

Common Financial Language

Everyone wants to know how much money they can make if they purchase a franchise. The most common place to validate this type of data is with the Item 19 section in the Franchise Disclosure Document and by talking to existing franchisees (franchise owners).

The challenge when talking to franchisees is to make sure you share a common financial language. You may be surprised to learn that many successful franchisees are not certified public accountants. In fact, many franchisees contract out their bookkeeping work to a third party. These franchisees may understand the key financial metrics to manage their business, but may not live and breathe the details of the numbers. Therefore, when you ask a franchisee detailed questions about their financials, you may need to politely dig deeper to clarify numbers. Let's also not forget that you are asking someone about their financial numbers-- you are snooping around in their bedroom sort of speak.

When you are analyzing franchise unit financial performance, the focus should be on understanding the numbers through Operating Profit or EBITDA (Earnings Before Interest Taxes Depreciation and Amortization).

Sample Annual P&L

Net Revenue (1)	\$1,000,000	100%
Cost of Materials	\$160,000	16%
Cost of Direct Labor	\$350,000	35%
Royalties	\$50,000	5%
Total Variable Expenses (2)	\$560,000	56%
Gross Margin	\$440,000	44%
Rent & Utilities	\$40,000	4%
Salaries/ Payroll	\$200,000	20%
Marketing	\$70,000	7%
Miscellaneous	\$30,000	3%
Total Fixed Expenses (3)	\$340,000	34%
Operating Profit/EBITDA (4)	\$100,000	10%
Interest on loans	\$25,000	1.5%
Depreciation & amortization	\$5,000	0.5%
Net Income (4)	\$70,000	7%

Notes:

1. **Net Revenue** is the gross revenue collected minus local sales and excise taxes.

2. **Variable expenses** are expenses that, for the most part, are a percentage of sales. These expenses vary by the sales level. Some examples of common variable expenses include Cost of Materials and Direct Labor (the worker bees).
3. **Fixed expenses** are operating expenses that do not increase proportionally with sales. Some examples of common fixed expenses include rent, utilities, insurance, telephone, and indirect labor (management, admin staff). Whether you have any revenue or not, you will still need to pay most fixed expenses.
4. **Operating Profit** is equal to the Net Revenue – Variable Operating Expenses – Fixed Operating Expenses.
5. **Net income** is the profit after all expenses have been paid including loan interest expense, depreciation, etc.

Some Key Questions to Really Understand Operating Profit

- ***Does the owner work full-time or part-time?***
If they work part-time, then they may be paying for someone to handle many “owner level” responsibilities. This is a life style choice that will reduce their operating profit. If you plan on working fulltime, then your “total benefit to owner” will be higher.
- ***Does your operating profit include a salary for you as an owner? Your wife?***
If a franchisee says that they make an operating profit of \$100K on sales of \$1,000,000 and their salary is \$150K, then the total benefit to the owner is \$250K.
- ***Are their personal expenses included in your operating profit?***
It is not uncommon for people to pad their business with personal expenses (i.e., car leases, trips, meals, subscriptions) in order to minimize their taxes. It is important to make adjustments for personal expenses that are not required company expenses.
- ***Does your operating profit include any loan interest payments or leasing payments?***
Some owners confuse Net Income with Operating Profit. Any payments related to loans should be below Operating Profit.

Many franchisors will provide you with a blank pro forma P&L. Just remember that franchisors are limited in what they can share with you related to financial performance. The Franchise Disclosure Document Item 19 Financial Performance Representations should provide you with some basic financial information.

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