

The effectiveness of undertaking due diligence prior to starting up or purchasing a small business or franchise



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A collaborative research project:
Asia-Pacific Centre for Franchising Excellence, Griffith University
University of New South Wales, Australia

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The views expressed in this report are those of the authors

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Executive summary

This research was supported by CPA Australia through their Global Research Perspectives Program. The project involves collaboration between Griffith University's Asia-Pacific Centre for Franchising Excellence and the University of New South Wales School of Taxation and Business Law. The aim of the research is to explore the ways in which prior due diligence affects small business performance. This paper reports the findings of the first phase of the research.

Interviews were conducted with 60 current and former independent small business owners ('independents') and franchisees across five Australian states and territories in capital cities, regional cities and towns and remote locations. Participants were selected from a range of industries representing diverse business experiences. The interviews explored the diversity of approaches to undertaking due diligence prior to entering the business.

The research revealed significant differences in both the type and amount of due diligence undertaken by independent small business owners and franchisees and highlighted further differences between currently operating participants and those who had exited their businesses. Many participants were unfamiliar with the term 'due diligence' or with how to conduct effective due diligence.

The most common type of due diligence undertaken was to consult an accountant. However, participants tended to use their current accountant or people within their networks rather than seek an accountant with expertise in small business or franchising. Similarly, lawyers were widely used by franchisees but less so by independents. In contrast, independent small business owners conducted more independent market research than franchisees prior to making a decision.

Franchisees tended to undertake more thorough due diligence than their independent counterparts who lack the support and expertise of a franchise system. In addition, the franchising sector is regulated and franchisees are strongly encouraged to undertake due diligence prior to entering a franchise agreement.

Overall, the due diligence undertaken was relatively unsophisticated with few exceptions of rigor and planning. Where prospective independents and franchisees were entering business for the first time their appreciation of business was naïve. A steep learning curve followed during which they often recognised flaws in their initial research. Nevertheless, the level of satisfaction with their business ventures was reasonably high, particularly with those who were continuing to operate the business.

In summary, this preliminary research suggests that prospective small business owners (particularly independent operators) may be in need of greater education and support during the decision making process prior to starting or purchasing a small business.

2.1 MILLION

small businesses
operating in Australia



96%

of all
Australian businesses
are small businesses



Small businesses
employ over



4.5 Million



Australians



60

interviews



Most interviews took

45 minutes

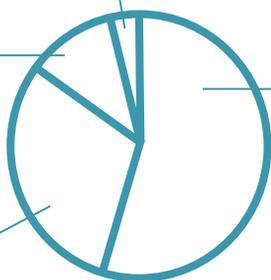
to complete



3% were
operating as
a partnership

12% operated
as a trust

32% were
operating as
a sole trader



53% were
operating as
a company
(PTY LTD)

7.2 years

was the average length of time
the interviewees had been
operating their small business

1.0 Background

This report outlines preliminary findings of a research project that investigates the effectiveness of undertaking due diligence prior to starting or purchasing an independent small business or franchise. Both of these business models are included in this research, which investigates the due diligence conducted *before* a prospective investor commits to a business. Hence, ongoing due diligence is not part of this research. For the purposes of this research we have adopted the Australian Bureau of Statistics (ABS) definition of a small business as a business employing less than 20 people (ABS 2002).

Small businesses make a significant contribution to Australia's economic growth and performance. There are more than 2.1 million small businesses operating in Australia (ABS 2014), including independently owned and franchised businesses. Hence, preparation in the form of adequate due diligence is important for prospective business owners, in order to maximise their chance of success.

The small business literature argues that the opportunity identification process is a critical step in ensuring entrepreneurial success (Stevenson et al. 1985) and involves a process in which the entrepreneur develops a business plan that clearly articulates constraints (such as market potential, risk assessment, financial resources and personal goals) attached to a specific business opportunity. However, this process is influenced by the individual's prior experience and information search ability, access to professional business advice and the type of business model being evaluated (Cassar, 2014; Singh et al. 1999, Weaven et al. 2010). Hence, the process of conducting due diligence and the quality of assessment will vary among individuals and it will impact the owner's expectations as well as their future performance and survivability.

There are major differences and ramifications for prospective small business operators depending on whether they choose to enter an independent business or a franchise. The Australian franchising sector is highly regulated and there are some safeguards built into the process of entering a franchise. However, independent small business owners have no such protection. The Competition and Consumer (Industry Codes – Franchising) Regulation 2014 (known as the Franchising Code of Conduct, here, 'the Code') mandates that incoming franchisees seek professional business advice prior to entry, or that they waive their right to do so. In contrast, independent small business owners exercise their own judgement about whether or not to seek independent legal, business or financial advice prior to purchasing or starting up a small business.

Research undertaken by the Asia-Pacific Centre for Franchising Excellence reveals that many independent small business owners and franchisees choose to conduct only limited amounts of due diligence (Frazer et al. 2013). This behaviour is attributed to their limited information search abilities, need to rapidly enter business, or information disadvantage. Hence, the current project explores the differences between independent small business owners and franchisees and the difficulties they experience which impact the accuracy of their research and evaluation processes.

1.0 Background

Thus, the conduct of sufficient pre-commitment due diligence is predicated on investors receiving correct professional advice on how to follow a systematic approach to identifying the highest commercial and legal risks in the business, then collecting and evaluating information pertaining to that identified business opportunity. However, the full gamut of factors influencing this process is currently unknown, highlighting a need to investigate the effectiveness of due diligence approaches by both independent small business owners and franchisees.

The research will reveal the amount and types of due diligence that prospective investors undertake prior to starting up or purchasing an independent small business or franchise. It compares the practices of independent small business owners and franchisees to determine whether there are differences between the two business models. Further, the research will explore whether the amount and type of due diligence affects the owner's expectations and level of satisfaction with the business as well as its impact on overall business performance. It is anticipated that the research will lead to a better understanding about the impact of due diligence prior to entering a small business or franchise, thus assisting educators, practitioners and advisors to provide accurate, timely and relevant advice to the franchising and small business sector.

The research is being undertaken in two phases. Phase 1, which is the basis of the current report, uses a qualitative approach to explore the topic of due diligence. Some 60 (current and former) independent small business owners and franchisees were interviewed to gather preliminary data and formulate insights into the role of due diligence in the decision to enter their business. The findings of this phase of the research follow in this report.

Phase 2 of the research will be conducted in the latter part of 2015 and will involve an online survey of a large national sample of independent small business owners and franchisees. The measures used in the survey will be developed from the initial qualitative phase in conjunction with well-established perceptual and objective measures of small business performance.

This report is organised as follows. An outline of the methodology and data collection that was employed in the initial phase of the research is provided in section 2. The main themes generated from the research are described in the findings (section 3). Finally, the implications of the findings and the next stage of the research are covered in section 4.



2.0 Methodology & data collection

The research project will be conducted in separate phases. The current report reflects the findings of the *first phase* of the research only. The project will investigate the effectiveness of undertaking due diligence prior to starting up or purchasing a small business or franchise.

The first phase of the project was *qualitative* in nature, providing in-depth data about the type and amount of due diligence that prospective independent small business owners and franchisees undertake prior to entering business. The second phase of the research will be a quantitative analysis of the effect of due diligence on business owners' expectations, satisfaction and performance.

Ethical clearance

In accordance with the *National Statement on Ethical Conduct in Human Research (2007)*, ethical clearance was obtained for the project from both the Griffith University and University of New South Wales Human Research Ethics Committees*.

Samples

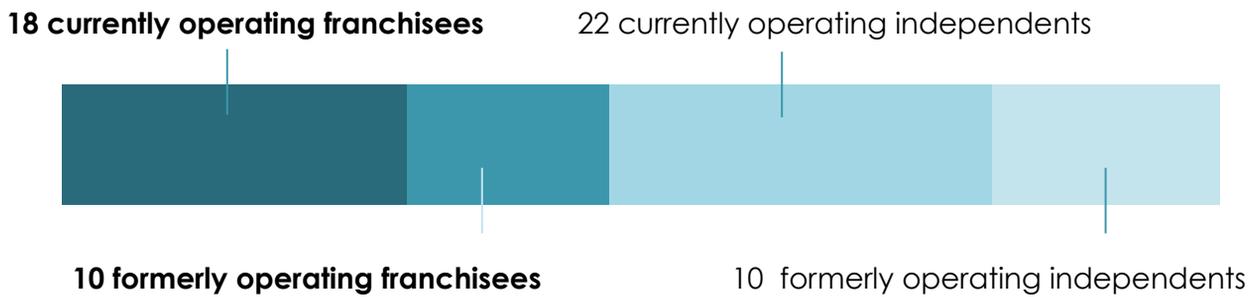
Four samples were selected for the preliminary qualitative research. Since the purpose of this phase of the research is not statistical generalisation, the sample sizes chosen were small to be manageable within the time frame of phase one of the research project. The first sample comprised 22 currently operating independent small business owners. The second sample comprised 18 currently operating franchisees. The third sample comprised 10 former independent small business owners and the final sample comprised 10 former franchisees. Hence, a total of 60 interviews were undertaken as illustrated in Table 2.1. The mix of 40 currently operating business owners and 20 former business owners was chosen to ensure a wide range of experiences and opinions was canvassed from participants.

Table 2.1 Composition of samples

Sample	Independents	Franchisees	Total
Currently operating	22 (37%)	18 (30%)	40 (67%)
Formerly operating	10 (16.5%)	10 (16.5%)	20 (33%)
Total	32 (53.5%)	28 (46.5%)	60 (100%)

* <http://www.nhmrc.gov.au/health-ethics/human-research-ethics-committees-hrecs/human-research-ethics-committees-hrecs/national>

Figure 2.1 Composition of samples



Recruitment

Several different approaches were used to recruit participants for the research. An announcement in an eNewsletter of the Asia-Pacific Centre for Franchising Excellence invited interested people to respond. The professional networks of the research team were also used to locate initial respondents. A snowballing technique was employed whereby interviewees were asked if they knew of other eligible participants. This approach was particularly useful in locating people who formerly owned businesses as this group is difficult to locate. Finally, in many cases the research team 'cold called' business owners to enlist their cooperation. Care was taken to ensure that a mix of industries, locations, sizes and ages of businesses was maintained.

Following initial contact, people who expressed interest in participating in the research were forwarded an information sheet and consent form (Appendix) to allow them to make an informed decision about their participation in the research.

Interviews

The interviews were conducted by telephone or in person, depending on geographical limitations or the preference of the interviewee. The interviews ranged from 15 to 90 minutes, with most taking about 45 minutes to complete. The interviews were recorded (with permission from participants). Recordings were erased following transcription. The interviews were conducted over a period of three months in early 2015.

A standard set of questions was used for each of the four samples, allowing comparisons across the samples where appropriate. The standardisation of questions was necessary to ensure the reliability of the data. In addition to obtaining demographic information, respondents were invited to tell their 'stories' in order to capture authentic accounts of their lived experiences. The interview data was analysed using NVivo - qualitative data analysis software that assists with the analysis of large volumes of unstructured data.

Respondent profile

A profile of respondents is displayed in Table 2.2. Comparative data for the full sample and former and current independents and franchisees is provided and discussed below.

Gender. Of the 60 participants, 62 percent were male and 38 percent were female. The sample roughly reflects the gender breakdown in the franchising and small business populations (franchising typically has a higher proportion of males).

Age. Some 7 percent of the total sample were younger than 30 years; 33 percent were aged between 31 and 45 years; 48 percent were aged from 46 to 60 years; and 12 percent were over 60 years of age. The majority of independent small business owners we interviewed were younger than the franchisees, again reflecting the overall patterns found in the small business and franchising populations*.

Birthplace. The majority of participants (77 percent) were born in Australia. The remaining 23 percent of participants were born overseas. This pattern was consistent across both independent and franchisee business models.

Location. Interviews were conducted with participants from a diversity of locations. Five Australian states/territories were included (Queensland, New South Wales, Victoria, Northern Territory and Western Australia). Some 68 percent of participant businesses were located in capital cities. A further 30 percent were located in regional towns or cities and 2 percent were in a remote locality, thus providing a range of examples for the study.

Industry. We ensured representation of a wide range of industries across the full sample of 60 participants. The fast food/retail food industries accounted for 15 percent of the sample and a further 15 percent were in cafes or restaurants. Some 13 percent of respondents were involved in administration or support and a further 12 percent in retailing (non-food). Ten percent of businesses were engaged in educational activities and 8 percent in businesses offering personal services. Other industries (including arts/recreation, finance/insurance, construction, manufacturing and real estate) were also represented. The proportion of participants varied across the business models.

Experience. The sample included current and former independent small business operators and franchisees with varying degrees of experience. The average time operating their businesses was 7.2 years, ranging from just one month in operation to 22 years.

Business type. We were careful to include examples, across both business models of independent ownership and franchising, of participants who had started a new business ('greenfield' site) as well as those who purchased existing businesses. Slightly over two thirds (68 percent) of participants started a new business themselves and 32 percent purchased an existing business.

* See 'Franchisee gender and age' in Franchising Australia 2010, Asia-Pacific Centre for Franchising Excellence, Griffith University, pages 53-55 and Australian Small Business Key Statistics and Analysis, Commonwealth of Australia 2012.

Respondent profile (cont.)

Legal structure. The majority of respondents (53 percent) chose to operate their businesses under a company (Pty Ltd) structure. Operating as a sole trader was also common (32 percent). Some 12 percent operated as a Trust and only 3 percent were in a partnership arrangement. Ownership patterns across both business models (independent and franchising) were similar.

Previous business background. The sample was relatively inexperienced. More than half the participants (58 percent) had no previous business ownership experience prior to purchase or start-up. Just over a quarter (28 percent) had previously owned a business or franchise and 14 percent had owned more than one entity.

Highest level of education. Participants were relatively well educated. Just over one third (35 percent) were educated to secondary school level but the remaining 65 percent were TAFE or university educated. Patterns of distribution were consistent across both independent business and franchising models.

Business education. Although participants were well educated, many were not specifically business educated. Some 45 percent of the sample had received no business education at all. Only 13 percent of participants had undertaken short courses in business and the remainder had obtained business degrees.

Family history of business ownership. A large proportion (42 percent) of participants did not hail from a family history of business ownership. These people were pioneers, being the first in their immediate families to own their own business. Higher proportions of former independents (70 percent) and former franchisees (50 percent) were found to have no family history of business ownership and therefore had not been exposed to family business role models.

Size of franchisor. Franchisees in the sample belonged to franchise systems with an average of 168 total units (ranging from 1 to 900 units). However, currently operating franchisees belonged to larger franchise systems (average 240 units) compared to former franchisees (average 44 units).

Age of franchisor. The franchise systems to which franchisees belonged had been operating for an average of 23 years. Again, currently operating franchisees were attached to more experienced franchisors (operating for an average of 29 years) compared to former franchisees (whose franchisors had been operating for only 15 years).

Reason for exiting the business. The former independent and former franchisee samples comprised people who had previously operated a business but had since exited. The reasons for exiting were varied and included poor financial performance, personal reasons such as physical stress, 'enthusiasm fatigue' and seeking other business opportunities.

