

**AUDITING INTANGIBLE ASSETS AND EVALUATING FAIR MARKET  
VALUE – THE CASE OF REACQUIRED FRANCHISE RIGHTS**

**ABSTRACT**

The Roman Holiday Pizza Paradise case provides an audit setting that requires students to understand and perform procedures related to the audit of a fair value estimate in connection with the impairment of an unusual intangible asset, reacquired franchise rights, in the pizza restaurant industry. The case focuses on one key aspect – auditing fair market values – a concept that is increasing in importance as financial accounting standards evolve and requires a significant level of auditor judgment. Planning activities as well as performance of year-end auditing procedures are included in this self-contained module that incorporates client interaction and obtained external evidence.

# **AUDITING INTANGIBLE ASSETS AND EVALUATING FAIR MARKET VALUE – THE CASE OF REACQUIRED FRANCHISE RIGHTS**

## **Introduction**

Roman Holiday Pizza Paradise (Roman Holiday, or the Company) is a restaurant franchise featuring Chicago-style wood-fired pizzas. The Company was founded in Atlanta, Georgia, in 1970.<sup>1</sup> The Company's efforts were concentrated in the Georgia, South Carolina, and North Carolina markets for much of its early life. By 1995, the Company had steadily grown to 120 restaurants (40 of which were franchised) in the three-state region (an average of 5 restaurants were opened per year).

The Company developed an aggressive growth plan in the late 1990s to expand across the continental United States. The Company initially financed this growth by forming alliances with "Senior Franchisees" and retaining minority equity stakes in the developing ventures. Details about the arrangements supporting these alliances are provided below. In 1999, the Company boosted its expansion program with an injection of capital from an initial public offering of equity (IPO), in which approximately 2.5 million shares were sold for total proceeds of \$50 million.

By 2004, the number of Company-owned restaurants had increased to 127, and the Company had franchised an additional 800 operations. Restaurant sales posted a high growth rate of approximately 19% per annum in 2004 (see Exhibit 1 for industry growth

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<sup>1</sup> This case is not intended to represent any specific company. The data provided in the exhibits to this case is derived from transformed financial statements of actual companies. Information that is commonly considered to be private was developed by the authors to be consistent with the financial statements.

rates during this period). Despite this growth program, the Company captured less than 5 percent of the U.S. quick-service restaurant (QSR) pizza category market.

Roman Holiday financed its growth by attracting investors through the IPO, debt financing, and by reinvesting earnings. The debt consists of \$22 million outstanding under a five-year \$75 million revolving credit agreement with a consortium of insurance companies. The agreement expires in 2008 and carries an interest rate of LIBOR (London Interbank Offered Rate, the rate charged by one bank to another bank for lending money) plus 2.5%. The company also funded some property acquisitions with other long-term debt totaling \$29 million and bearing interest at an average fixed rate of 6.2%. Investors in the company's common shares have benefited with returns that exceeded the overall market in recent years, averaging 16% per year over the last three years.

### **Pizza Paradise**

Roman Holiday is a specialty pizza restaurant offering dine-in and carry-out services. Operations in some low-density residential areas also provide delivery services. Its principal business is to own and franchise Roman Holiday pizza restaurants in the US. The restaurants offer Chicago-style (deep-dish) pizzas made to order, along with side items including breadsticks, salads, and bottled and fountain soft-drinks. Beer and wine are available to dine-in customers only. Roman Holiday markets itself as a gourmet pizza restaurant and targets consumers willing to pay for a premium product. For example, pizza prices are approximately 20% greater than Pizza Hut, Papa Johns, and Domino's Pizza.

The specialty crusts are made from a proprietary recipe and are available in white and whole-wheat variations, layered with a proprietary-recipe herbed tomato sauce made daily from fresh (not canned or concentrated) tomatoes. Pizza dough and tomato sauce are provided by Regional Commissaries (RCs), which are owned and operated by the Company for quality-control purposes. Available toppings include fresh vegetables and a variety of meats and cheeses, and are customized to local tastes. The proprietary crusts and sauce have provided the Company with a very loyal customer base.

A typical Roman Holiday restaurant averages 2,000 to 2,500 square feet, and is designed to promote an entertaining dining experience for adults and families. Large glass windows provide visual access to the kitchen, permitting diners to watch their pizza being made and then baked in the kitchen's wood-fired ovens. The dining areas feature the Company's signature-style rustic wood furniture and are decorated in a southern Italian travel theme.

