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AUASB Meeting 26 July 2010

Auditing and Assurance Guidance Statement

AGS 1040

(November 2002)

Franchising Code of Conduct – Auditor’s Reports

Prepared by the **Auditing & Assurance Standards Board** of the
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AUDITING AND ASSURANCE GUIDANCE STATEMENT
AGS 1040 “FRANCHISING CODE OF CONDUCT – AUDITOR’S
REPORTS”

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Introduction

- .01 Item 20 of Annexure 1¹ to the *Franchising Code of Conduct*² (the “*Franchising Code*”) imposes mandatory disclosure requirements in relation to financial details, which must be provided by franchisors to franchisees when entering into a new franchise agreement on or after 1 October, 1998.
- .02 Item 20 states:
- “20. Financial details
- 20.1 A statement as at the end of the last financial year, signed by at least 1 director of the franchisor, whether in its directors’ opinion there are reasonable grounds to believe that the franchisor will be able to pay its debts as and when they fall due.
- 20.2 Financial reports for each of the last 2 completed financial years that have been prepared by the franchisor in accordance with sections 295 to 297 of the Corporations Law³
- 20.3 Item 20.2 does not apply if :
- (a) the statement under item 20.1 is supported by an independent audit [report specifically relating to that statement] provided by a registered company auditor within 12 months after the end of the financial year to which the statement relates; and
- (b) a copy of the independent audit [report] is provided with the statement under item 20.1.”

¹ Annexure 1 (Disclosure document for franchisee or prospective franchisee) to the *Franchising Code* sets out the content requirements of the franchising disclosure document when the expected annual turnover of a franchised business is \$50,000 or more. Annexure 1 requires the disclosure of certain information including financial details, franchisor details, intellectual property, and litigation. Annexure 2 (Short form disclosure document for franchisee or prospective franchisee) to the Code sets out the content requirements of the franchising disclosure document when the expected annual turnover of a franchised business is less than \$50,000. Item 10 of Annexure 2 has the equivalent requirements about financial details as Item 20 of Annexure 1 to the Code. For the purpose of this AGS, the guidance applicable to the auditing requirements of the solvency statements under Annexure 1 and Annexure 2 is the same.

² The *Franchising Code of Conduct* came into operation on 1 July 1998 and was amended on 1 October 2001. A copy of the Code is available from the Australian Competition and Consumer Commission (ACCC) website (<http://www.accc.gov.au>).

³ On and from 15 July 2001, the *Corporations Act 2001* replaced the Corporations Law.

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- .03 Generally, the financial statements of the franchisor need to be accompanied by an independent audit report addressed to the directors of the franchisor company for the specific purpose of being provided to franchisees as part of the disclosure document to franchisees. However, as indicated in Item 20.3, a franchisor will not be required to provide financial statements where the directors’ statement relating to solvency which is provided pursuant to Item 20.1 is supported by an independent audit report provided by a registered company auditor.
- .04 The purpose of this guidance is to assist auditors engaged to report under Item 20.3 in interpreting and discharging that requirement.

Nature of the Engagement

- .05 In the context of the *Franchising Code*, if the statement by the auditor is in substance a substitute for the information provided under the requirements of Item 20.2 of Annexure 1, the level of assurance provided would need to be at the highest level. Under Auditing and Assurance Standard AUS 106 “Explanatory Framework for Standards on Audit and Audit Related Services” this engagement would be an “attest audit” engagement.
- .06 AUS 106 states:
- “05 ‘Audit’ means a service where the auditor’s objective is to provide a high level of assurance through:
- (a) the issue of a positive expression of an opinion that enhances the credibility of a written assertion(s) about an accountability matter (‘attest audit’); ...”
- “10 An audit engagement is designed to provide a high but not absolute level of assurance on an accountability matter. The auditor expresses this as reasonable assurance in recognition of the fact that absolute assurance is rarely attainable due to such factors as the need for judgement, the use of testing, the inherent limitations on internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.”

