

**Agenda Item 12(g).2**

**GS XXX**

(September 2010)

**Guidance Statement GS XXX**  
***Franchising Code of Conduct***  
***– Auditor's Reports***

Issued by the **Auditing and Assurance Standards Board**

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## CONTENTS

### AUTHORITY STATEMENT

	<i>Paragraphs</i>
Application.....	1
Issuance Date .....	2
Introduction.....	3-5
Nature and Extent of the Audit Engagement .....	6-11
Audit Approach.....	12-16
Auditor’s Report .....	17-21
Conformity with International Pronouncements.....	22
Appendix: Example Unmodified Audit Report	

### **AUTHORITY STATEMENT**

The Auditing and Assurance Standards Board (AUASB) formulates Guidance Statement GS **Error! Reference source not found.** pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001*, for the purposes of providing guidance on auditing and assurance matters.

This Guidance Statement provides guidance to assist the auditor to fulfil the objectives of the audit or assurance engagement. It includes explanatory material on specific matters for the purposes of understanding and complying with AUASB Standards. The auditor exercises professional judgement when using this Guidance Statement.

The Guidance Statement does not prescribe or create new requirements.

Dated:

M H Kelsall  
Chairman - AUASB

## GUIDANCE STATEMENT GS XXX

### *Franchising Code of Conduct – Auditor's Reports*

#### Application

- 1 This Guidance Statement has been formulated by the Auditing and Assurance Standards Board (AUASB) to assist auditors to interpret, discharge and report under Item 20 of Franchising Code of Conduct<sup>1</sup> (the “Franchising Code”).

#### Issuance Date

- 2 This Guidance Statement is issued on 1 October 2010 by the AUASB and replaces AGS 1040 *Franchising Code of Conduct – Auditor's Reports* issued in November 2002.

#### Introduction

- 3 Item 20 of Annexure 1<sup>2</sup> to 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.

- 4 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 in accordance with sections 295 to 297 of the *Corporations Act 2001*, or a foreign equivalent of that Act applicable to the franchisor, prepared by the franchisor.

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<sup>1</sup> The *Franchising Code of Conduct* came into operation on 1 July 1998 and was last amended on 3 June 2010. A copy of the Code is available from the Australian Competition and Consumer Commission (ACCC) website (<http://www.accc.gov.au>).

<sup>2</sup> Annexure 1 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 2 to the *Franchising 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. For the purpose of this GS, the guidance applicable to the auditing requirements of the solvency statements under Annexure 1 and Annexure 2 is the same.

20.2A If:

- (a) the franchisor is part of a consolidated entity that is required to provide audited financial reports under the *Corporations Act 2001*, or a foreign equivalent of that Act applicable to the consolidated entity; and
- (b) a franchisee requests those financial reports; financial reports for each of the last 2 completed financial years, prepared by the consolidated entity.

20.3 Item 20.2 and 20.2A do not apply if :

- (a) the statement under item 20.1 is supported by an independent audit [report specifically relating to that statement] provided by:
  - (i) a registered company auditor; or
  - (ii) if the franchisor is a foreign franchisor – a foreign equivalent for that franchisor; 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.”

5 Generally, the financial report of the franchisor needs to be accompanied by an independent audit report addressed to the directors of the franchisor entity for the specific purpose of being provided to franchisees as part of the disclosure document. However, as indicated in Item 20.3, a franchisor will not be required to provide a financial report 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.

### **Nature and Extent of the Audit Engagement**

6 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 liabilities over the 12 month period from the end of the last financial

**Guidance Statement GS XXX *Franchising Code of Conduct – Auditor's Reports***

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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 Franchising 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 *Corporations 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 report and the appropriateness of the going concern basis in accordance with *ASA 570 Going Concern*.

- 7 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 Franchising 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.
- 8 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.
- 9 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.

**Guidance Statement GS XXX Franchising Code of Conduct – Auditor's Reports**

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- 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 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 the *Corporations Act*, as discussed in paragraph 9, 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 obtained 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.
- 11 The audit procedures performed are likely to include a review and assessment of prospective information in relation to cash flows and revenue streams and reflect assumptions that are dependent upon future events and subject to the risks inherent in the business and future economic conditions. The auditor would need to apply professional judgement in auditing these assumptions to determine their reasonableness as such evidence is future orientated and speculative in nature.

