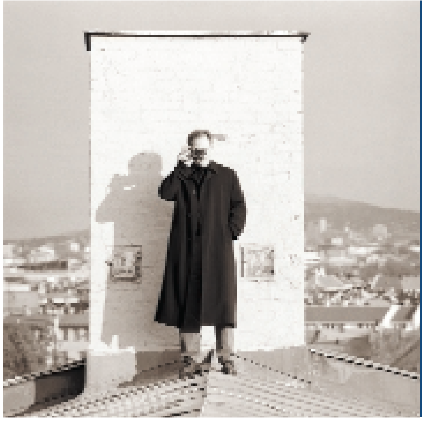

PRICEWATERHOUSECOOPERS

Hospitality Directions Europe Edition*

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As franchising becomes a priority tool for global hotel growth, PricewaterhouseCoopers asks, can you trust your franchisee?

Franchising is a quick way to grow the numbers without eroding capital earmarked for investment in must-have destinations or opportunistic deals. Major hotel groups are increasing the proportion of their portfolios under franchising both as part of expansion of their networks and conversion of existing owned or managed properties. Andrew Cosslett, CEO of InterContinental Hotel Group (IHG), the world's largest hotel group, wants IHG to grow and he wants it to grow fast, adding between 50,000 and 60,000 net new rooms to the worldwide IHG 'system' by the end of 2008. Coslett has acknowledged that the future lies in managing hotels on behalf of property owners and in franchising its brands to others.

PricewaterhouseCoopers estimates that existing franchisees will account for roughly two-thirds of the project pipelines for franchisors in the United States over the next two years, a figure most chains confirm. In Europe franchising has less penetration but is becoming more important.[1]

Ninety per cent of PricewaterhouseCoopers' contract compliance examinations to date have identified misreported licence fees

Higher returns but higher risks

While franchising offers higher returns than direct control as well as reduced capital requirements, the franchisor's exposure to risk is increased. The key to successful franchising programmes includes selecting the right properties and business partners, on-going relationship management with those business partners, strong agreement terms and conditions and a commitment to enforcing the franchising rights. Franchisors need proactive monitoring programmes to ensure that quality is maintained to protect the brand and minimise financial risks such as revenue leakage.

1 Customers want a better night's sleep. Franchisees want more profit. Franchisors are battling to find cost-effective ways to keep both camps happy and loyal, *Hotels Magazine June 2005*

*connectedthinking

Selected hotel companies that franchise The proportion of hotel rooms and properties under franchise				
	Rooms		Properties	
	Latest Available	Prior year	Latest Available	Prior year
Accor	19%	18%	26%	24%
Cendant	100%	100%	100%	100%
Choice	100%	100%	100%	100%
IHG	76%	69%	90%	86%
Marriott International	46%	47%	63%	62%
Hilton Hotels	70%	68%	84%	83%
Starwood	34%	35%	41%	41%

Source: PricewaterhouseCoopers 2006, from latest available company reports

"Why do we need to conduct a review of our franchisees? We trust them!" This is all too often the response from companies when an examination is suggested. Of course it is desirable that the franchisor and franchisee should have a good working relationship, which will involve mutual trust and respect. But this does not mean that decades of statements should be accepted without question. After all, most companies place trust in their employees but still check their expense claims.

One consequence of this sentiment is that a large number of brand owners are failing to monitor agreements adequately and are losing millions of pounds as a result. Ninety percent of the 600 contract compliant examinations undertaken by PricewaterhouseCoopers' to date have identified misreported royalties or licence fees. This is not a trend that is specific to the hospitality and leisure industry and across technology, consumer product, software and luxury brands the facts remain the same. The majority of non-compliance and revenue leakage involves honest error due to accounting, clerical and contractual interpretation differences, as opposed to a deliberate understatement. However, over the life of a long-term franchising agreement, the revenue leakage that results can amount to hundreds of thousands, and in some cases, millions in lost income.

The facts:

Underreported Royalty: £6 million
Reason: Underreported sales over 10 year period

Underreported Royalty: £430,000
Reason: Accounting oversight by the licensee

Underreported Royalty: £4.5 million
Reason: Misunderstanding of net sales definition

Source: PricewaterhouseCoopers royalty examinations

The key to ensuring that the correct royalties or licence fees are being reported lies in the following steps:

- Ensuring that the agreement terms (i.e., net room revenue, allowable deductions) are clearly and concisely defined;
- Ensuring the agreement allows for a thorough and unrestricted examination to be conducted;
- Exercising these rights regularly; and
- Maintaining regular contact with the franchisee.

These are described in more detail below.

Clear and concise agreement terms

Crucially, any deal is only as good as the agreement underpinning it. Large discrepancies arise after an agreement has been signed over what seems like little issues during the negotiation. A great deal of time and effort is spent determining the royalty or fee rate but little consideration is given to some of the other financial terms and conditions.

When negotiating an agreement, it is vital that both the franchisor and the franchisee are clear as to exactly what the terms and conditions state and the parties agree that the clauses say the same things. If such clarity is not established at the outset, discrepancies in interpretation will often mean disputes further down the line, as the franchisor does not receive the income it was expecting or the franchisee is asked to pay out more than it believes is fair. These disputes cost time and effort, as well as money, to sort out.

When an agreement is being drafted, there are a number of areas that have the potential to cause difficulties. If it is decided that the license fee is to be made on a royalty basis, should this be based on gross room revenue, net room revenues or some other calculation? Whatever is decided has to be very carefully defined. If it is net room revenue, for example, does net mean money actually received from room sales, less sales, use, exercise, value-added, tourist or other taxes or government imposed surcharges on such room use or room occupancy less standard industry deductions? In such circumstances, what are the standard industry deductions?

