

# [Auditing reacquired franchise rights](https://assignbuster.com/auditing-reacquired-franchise-rights/)

### Worksheet 1: Summary of Reacquired Franchise Rights

Verifying Mathematical Accuracy of Reacquired Franchise Rights Balance

It has been assumed that the beginning balance of reacquired franchise rights was audited last year. Therefore, changes (if any) to this account are audited in the current year so that an auditor can give an opinion on the balance of this asset. Reductions to this asset are likely to be due to a sale, other disposal, or impairment. However, based on the case facts, there is no indication of changes in the current year. The following were the procedures performed:

1. Checking to see if the client reported any impairment – Based on the case facts, Roman Holiday did not identify or report any impairment in the reacquired franchise rights in the current year.
2. Ensuring that each Franchisee market recorded the correct amount for the BV of Reacquired Franchise Rights – Roman Holiday did not sell or dispose any of its reacquired franchise rights (reductions)
neither did they reacquire any new franchise rights (additions) during the current year. This is the reason that there was no change in the recorded amount for these assets.
3. Verifying that the company correctly added the book values of the reacquired franchise rights to include all of the senior franchise markets (please refer to Appendix A) – Upon reviewing the client-
prepared schedule of reacquired franchise rights, the sum of the book values of these intangible assets, for each franchise market, totaled $127, 414, 000. However, there is a $2, 000 ($127, 414 – 127, 412)
deviation between the actual total and the amount that the client reported on its balance sheet ($127, 412, 000). Since, a planned materiality of $5 million is being used this deviation is immaterial and is
likely due to rounding errors.

Based on the above procedures performed and the immaterial deviation between the actual total and the client’s reported amount for the book value of the reacquired franchise rights, we feel that the proper amount has been recorded and as such no further procedures are necessary.

Is the Indefinite life classification for the reacquired franchise rights correct?

According to SFAS 142, it identifies how goodwill and other intangibles are accounted for after their acquisition or in this case their reacquisition. Essentially, it requires the classification of intangible assets as having either a definite or indefinite life. The main difference is that definite-life intangible assets are amortized in a pattern depending on how and when the economic benefits are expected to be received (e. g.: if expected evenly over each year then the straight line method of amortization should be used). In determining whether or not the indefinite-life classification for the reacquired franchise rights is correct we must review through the criteria in SFAS 142 and see how it relates to our client, Roman Holiday. According to SFAS 142, the estimate of the useful life of an intangible asset to an entity is based on an analysis of all pertinent factors, in particular the following[i]:

The expected use of the asset by the reporting entity

Case facts: Essentially, the purpose of reacquired franchise rights is to allow the franchisor (Roman Holiday) to utilize their own brand name in the specific senior franchisee market(s) that they reacquired the rights from.

The expected useful life of another asset or a group of assets to which the useful life of the intangible asset may relate (such as mineral rights to depleting assets)

Case facts: The group of assets that the reacquired franchise rights may relate to is the reacquisition of rights from existing and/or underdeveloped markets or restaurants. Under the contractual repurchase agreement, which has a useful life of 14 years, Roman Holiday is entitled to the use and benefit of these assets (e. g.: the right to continue operating existing restaurants and the right to collect royalties from sub-franchises developed by the Senior Associate)

Any legal, regulatory, or contractual provisions that may limit the useful life

Case Facts: same as part ii. (i. e.: The contractual agreement has a useful life of approximately 14 years which is the same length of the underlying Senior Associate agreement)

Any legal, regulatory, or contractual provisions that enable renewal or extension of the asset’s legal or contractual life without substantial cost (provided there is evidence to support renewal or extension and renewal or extension can be accomplished without material modifications of the existing terms and conditions)

Case facts: The Senior Associate Agreement has a useful life between 10-20 years (approximately 14 years). These agreements are renewable if mutually agreeable to both parties with no substantial costs or material modifications of the existing terms and conditions.

The effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing regulatory environment, and expected changes in distribution channels)

Case facts: According to analysts, the company’s growth will slow (indicating that the pizza industry is in its maturity stage) in the next few years but will still exceed industry averages. However, most of Roman Holiday’s revenue growth, in recent years, is largely due to the reacquisition of franchise rights and existing restaurants as opposed to real growth in the franchise itself. Therefore, Roman Holiday faces stiff competition in this highly competitive industry. In addition, the company markets itself as a gourmet pizza restaurant and only targets consumers willing to pay for a premium product. There are may substitute pizza places that consumers can go to such as Pizza Hut and Domino’s Pizza unless Roman Holiday can continue to distinguish itself from these other restaurants (e. g.: incentives and price discounts).

The level of maintenance expenditures required to obtain the expected future cash flows from the asset (for example, a material level of required maintenance in relation to the carrying amount of the asset may suggest a very limited useful life)

Case facts: There is no maintenance expenditures related to reacquired franchise rights except annual impairment losses, if any.

Based on the above pertinent criteria & related case facts, we feel that the indefinite-life classification is wrong. Instead, it should have a definite life of 14 years, which is consistent with the underlying Senior Associate agreement. Beyond 14 years the intangible asset and its related benefits will expire.

### Worksheet 2: Auditee client impairment analysis

* SFAS 142 vs. SFAS 144
* Types of Auditing Procedures to Evaluate Management’s Assertions
* Client’s Methodology in Estimating the FV of Reacquired Franchise Rights
* Verifying the mathematical accuracy of the client’s estimation the FMV of Reacquired Franchise Rights

### Worksheet 3: Analysis of key assumptions

* Key assumptions made by client in arriving at the FMV Estimate
* Comparison to external & internal information
1. Which provides the greatest level of assurance?
2. Information sources
3. Preparation of a document request to the client
4. Evaluating of key assumptions
5. Evaluation of appropriateness of key assumptions

### Worksheet 4: Auditor impairment analysis on book value of reacquired franchise rights for Arizona acquisitions

* Is Client’s Impairment Assessment Appropriate?
* The role of specialists
* What would be included in a set of working papers?