product waiting at the back door to be delivered, and then see sales reports showing no wholesale sales.

Franchisee lifestyle and attitude should always be evaluated. The field staff already has a wealth of information; they just need to be asked about it. Everyone knows which franchisee just built a beach house and which one drives a late model Mercedes Benz. The problem is that no one has thought to put this information together with the sales reports and P&Ls and see if it all makes sense. The same goes for the franchisee who is happy and wants to expand. Has anyone checked to see how much he claims to earn from the business? If his P&Ls look so bad that you would expect him to be begging to get out of the system, you have probably discovered another underreporter. Of course, a poor attitude also may bespeak a problem. In any walk of life, a natural response of someone who is unhappy with his or her situation is to retaliate. A franchisee who feels the system has not worked for him may decide to use a little "self-help" by underreporting sales.

## 2. *Surveillance*

One of the best ways to gather evidence that will potentially have some impact in court is to conduct surveillance of the franchise. The easiest type of surveillance is following a delivery vehicle as it makes its daily run delivering products to the unreported wholesale or catering customers. Not only does it establish the fact of underreporting, but it provides the identity of customers who can be subpoenaed if it becomes necessary to file suit. The customers will produce records that help to establish the volume of unreported business, i.e., damages.

The tougher trick is conducting surveillance inside the franchise, usually designed at establishing that sales are not being rung into the register, hopefully including video of the franchisee himself making sales and pocketing the cash. There are logistical problems here, as one might imagine, although investigators are fairly ingenious at figuring out ways to get the job done. Some are known to use small video cameras that can fit inside a briefcase or backpack, so an investigator posing as a customer can shoot footage while waiting on line or sitting at a table.

An investigator can pose as a potential buyer if the franchisor has the business on the market. The time when the franchisor has the greatest incentive to reveal the true sales of the business is when he is trying to sell it. A skillful investigator will be able to draw this information out of the seller. If direct contact is going to be made with the franchisee, however, one needs to be aware of ethical considerations that prevent an attorney from doing indirectly what he or she cannot do directly, i.e., have contact with a party known to be represented by an attorney.

Surveillance has its limitations. There are quite a number of former federal agents who now make a living as private investigators, and they certainly are the best at obtaining good results. Others are not quite so good, and regardless of which type one retains, investigators can get expensive. They also can get caught, and this will put the franchisee on his guard, possibly preventing the franchisor from getting the evidence it needs to confirm its suspicions. The best use of surveillance is not necessarily to generate evidence for court, but to confirm that a franchisor's suspicions are correct and provide some ammunition for a confrontation meeting with the franchisee. If the case goes to court, the franchisor can always use subpoenas to gather all the evidence, of which surveillance will provide but a snapshot.<sup>1</sup>

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<sup>1</sup>Mr. Haff notes that surveillance also may adversely affect franchisee morale and trust of the franchisor. If the basis for terminating an underreporting franchisee is "breach of trust," hasn't the franchisor breached the trust of an innocent franchisee by putting him under surveillance?