Table 2.2 Respondent profile (n=60)

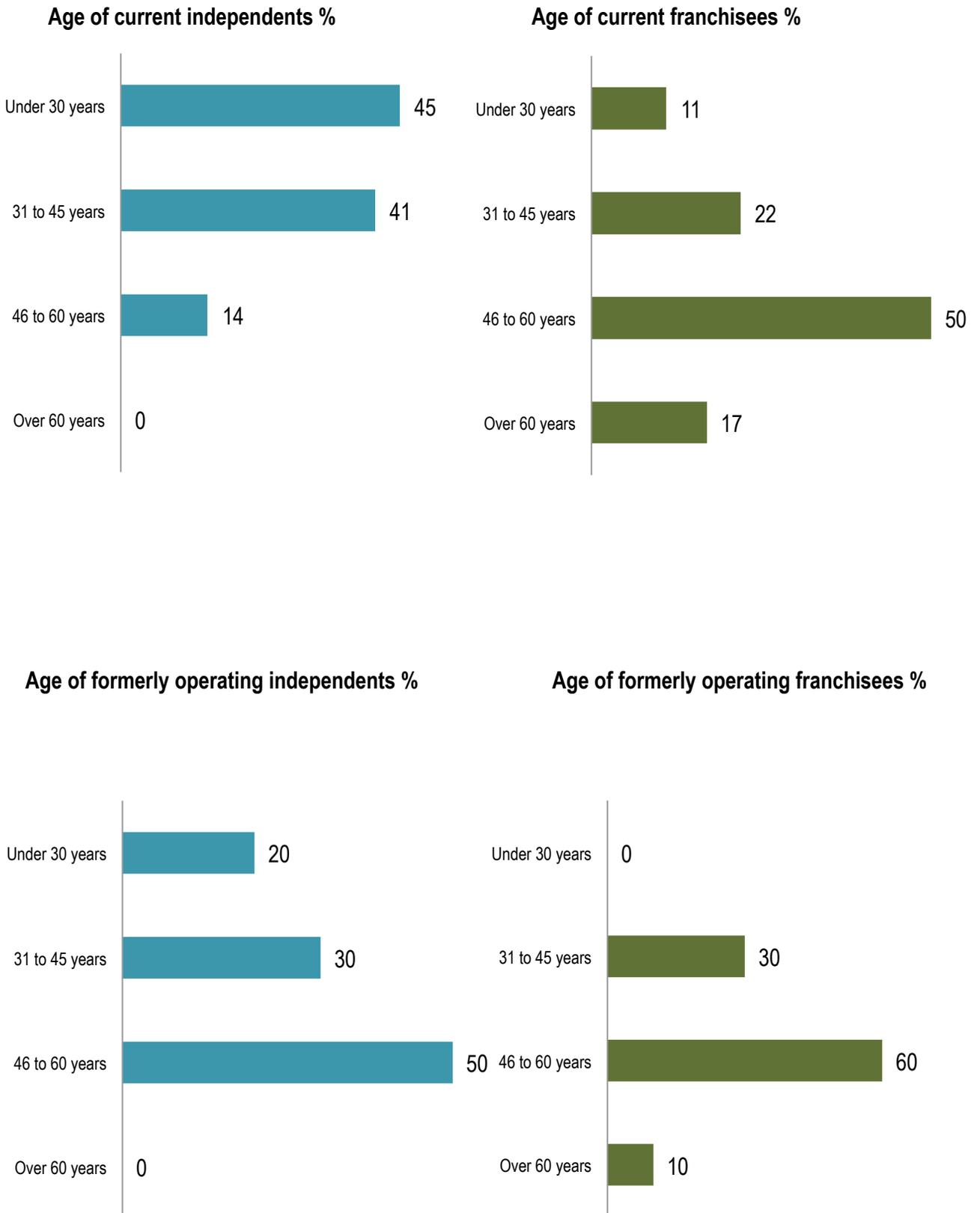
	Total Sample %	Currently Operating		Formerly operating	
		Independent %	Franchisee %	Independent %	Franchisee %
Gender					
Male	62	64	83	50	30
Female	38	36	17	50	70
Age					
Under 30 years	7	45	11	20	0
31 to 45 years	33	41	22	30	30
46 to 60 years	48	14	50	50	60
Over 60 years	12	0	17	0	10
Origin					
Born in Australia	77	73	83	70	80
Born overseas	23	27	17	30	20
Location					
Capital city	68	55	72	90	70
Regional town or city	30	45	22	10	30
Remote locality	2	0	6	0	0
Industry					
Fast food / Retail food	15	4	22	10	30
Cafes / Restaurants	15	14	28	10	0
Administration/ support	13	14	6	10	30
Retail (non-food)	12	18	11	10	0
Education / training	10	0	11	10	30
Personal services	8	14	0	10	10
Media /telecommunications	5	9	0	10	0
Arts / recreation	3	9	0	0	0
Finance / insurance	3	0	11	0	0
Construction	3	5	0	10	0
Manufacturing	3	0	0	20	0
Rental / hire / real estate	2	4	0	0	0
Other industry	7	9	11	0	0
Experience (years operating)	7.2 yrs	6.6 yrs	6.8 yrs	6.6 yrs	9.8 yrs

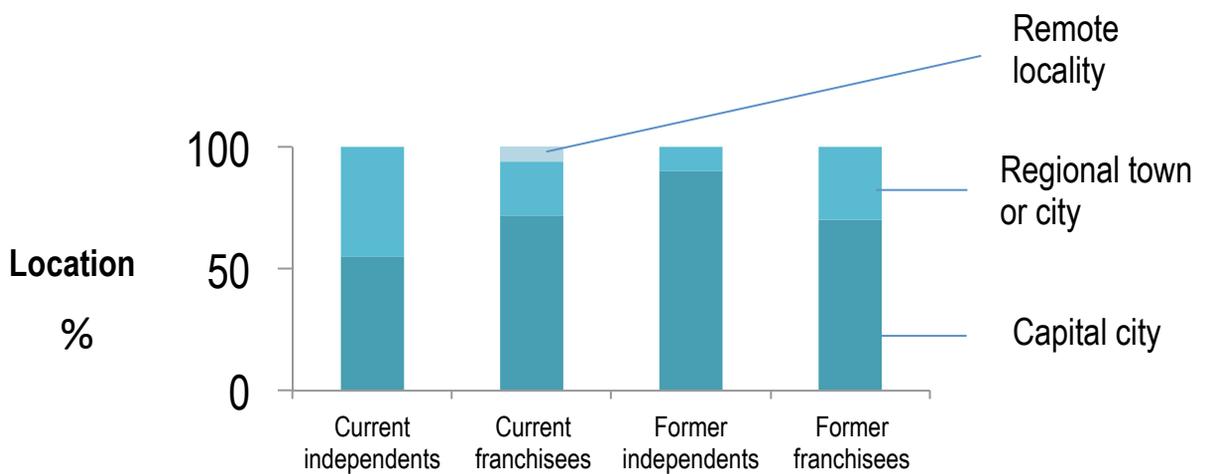
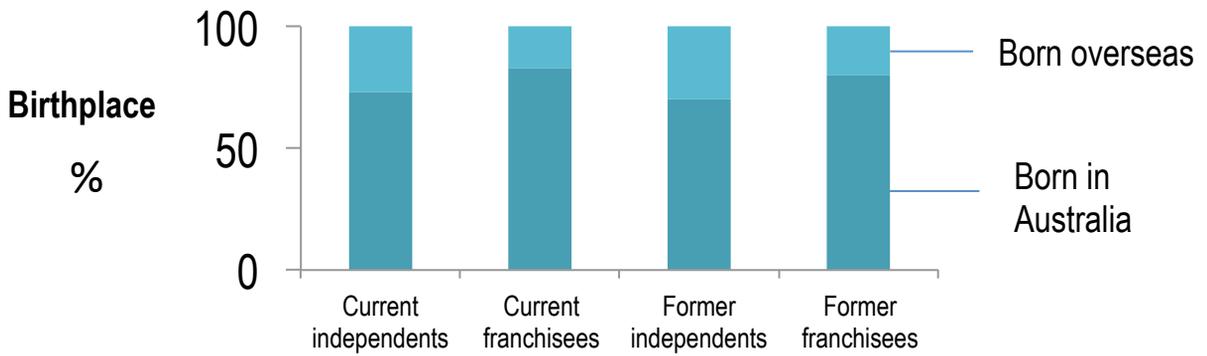
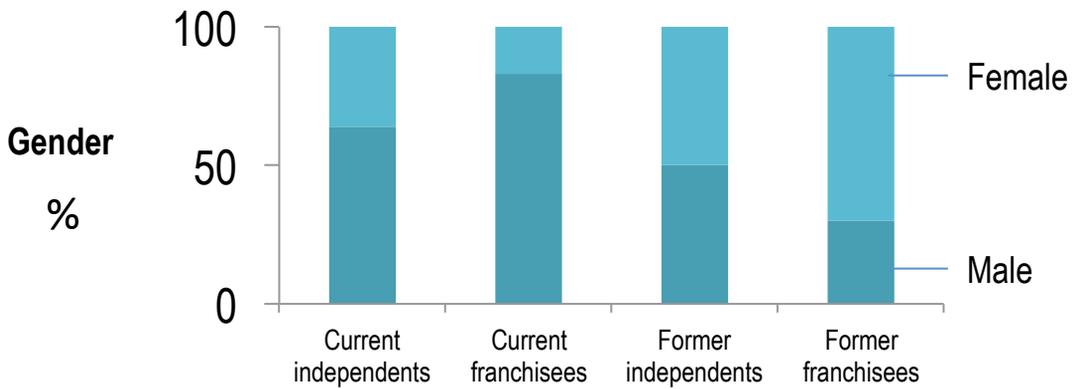
Table 2.2 (cont.)

	Currently Operating			Formerly operating	
	Total Sample %	Independent %	Franchisee %	Independent %	Franchisee %
Business type					
Started new (greenfield)	68	73	50	80	80
Purchased existing business	32	27	50	20	20
Legal structure					
Sole Trader	32	27	33	10	60
Partnership	3	9	0	10	0
Trust	12	9	22	0	0
Company	53	55	45	80	40
Previous business background					
No previous business/franchise	58	41	66	70	70
Previously owned a business/franchise	28	41	17	20	30
More than one prior business/franchise	14	18	17	10	0
Highest level of education					
Secondary school	35	36	39	30	30
TAFE	12	14	11	10	10
Undergraduate degree	28	27	28	40	30
Masters degree	22	23	22	10	20
Higher degree	3	0	0	10	10
Business education					
Short courses in business	13	9	16	30	0
TAFE business course	19	18	17	20	20
Undergraduate degree in business	10	5	11	30	0
Masters degree or higher in business	13	14	17	0	20
No specific business education	45	54	39	20	60
Family history of business ownership					
No family history	42	32	33	70	50
Family history with no direct involvement	42	50	56	20	20
Family history with some involvement	16	18	11	10	30
Size of franchisor (franchise units)					
	168	N/A	240	N/A	44
Age of franchisor (years)					
	23	N/A	29	N/A	15

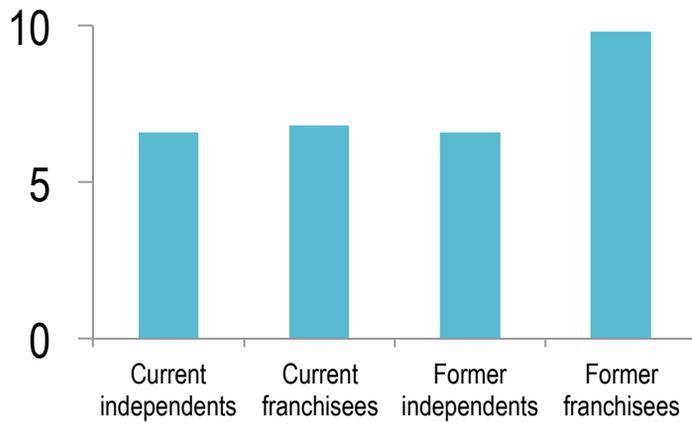
Note: Percentages rounded to whole numbers for ease of comprehension