Extent of Audit

- .07 The directors’ statement required by Item 20.1 of Annexure 1 to the *Franchising Code* contains their opinion on “solvency” as at the end of the last financial year in respect of recorded liabilities as at the end of that year, and which relates to the ability to meet those

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liabilities over the 12 month period from the end of the last financial year. The auditor’s direct responsibility is to form and express an opinion on the directors’ statement made pursuant to Item 20.1 of Annexure 1 to the Code. The substance of this responsibility is similar to that assumed by a company auditor in relation to the “solvency” statement by directors which forms part of the directors’ declaration under Section 295(4) of the *Corporations Act 2001* (the “*Corporations Act*”), and on which the auditor forms an opinion and reports, as a component of the financial report, under Sections 307 and 308 of that *Corporations Act*. For audits under the Act, the auditor’s opinion on the directors’ solvency opinion is derived from, and is integral to, the audit process related to forming an opinion on the financial statements and the appropriateness of the going concern basis in accordance with AUS 708 “Going Concern”. In the case of a *Corporations Act* audit, the auditor’s responsibility is to consider the appropriateness of the going concern basis (defined for financial reporting purposes) in the context of the audit of a financial report. The auditor therefore considers the going concern assumption (including solvency) for the “relevant period”, being the period from the date of the auditor’s current report to the expected date of the next auditor’s report on the financial report for the next period. Because of the specific nature of the engagement under the Code, and the fact that the directors’ statement and audit reporting thereon occurs outside the formal financial reporting process, it has been determined that a 12 month period from the end of the financial year is a reasonable relevant period.

- .08 Whilst recognising that for entities subject to audit under the *Corporations Act*, there is an interrelationship between the opinion under the Act and that required under Item 20.3 of Annexure 1 to the *Franchising Code*, the AuASB is of the view that the Item 20.3 audit report is a separate audit engagement. It is acknowledged, however, that in situations where the reports are to be provided by the same auditor, much of the evidence to support the opinion under Item 20.3 will be derived from the financial report audit under the Act.
- .09 For engagements under Item 20.3 of Annexure 1 to the *Franchising Code*, the auditor considers the risks inherent in issuing an audit report without the support of an accompanying financial report. For example, unlike the auditor’s opinion on solvency under the *Corporations Act*, which is one element of the information reported on by the auditor, the Item 20.3 opinion is a specific report on solvency and stands in its own right.
- .10 In situations where no audit has been conducted as at the end of the last financial year, the AuASB is of the opinion that to report under

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Item 20.3, the nature and extent of the audit procedures to be undertaken by an auditor of the entity’s financial information would need to be similar to those required to express an opinion under *Corporations Act*, as discussed in paragraph .07, before being able to report under Item 20.3. Whilst the audit process need not be directed to supporting an opinion on a complete financial report, but rather on the directors’ assertion in their statement, the auditor would, for example need to have sufficient appropriate audit evidence about the assets, liabilities, revenues, expenses, cash flows, budgets and projections etc. of the entity in order to assess the basis for the directors’ “solvency” statement.

Audit Methodology

- .11 The nature, timing and extent of the audit procedures appropriate to achieve audit assurance are a function of the circumstances of each engagement, and will depend on:
- (a) whether the auditor is a new or continuing auditor;
 - (b) the proximity of the most recent audited financial report;
 - (c) the extent and nature of changes in the entity’s activities and/or industry/industries in which it operates since the issue of the most recent audited financial report; and
 - (d) the nature, timing and extent of the audit procedures conducted since the issue of the most recent audited financial report.
- .12 For the continuing auditor where an audited financial report has recently been issued under the *Corporations Act*, the audit process may be limited to a consideration of any changes in the company’s circumstances since the audit of the directors’ opinion on solvency included in the directors’ declaration that is required by that Act. This would involve the auditor:
- (a) enquiring of management/directors as to the basis on which they have formed their opinion on solvency under Item 20.1, and evaluating the appropriateness of any new assumptions underlying their opinion;
 - (b) updating knowledge of the entity’s business and industry, to evaluate whether there have been any significant changes to the appropriateness of significant assumptions underlying the previous solvency opinion. Procedures to be applied in this regard could include those identified in

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AUS 304 “Knowledge of the Business”. Particular emphasis needs to be given to any changes in expectations concerning cash flow, trading conditions, financial commitments, financing arrangements etc;

- (c) enquiring as to any changes to the entity’s internal control structure in relation to cash flow and management of debt; and
- (d) applying appropriate analytical review procedures, for example comparing the latest management accounts with budgets and cash flow forecasts.

In the absence of evidence contrary to the representations made by the directors in their Item 20.1 solvency statement, the auditor could express the opinion required under Item 20.3.

