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Consumer Business COMPASS

Bottom Line v. Top Line: Retailers Increase Focus amid Various Risks

The retail industry, like many industries in late 2008 and 2009, has been severely impacted not only by the recession, but also by the unprecedented credit tightening enforced by lenders. The confluence of both caused earnings to plummet, stores to close, layoffs to surge and, in some cases, led to high-profile bankruptcies such as Circuit City and Linens N Things. Hoping to see a glimmer of light at the end of the tunnel, analysts, investors and retailers collectively held their breath as first quarter earnings trickled out in early May. In the end, many retailers beat modest expectations – not because consumers starting spending en masse, but because an intense focus on easing certain risk factors helped to stabilize their bottom line.

An analysis of leading risk factors cited by the 100 largest public U.S. retailers, *BDO Seidman's 2009 RiskFactor Report for Retail Businesses* identifies general economic conditions (96%) and credit availability and company indebtedness (93%) as the most common risk factors. Retail was the only industry whose incident rate dropped in 2008 from previous years (to 13%).

The report found that half (50%) of all fraud incidents at retailers are personnel management related (up from 44% in 2007), followed by corruption and fraud and employment law violation accounting for thirteen and twelve percent respectively. Incidents regarding company/professional code violation have decreased by more than half since 2004 and now account for only eight percent of all incidents.

According to BDO Consulting, the leading methods of fraud awareness in 2008 for retail trade participants were the poster (39%), a fellow employee or manager (19%), the employee handbook (11%) and other means (13%).

Approximately one-third (32%) of retail trade participants notified management of the incident prior to submitting a report via the hotline. This number has remained somewhat steady since 2004.

BDO Consulting found that less than half (45%) of retail trade industry participants chose to provide their names when submitting a report - consistently over the five-year period. The number of cases where an investigation was not warranted has decreased dramatically by half in 2008 (from 35% in 2007 to 17% in 2008.) The number of cases investigated but that did not warrant a correction action also increased.

Sink or Swim? Franchises Rise to the Top

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The axiom "when one door closes, another one opens" applies particularly well to retail franchises. On June 10th, the Labor Department revealed that the number of workers filing for jobless claims rose 59,000 to a record 6.8 million. Due to the low cost of entry fees, inexpensive retail space and the security of an established retail concept, franchise businesses – some of which are considered to be "recession-proof" – are increasingly attractive to the rising population of the unemployed.

The International Franchise Association (IFA) reports that franchises not only directly employ more than 11 million workers, but also indirectly employ nearly 21 million workers, or 15.4 percent of all U.S. private-sector jobs, through employment opportunities with their service providers.

"After the recession of 2000-2001, franchises created more than 140,000 new businesses and 1.2 million new jobs over a five-year period" said Catherine Fox-Simpson, a Partner in the Retail and Consumer Product Practice at BDO Seidman, LLP. "Even in the current crisis, franchises still can serve as vehicles of economic growth."

There are several ways for individuals to obtain financing and secure tax deductions for a franchise, including:

401k Plans

The Employee Retirement Income Security Act enables individuals to go into business for themselves before retirement age by using equity from their IRA or 401(k) instead of taking on debt in the form of higher-interest loans. Individuals can borrow up to 100 percent of their retirement savings to fund their business. As a result, as the loan is repaid interest is essentially paid back to the borrower.

In the past, experts have not advocated tapping a 401k to finance a new business. This is mainly because if the business fails and the owner does not repay, the loan will be deemed an early withdrawal, which is subject to a 10-percent penalty on top of the initial tax. However, with the tight credit markets and down economy, potential franchisees may consider funding from a 401k a viable option.

Industry Financial Incentives

To attract new franchisees, many businesses in the franchise industry are offering financial incentives. Depending upon the amount of equity required, some franchises will offer initial fee reductions, extended initial fee payments, royalty fee discounts and other individually-tailored incentives such as loan guarantees. Here are some examples happening today:

• Papa John's offers no franchisee fee ($25,000 value), no royalty for one year and a $10,000 early opening award.
• Domino's Pizza provides a $20,000 discount for franchise owners who have prior businesses management experience;
• Furniture Medic offers to front up to 80 percent of the financing initial fee and equipment package and the payments can be spread out up to 60 months.

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In addition to these discounts, some companies are acknowledging the tight credit market and providing financing to the franchisees directly from the company. This can help secure the right amount of capital for a new business even when banks are not lending. In some cases, landlords are likely to cover build-out costs upfront and amortize them over the life of a lease.

Government Incentives

There are several government incentives for small business owners that were designed specifically to mitigate the recession. In fact, the Treasury Department is purchasing more securities to open up in the secondary market for Small Business Association (SBA) loans and the SBA will now guarantee up to 90 percent of each loan for new franchisees.

In addition to SBA funding, the American Recovery and Reinvestment Act includes depreciation provisions which permit retailers to expense a larger amount of capital purchases, helping individuals who are looking to open a franchise not only get started, but also reap substantial tax benefits at year-end.

Finally, the Work Opportunity Tax Credit (WOTC) is used to reduce the federal tax liability of private-for-profit employers, while also helping nine specific target groups.[1] Recently, the American Recovery and Reinvestment Act expanded the WOTC program to include two additional target groups – unemployed veterans and disconnected youth. Since franchisees often employ labor that falls within these groups, they are especially poised to take advantage of this tax incentive.

With the right strategy in place and new pathways to secure financing and reap tax breaks, franchising is an attractive career option.

[1]The 11 groups identified in the Work Opportunity Tax Credit Groups include: Qualified TANF Recipients, Qualified Veterans, Qualified Ex-Felons, Qualified Designated Community Residents (DCR), Qualified Vocational Rehabilitation Referrals, Qualified Summer Youth, Qualified Food Stamp Recipients, Qualified Supplemental Security Income (SSI) Recipients, Qualified Long-Term, Disconnected Youth, Veterans

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