Figure 2.2 Graphical representations of respondent profile

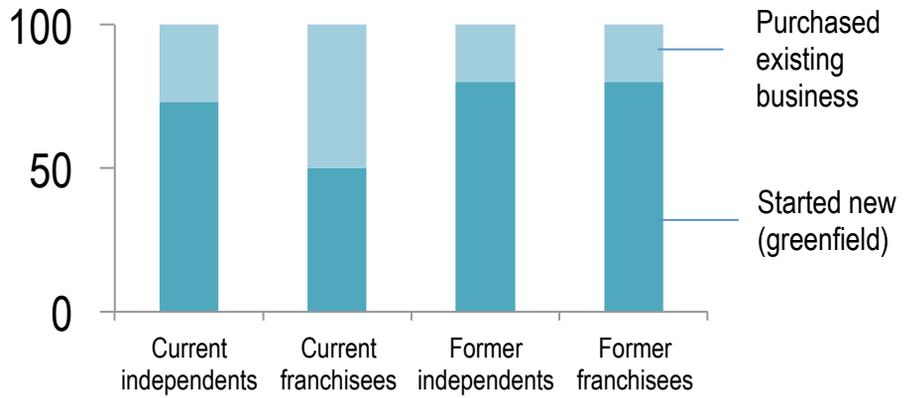




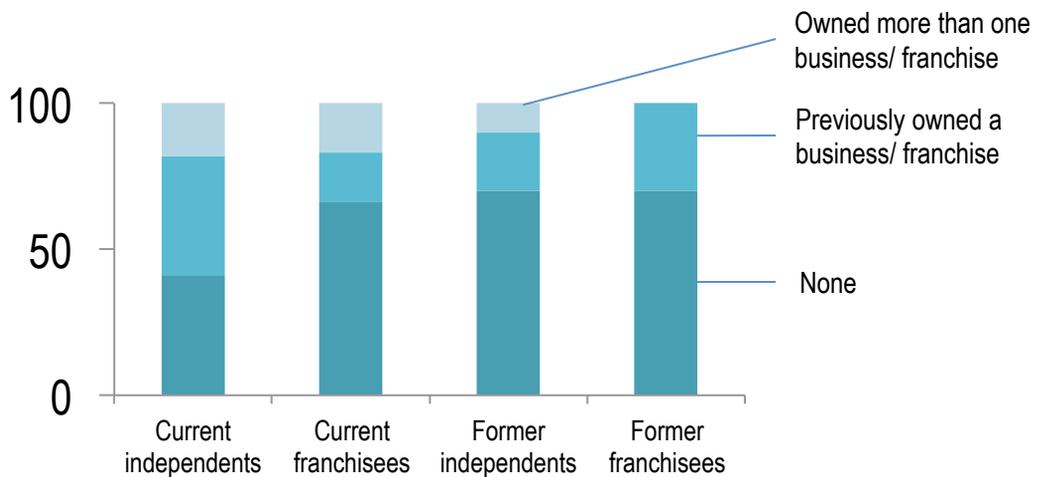
Experience
Number of years operating



Business type
%

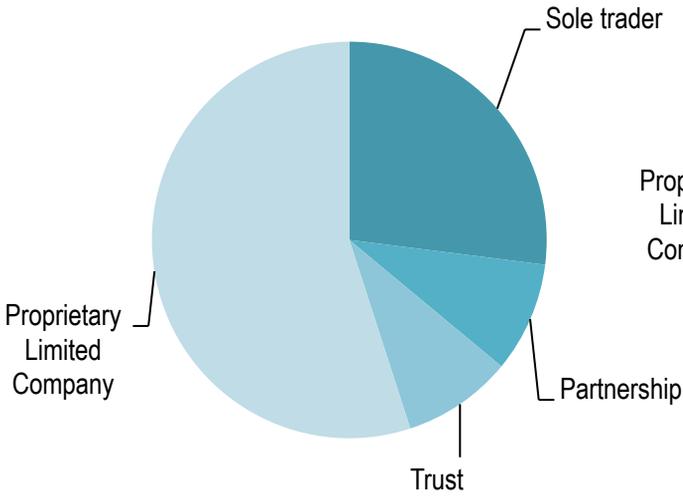


Previous business background
%

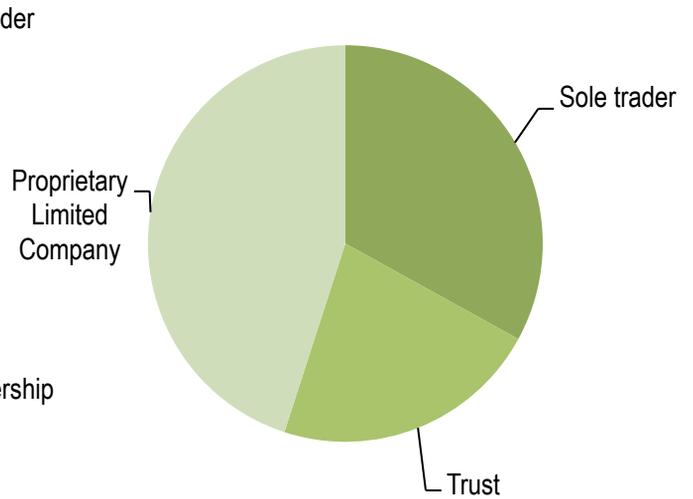


LEGAL STRUCTURE OF THOSE CURRENTLY OPERATING

Independents

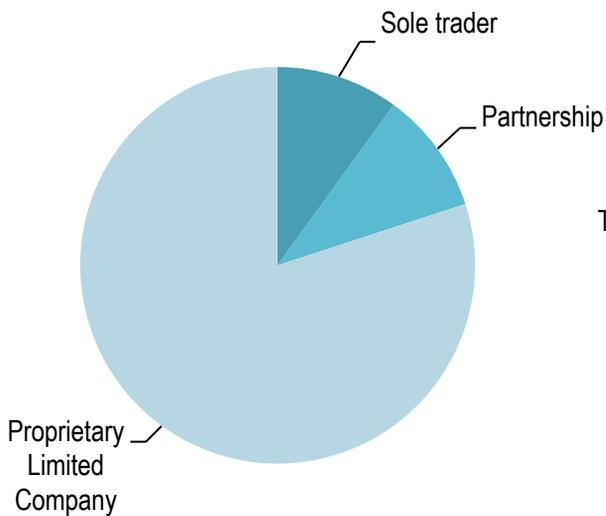


Franchisees

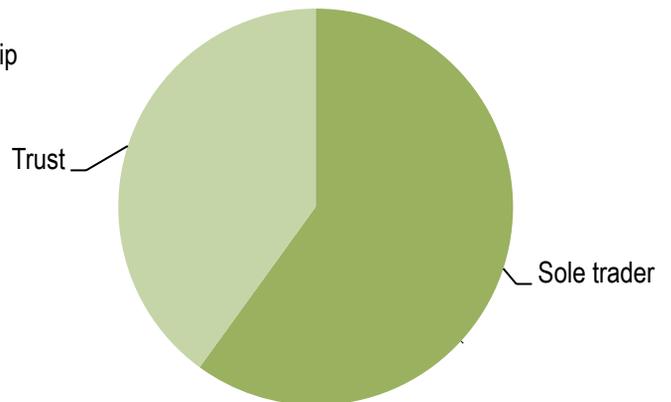


LEGAL STRUCTURE OF THOSE FORMERLY OPERATING

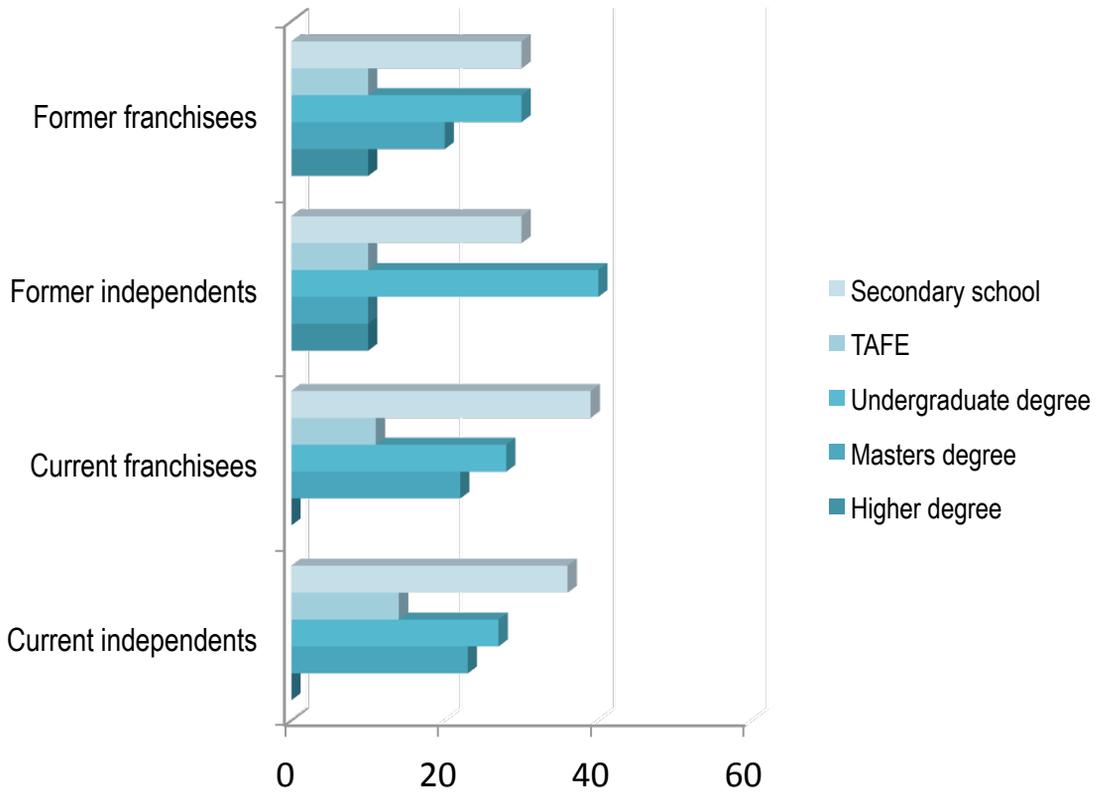
Independents



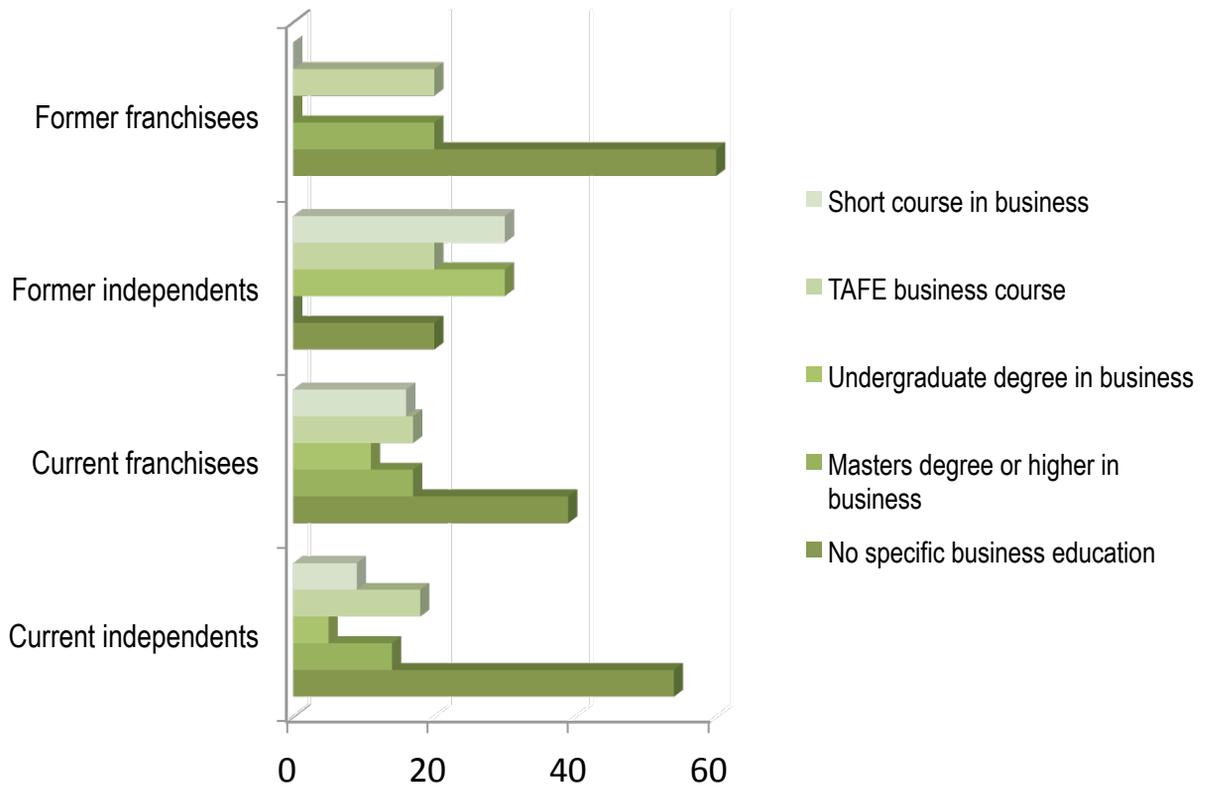
Franchisees

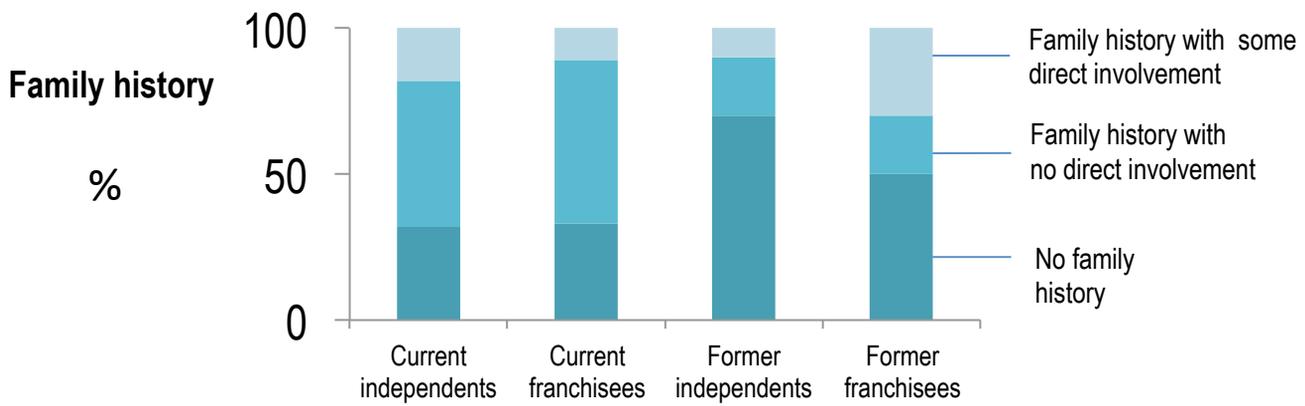


HIGHEST LEVEL OF EDUCATION %

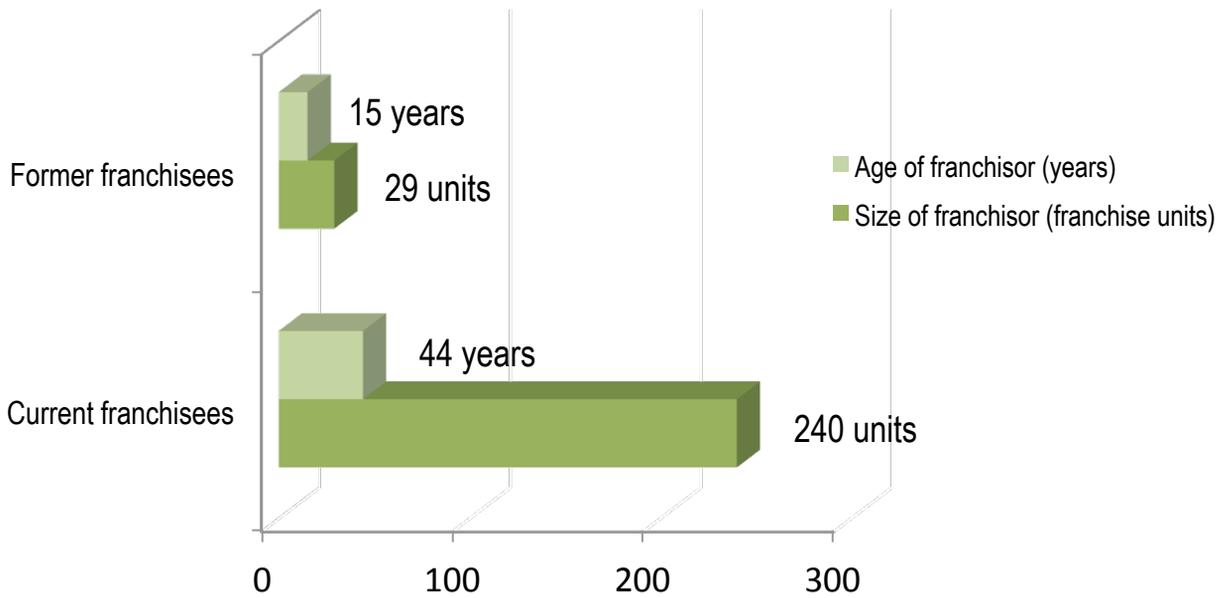


BUSINESS EDUCATION %





CHARACTERISTICS OF THE FRANCHISOR



*This data is relevant to the franchisee respondents only



3.0 Findings

The main themes arising from the interviews with research participants are summarised in this section. Quotations from the respondents have been included to illustrate their opinions and experiences.

3.1 Understanding of 'Due Diligence'

As the research concerned the practice of undertaking due diligence prior to entering a franchise or independent small business, we began by asking participants if they were familiar with the term and/or what they understood by the term 'due diligence'. Whilst the majority of interviewees were familiar with the term, some were not. It seemed that those who had a reasonable degree of business experience or who had undertaken some form of business education were more likely to be familiar with the term. Outside business circles the term 'due diligence' has less relevance.

Many of the current and former independent small business owners were familiar with the term 'due diligence'. Some of their explanations are as follows:

'Do a bit of research and have a look at the market potential and what you're getting involved in.' (Current independent, retail)

'...it's the research required to work out your percentage of risk ... you are a calculated gambler and you're trying to weigh the odds in your favour to win most often'
(Current independent, business services)

'Due diligence to me is understanding the previous history of the business, going through all of the accounting and the books ...and making sure that all the sales figures and all of that sort of thing add up.' (Current independent, retail)

'...researching into any risks, obligations, or necessary actions to take out to operate the business' (Current independent, administration)

'...taking a dispassionate interest about the business' (Former independent, manufacturing)

'...really doing your homework before you open the doors' (Former independent, education)

“Due diligence is about taking a dispassionate interest about the business.”
- Former independent, manufacturing

“It’s the work you do prior to signing on the dotted line. It’s the research that goes into making sure that you are not buying a lemon or setting up in the wrong area, employing the wrong builders, or buying the wrong equipment.”