Roman Holiday generates revenue from three sources: (a) profits from the operation of Company-owned restaurants, (b) franchise fees and royalties from franchise restaurants (discussed in the following section), and (c) profits of the Regional Commissaries from which all restaurants (company-owned and franchised) are required to purchase pizza dough and sauce (see Figure 1). In addition to a royalty stream, franchising allows the Company to expand its markets without providing the required capital to fund the start-ups of each location. Franchisees provide the capital for expansion. The commissary arrangement permits individual restaurants to lower their cost of goods sold through economies of scale not available to individual restaurants. The

Company captures additional profit margins on these sales while maintaining consistent quality levels across restaurants.

### **The Franchise Business**

Roman Holiday restaurants are divided into three categories. First, Company restaurants are those owned and operated by Roman Holiday. Second, the Company has had an Associate program since the mid-1970s, where restaurants are owned and operated by franchisees. Associates enter into 10-year licensing agreements to operate specific restaurants and are expected to concentrate on operations of these existing restaurants rather than on developing new markets. Associates pay non-refundable franchise agreement fees of \$20,000 for the first restaurant and an additional \$5,000 for each additional restaurant opened. The Associates also pay royalties of 3% on restaurant sales. The licensing agreements are automatically renewed at the end of the term for an additional ten years if the franchisee in good standing (not in default under the agreement).

The third category is the Senior Franchisee program, launched in the mid-1990s, where senior franchisees have responsibilities to develop new territories in addition to operating existing restaurants. Development targets pertaining to the territory include the number of restaurants and timing of development, and are specified in the Senior Franchisee agreements. The Senior Franchisee agreements have durations from ten to twenty years and also grant the right to create sub-franchises. Senior Franchisees have significantly higher fees: they pay 1) a non-refundable \$50,000 fee to become a Senior Franchisee, 2) royalties of 4% on all sales, and 3) an initial franchising fee of \$30,000 for

the first restaurant with fees of \$10,000 for each additional restaurant. However, the Senior Franchisees are able to charge its sub-franchisees even higher fees. Senior Franchisee agreements are also renewable if mutually agreeable to both parties. Under both the Associate and Senior Franchisee programs, Roman Holiday retains the final approval before any franchise (or sub-franchise) agreement is signed or restaurant is opened.

A total of 206 Roman Holiday restaurants were opened in 2005, consisting of 20 Company restaurants, 61 Associate restaurants, and 125 restaurants opened by Senior Franchisees or their sub-franchisees. Approximately one-half of the Company's growth over the next few years is expected to come from the Senior Franchisee agreements. In general, Roman Holiday requires a population of 25,000 within five miles of a proposed location before it would open a restaurant itself or grant a franchisee permission to proceed with launching operations. The Company also establishes a base territory size, within which multiple restaurants are not permitted to operate. This policy increases the probability of success and limits potential cannibalizing between Roman Holiday restaurants.

As of December 31, 2005, there were 147 Company restaurants, 132 associates operating 361 restaurants, and 64 Senior Franchisees operating 625 restaurants. The Senior Franchisees were under contract to open an additional 179 restaurants over the duration of their contract periods. All franchise fees for initial restaurants are due at the time the franchise agreement is signed. Any franchise fees for subsequent restaurants are due when the restaurant opens. Percentage fees on restaurant sales are remitted to the Company at the end of the month in which they are earned by the franchisee.

In addition to initial franchise contracting rights, the Company provides layout and design services to franchisees. Franchisees may also purchase kitchen equipment packages (including the wood-fired ovens) from a third-party supplier at a discount arranged through the Company. The Company provides, for an additional fee, site-selection services to franchisees. Site-selection services encompass economic analyses of market demands, foot and automobile traffic patterns, local demographic characteristics, and other competitive elements. Franchisees are not required to purchase site-selection assistance from the Company.

### **Planning Meeting**

Roman Holiday has been a client of your auditing firm for over ten years and has grown in importance with the audit fees that have accompanied its recent growth spurt. The client is one of the top 20 audit clients in the office in terms of recurring audit fees, and is the primary client for the past three years for the partner in charge of the audit who will be rotating out from the client in two years. Your firm provides no significant non-audit services to Roman Holiday. An unqualified audit opinion with no explanatory language accompanied the 2004 financial statements.

