NEWS ALERT
March 10, 2006

AUDIT – INVENTORY EXTENSION OR YIELD USAGE? WHAT DOES IT MEAN AND WHAT YOU NEED TO KNOW.

We have learned that many of our members are facing detailed "yield and usage" audits from ADQ. We asked our legal counsel, Scott Korzenowski of Dady & Garner, P.A., to write an article regarding the legal obligations of franchisees to cooperate with such audits. The following article is his response to that request.

By Scott E. Korzenowski, Attorney, Dady & Garner, P.A.

American Dairy Queen Corporation ("ADQ") has begun to perform "inventory extension" or "yield and usage" audits of franchisees throughout the Dairy Queen System. This article will tell franchisees what "inventory extension" or "yield and usage" audits are; how franchisees can recognize when they become subject to such "inventory extension" or "yield and usage" audits, and what franchisees should do when faced with such audits.

What is an "inventory extension" or "yield and usage" audit?

An "inventory extension" or "yield and usage" audit is process whereby ADQ will audit a franchisee's actual purchases of ice-cream mix and other food products (including paper products) for the purpose of extrapolating "projected total sales." If the "projected total sales" are greater than the "actual total sales" the franchisee reported to ADQ, ADQ will demand that the franchisee pay royalties and advertising-fund fees on the difference between the "projected total sales" and the "actual total sales."

The process works as follows:

- ADQ determines a franchisee's purchases of ice-cream mix and other food products (including paper products);
- ADQ concludes how many retail products the expended ice-cream mix and other food products (including paper products) should have generated;
- ADQ then allows for a certain amount of waste and then multiplies the projected retail products times the prices charged by the franchisee to determine "projected total sales."

- If the “projected total sales” are greater than the “actual reported sales,” ADQ will demand that the franchisee pay royalties and advertising-fund fees on the difference between the “projected total sales” and the “actual total sales.”

How will a franchisee know it is subject to such an audit?

The typical ADQ letter announcing an “inventory extension” or “yield and usage” audit will request that the franchisee make the following documents available for an auditor:

1. Check register or disbursement journal;
2. Record of all bank deposits and bank withdrawals;
3. Monthly bank statements and canceled checks;
4. Invoices and cash-receipt records for all goods purchased for resale;
5. Records of retail price for each category of items sold;
6. Records of any products or supplies disposed of other than by regular sale to customers;
7. Inventory records;
8. Copies of sales tax returns and Schedule C, Form 1040, of the franchisee’s Federal tax returns;
9. All cash-register tapes and daily sales logs; and
10. Copies of all P&L statements.

These items reflect not only the revenues generated by the franchisee, but also the purchases made by the franchisee. As such, these records will allow ADQ to determine the amount of ice-cream mix and other food products (including paper products) the franchisee has purchased and used so that ADQ can begin the process of extrapolating the “potential total sales” that ADQ would expect the franchisee to have generated from the use of ice-cream mix and other food products (including paper products).

In addition, these letters typically will state that the auditor will review the documents at the franchise location and that the audit will take three to five days.

After the auditor has completed the audit, ADQ eventually will provide the franchisee with a letter outlining the extrapolation process and identifying what ADQ will state are “under-reported sales.” In that same letter, ADQ will demand payment of royalties and advertising-fund fees on these alleged “under-reported sales.” ADQ typically also will provide the franchisee with a list of “suggestions and recommendations” aimed to improve the franchisee’s operations and financial results.

What should a franchisee do when it receives such an audit notification?

Whether ADQ legally can perform an "inventory extension" or "yield and usage" audit and extrapolate "projected total sales" from such an audit will be dependent largely upon the audit provisions in each franchisee's franchise agreement. Even the older franchise agreements authorize ADQ to "examine all books and records of accounts" of franchisees to ensure that franchisees are paying ADQ the amounts due ADQ under the franchise agreements. These older agreements, however, are ambiguous regarding the actual records ADQ can inspect. More recent agreements provide ADQ with the authority to inspect the records "from which all sums payable under this Agreement and the dates of accrual thereof may be readily determined." In either of these instances, the franchisee can persuasively argue that ADQ can inspect only those documents related to the generation of revenues; that is, daily sales logs, monthly sales reports, that portion of tax returns reflecting store revenues, and, perhaps, bank deposits and other items related to the revenue portion of the business.

Because the older agreements do not expressly state what records ADQ can audit, franchisees operating under these types of agreements certainly can take the position that ADQ is not authorized to review documents related to the expense side of the business since the franchise agreement requires the franchisee to pay ADQ royalties and advertising-fund payments based on actual sales (except for those agreements that require franchisees to so many cents per gallon of mix purchased).

Such a franchisee could decide, therefore, to allow ADQ to inspect only those documents related to the revenue side of the business. Franchisees that take such a position, however, are likely to face retribution from ADQ, including, perhaps, letters that threaten termination if the franchisee does not provide all the documents requested by ADQ. If a franchisee receives such a letter, its only choices will be to turn over the documents or seek legal assistance to halt any such termination.

Even franchisees with narrowly-worded franchise agreements may decide to cooperate with ADQ and provide all documents requested by ADQ. In such a situation, franchisees should write ADQ a letter stating that the franchise agreement does not authorize ADQ to inspect expense-related documents, that the franchisee is not waiving its right to later preclude ADQ from inspecting such expense-related documents, and that the franchisee is providing such expense-related documents only in an effort to cooperate. Such a letter will allow the franchisee to make it clear that it is not waiving its right to later take the position that the franchise agreement does not authorize ADQ to review such expense-related documents.

Some of the more recent franchise agreements, however, expressly authorize ADQ to “reconstruct Licensee’s sales through the inventory extension method or any other reasonable method of analyzing and reconstructing sales.” If a franchisee’s agreement provides such express authority to ADQ, the franchisee will have a much less persuasive argument that it does not have the obligation to provide such expense-related documents and probably should provide such documents.

That said, franchisees that provide ADQ with access to all the requested documents (whether the franchisee chooses to provide such expense-related documents or is forced to provide such expense-related documents by the terms of its franchise agreement), should not accept ADQ’s subsequent conclusion that higher-than-expected food costs somehow proves that the franchisee under-reported its sales. There are many reasons unrelated to under-reported sales that can cause a franchisee to experience higher-than-expected food costs. The reasons include waste, theft, unrecorded employee meals, and unrecorded personal use. Franchisees should be prepared to respond to any demand by ADQ that higher-than-expected food costs require a franchisee to pay additional royalties and advertising-fund fees. They do not.

In the end, most franchise agreements obligate franchisees to pay royalties and advertising-fund fees as a percentage of sales (except for the older cents-per-gallon agreements that require franchisees to pay so many cents per gallon of ice-cream mix purchased). With the lone exception of the old cents-per-gallons agreements, the franchise agreements do not obligate the franchisees to pay any royalties or advertising-fund fees as a percentage of purchases.

The end result, therefore, is that franchisees, especially franchisees with franchise agreements that allow ADQ to inspect expense-related records, should keep careful records of their actual use of ice-cream mix and food products (including paper products) so that franchisees later can effectively refute ADQ’s conclusion that higher-than-expected food costs must mean that the franchisee has under reported its sales. And in most any event, franchisees that are facing these “inventory extension” or “yield and usage” audits should seek legal counsel sooner rather than later.

1654 Lake Drive West • Chanhassen, MN 55317
(952) 556-5511 • FAX: (952) 556-5522