- Current franchisee, auto repairs

A greater number of independent small business owners (than franchisees) were unfamiliar with the meaning of ‘due diligence’. Several admitted to not understanding the term or having heard of it but not knowing what it meant. These included people who were highly skilled or educated in their field but not necessarily educated in business. Some common responses were:

‘I don’t have any understanding of it.’ (Former independent, retail)

‘To be honest, I don’t know (what the term means)’ (Current independent, personal services)

‘No idea, whatsoever’ (Current independent, construction)

Moreover, some participants misunderstood the concept of due diligence. For example:

‘An ethical responsibility as a business owner and a personal community member’
(Current independent, café)

‘I suppose to me it means care for yourself in case others ... in a sense that I am not going to fudge some supplier by intentionally knowing that I am not going to pay him but I will still get him to do that job’ (Current independent, administration)

Most of the current and former franchisees were familiar with the need to undertake due diligence. These were some examples of their responses:

‘...making sure you research the feasibility of the endeavour. Is it worth doing? Is it likely to be successful?’ (Current franchisee, finance)

‘...it’s the work you do prior to signing on the dotted line. It’s the research that goes into making sure that you are not buying a lemon or setting up in the wrong area, employing the wrong builders, or buying the wrong equipment.’
(Current franchisee, auto repairs)

‘...making sure that what you think you are buying is what you are buying’
(Current franchisee, fast food)

‘...doing research before you make a decision’ (Former franchisee, business services)

Only one (former) franchisee mentioned the need to undertake due diligence on the franchisor:

‘...you need to do due diligence on the franchisor to see whether it is a reputable franchisor and the system that you are buying into is good and suits your needs’
(Former franchisee, fast food)

The fact that no other franchisees mentioned the franchisor suggests that prospective franchisees may tend to inherently trust the franchisor, thus neglecting to investigate the business and personal background of the franchisor*.

Another franchisee focused on the franchise agreement, proposing that due diligence included investigating:

‘...what the franchise agreement entails before you make the plunge’
(Current franchisee, finance)

These particular franchisees had operated multiple franchise concepts and had undertaken due diligence on a number of occasions so they were more experienced than many other participants. In general, it appeared that franchisees understood the process of due diligence but their commitment was fairly cursory, perhaps relying on the fact that it was a franchise to substitute for their own research.

In brief, although the majority of participants possessed a general understanding and appreciation of the meaning of due diligence, some (particularly those who had not specifically completed business education) were unfamiliar with the concept.

“You need to do due diligence on the franchisor to see whether it is a reputable franchisor and the system that you are buying into is good and suits your needs.”
- Former franchisee, fast food

* Further evidence of this assumption was discovered later in the interviews when it was found that only 5 percent of franchisees had conducted a credit check on the franchisor prior to joining the franchise.

3.2 Type of Due Diligence undertaken

Participants were asked to explain the *type* of due diligence or research they undertook prior to entering the franchise or independent business. As some needed to recall their activities which had occurred years previously we provided some prompts to ensure as full a coverage as possible of the range of behaviours undertaken.

Table 3.1 illustrates the range of activities undertaken across the whole sample and Table 3.2 (on the following page) classifies the types of due diligence further according to franchising or independent business ownership.

Table 3.1 Due diligence undertaken (full sample)

Due Diligence activity	Number of participants	Percent
Sought professional advice:		
Consulted an accountant	33	55
Consulted a lawyer	27	45
Consulted personal networks		
Consulted a friend	18	30
Consulted family members	12	20
Conducted own research		
Conducted desktop research	31	52
Conducted market research	17	28
Spoke to other franchisees*	16	27
Observed the business	9	15
Visited other franchisees*	6	10
Spoke to customers	4	7
Other type of due diligence	17	28
Did not conduct any form of due diligence	2	3

* Relevant to franchisees only

Figure 3.1 Due diligence undertaken (full sample) %

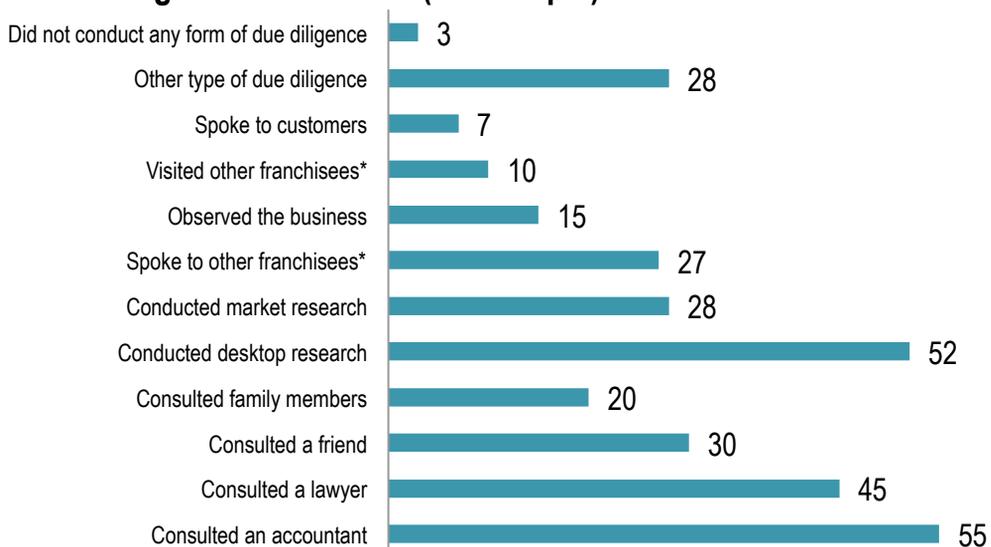


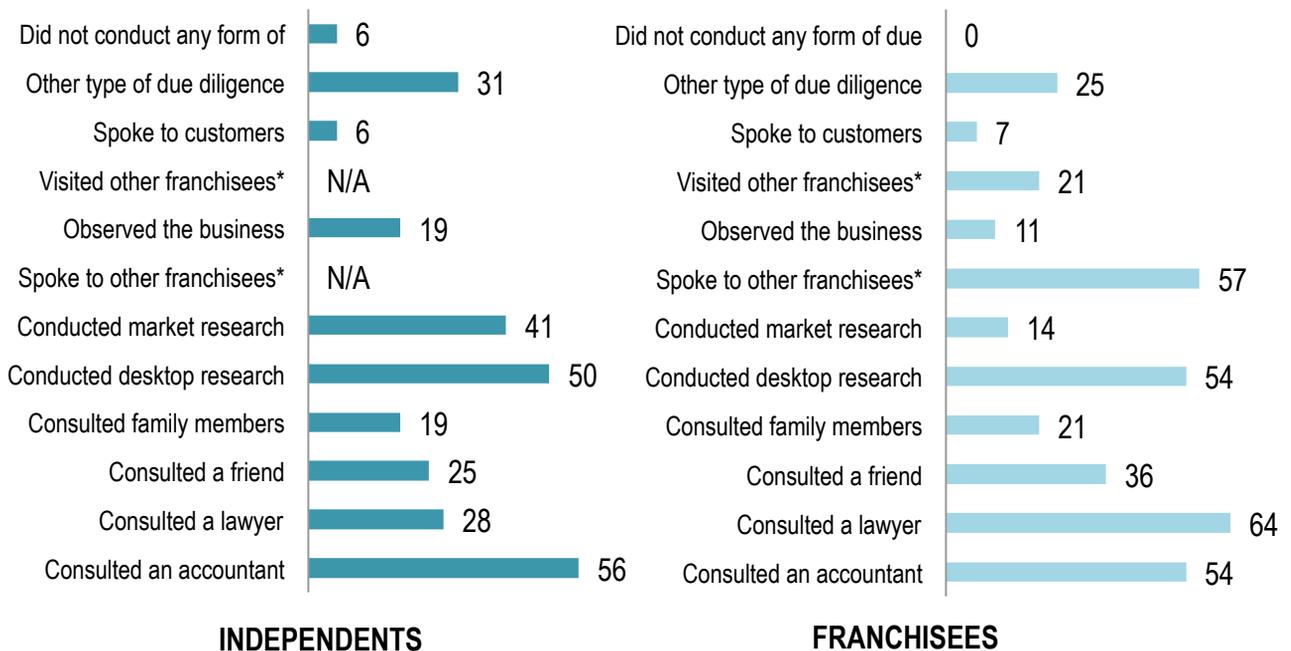
Table 3.2 Due Diligence undertaken (comparison of business models)

Due Diligence activity	Independents		Franchisees	
	Number	Percent	Number	Percent
Sought professional advice:				
Consulted an accountant	18	56	15	54
Consulted a lawyer #	9	28	18	64
Consulted personal networks				
Consulted a friend	8	25	10	36
Consulted family members	6	19	6	21
Conducted own research				
Conducted desktop research	16	50	15	54
Conducted market research #	13	41	4	14
Spoke to other franchisees*	N/A	N/A	16	57
Observed the business	6	19	3	11
Visited other franchisees*	N/A	N/A	6	21
Spoke to customers	2	6	2	7
Other type of due diligence	10	31	7	25
Did not conduct any form of due diligence	2	6	0	0

Significant difference between independents and franchisees

* Relevant to franchisees only

Figure 3.2 Due Diligence undertaken (comparison of business models) %



The most common type of due diligence undertaken by participants was to use the services of an **accountant**. Some 56 percent of independents and 54 percent of franchisees sought this type of assistance when undertaking their due diligence. However, participants tended to use their current accountant rather than seek one with either small business or franchising experience. The following quotes illustrate the reliance that participants placed on existing relationships with accountants.

'When I got my tax done, I asked the accountant what I had to do. He advised me to open a separate bank account, keep a record of how many clients I had, and keep a basic record of what was coming in and out of the bank account.' (Current independent, recreation)

'I used an accountant who has looked after my financial matters for the business for the last ten years.' (Current independent, administration)

'I took all the figures to my accountant and they went through everything.'
(Current independent, food retail)

'I did use an accountant who happened to be in the office next door.' (Current independent, administration)

'I used the family bookkeeper to do my books and I should have used someone who really understood the retail trade.' (Former independent, non-food retail)

'I have a very good accountant ... He said don't think you're going to go in there and make a million dollars ... (He said) you can put it down that you're buying a job. That's what it is.'
(Current franchisee, café)

'I took it to an accountant who shrugged his shoulders and said it looks alright.'
(Current franchisee, fast food)

'If I remember there was an actual form that (the franchisor) stipulated that you sign off either you had sought advice or you had been advised you should get advice and had chosen not to. I said I had spoken to my accountant and that was the extent of it.'
(Current franchisee, fast food)

'I spoke to my accountant, who is also my friend.' (Former franchisee, administration)

"I took all the figures to my accountant and they went through everything."
-Current independent, food retail

Independent small business owners (28 percent) were less likely to use **lawyers** than franchisees (44 percent). Given that franchisees enter a legal franchise agreement with their franchisor, the use of lawyers is not surprising. However, one third of franchisees did not use a lawyer to check their franchise agreement, once again signalling the level of trust that prospective franchisees seem to place in their franchisor. When asked why she did not show the contract of sale to a lawyer a former independent manufacturer replied: *'it was a mixture of cost and that I did not know any better We were really naïve. I won't do that again'*.

In contrast, a currently operating fast food franchisee explained:

'I went to a solicitor. Never used a solicitor before. They charged me \$470 to read it for 3 hours. They told me that I should think about this clause and that clause.'

Similarly, a currently operating retail franchisee admitted:

'My mum told me I needed to get a lawyer who specialised in franchising. I couldn't afford it because they cost too much so mum paid it for me. Thank goodness she did because there were some important clauses that the lawyer managed to get changed in my favour.'

Often, people realised after the event that they should have sought specialised legal advice. A former franchisee providing business services related:

'We used a solicitor who was recommended to us but he didn't have any experience with franchising so, of course, he didn't point out any flaws in the agreement or attempt to negotiate any changes ... We walked from the franchise after five years and got another lawyer then to advise us on how to continue operating independently without breaching the agreement.'

The ability for franchisees to negotiate favourable terms in their franchise agreements may not be apparent to many first-time franchisees. An experienced fast-food franchisee advised:

'There were a number of things that my solicitor recommended that were showstoppers and they decided to fix the showstoppers. I was prepared to negotiate some things and others they said no way. We met in the middle in a lot of areas. A lot of prospective franchisees do not realise how much power they actually have as franchisors want good operators.'

An independent fast-food operator provided sage advice in relation to legal matters:

'Make sure you understand everything that is in the contract ... everything. Don't rely on your solicitor's advice ... Don't just say oh yeah, yeah, yeah because you think it's mumbo jumbo. Make sure you understand it.'

Further differences are apparent when we consider the use of both an accountant *and* a lawyer. Whereas 22 percent of independent small business owners accessed both types of advice, some 43 percent of franchisees did so, indicating the greater reliance on professional support by franchisees than independent operators.

“The first thing I did prior to starting this business was to Google results for a period of 12 months.”

- Current independent, business services

One further area of difference between the two models was in relation to conducting *market research* about the business opportunity. Whereas 41 percent of independents undertook this activity, only 14 percent of franchisees did so. This difference in behaviour reflects the benefit of entering a franchise system whereby the brand is already established. Independents, on the other hand, need to analyse the market opportunity more thoroughly and without assistance.

For instance a currently operating café owner explained the market research he undertook prior to opening a new café in a shopping centre:

‘We looked at our statistics drawn on the business growth from our existing store. We knew what our customers wanted. We also looked at foot traffic, business growth, traffic within the centre and the proximity of entrance and exit ramps relative to the new motorway link.’

Extensive market research spanning more than two years was used by a current independent operating in business services:

‘The first thing I did prior to starting this business was to Google results for a period of 12 months. I kept Googling for the same search query. There were two major players who were seen as two giants. During the course of twelve months, people would come and go. I thought that was interesting. I measured for about twelve months. I found out that they were using a lot of schemes and a lot of tricks and to get them to the top. But, I never thought I could overtake their status at that time. When I eventually did, it was a big surprise. That took about two years to achieve.’

The market research undertaken by franchisees appeared to be more cursory. For instance, a currently operating fast food franchisee explained:

‘We looked at council records. We looked at census records to try and understand the demographics of the area. And we literally stood on different points of the centre and counted foot traffic.’

A former fast food franchisee lamented his over reliance on the franchisor when undertaking his due diligence:

‘I remember standing outside the site where the shop was going to be. The franchisor was saying look at all the foot-traffic. In hindsight, there were a lot of people walking past but not walking into the store because it was outside the shopping centre. They were just walking past to go to the shopping centre. Obviously the demographics of the clients in that area couldn’t afford our product. We were new to Australia, we didn’t know about this. It was not until after that we found out that the suburb was not a rich place.’

Desktop research was the second most common type of due diligence undertaken across the full sample (52 percent) with a similar pattern across both business models. This technique involved prospective investors mostly using the internet to access information about business and demographic trends which might assist them to make a decision.

For example, a franchisee operating in the finance sector explained:

'I worked out the potential of the area through research with council. I got statistics on potential growth patterns in land subdivision, shopping centres etc. My research looked ahead 10 years ... (I researched whether) I would get the return for the effort that I was going to put in I did a lot of work and believed in what I was reading and the statistics that were coming out signalled that the area had a lot of potential.'

Friends (consulted by 30 percent of participants) rated higher than **family** members (approached by 20 percent) across both business models when seeking advice. Franchisees relied more heavily on both these sources of information than did their independent counterparts.

An independent business owner operating in the media industry was not discouraged by the attitude of his friends:

'I remember talking to my friends about it and most of them said I was stupid! They said it would be pretty tough and it won't work. At that point, I stopped talking to people about it, as they were not supportive.' (This participant rated his level of overall satisfaction with his business as '11 out of 10'.)