During 2005, management completed its interim documentation and assessment of the internal control environment as required by Section 404 of the Sarbanes-Oxley Act of 2002. Management concluded that there were no substantive problems with the internal control system.

The 2005 financial statement audit is to begin in the next few weeks. The audit manager held a planning meeting with the audit senior and other staff assigned to the

engagement. The following dialog is from the portion of the planning meeting that relates to 1) background and update on the client and 2) the audit of reacquired intangible assets.

MANAGER: Welcome everybody. The Roman Holiday audit this year is going to provide a number of challenges for us and I believe each of you will have a very rewarding experience. I want to remind everyone that Roman Holiday is an important client for our office. First, I want to introduce the newest member of our team, Chris, who will be the audit senior for the engagement.

SENIOR: Thank you. I look forward to the audit and working with everyone. I believe my previous audit experience in the franchise industry will contribute to the quality of the audit.

MANAGER: I would like to start by providing an industry update – both pizza in general and franchised operations. Chris, would you like to provide the update?

SENIOR: No problem. The industry consists of a number of household names that are present in many parts of the country and a large number of family-owned restaurants. The industry is therefore very competitive. Overall, the quick-service pizza restaurant business continues to experience strong growth. However, this growth is not uniformly distributed amongst industry members. The larger players (such as Pizza Hut, Domino's) continue to grow, primarily through restaurant openings rather than same-restaurant growth. Smaller players tend to serve a subset (niche) of the market. The growth of these firms depends on the niche they serve and their ability to execute their individual strategies. For example, restaurants providing gourmet pizzas are experiencing higher growth as new



locations and markets are being developed. There appears to be higher consumer demand for this type of pizza.

MANAGER: What about the franchise part of the business?

SENIOR: Franchising is very common among the larger players and is how these businesses became household names. Franchising continues to provide the capital to finance their growth. These companies lend their brand name and operating expertise for a share of the revenue (typically between three and four percent of revenue). In addition to royalty payments, franchisors commonly require upfront fees to purchase the franchise and many require franchisee to purchase supplies from a central location to maintain consistency. Franchisors who want to expand operations at minimal financial risk and greater profits find this process very attractive.

While franchising continues to be used to fund growth, we are also seeing some reverse franchising in the past few years. Specifically, franchisors are reacquiring rights for existing restaurants and/or undeveloped markets. Roman Holiday has been involved in these types of transactions over the past few years. The reason for these acquisitions are varied and include taking over poorly-performing restaurants to protect the Company's brand name, and to preserve the value of the local market. Reacquisitions also take place for strategic cash-flow management reasons whereby investing current free cash flows in the reacquisition yields the expectation of replacing franchise royalties with the larger profits from the restaurants themselves. Prices paid in these acquisitions vary substantially, but almost always include some premium related to the contractual

element of the franchise rights that is capitalized as an intangible asset. However, it must be noted that the classification and nature of the intangible asset varies substantially. For example, Krispy Kreme recorded the asset as an indefinite-life intangible asset, Brinkers International (parent of Chili's) recorded the asset as a definite-life intangible asset and amortized it over the life of the franchise agreement, and Yum Brands, Inc. initially recorded it as a separate asset, but changed their approach several years ago and now classifies its reacquired franchise rights as part of goodwill.

MANAGER: Thanks, Chris. Now, let's discuss the client. The company continues its high growth in its post-IPO stage. This past year, over 200 restaurants were opened by the Company and its franchisees.

ASSISTANT: Is the growth sustainable? A recent industry analysis suggests annual sales growth for firms within this industry was approximately 4.3% in 2005.

MANAGER: That represents a risk the company faces. Analysts generally believe that the growth will slow in the next few years, but will still exceed the industry averages. However, much of the company's revenue growth in recent years came from acquisitions of franchise rights and existing restaurants rather than real growth in the franchise. Management is aware of these issues and may be feeling some pressure to meet growth targets and earnings forecasts.

SENIOR: When reviewing the memo about the SAS 99 brainstorming session held prior to my involvement with this client, I noticed that there did not appear to be a concern about irregularities with the client. Do you think the pressure that

management is feeling towards meeting earning forecasts could lead in the future to a heightened risk for possible irregularities?

