



All franchisors will be aware of the current requirement in the Franchise Code of Conduct regarding marketing funds audits.

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Marketing fund audits

If a franchise agreement directs a franchisee to pay money to a marketing or other cooperative fund, the franchisor must – within three months after the end of the last financial year – prepare an annual financial statement of the fund's receipts and expenses for the last financial year. This must include amounts spent on production; advertising; administration; goods and services supplied by the franchisor or an associate of the franchisor; and other stated expenses.

Many franchisors who prepare such statements do not have them audited. This is due to Franchising Code of Conduct directing that an audit is not required if 75% of the contributing franchisees agree.

One of the recommendations from the Matthews Inquiry into the Code (and since accepted by the Government), is that in future all marketing funds must be audited. No longer will there be an exemption, not even if all the franchisees decide an audit is not required.

The Code currently provides that an audit, if carried out, must be carried out by a registered company auditor (rather than an unregistered auditor), and it is most likely the amendment will continue the requirement that the audit be performed by a registered company auditor.

The marketing fund annual financial statements and the auditor's report are prepared for the franchise's use only – for franchisors and franchisees – and are not normally released to the public.

So audits of marketing funds are here, like it or not.

Given this, franchisors should attempt to minimise the costs of the audit and maximise the benefits gained from the audit.

The marketing fund is used to collect marketing and advertising royalties and other fees paid by franchisees to the franchisor, for marketing activities on behalf of the franchise.

Sometimes, some of the monies collected are applied to marketing activities in a particular franchise area and sometimes for the benefit of the brand as a whole. Franchisees are naturally concerned to ensure that marketing fees paid are correctly applied for the purposes set out in the franchise agreement. The provision of an unqualified audit report by an auditor provides franchisees with assurance the funds have been properly applied and to ensure transparency and accurate reporting of marketing fund transactions. This is one tangible benefit of an audit and franchisors should ensure their franchisees are aware of this.

What are the other benefits of an audit to a franchisor?

As with any audit, if the auditor is able to provide an unqualified report, it provides the franchisor with a reasonable level of assurance that transactions are being properly accounted for and monies coming into and leaving the fund are being properly applied. A suitably qualified and experienced auditor will also review internal control systems and make recommendations to the franchisor for improvements in systems and processes.

A marketing fund statement will typically list marketing royalties paid by franchisees, amounts paid into the fund by the franchisor, marketing royalties outstanding from

franchisees, and details of marketing expenses paid for using the funds received. The auditor is required to test the statement and underlying transactions to form an independent, objective opinion on the accuracy of the statement. If the auditor is satisfied with the accuracy of the statement, he will provide an unqualified audit report. If the auditor is not able to obtain the level of satisfaction that is required, he will provide a qualified audit report.

If an auditor is forced to qualify his statement in the marketing fund, this will reflect badly on the franchisor and is likely to cause discontent among franchisees. What can the franchisor do to avoid this?

Franchisors should appoint a suitably qualified and experienced auditor as soon as possible, and in conjunction with the auditor establish at an early stage exactly what the auditor's requirements will be. This will enable the franchisor to ensure proper and accurate records are kept which in turn will enable the auditor to carry out the tests that must be performed. This will make it less likely that the auditor will have to provide a qualified audit report.

Generally, the work performed by the auditor will include:

- A review of the internal control and record keeping procedures of the franchisor to ensure the data used to create the marketing fund statement is reliable.
- Testing of expenses to ensure they are expenses that can be validly incurred by the marketing fund and testing to ensure these are correctly recorded in the statement.
- Testing that royalties paid by franchisees are being correctly recorded in the marketing fund report, and ensuring that all royalties are being recorded.
- Ensuring the statement is reasonable by conducting an independent review.

A franchisor who is aware of the auditor's requirements and the testing to be carried out is more likely to be able to provide all the information that the auditor needs.

This will reduce the likelihood of the audit report being qualified and lower the cost of the audit.

The cost of an audit is a cost usually borne by the marketing fund. Most franchise agreements provide the costs of preparing and auditing the marketing fund report which can be paid out of the fees paid into the marketing fund. The better the franchisor's record keeping and preparedness, the lower the cost of the audit. The lower the cost of the audit, the more money that can be spent on external marketing activities for the benefit of franchisees and the system as a whole.

Franchisors would do well to take heed of the new audit requirements and ensure that they are properly prepared for marketing fund audits.

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