Some 57 percent of franchisees spoke to existing or **former franchisees** in the system prior to making a decision. Considering that prospective franchisees are provided a list of existing franchisees (and those that have left in the last three years) in The Disclosure Document, it is interesting that many did not bother to contact at least some franchisees. Similarly, less than a quarter of franchisees (21 percent) visited other franchisees on site to query them about their experiences in the franchise. Only a handful of participants spoke to customers.

The stories related by franchisees revealed mixed experiences. Some spoke to other franchisees on the advice of the franchisor or with respect to good practice:

'I think we made a couple of phone calls to a few franchise owners. We didn't go in their stores. We were provided with a contact list of other franchise owners by the franchisor, so we had a chat to a few people.' (Current franchisee, food retail), and

'I spoke to around six to eight current franchisees and ex franchisees. I learned that from the (Griffith University) pre-entry program.' (Current franchisee, business services)

Others chose to give little weight to the opinions of other franchisees:

'I visited a couple of franchisees, but they were set in their ways and very negative.'
(Current franchisee, automotive repairs)

Several former franchisees whose businesses had not been successful regretted that they neglected to contact other franchisees prior to their decision to join the franchise:

'To be fair to the franchisor they did encourage would-be franchisees to speak to other franchisees. If I had done that I would have heard how hugely unhappy they were with the franchise and how the financial model did not work. I probably would not have gone ahead. Simple as that!' (Former franchisee, fast food)

Only a handful of participants indicated that they obtained a **credit check** on the franchisor (in the case of franchisees) or the vendor (in the case of independents buying an existing business). Most respondents admitted that conducting a credit check did not enter their minds. Some franchisees were thorough, such as:

'I didn't (obtain a credit check) but my advisor did. He was thorough. I actually felt sorry for head office. It had to be done though. They did one on me!' (Current franchisee, automotive repairs)

However, the majority (95 percent) of franchisees did not appreciate the need for a credit check at the time, blaming their ignorance on naivety:

'...I didn't see the point ... They would have a responsibility to do the right thing because the banks were dealing with them. That may have been naïve, but that was just my take.'
(Current franchisee, finance)

'No, I didn't (conduct a credit check). I was naïve and I got excited with the music and the product. Pure emotion.' (Former franchisee, fast food)

'I would now, definitely. I would check it out now, but in those days they had a good name .. it was like one big family.' (Former franchisee, administration)

**“I visited a couple of franchisees,
but they were set in their ways
and very negative.”**

- Current franchisee, automotive repairs

Overall, franchisees used a *wider range* of approaches to conduct due diligence than their independent counterparts. The average number of due diligence activities undertaken by franchisees was 3.4, compared with 2.5 for independents. Only two participants (both currently operating independents) did not conduct any due diligence at all. One participant was in the construction industry. He had not formed a strong intention to start a business. However, he was asked by a neighbour to do some work from which his client base began to form:

Interviewer: *'Oh, so really you were in business before you knew about it?'*

Participant: *'Yeah, and then I just made up a few business cards and it just grew from there.'*

The other case involved a woman working in an artistic field who simply began the business without any investigation. She explained:

'I didn't do anything I think it's a typical problem in small business. You have what you think is a great idea and you just start.'

We also asked participants whether, if they had *their time over again*, would they have conducted their due diligence any differently. More independent business owners (60 percent) indicated that, in hindsight, their due diligence was deficient, whereas only 32 percent of franchisees felt so. Broken down further, some 33 percent of currently operating franchisees and 30 percent of former franchisees experienced regret about their due diligence, compared with 46 percent of currently operating independents and 90 percent of former independents.

The areas that people believe they should have researched more thoroughly were diverse and included such things as financing, price paid for the business, cash flow modelling, checking inventories and checking leases.

A former independent manufacturer lamented that she did not follow her 'gut instinct':

'There was a bit of ego at play. Due diligence and outside advice would have made a saving grace. I should have done what I knew was right.'

An independent operator in the personal services industry felt she was too trusting of the seller:

'I would clarify a lot more about the information that the previous owners gave me regarding the lease and the business ... Some of the information provided was not correct ... I trusted them.'

Many participants commented that starting their first business was part of a 'learning curve' and that the only way to learn was to go through the experience. For instance:

'It's definitely a big learning curve with your first business. Everything you thought would happen doesn't. So definitely the second time I'll know more questions ... and have a better understanding. That's just experience. You learn starting a business from scratch, so much more than you do learning it through books. There's nothing like experience.'
(Former independent, technology)

In summary, whilst some participants undertook reasonably thorough due diligence prior to making a decision to start or purchase a business, most were not comprehensive in their coverage, tending to be a little ad hoc with the process. To explore this phenomenon further we asked people about the depth and cost of undertaking their due diligence as reported in the following section.

“It’s definitely a big learning curve with your first business. Everything you thought would happen doesn’t.”

- Former independent, technology

3.3 Cost and time devoted to Due Diligence

The type of due diligence undertaken by prospective business investors provides insight into the extent and breadth of activities selected. However, to better understand the *quality* of due diligence undertaken it is interesting to observe the amount of time spent on the process. We asked participants to recall the time span over which the due diligence process occurred (rather than to estimate the amount of time on task which would be difficult to recall). As noted in table 3.3, the average time spent on due diligence was 16.1 weeks across all participants. However, the data reveals that currently operating franchisees and independents were more thorough in their research taking 21.7 weeks and 16.7 weeks respectively. Vast differences in the amount of time taken by former operators were apparent with former franchisees spending just 5.4 weeks and former independents taking 14 weeks on due diligence. Indeed six people (five of whom were independents) indicated their due diligence took no time at all.

A former franchisee involved in business services recalled minimal time spent on due diligence:

‘We basically had a meeting with them (the franchisor) for about two hours. Then they sent us all the paperwork which we went over and then we gave it to our solicitor to have a look through ... it would have only been a matter of days.’

In contrast, a more thorough approach was used by a current fast-food franchisee:

‘(The due diligence) took probably 12 months from enquiry, looking at figures and going through the different stages, looking at documents, going to see the solicitor and accountant, reviewing business plans and so forth.’

A franchisee within a large café chain noted that the franchisor also conducted due diligence on the franchisee:

‘...there was a lot of due diligence done by the franchisor. We had psychological profiling. We had forensic reviews of our financial situation and background. So it was a two way street.’

Similar differences were found in relation to the *cost* of due diligence (that is, the amount of out-of-pocket expenses that prospective investors paid in order to complete their due diligence). The average cost of due diligence across the sample was \$3214. Currently operating independent operators spent an average of \$2808 on due diligence compared with \$5003 by franchisees. In contrast, former independent operators spent an average of \$2422 compared with \$1520 incurred by former franchisees. Six franchisees and ten independents reported that they spent nothing at all on due diligence, highlighting the fact that prospective business owners are often reluctant to invest in due diligence as part of their total investment. For instance a currently operating retail franchisee noted:

‘It cost me \$240,000 to buy the franchise ... most of this was for stock. There was no way that I could afford to spend money on a lawyer or accountant. I was totally stretched.’

An independent retail operator admitted that his attention to due diligence was superficial:

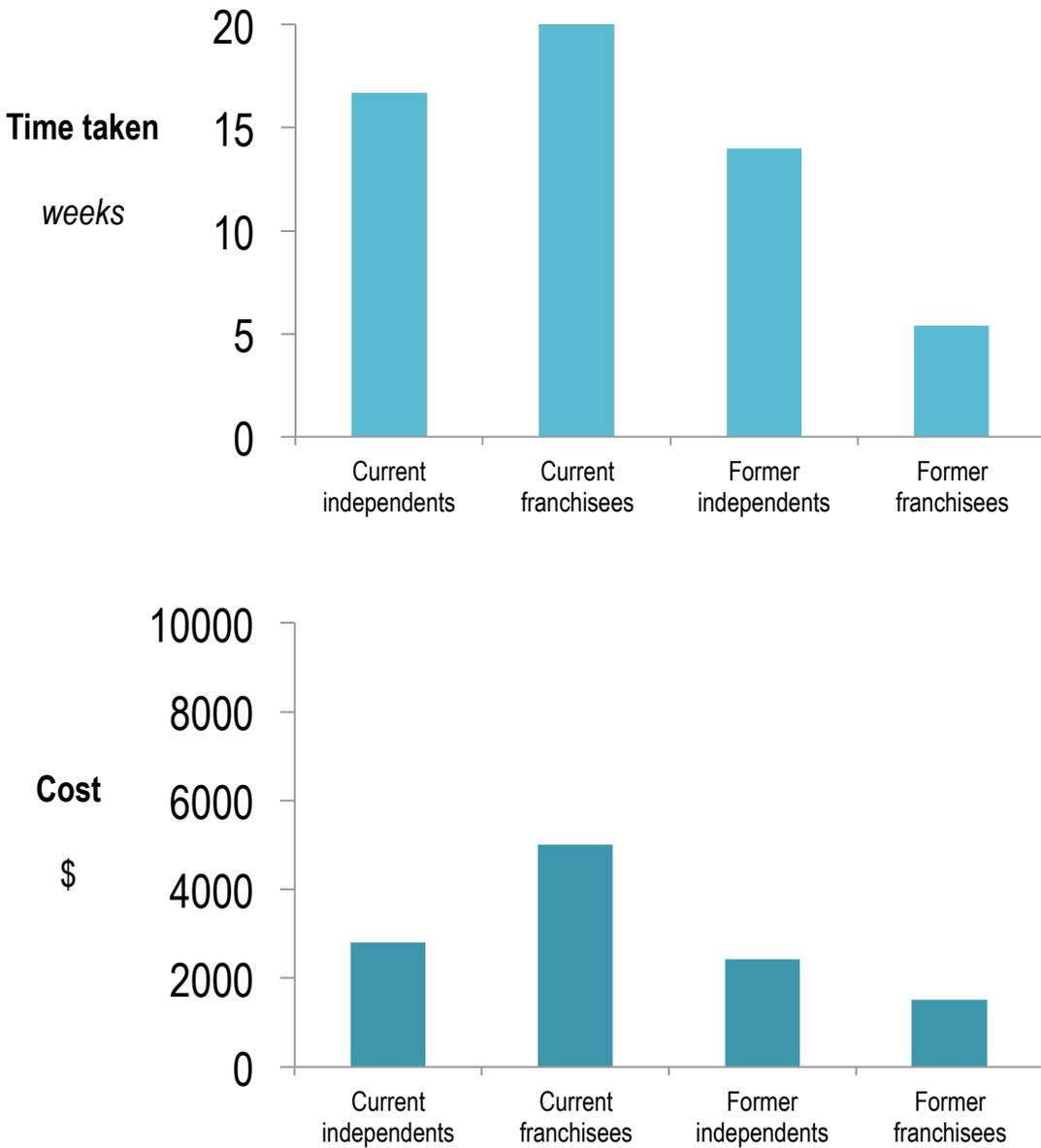
‘I opened up a bottle of wine I think the wine cost \$12.99’.

Table 3.3 Time and cost of due diligence (n=60)

	Total Sample	Currently operating		Formerly operating	
		Independent	Franchisee	Independent	Franchisee
Time taken on due diligence (in weeks)	16.1	16.7	21.7	14.0	5.4
Cost of due diligence	\$3,214	\$2,808	\$5,003	\$2,422	\$1,520

- 1) The range of time taken on due diligence was 0 to 76 weeks
- 2) The range of the cost of due diligence was 0 to \$20 000

Figure 3.3 Time and cost of due diligence



3.4 Choice of business and motivation for entry

Half the sample (50 percent) *considered* only one business at the time of starting up or purchasing the business being investigated in this research. Their efforts were focused on a particular business and they did not consider alternative options. Of the remainder who considered more than one option, the choices were generally limited to two or three similar types of businesses with which participants could identify. One exception was a franchisee who looked at a variety of business options (including a nightclub, property development, several food and beverage franchises, a restaurant, a food truck and a catering business). She explained her motive behind her final choice of a fast food franchise:

‘I knew I was not in target market for the product in any shape or form. I’m not going to eat it, so it doesn’t matter. It’s about money. I have no emotional attachment to the brand. It’s just a business decision. It’s the challenge that I need.’

We asked independent operators whether they had ever considered entering a *franchise*. Almost one quarter (22 percent) indicated they did but the majority quickly abandoned the idea because they perceived franchises to be more expensive to start up or purchase. However, some independents indicated they had thought about franchising their own business (that is, becoming a franchisor). For instance:

‘I probably considered being a franchisor but not a franchisee. I never liked the idea that people would put me in a box and tell me how to run my business. I do like the flexibility of being a business owner. It’s too dependent on other people’s decisions.’

(Current independent, personal services)

Table 3.4 lists the main *reasons* nominated by participants for becoming *self employed*. The desire to achieve autonomy and independence was the main driver for the majority of participants with just over two-thirds (67 percent) nominating this reason. Similar patterns were noted across both business models (franchisees and independents). Financial benefits were less compelling (35 percent) but rated second in importance; however franchisees were motivated more by financial prospects than independents. Other reasons nominated were the desire to obtain work-life balance (18 percent), flexible working hours and arrangements (15 percent) and as a means of seeking employment following retrenchment or unemployment (10 percent).

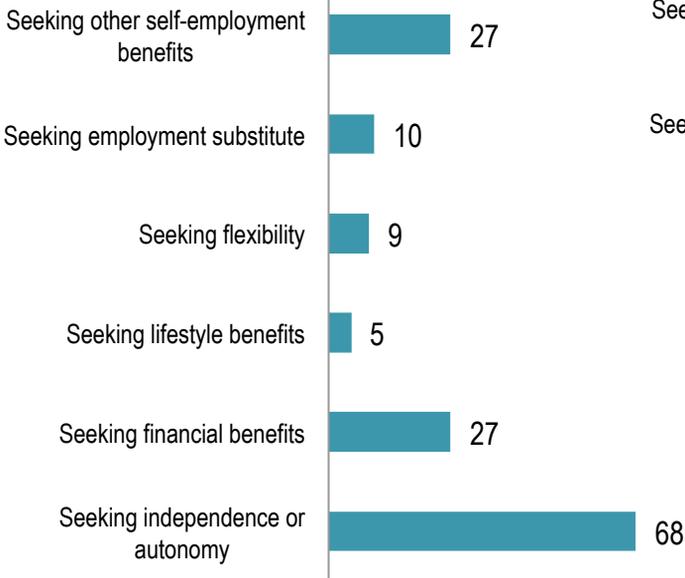
Table 3.4 Reasons for choosing self employment (n=60)

	Total Sample %	Currently operating		Formerly operating	
		Independent %	Franchisee %	Independent %	Franchisee %
Seeking independence or autonomy	67	68	72	70	50
Seeking financial benefits	35	27	56	20	30
Seeking lifestyle benefits	18	5	33	20	20
Seeking flexibility	15	9	6	20	40
Seeking employment substitute	10	10	11	0	20
Seeking other self-employment benefits	20	27	22	20	60