MANAGER: No, I don't think so. We believe that the integrity of management, the tone at the top, is good, and we have not noticed any red flags that would suggest irregularities during previous audits. However, as always, you should maintain your professional skepticism as you conduct your audit procedures.

ASSISTANT: What about this growth by acquisitions? Is this an area of the audit that we should be concerned with?

MANAGER: Yes, I do consider this a higher risk area. I want to expand on two issues that will affect our audit in this area. First, I want to discuss the accounting for reacquired franchise rights and second, the required impairment analyses. The 2004 balance sheet included \$127 million in reacquired franchise rights. This is clearly significant as it is over 25% of the company's total assets. These Rights are acquired from Senior Associates and consist of the contractual responsibility to develop new territories, the right to continue operating existing restaurants, and the rights to collect royalties from sub-franchisees developed by the Senior Associate.

ASSISTANT: In the 2004 annual report, the company defined reacquired franchise rights as "the excess of the net amount assigned to identifiable assets and liabilities recorded upon the acquisition of franchise markets." That definition sounds more like goodwill to me.

MANAGER: Normally, the excess of the purchase price over the fair values of net assets acquired would be assigned to goodwill. In this case, the company historically

followed the residual value approach to provide an initial valuation of the reacquired franchise rights (assigning excess purchase price above the fair value of tangible acquired assets to an intangible). The residual valuation approach was permissible in prior years to provide intangible asset values when a direct valuation was not practical. As of September 29, 2004, the SEC no longer considers the residual value approach acceptable for new acquisitions (SEC 2004). However, all of the company's re-acquisitions were completed before this date, so are not affected by the new rule. All amounts capitalized as reacquired franchise rights were therefore determined under the residual valuation approach.

**SENIOR:** SFAS 142 requires the classification of intangible assets as either a definite life or indefinite life intangible asset. The main difference is that definite life intangible assets are amortized. The client classifies the reacquired franchise rights as indefinite life intangible assets. This classification is important and we need to challenge this assessment annually to determine if circumstances are such that a change in classification is warranted. Of the companies that separately record required franchise rights, there are very few that classify the intangible asset as indefinite life. SFAS 142 also requires companies to review all intangible assets at least annually for impairment or whenever events or circumstances indicate the carrying amount of the asset may be impaired. What is the client's policy?

**MANAGER:** The client's policy is to review all intangible assets annually for the potential for impairment. Since this is such an important account from a materiality perspective, we tested the controls related to reviewing impairments

and found the controls in place and operating effectively. However, these controls primarily focus on identifying impairment issues, completing the required analysis, using appropriately trained staff members, and adequately reviewing the analysis and conclusion. The content of the actual analysis is the most important step. I therefore discussed the issue of impairment with the CFO yesterday. She indicated that their analysis suggested that impairment did not exist.

SENIOR: What type of analysis did the company do?

MANAGER: That was the problem. In the past, the Company estimated the fair value of the reacquired franchise rights associated with each market. The CFO directed her staff to take a different approach this year that emphasizes the firm as a whole. The current analysis is therefore based on the market capitalization of the company. Her reasoning was that the book value of the net assets of the company excluding the reacquired franchise rights reasonably approximate their fair values. The balance of the market capitalization therefore relates to the company's combined reacquired franchise rights. Since the market capitalization exceeds the book value of equity, no impairment exists.

SENIOR: Their new approach is not consistent with SFAS 142 as other non-recorded assets are ignored in this approach. We should not rely on this analysis. What are we going to do?

MANAGER: I did let the CFO know that the Company's impairment analysis was unacceptable for GAAP reporting purposes. She said that she would have her staff prepare a more detailed present-value analysis to estimate the fair value of the reacquired franchise assets for each market. The analyses should be complete by

the time we begin our year-end procedures. We need to really understand their analysis to be able to audit management's valuation in an objective and intelligent manner.

## **REQUIREMENTS**

### **Part 1 - Planning**

You are the audit senior assigned to the audit of Roman Holiday Company. You recently attended the audit planning meeting for this year's engagement and want to get started on the other planning activities. Complete the procedures below.