**Audit Approach**

- 12 The nature, timing and extent of the audit procedures appropriate to achieve reasonable 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.

*Continuity in Auditor*

- 13 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 entity's circumstances since the audit of the directors' opinion on solvency

**Guidance Statement GS XXX Franchising Code of Conduct – Auditor's Reports**

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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, for example, those identified in Appendix 1 of ASA 315 *Identifying and assessing the risks of Material Misstatement through Understanding the Entity and Its Environment*. 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.

- 14 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.

*Initial Engagement – New Auditor*

- 15 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. This may involve the auditor placing further emphasis on certain areas of the audit:

**Guidance Statement GS XXX *Franchising Code of Conduct – Auditor's Reports***

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- (a) Understanding the entity and its environment and assessing the risks of material misstatement under ASA 315.
  - (b) Obtaining sufficient appropriate audit evidence under ASA 500 *Audit Evidence* to support the solvency statement by Directors:
    - (i) enquiring of management as to the basis on which they have formed their opinion on solvency and evaluating the appropriateness of assumptions on which this is based;
    - (ii) reviewing procedures and controls over cash flows, trading conditions, financial commitments etc that may affect cash flow and budgetary forecasts and the ability of the entity to pay its debts as and when the fall due;
    - (iii) appropriateness of management's use of the going concern assumption in the preparation of the solvency statement under ASA 570 *Going Concern*; and
    - (iv) obtaining written representations under ASA 580 *Written Representations* from management based on the assertions made throughout the engagement.
  - (c) Consideration of subsequent events under ASA 560 *Subsequent Events* that may have the potential to affect the solvency statement by Directors.
- 16 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**

- 17 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.
- 18 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

**Guidance Statement GS XXX Franchising Code of Conduct – Auditor's Reports**

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directors in their solvency statement, an unmodified auditor's report can be issued refer to ASA 700 *Forming an Opinion and Reporting on a Financial Report*. An example report is provided in Appendix 1 to this Guidance Statement.

- 19 If the auditor is of the opinion that the audit evidence is inconsistent with the representation made by the directors, the auditor issues a modified report under ASA 705 *Modifications to the Opinion in the Independent Auditor's Report*.
- 20 If the auditor is of the opinion that there is sufficient and appropriate audit evidence to support the representation made by the directors that events exist that put into doubt the ability of the entity to pay its debts as and when they fall due, the auditor shall express an unqualified opinion but add an emphasis of matter section. ASA 701 *Modifications to the Auditor's Report* may provide the auditor with some further guidance in this area.
- 21 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.

**Conformity with International Pronouncements**

- 22 There is no equivalent International Auditing Practice Statement (IAPS) or Auditing Standard to this Guidance Statement.

## **Appendix 1**

### **Example 1: Example of An Unmodified Auditor's Report**

#### **INDEPENDENT AUDITOR'S REPORT**

[Appropriate Addressee]

#### **Report on Solvency**

We have audited the statement by directors (“the statement”) of [name of entity] dated [insert date] made for the purposes of fulfilling the requirements of Item 20 of Annexure 1<sup>3</sup> to the Franchising Code of Conduct

#### **Directors' Responsibility for the Statement**

The [name of entity] directors are responsible for the preparation and fair presentation of 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. This responsibility includes establishing designing, implementing and maintaining internal controls relevant to the preparation and fair presentation of the statement that is free from material misstatements, whether due to fraud or errors, selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

#### **Auditor's Responsibility**

Our responsibility is to express an opinion on the statement based on our audit. We conducted our audit in accordance with Australian Auditing Standards. These Auditing Standards require that we comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance whether the statement is free from material misstatement.

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

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<sup>3</sup> 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.

**Guidance Statement GS XXX *Franchising Code of Conduct – Auditor's Reports***

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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 required to fulfil the requirements of Item 20 of Annexure 1 to the Franchising Code, 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 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 statement has been prepared pursuant to Item 20 of Annexure 1 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.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Auditor's Opinion**

In our opinion, the statement by directors dated [insert date], presents fairly, in all material respects, the directors' opinion pursuant to Item 20 of Annexure 1 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.

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]