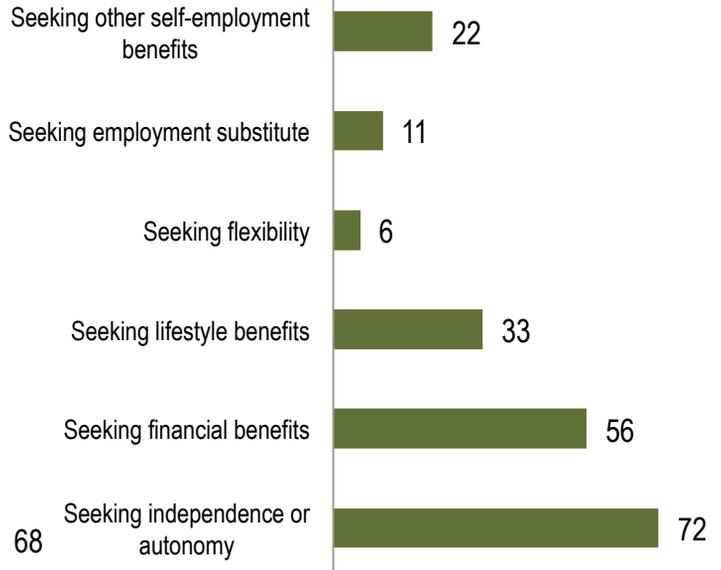
Figure 3.4 Comparison of business models: reasons for choosing self employment

CURRENTLY OPERATING %

Independents

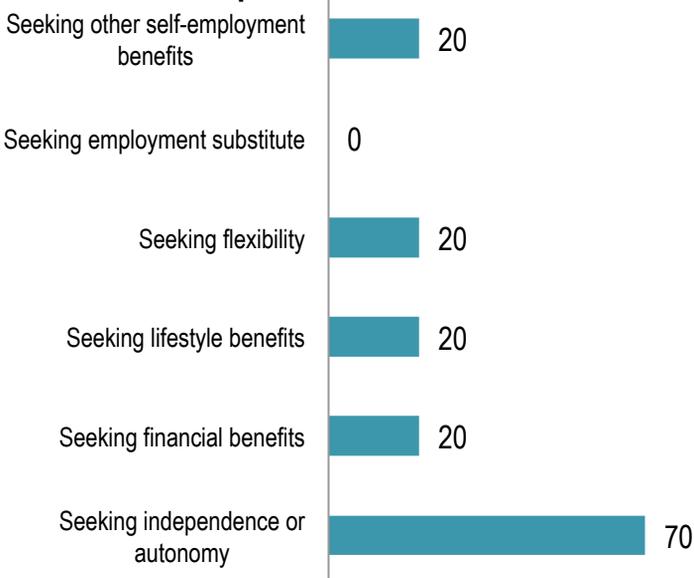


Franchisees

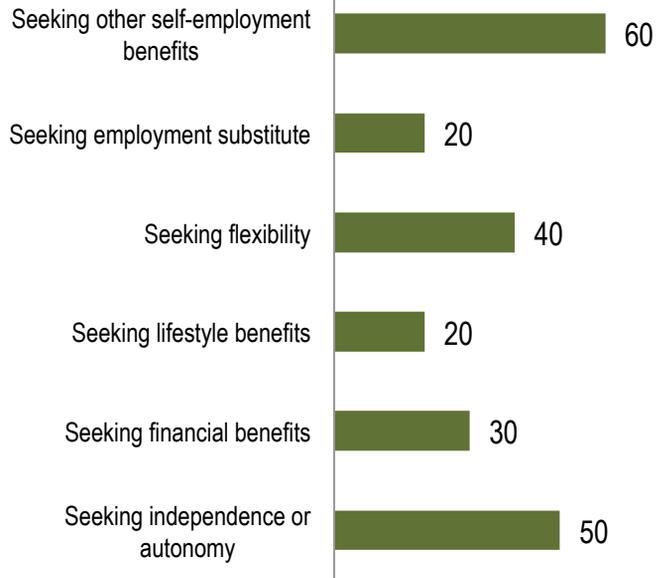


FORMERLY OPERATING %

Independents



Franchisees



3.5 Start up costs

Start-up costs varied considerably within the sample, ranging from zero (current independent operating a home-based micro business) to \$3,150,000 (former independent operating in hospitality). After removing two outliers with start-up costs higher than \$3 million the average costs are displayed in Table 3.5.

The average start-up cost across the full sample was \$145,772. Currently operating businesses had higher average start-up costs (\$137,140 for independents and \$230,625 for franchisees). Former businesses reported lower average start-up costs of \$41,940 for independents and \$116,980 for franchisees.

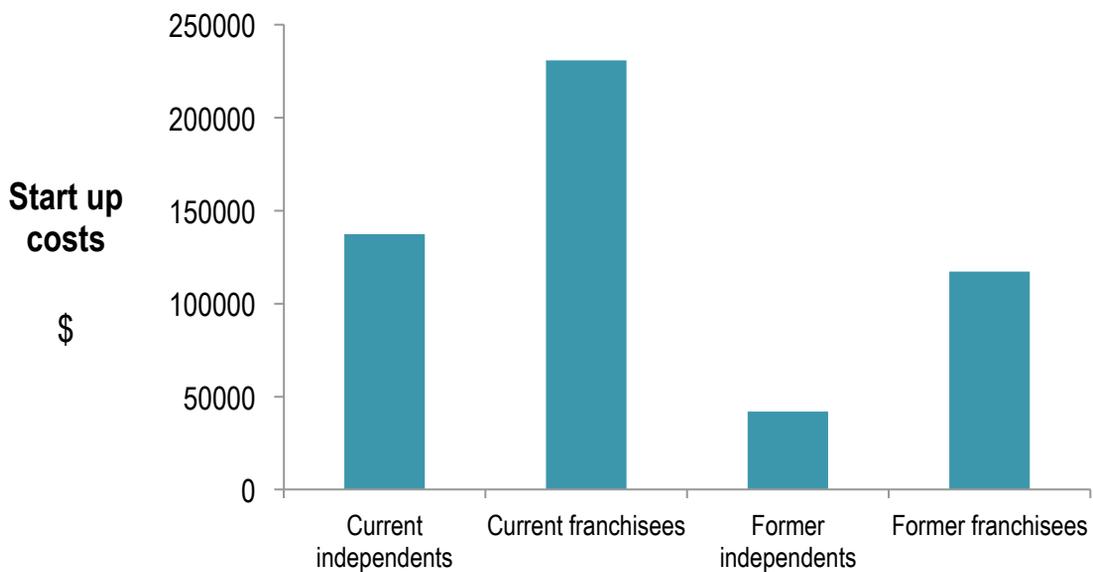
The start-up costs provided by participants were historical costs and have not been adjusted to current market values.

Table 3.5 Start-up costs (n=60)

	Total Sample	Currently operating		Formerly operating	
		Independent	Franchisee	Independent	Franchisee
Total start-up costs	\$145,772	\$137,140	\$230,625	\$41,940	\$116,980

Note: Two outliers (current franchisee and former independent) with start-up costs greater than \$3 million were removed to avoid data being skewed.

Figure 3.5 Comparison of samples



3.6 Financing the business acquisition

The most common method of financing the purchase of the business was via the participant’s personal resources. Nearly half (46 percent) the sample paid cash for the business. Bank loans were used by 22 percent of participants with a further 20 percent using a combination of a bank loan and cash or family loan. Very few participants relied solely on family (6 percent) or redundancy payouts (4 percent). Some 6 percent of franchisees took advantage of franchisor finance. A breakdown of financing options is provided in Table 3.6.

Table 3.6 Finance options (n=60)

	Currently operating			Formerly operating	
	Total Sample %	Independent %	Franchisee %	Independent %	Franchisee %
Cash	46	58	39	45	37
Bank loan	22	11	39	22	13
Bank loan plus other source of finance	20	26	11	22	25
Family loan	6	5	0	11	13
Redundancy payout	4	0	6	0	13
Franchisor finance	2	N/A	6	N/A	0
Total	100	100	100	100	100

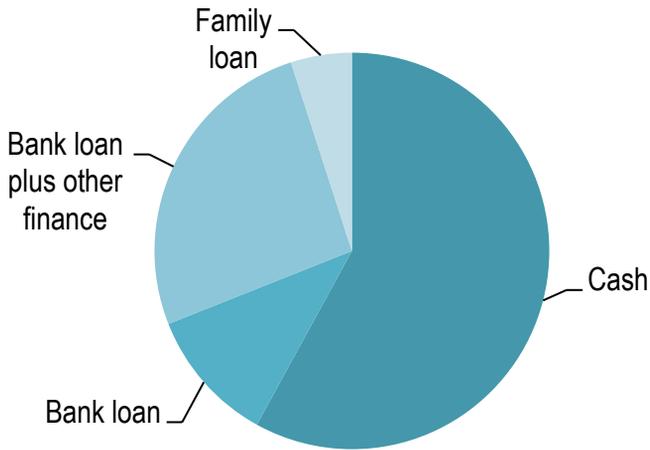
“It cost me \$240,000 to buy the franchise ... most of this was for stock. There was no way that I could afford to spend money on a lawyer or accountant. I was totally stretched.”

- Current franchisee, retail

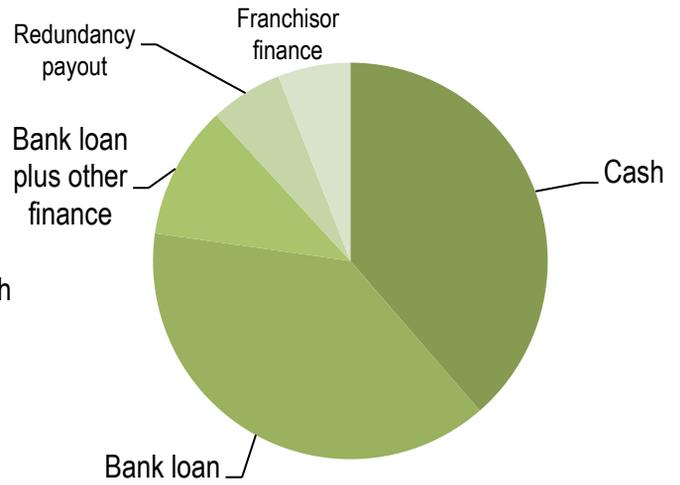
Figure 3.6 Comparison of business models

CURRENTLY OPERATING

Independents

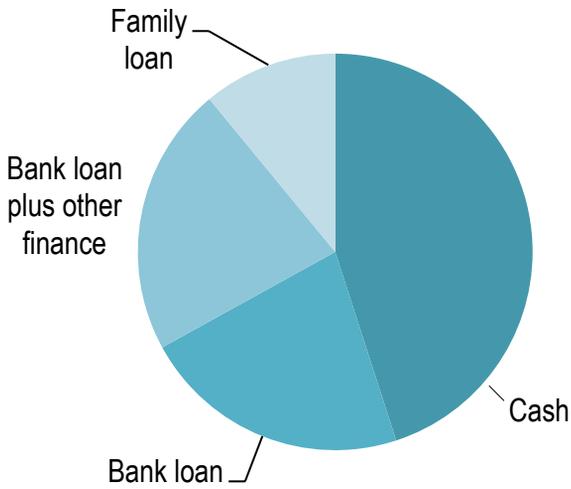


Franchisees

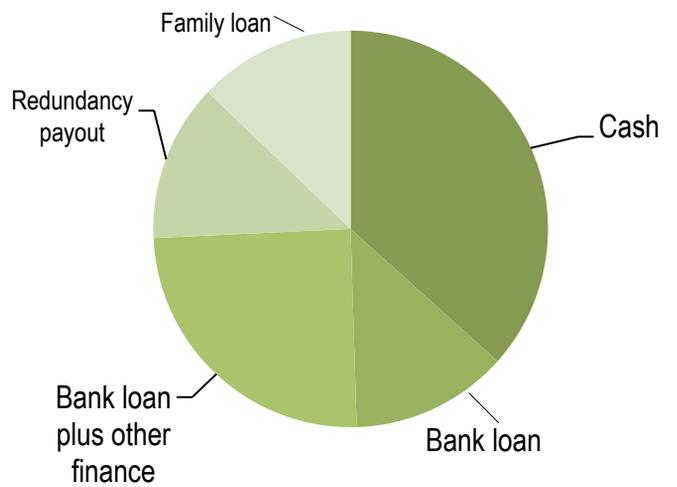


FORMERLY OPERATING

Independents



Franchisees



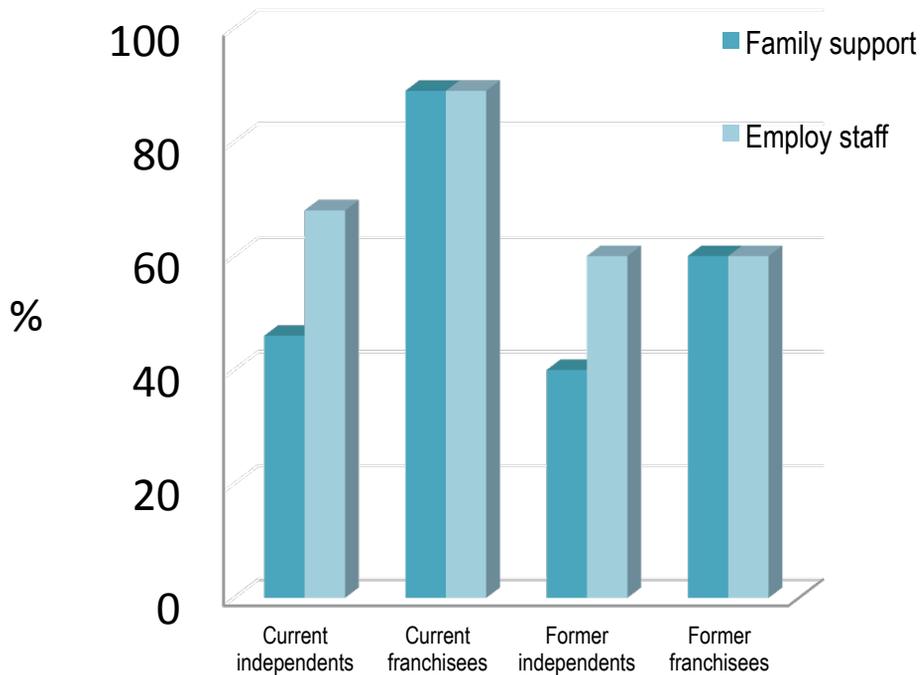
3.7 Family support and staffing

The majority of participants (60 percent) revealed that they had active family support running their businesses. This was generally in the form of their life partner or children working part-time in the business. Franchisees were more likely to involve family members than independents. Similarly, most participants (72 percent) employed staff. Details of business operational support are provided in Table 3.7.

Table 3.7 Business operational support (n=60)

	Total Sample %	Currently operating		Formerly operating	
		Independent %	Franchisee %	Independent %	Franchisee %
Family support	60	46	89	40	60
Employ staff	72	68	89	60	60

Figure 3.7 Business operational support (comparison of models) %



The emotional support provided by a life partner was often mentioned by participants. A former franchisee involved in recreation acknowledged the important role her husband played through providing family support:

'My husband was there to look after the children if I had to work weekends ... He was very supportive of me as my partner. I could cry, scream or laugh and he was there.'

Another franchisee currently operating in finance paid tribute to his wife who had recently passed away:

'In my case, it's a personal thing. My wife was a big supporter of the business but she passed away (recently) and it's very sad that she's not here to enjoy the benefits of what she worked very hard to achieve ... The point of being in business was that it was a shared experience and we can't do that any more.'

As a final example, a former independent manufacturer revealed the toll that the business had paid on the marriage:

'It did affect our relationship to a degree, which is why I closed the business. It was the final straw. I realised that I was resenting him. We had arguments at home where I realised that I was angry ... I made the call and gave him an ultimatum to close the business. He was so relieved.'

“My husband was there to look after the children if I had to work weekends ... He was very supportive of me as my partner. I could cry, scream or laugh and he was there.”