1. Identify the most relevant client assertions with respect to reacquired franchise rights. Some of these assertions may have been identified as part of the internal control audit. Specify which of these assertions may possibly have been identified as part of the control environment.
2. Determine the audit risks associated with the reporting of reacquired franchise rights (specific to the audit of reacquired franchise rights). Consider the risks associated with each assertion identified in question 1, above.
3. Identify possible controls pertaining to reacquired franchise rights that may increase the likelihood that each of the assertions identified in question 1, above, are correct and map the controls to the audit risks you identified in question 2, above. Consult SAS 101, paragraph 12 (AICPA 2003) for information on controls.

4. What is your preliminary assessment of the audit risk associated with the audit of reacquired franchise rights? Make a qualitative assessment of audit risk as high, moderate, or low and then indicate why you chose that level of risk assessment.
5. Use the preliminary financial 2005 financial information provided in the Exhibits and other qualitative information about the client to determine an overall quantitative materiality level as well as a materiality that should be used for the audit of reacquired franchise rights. How does this differ from a qualitative materiality level?
6. Explain how your assessment of the risk associated with the audit of reacquired franchise rights affects the nature, extent and timing of audit testing. In what ways will this assessment affect the allocation of professional staff by rank and expertise?

## **Part 2 – Year-end Procedures**

After the fiscal year end, management updated its assessment of the internal control environment finding no additional problems. Your firm also completed its testing and review of controls and intends to issue an unqualified opinion based on the audit team's assessment that there are no *material* weaknesses in the controls. You reviewed the results of the interim procedures and determined that the year-end procedures for the auditing reacquired franchise rights are appropriate. The audit of intangible assets is complicated this year and potentially creates increased audit risk. As the audit senior, you determined that you should complete certain year-end procedures yourself based on discussions during the planning meeting.

Preliminary financial information for 2005 along with comparative financial information extracted from Roman Holiday's 2004 annual report is provided in Exhibits

2 through 4. The financial information includes the comparative balance sheet, statement of operations, and accounting policies related to intangible assets.

Complete the following procedures contained in the audit program.

1. Obtain the client-prepared schedule of reacquired franchise rights during the year (Exhibit 5) and verify the mathematical accuracy of the schedule and reconcile the total to the preliminary balance sheet. Assume that all amounts are unchanged from prior years and that all amounts agree with last year's audit work papers. Indicate all procedures performed.
2. Evaluate the client's determination of an indefinite life classification for the reacquired franchise rights in accordance with SFAS 142. Is the indefinite life correct? If not, what should be the asset life?
3. In past years, the Company executed a number of acquisitions. You assigned different members of the audit team to audit the impairment analysis of the various markets in which the Company made acquisitions and recorded reacquired franchise rights. You retained responsibility to analyze the Arizona market. Obtain and evaluate the client's impairment assessment for the reacquired franchise rights related to the Arizona market (Exhibit 6). Supporting details for the calculations are found in the notes to Exhibit 6.
  - a. Review SFAS 142 and SFAS 144 to determine which standard is applicable in the current situation and establish the type of analysis required to determine whether an intangible asset is to be impaired



- b. Review SAS 101 (AU section 328) and identify the types of auditing procedures necessary in order to evaluate management's assertions in estimating the fair value of the reacquired franchise rights.
- c. Compare the client's methodology to those discussed in SFAS 142 and SFAS 144. Is the client methodology in estimating the fair value of the reacquired franchise rights acceptable based on the methodologies suggested by SFAS 142 or SFAS 144? Why or why not? If you do not believe that the client's methodology is appropriate, what course of action would you take?
- d. Verify the mathematical accuracy of the client's estimation of the fair value of the reacquired franchise rights associated with the Arizona market (Exhibit 6). Indicate the procedure(s) performed.
- e. Based on your review of the client's valuation of the reacquired franchise rights, identify the key assumptions made by the client in preparing the fair value estimate.
- f. Evaluate the client's key assumptions in arriving at the estimated fair value for the reacquired franchise rights by comparison to external and internal information.
  - i. Which provides the greatest level of assurance: internal or external information? Why?
  - ii. Identify information sources from which to obtain the information required to audit each assumption.
  - iii. Prepare a document request to the client to a) obtain the information the client relied on in determining the assumptions, and b) other client-