It is clear that if these definitions are not set out in the agreement, the franchisor will think there are no restrictions or qualifications, while the franchisee will want to do everything possible to keep payments down. If the parties are in different countries with different languages, different cultures, different standards and business practices, the issue is only exaggerated. But, if all parties are in agreement from day one, there is little room for uncertainty.

In addition, the agreement needs to include the relevant reporting requirements to ensure that information the franchisor needs to determine royalty and operational compliance is obtained. Clear guidance on what is required, including proforma documentation, should improve the information submitted.

Other areas to consider when drawing up the agreement include:

- alignment of reporting periods with the franchisee's reporting period to allow comparisons to be made to public documents such as audited statutory accounts;
- clarification of payment methods as certain methods of payment can delay receipt of available funds by a significant number of days;
- confirming who pays for any independent inspection if significant misreporting is identified; and
- providing contract termination rights for the franchisor for in the event of substantial misreporting.

Audit access clauses

On some occasions our attempts to conduct examinations have been hampered by poorly worded agreements which give the franchisor only restricted rights, for example, "audit all the information which the franchisee has used in preparing the license fee statements." This is of little value because it is precisely the information, which has not been used which is of most interest. The wording above allows us to verify accuracy but not the completeness of the statements. A well-worded agreement is the foundation for a successful examination and should give any firm of accountants appointed by the franchisor complete and unfettered access to all the books and records in the custody or control of the franchisee, including electronic data.

Exercising audit rights regularly

Research to date across all industries indicates that around 8 in 10 licensors do not have a formal compliance programme. Specific data is not presently available for franchisors. However our impression is that the majority of major franchisors have a programme although the breadth and depth of geographical coverage and frequent varies significantly. Some variety would be expected due to the different arrangements, network size and systems. A best practice programme will contain a number of elements.

Monitoring

Monitoring of the franchisee by the franchisor on a regular basis is essential. This should include timely follow-up of missing or incomplete returns and robust enquiry into unusual items. This should also include basic checks and balances. Reconciliation of returns to actual payments received is also needed particularly where cash received and monitoring are separated functions.

Monitoring should also include review of franchisee auditor certificates normally submitted annually in arrears to the monthly franchisee submitted returns. Where appropriate the returns should also be reviewed with audited financial statements. Franchisee auditor certificates also need careful review particularly for complex operations. Some are comprehensive reports based on specifically commissioned exercises, however others may not focus on detecting misreporting at their client, may not meet requirements set out in the contract and contain heavy caveats.

Risk analysis

Franchisors should look out for red flags such as inadequate or late reporting, reluctance to answer questions and lower than expected returns. By closely monitoring statements and comparing them to industry statistics and data from other sources, those franchisees most in need of a visit can often be identified.

There are always costs versus benefit decisions to be made particularly with smaller single location franchisees located far away from head office. Developments in technology can help such remote access but many high-profile frauds have involved faxed and copy documents and have been uncovered following face to face meetings so a visit may still be necessary.

Site visits

There is unquestionably a correlation between the frequency of examinations and the degree of adherence to an agreement. We recommend that an examination is carried out preferably annually and certainly every two or three years. Examinations should be performed one year after the first statements are received. We have found that reviews which follow a forensic investigation methodology tailored in detail for each franchisee are more effective rather than a list of agreed upon procedures or a standard work programme.

It is equally important to maintain an element of surprise/unpredictability. There is a balance between detailed notification of the testing to be carried out and unpredictability. However unpredictability should be incorporated into any programme to limit options for information to be prepared to support misreporting.

Local knowledge, cultural awareness and language skills within the review team will also improve effectiveness. Misreporting may not be detected where errors are due to actual practices being significantly different to expectations based on home markets. Similarly, cultural insensitivity and a lack of local language skills can prolong a review or damage the relationship.

Benefits

In addition to identifying compliance issues with franchisees, a proactive approach to licensing management encourages franchisees to improve future reporting, increases the licensor's predictability of future payments and, for both parties, identifies areas for improvement in drafting of future agreements. A well publicised programme may act as a deterrent to deliberate misreporting particularly where this is backed penalties and recovery of audit cost clauses. Similarly, such visits are more widely accepted when thought to be "normal" best practice behaviour rather than seen to be snooping.

Sensitivity to relationships

As mentioned above, to address red flags, highlight discrepancies and as best practice, franchisors should be prepared to exercise their rights to inspect the franchisees' books. Historically, this has often been considered bad practice as it was thought such action indicated mistrust and would therefore damage relationships. This is not the best way to view the matter. Franchisors need to understand exactly what is happening so that both parties can work out where the differences are, investigate them and then move forward. After all, both sides need each other in order to do business.

It is important for franchisors to balance the compliance goals without damaging the relationship with franchisees. Often franchisors do not implement a compliance programme as they are afraid of offending the franchisees. Franchisors will have invested considerable time in building relationships with various franchisees and the last thing they need is for this process to damage that relationship. This is a false perception.

If the franchisor routinely conducts examinations, and the franchisee is made aware of this, we believe that a structured compliance programme can strengthen franchisors' relationships with their franchisees by identifying problem areas, defusing potential disputes and resolving issues quickly and equitably.

Through implementing a proactive compliance programme, an excellent franchisor/franchisee relationship can be developed and maintained, based on mutual trust and respect. By ignoring the franchisee, the relationship is more likely to degenerate into one where the franchisor thinks he can trust the franchisee, but areas of non-compliance are not identified. Until the franchisor exercises their right and performs an examination, one will never know.

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