- Former franchisee, recreation

3.8 Expectations vs reality

We asked participants to relate their *initial expectations* about the business across three areas - lifestyle, financial performance and relationships – and to reflect on whether these expectations had been met. In the case of franchisees we focused on the franchisor-franchisee relationship, whereas independents were asked to consider their relationships with other contractual parties such as key suppliers and landlords.

In terms of *lifestyle*, most people had realistic expectations about how hard they would need to work, particularly in the first couple of years of the business. They were prepared to do this to become successful. Some were seeking more flexibility than they were able to achieve but, on balance, they were generally satisfied with their level of autonomy.

Some participants related that they had to work very hard in the initial stages of the business but that eventually it reaped rewards. For instance:

'I was often getting to bed at 1 o'clock in the morning, doing 5 or 6 appointments a day, driving to see people 6 days and sometimes 7 days a week. It's a different story for me now. I don't even have to work. My family is in the business and I have staff. I just come in to make decisions and to ensure that people are going in the right direction.' (Current franchisee, finance), and

'... I spend a lot of time on my business. I spend more time doing that than I would in a normal full time job. I love every minute of it. The good thing is that if I ever want to walk out I can. I can come and go as I please. I spend a lot of time there – maybe too much! That is in line with my expectations that I can come and go as I want.' (Current franchisee, fast food)

Others were not expecting to work as hard as became necessary. For example:

'I was happy to work a normal 40 hour week and then employ people to do weekends and evenings ... I was supposed to employ two staff. It quickly became apparent that the cost could not be afforded. It was assumed that you and your partner would be those two staff! (Former franchisee, fast food)

Sometimes there was a trade-off between the lifestyle that self-employment provided and financial rewards:

'I expected that the amount of money that I would earn would be less than when I was employed, but I also expected that I would be working less hours, more flexible hours. So basically I was expecting my income to go down but my free time to go up ... And that's how it worked out. I'm not trying to make a lot of money out of it. I just enjoy the jobs that I get and do the best job that I can and really put the effort in if the work is there but if the work isn't there I have other things in life that I enjoy.' (Current independent, construction)

The need to work very hard in the initial phase of the business sometimes had a detrimental affect on people's family and social networks:

'For the first 18 months I absolutely worked my butt off. I sacrificed my social and family life.'
(Former franchisee, education)

Participants' expectations about **financial performance** were also fairly realistic. Most did not expect to be earning a great deal immediately but expected to do so over time. For instance:

'I was not expecting losses but our initial builder went bankrupt. We made an operational profit despite that. We traded profitably in the first 12 months so my expectations were met.' (Current independent, café)

However, some people discovered that financial success took longer to achieve than anticipated:

'I thought I'd have a lot more free time and make a lot more money. Both were wrong ... My expectations were that I'd be making 100k a year and driving a Maserati. In reality I drove a Hyundai for seven years!' (Current independent, media)

Others indicated that they had to be satisfied earning less than their previous employment:

'I was paying myself the absolute minimum. We often had weeks when there was just enough money for wages and who would be the first one that didn't get paid? It was me! I had to pay staff before paying myself.' (Current independent, personal services)

Many participants did not set high expectations regarding financial performance. Often they continued to work in paid employment until the business became viable:

'When I first started I wasn't looking to make a fortune because I was prepared to still work in my other job. It was just some extra money but it did end up making me a decent wage. I was a single mum with three kids. It did what I needed it to do – it paid for my mortgage and all that sort of stuff. I didn't expect it to be as good as it was in the end.' (Former franchisee, recreation)

"I was often getting to bed at 1 o'clock in the morning, doing 5 or 6 appointments a day, driving to see people 6 days and sometimes 7 days a week. It's a different story for me now. I don't even have to work. My family is in the business and I have staff."

- Current franchisee, finance

Similarly, in terms of expectations surrounding franchising **relationships** or relationships with suppliers, most people were not disappointed:

'I was not expecting a lot in terms of ongoing hand holding. It was just more support and having a relationship with other franchisees and vendors. Setting up preferred suppliers for special discounts and rates. To make it easy for franchisees to use preferred suppliers so that we can get a good margin and make it worthwhile for customers. I attend conferences and speak to vendors. I'm pretty happy with the franchisor.' (Current franchisee, business services)

'At the beginning, we didn't have the funds to pay (suppliers) and we owed them a lot of money. So I had to have really strong relationships with them for to trust us and to believe in us and to stick with us. And then we became a good payer. For our regular suppliers we have very good relationships.' (Current independent, personal services)

Former franchisees and independents tended to relate negative experiences concerning their business relationships:

'I expected more jobs to come from them (the franchisor) actually. That was not the case. They gave us some but not many. They expected us to do more marketing.'
(Former franchisee, business services)

Some franchisees commented that they rarely interact with the franchisor but they prefer to be independent anyway. For instance:

'In any franchise business if you don't hear or see them it's a good thing.'
(Current franchisee, retail), and

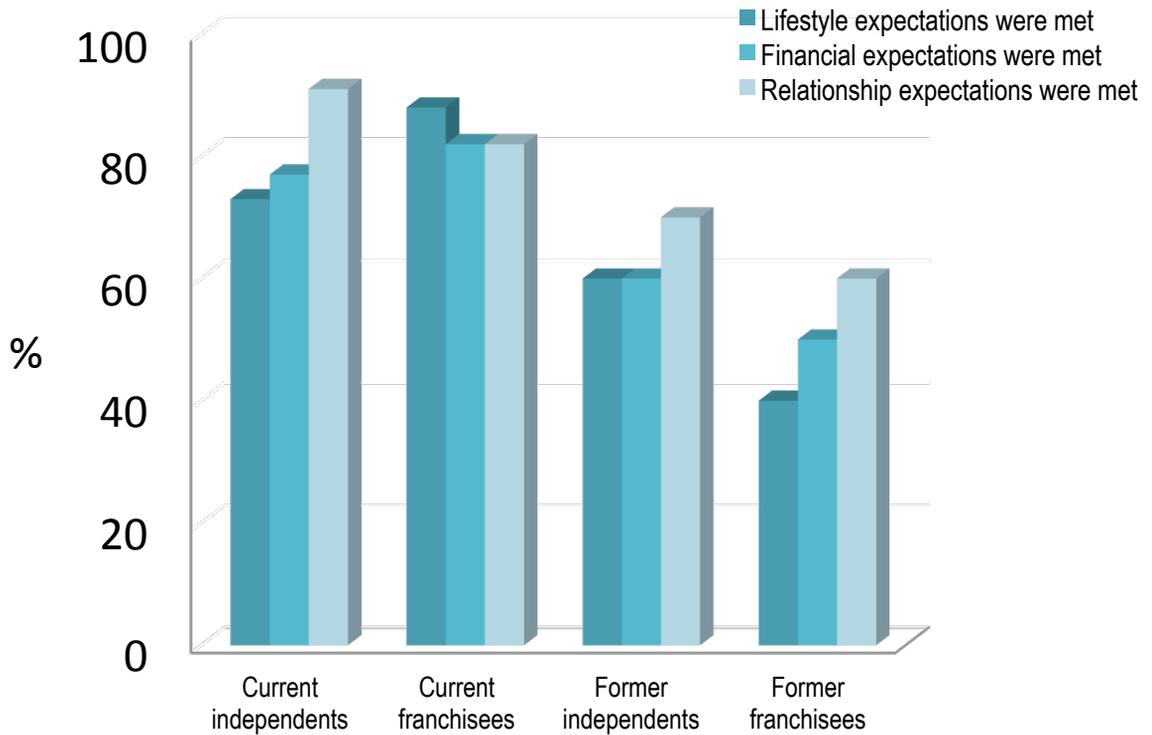
'We don't see the business coach very often ... only when they come to audit. Having said that we are the type of franchise owners that run our own race anyway.'
(Current franchisee, food retail)

Table 3.8 compares the proportion of participants across business models who indicated their initial expectations about the business were met.

Table 3.8 Expectations gap (n=60)

	Currently operating			Formerly operating	
	Total Sample %	Independent %	Franchisee %	Independent %	Franchisee %
Lifestyle expectations were met	70	73	88	60	40
Financial performance expectations were met	71	77	82	60	50
Relationship expectations were met	80	91	82	70	60

Figure 3.8 Expectations gap (comparison of models) %



“I thought I’d have a lot more free time and make a lot more money. Both were wrong ... My expectations were that I’d be making 100k a year and driving a Maserati. In reality I drove a Hyundai for seven years!”

- Current independent, media

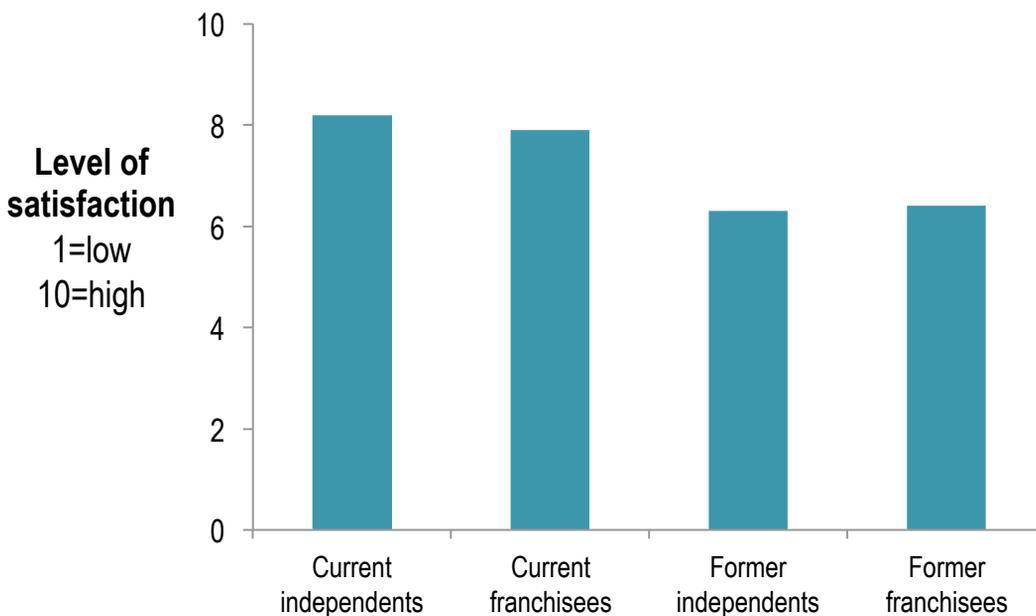
3.9 Level of overall satisfaction with the business

As a final reflection in the interviews we asked participants to rate (on a scale of 1 to 10) their current level of overall *satisfaction* with the business (for current operators) or their level of satisfaction at the time they exited the business (for former operators). If their rating was below 10 we also asked participants to indicate what it would take to improve their level of satisfaction. Results across the samples are provided in Table 3.9. Former business owners rated their levels of satisfaction lower than those currently in operation.

Table 3.9 Overall level of satisfaction (n=60)

Overall satisfaction level (Scale: 1 = low, 10 = high)	Currently operating		Formerly operating		
	Total Sample	Independent	Franchisee	Independent	Franchisee
Overall level of satisfaction with the business	7.5	8.2	7.9	6.3	6.4

Figure 3.9 Comparison of samples



Franchisees tended to request more support and understanding from their franchisors as a means of improving overall satisfaction. For instance:

'The head office support has not been as much as I would have liked.' (Current franchisee, hospitality).
Similarly:

'If the franchisor started doing their role, which is investing in the brand and the brand profile in the market – basically getting their feet in the stores.' (Current franchisee, café), and

'If the franchisor was a little bit more understanding of the challenges involved in our operations.'
(Current franchisee, finance)

In contrast, and because they are autonomous, independent operators sought improvements in their business operations. For instance:

'Things like travel are non-existent because you are chained to the business.'
(Former independent, hospitality).

One independent business owner operating in media rated his level of satisfaction (out of 10) as '11', crediting his personal achievement:

'Because I've done things in the last seven years that most people will never do in their entire life time.'

The next section of the report discusses the main themes and conclusions arising from phase one of the research.

“Because I’ve done things in the last seven years that most people will never do in their entire life time.”

- Current Independent, media



4.0 Discussion

4.1 Implications of phase one findings

The first phase of the research involved in-depth discussions with 60 former and current independent small business owners and franchisees. It revealed some common themes which can best be explored by considering the issue of due diligence itself in terms of scope and awareness. The most difficult aspect of due diligence is determining the *scope* of the investigation, which is ultimately shaped to an extent by the party benefiting from (buyer) or the party producing (seller) the due diligence, or bilaterally. The scope can be wide or limited and is subject to the awareness level, appetite for risk and the budget of either buyer or seller. It is also subject to any legislative requirements. In fact, in the context of this research, the awareness of the need and content of due diligence investigations prior to committing to an independent small business or franchise appears to underpin several of the key findings. The research revealed that franchisees tended to have a better *understanding* of the term 'due diligence' than many independent owners. Whether this was due to legislative requirements, formal or career education or other influences is a question that will be addressed in the next phase of the research.

Due diligence means the process of ensuring that investors are getting what they think they are buying and what they are buying is worth what they are paying.

The motivations for entering small business can be characterised as *emotional* as well as legal or financial. If the motivation of buying a business is purely to maximise return on investment and the buyer is aware of the role of due diligence, it is highly likely that an investigation will be undertaken. In contrast, the buyer with no awareness of due diligence who seeks a business purely for lifestyle, may not accord high priority to due diligence. In other circumstances, a buyer may be compelled to undertake due diligence by the law, or by a financier or other third-party. In other instances, they may be emotionally attached. Emotional attachment to the idea of the business venture was a strong driver for the majority of potential owners. Most considered only one business choice and a minority considered a couple of different possibilities. It is possible that people's minds were made up from the beginning and their emotional attachment then skewed the due diligence because it became a subjective, rather than an objective, exercise. We uncovered only a couple of cases in which participants were able to demonstrate 'dispassionate interest' as most were already somewhat emotionally committed to the venture prior to undertaking the due diligence exercise. It is given that a major requisite for effective due diligence is the ability to keep an open mind and to dispassionately question information that is presented. Some participants actively chose to turn a blind eye to information that was uncovered or that would have been relatively easy to scrutinize in more depth. This may be related to the personality type of the individual and it is something we will explore in more depth in the second phase of the research. In fact there were several examples where, in hindsight, respondents felt they had been given incorrect or incomplete advice which ultimately led to a bad decision being made. Therefore awareness and motivation will influence whether parties proceed with due diligence and in what depth.

Given this research focuses on independent small businesses and franchisees, it is appropriate that 'due diligence' is defined. As mentioned above, awareness and motivations create conditions where due diligence means different things to different people - buyer, seller, and advisor alike. A due diligence investigation is not an audit. Its scope could be anywhere on a continuum with broad at one end and deep at the other. The buyer's due diligence budget, prior experience, appetite for risk, as well as the amount of their total wealth that they will invest will also significantly impact due diligence decisions. The scope will be different for a small, medium, and large business as the constraints are different. In the case of a buyer of an independent small business or franchise, *due diligence means the process of ensuring that investors are getting what they think they are buying and what they are buying is worth what they are paying*. It is a process that requires an understanding of legal, financial, commercial, relational, and operational risks associated with the business prior to commencement, during and at the end of ownership. In terms of continuing to make informed decisions throughout the life of the business, the due diligence process is ongoing as the business plan is revisited. An independent business consultant referred to 'continuous learning' and others indicated they applied **ongoing due diligence** to all major business decisions. Most acknowledged the existence of a steep learning curve when entering business for the first time, which can be costly and time consuming. In brief, the due diligence process is not necessarily relevant only to one point in time; it is ongoing and forms part of the overall experience of an entrepreneur throughout the life of the business. That said, the best time to conduct thorough due diligence, especially for a franchisee, is before committing to buy. Because of the nature of the relationship it enters with a franchisor the franchisee will always have much less control over its business than an independent business owner does.