- .13 Significant changes in fundamental assumptions and/or conditions, for example changes in the nature of the entity’s business, plans for significant acquisitions, disposals, products, may require application of more extensive procedures.
- .14 For a new auditor, and/or a situation where there has been a significant time lag since the issue of the latest audited financial report, and limited audit procedures applied in relation to forming an audit opinion of the accounts of the current financial period, the nature, timing and extent of the audit procedures will need to be more extensive.
- .15 In any of the situations described above where the audit procedures create doubts as to the directors’ representations concerning solvency, additional audit procedures will need to be applied as necessary to enable an opinion to be expressed.

Auditor’s Report

- .16 The auditor is concerned with obtaining sufficient appropriate audit evidence that the opinion stated in the directors’ solvency statement is reasonable, based on the foreseeable commercial circumstances facing the entity and which the auditor can reasonably perceive to exist.
- .17 If, as a result of applying the appropriate level of audit procedures, the auditor forms the opinion that there is sufficient and appropriate audit evidence obtained to support the representation made by the directors in their solvency statement, an unqualified auditor’s report

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can be issued. An example report is provided in the Appendix to this AGS.

- .18 If the auditor is of the opinion that the audit evidence is inconsistent with the representation made by the directors, the auditor issues a qualified report.
- .19 Item 20.3 (b) requires the copy of the independent audit [report] to be provided with the directors’ statement before distribution of that report to any franchisee or prospective franchisee.

Operative Date

- .20 This AGS is operative from the date of issue. This version of AGS 1040 supersedes AGS 1040 “Franchising Code of Conduct – Auditor’s Report”, as issued in March 1999.

Compatibility with International Standards and Statements on Auditing

- .21 There is no corresponding International Standard or Statement on Auditing.

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APPENDIX

EXAMPLE AUDIT REPORT

INDEPENDENT AUDIT REPORT

To [name of franchisor]:

Scope

We have audited the statement by directors (“the statement”) of [*name and entity*] dated [*insert date*] made for the purposes of fulfilling the requirements of Item 20 of Annexure 1¹ to the *Franchising Code of Conduct*. The directors are responsible for the statement which has been prepared as at [*date of financial year end*] to reflect the debts of the entity at that date, and the ability of [*name of entity*] to meet these debts as and when they fall due over the 12 month period from that date. We have conducted an independent audit of the statement in order to express an opinion on it to [*name of franchisor*].

The statement has been prepared pursuant to Item 20 of Annexure 1¹ to the *Franchising Code of Conduct* for distribution to the franchisees and prospective franchisees of [*name of entity*]. We disclaim any assumption of responsibility for any reliance on this audit report or on the statement to which it relates to any other party, or for any other purpose than that for which it was prepared.

Our audit has been conducted in accordance with Australian Auditing and Assurance Standards, and accordingly involved such tests and procedures as we considered necessary in the circumstances. Our procedures included examination, on a test basis, of evidence supporting the reasonableness of assumptions and procedures used by the directors in forming their opinion as at [*date of financial year end*] whether there are reasonable grounds to believe (name of entity) will be able to pay its debts as and when they fall due over the 12 month period from [*date of financial year end*].

Because of the subjective nature of prospective information, the persuasiveness of the evidence available is limited. Prospective information relates to events and actions that have not yet occurred and may not occur, and reflect assumptions that are dependent upon future events and subject to the risks inherent in the business and future economic conditions. Whilst

¹ The requirements of Item 20 Of Annexure 1 are the same as those of Item 10 of Annexure 2 to the *Franchising Code*. Therefore the phrase ‘Item 20 of Annexure 1’ in the auditor’s report may be replaced with “Item 10 of Annexure 2”, as applicable to the relevant franchised business.

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evidence is available to support the assumptions on which the directors’ opinion is based, such evidence is future orientated and speculative in nature. As a consequence, actual results are likely to be different from the information on which the opinion is based, since anticipated events frequently do not occur as expected or assumed and the variations between the prospective opinion and the actual outcome may be significant.

The audit opinion expressed in this report has been formed on the above basis.

Audit Opinion²

In our opinion, the statement by directors dated [*insert date*], presents fairly the directors’ opinion pursuant to Item 20 of Annexure 1¹ to the *Franchising Code of Conduct*, that there are reasonable grounds to believe that [*name of entity*] will be able to pay its debts as and when they fall due.

Date	Firm
Address	Partner

² Under the *Franchising Code*, the independent auditor’s opinion is required to be provided within 12 months after the end of the financial year to which the statement by directors about solvency relates.