Notwithstanding the size and type of business due diligence investigations are subject to technical, informational, financial, temporal, and legal constraints, which are separately examined below in context of the research findings.

Technical. Technical constraints refer to the type of skills and capabilities required to perform the appropriate due diligence investigations. Whether the investigation is being undertaken by the buyer or by a seller, the skill sets required are diverse. While this research found that the majority of participants engaged an accountant or lawyer or performed desktop research, franchisees were twice as likely as independents to use all three of these tools. This practice highlights the divergence in approach and knowledge on the part of the buyer and seller. Indeed, a number of participants reported their disappointment in the skill level of their advisors in specific areas such as franchising or leasing arrangements.

Informational. Access to relevant information to perform due diligence can be problematic and expensive. Buyers would want unfettered access. This can be achieved through the use of confidentiality agreements. Sellers often attempt to impose limitations for commercial and legal reasons. Independents and franchisees need, and have the right to different information. For instance, in Victoria buyers of an independent small business with a sale value less than \$350,000 can expect a S 52 statement from the vendor under the *Estate Agents Act 1980* (Vic). This statement contains legal, operational, and financial information for the purchaser about the target business and includes a requirement that the party receiving the information will treat it as confidential. It is differently focussed than the information available to franchisees. Moreover, other Australian States and Territories do not have similar legislation. Twelve percent of the franchisees in our sample reported that they operated their business through a trust. This pattern has also been observed of franchisors*. Trusts present anyone attempting to conduct due diligence with significant difficulties. Whether and how these difficulties are addressed will form part of Phase 2 of the research.

Due to the legislative structure surrounding franchising, prospective franchisees are provided information to assist their due diligence before entering a franchise agreement. Firstly, the initial section of the mandatory Disclosure Document urges prospective franchisees to take their time assessing the franchise and to seek professional advice:

'Take your time, read all the documents carefully, talk to other franchisees and assess your own financial resources and capabilities to deal with the requirements of the franchised business.

You should make your own enquiries about the franchise and about the business of the franchise.

You should get independent legal, accounting and business advice before signing the franchise agreement.

It is often prudent to prepare a business plan and projections for profit and cash flow.

You should also consider educational courses, particularly if you have not operated a business before.' (Franchising Code of Conduct 2014, Annexure 1)

Further, under the Code franchisors are now required to provide an Information Statement* to prospective franchisees as soon as practicable after the prospective franchisee formally applies or expresses an interest in acquiring a franchised business. This document states:

Entering a franchise is a big decision. Before you do so, you should:

- **Conduct due diligence** – *this means researching the franchise system and talking to current and former franchisees.*
- **Get advice** – *get legal, accounting and/or business advice from professionals with expertise in franchising.*
- **Read all the documents** – *carefully study the disclosure document, franchise agreement and any other documents provided by the franchisor.*
- **Know your rights** – *make your own enquiries to ensure that it is the right decision for you. The Franchising Code of Conduct sets out the rights and obligations of the people involved in a franchising relationship. (Franchising Code of Conduct 2014, Annexure 2)*

*The requirement for an Information Statement took effect from January 2015 and therefore would not have impacted the participants in the current research whose tenure preceded this requirement.

Armed with information in the Disclosure Document about the need to undertake due diligence provides prospective franchisees with an incentive to research the franchise opportunity. The Disclosure Document is issued to prospective franchisees at least 14 days before entering into a franchise agreement (or at the time of making a non-refundable payment in relation to the franchise). Many would argue that at this stage of the negotiations the prospective franchisee may already be emotionally committed to the purchase and may have difficulty in remaining detached from the decision. Similarly, given the amount of time that it takes to conduct thorough due diligence, the 14 day period from issue of the Disclosure Document to committing to the franchise allows insufficient time for the prospective franchisee to complete all or most of the research required. There is a risk that the Disclosure Document may serve to delimit the prospective franchisee's due diligence. There may be significant risk factors lurking beyond the boundaries of the information in the Disclosure Document which, consequently, may not be investigated. Hence, prospective franchisees need to be encouraged to conduct much of their due diligence well before receipt of the Disclosure Document. This timing provides difficulties for advisors who require information contained in the Disclosure Document to initiate many inquiries. They must also be encouraged to use experienced franchise advisors.

Independent business owners do not have a similar legislative framework surrounding their business investment and therefore are not routinely exposed to information urging them to undertake broad scope due diligence prior to starting up or purchasing a small business. This may explain why more independent business owners (than franchisees) in our sample did not fully understand the concept of due diligence in relation to making their business investment. When removed from the business environment the term 'due diligence' may confuse people who have not been exposed to it. Whilst participants in the research were well educated, many had not specialised in business in their studies. These people, in particular, may be disadvantaged when preparing to enter a small business. Although they may possess relevant industry skills or have particular talent, they may not have developed a high degree of **business acumen**. Operating a business is a skill in itself and entrepreneurs need to develop this skill in order to succeed. In brief, as there are many roles involved in becoming a successful business owner, entrepreneurs need to be able to delineate between working in the business (skill) and working on the business (acumen).

The variety of due diligence activities reported by participants also highlights the degree of **formality** associated with conducting thorough due diligence. Entrepreneurs differ greatly in their approach to conducting due diligence. Some admitted to doing no due diligence at all ('you have a good idea ... and you just start'), others had a very casual attitude to the task (such as talking to family or friends) and the remainder were more systematic in their approach. One franchisee we interviewed showed us her copy of the franchise agreement that she had read thoroughly, highlighting, and annotating with questions to follow up with the franchisor and lawyer. Many others read the franchise agreement or contract of sale superficially, preferring to leave it to their lawyer to uncover any issues. Often, a great deal of trust was placed in other people (for example, in the lawyer, the previous business owner or the franchisor).

Financial. Whereas potential investors are prepared to invest considerable funds in a business venture they often avoid spending additional money to ensure they make a wise investment decision. This reluctance to invest in due diligence (in particular, reluctance to consult professional advisors) could pose a major hindrance to achieving long-term business success. Many participants did not appreciate the need to undertake due diligence in the first instance but regretted their lack of attention to detail down the track. This was particularly so in the case of independent business operators who admitted to being too naïve and lacking sufficient business savvy to know what questions to ask before they purchased their business.

In instances several respondents mentioned that, even if they were motivated, they did not have the financial resources to undertake a proper due diligence investigation. Given that by definition, due diligence occurs prior to commencing business, the investigation has to be self-funded and outside any financing arrangements for the actual business. Therefore, access and availability of sufficient financial resources may pose a significant constraint to thorough due diligence.

Temporal. The time between intention and decision is often a constraint in determining the type and extent of due diligence. Some respondents had more time than others to decide whether to proceed due to competing (or apparently competing) offers from other buyers, the need to generate cash-flow or leasehold commitments.

The time taken and financial investment devoted to due diligence also varied widely among participants. Although ours was a relatively small sample, we noticed differences in the time and cost of due diligence between current and former business owners, with current operators demonstrating greater commitment. We will explore this relationship further in the large-scale survey in the second phase of the research.

Legal. The law has created different due diligence environments for independent small business owners and for franchisees. Both have recourse to the misleading and deceptive conduct, and unconscionable conduct, provisions of the *Competition and Consumer Act 2010* (Cth) (CCA), and to the common law. The common law provides remedies for conduct such as breach of contract, fraud, mistake, negligent misrepresentation and a range of other contract, crime and tort-based actions. Beyond this, their protection from overly 'sharp' practice by their counterparty differs.

All purchasers of independent small businesses that involved retail premises are entitled to disclosure information that complies with their State or Territory's retail tenancy regulation. In addition, purchasers of an existing independent small business in Victoria are entitled to the s 52 statement referred to above. They have a legal right to ask for more information based on the s 52 statement. Beyond that, they decide on the extent of their due diligence, based on what they or their advisors determine to be the biggest commercial risks they would face as owner. Once the deal is done, the independent small business owner has no ongoing relationship with the seller.

Franchisees are contemplating entering what is known as a relational contract; that is, once they become a franchisee they will enter a long-term business relationship with the seller, the franchisor. For this reason it is important that prospective franchisees conduct due diligence on both the business **and** the franchisor. Since 1998 the franchisor has been required to provide franchisees with a Disclosure Document that complies with the Franchising Code of Conduct (Code). This contains a significant amount of information but may lead franchisees to confine their due diligence to a further investigation only of what is in the Code disclosure. This could result in deficient due diligence. In phase 2 of the project we will explore the extent to which franchisees do explore matters beyond the scope of the Code disclosure.

Aside from these constraints, the discussions with participants suggested that *attitudes* may also play a part in shaping the due diligence process. Firstly, exposure to role models in small business may impact the attitudes of prospective investors. Many of the people we interviewed were the first in their families to enter business, particularly former independents and former franchisees, suggesting that a **family history** of small business ownership may be influential in business outcomes. In particular, those who had previous exposure to family business are more likely to be comfortable with the lifestyle and culture associated with small business, making the transition from employment to self-employment more seamless. The adjustment from regular working hours, holidays and income to much less certainty could be expected to be easier for those accustomed to this environment during their formative years. Whilst some entrepreneurs felt they were taking a risk in venturing into business for the first time, others felt it was as natural as being alive. Hence, attitudes to business may be formed through early associations and experiences in the family.

Similarly, we noticed that some participants had a greater disposition towards **learning**. Many were well educated in their fields but not necessarily in business. A lack of family experience in business together with a lack of business education meant that some participants were not well prepared to enter business and, therefore, unlikely to appreciate the need or the process for undertaking due diligence. Moreover, business acumen may stem from an innate ability that can be nurtured and developed through experience.

Finally, some participants exhibited high levels of *trust* when entering business. This was manifested through areas such as trust in the brand, trust in the vendor or franchisor, trust in the lawyer, or ultimately trust in their own 'gut instinct' (based on prior experience and knowledge) that all would go to plan. Those who were less trusting were more likely to be more *assiduous* with their due diligence.

Overall, the main issue that the research has raised is the general level of *naivety* associated with small business ownership, particularly if it is the first business venture undertaken. Under such circumstances, franchisees should be at an advantage because of the structure, support and training provided by the franchisor enabling inexperienced operators to become self-employed. Independent small business owners, on the other hand, do not have easy access to support. It is possible for them to outsource professional advice and mentoring but if they are not aware of what due diligence entails, independent operators are less likely to be as thorough in their preparations. Although this first phase of the research is based on a sample of 60 respondents the preliminary results suggest that franchisees may be more willing to conduct due diligence than independent small business owners. The findings also suggest that the sophistication of the due diligence undertaken may be greater for those currently operating businesses rather than those who have exited. In brief, both independent small business owners and franchisees may need to be better educated about what due diligence entails and how it should be conducted in order to be more fully prepared to enter small business.

4.2 Next phase of the research

The *first phase* of the research has provided valuable insights into the due diligence process, providing comparisons between (current and former) independent small business operators and franchisees.

We will use these findings in the *second stage* of the research to develop a conceptual model and propositions in order to analyse whether due diligence affects small business performance. A large online survey of independent small business owners and franchisees will be used to clarify and test the model. Specifically, we will seek to explain:

- 1) To what extent is there a *difference* in the due diligence undertaken by independent small business owners and franchisees?
- 2) How due diligence is related to *performance* in both independent small businesses and franchisees.
- 3) To what extent does due diligence impact *satisfaction* levels experienced by independent small business owners and franchisees?
- 4) How due diligence accords with *expectations* experienced by independent small businesses and franchisees.

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Appendix – informed consent materials



GU Ref No: MKT/04/15/HREC

The effectiveness of undertaking due diligence prior to starting up or purchasing a small business or franchise

INFORMATION SHEET

Who is conducting the research

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Why is the research being conducted?

This research will analyse the effectiveness of undertaking due diligence prior to starting up or purchasing an independent small business or franchise. In particular we are interested in determining whether undertaking due diligence affects small business performance.

What the interviewee will be asked to do

You will be invited to participate in an interview that will take approximately 30 to 60 minutes. The interview will be conducted by members of the research team by telephone or in person. With your permission, interviews will be audio-taped and erased upon completion of the project.

The basis by which participants will be selected or screened

Interviews will be conducted with current or former independent small business owners and franchisees.

The expected benefits of the research

This research is expected to inform the small business sector about the effectiveness of undertaking due diligence prior to purchasing or starting up an independent small business or franchise. It is anticipated the research may identify areas in which due diligence could be improved. The findings may also help inform future small business sector policy reforms.

Risks to you

Your participation does not involve any risks other than what you would encounter in daily life.

Your confidentiality

All interviews are confidential. Only aggregated data will appear in the report and no participants will be able to be identified.

Your participation is voluntary

Your participation in this study is voluntary. You are also under no obligation to answer every question that is addressed to you during the interview. As a voluntary participant you are free to withdraw at any time from this study without any comment or penalty.

Storage of data

All audio recordings will be erased after transcription. However, other research data (interview transcripts and analysis) will be retained in a password protected electronic file for a period of five years before being destroyed.

Who is funding this research

This research has been funded by the CPA Australia as a Global Research Perspectives Program Grant. The research is being conducted independently by Griffith University and the University of New South Wales. The funding body will have no input into the conduct of the interviews, data collection, analysis, or preparation of the report.

The ethical conduct of this research

Griffith University conducts research in accordance with the National Statement on Ethical Conduct in Research Involving Humans. If you have any concerns or complaints about the ethical conduct of the research project you should contact the Manager, Research Ethics on (07) 373 54375 or research-ethics@griffith.edu.au.

Feedback to you

A summary of the research findings will be available on the website of the Asia-Pacific Centre for Franchising Excellence upon completion of the project in 2016: (<http://www.franchise.edu.au>)

Privacy Statement

The conduct of this research involves the collection, access and/ or use of your identified personal information. The information collected is confidential and will not be disclosed to third parties without your consent, except to meet government, legal or other regulatory authority requirements. A de-identified copy of this data may be used for other research purposes. However, your anonymity will at all times be safeguarded. For further information consult the University's Privacy Plan at <http://www.griffith.edu.au/about-griffith/plans-publications/griffith-university-privacy-plan> or telephone (07) 3735 4375.

GU Ref No: MKT/04/15/HREC

The effectiveness of undertaking due diligence prior to starting up or purchasing a small business or franchise

CONSENT FORM

Who is conducting the research

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By signing below, I confirm that I have read and understood the information package and in particular have noted that:

- I understand that my involvement in this research will include participation in an interview with the researcher for approximately 30-60 minutes;
- I have had any questions answered to my satisfaction;
- I understand the risks involved;
- I understand that there will be no direct benefit to me from my participation in this research;
- I am aware that my permission will be sought to record the interviews;
- I understand that recorded interviews are erased following transcription and that other research data (interview transcripts and analysis) will be retained in a password protected electronic file for a period of five years before being destroyed;
- I understand that my participation in this research is voluntary;
- I understand that if I have any additional questions I can contact the research team;
- I understand that I am free to withdraw at any time, without comment or penalty;
- I understand that I can contact the Manager, Research Ethics, at Griffith University Human Research Ethics Committee on (07) 373 54375 (or email research-ethics@griffith.edu.au) if I have any concerns about the ethical conduct of the project; and
- I agree to participate in the project.

Participant _____ Date _____

Investigator _____ Date _____

OR Verbal Consent: YES NO

Due diligence means the process of ensuring that investors are getting what they think they are buying and what they are buying is worth what they are paying