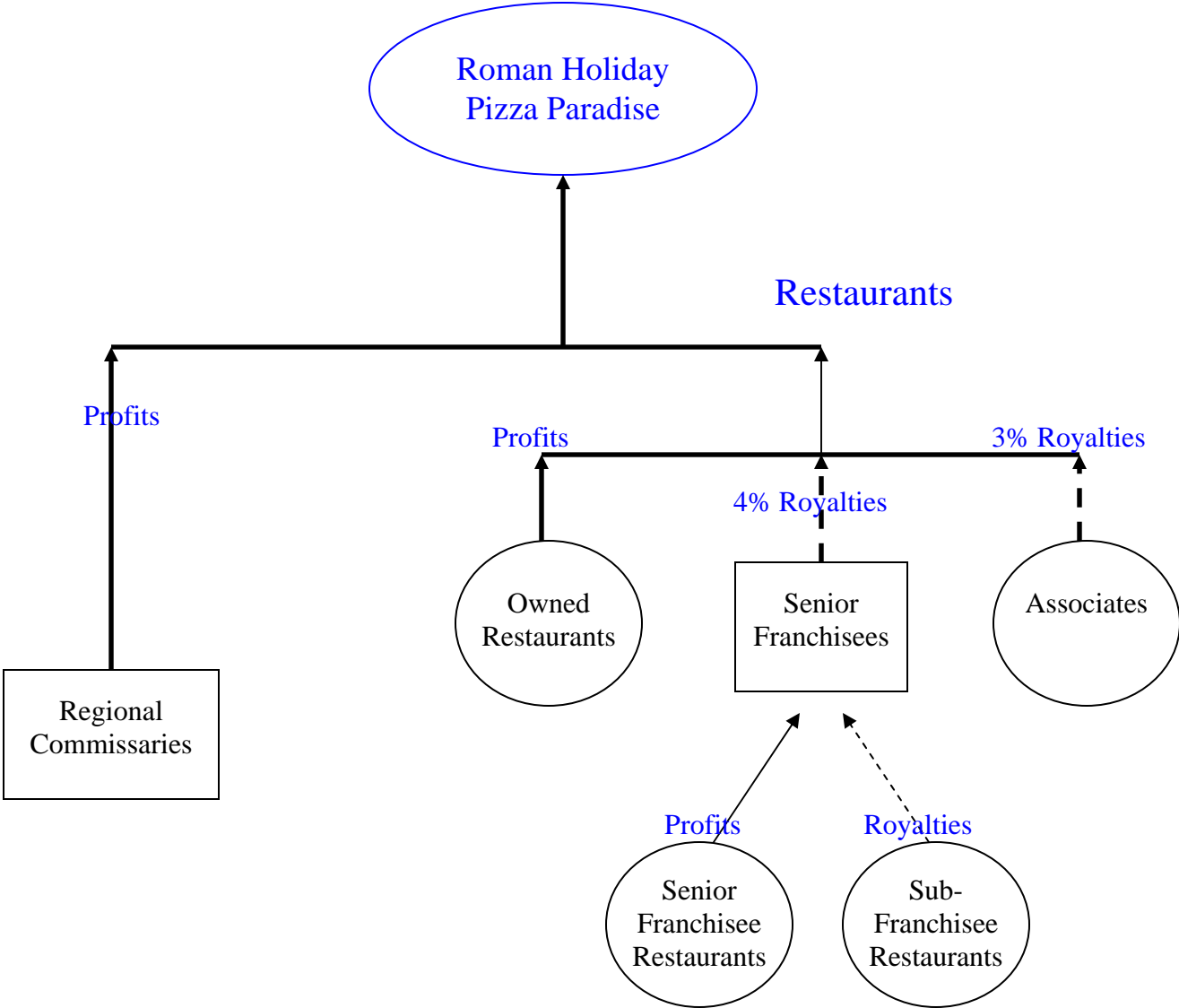
specific information that you may reasonably use to evaluate the assumptions and information supporting the assumptions (the instructor, acting for the client, will then provide requested information that is available from the client).

- iv. Identify Internet and other external sources to obtain additional evidence in order to evaluate the key assumptions. This external evidence may include information on the Arizona pizza market from industry sources to evaluate growth rates and revenue levels and financial market information to support discount rates
  - v. Use the information obtained from the client and on your individual search to complete your evaluation of the appropriateness of the key assumptions identified in requirement 3(e), above.
  - vi. Based on comparisons with applicable evidence and your assessment of the individual assumptions, determine acceptable value ranges for the key assumptions. Prepare a sensitivity analysis of the estimated fair value (and potential basis for impairment) of the reacquired franchise rights for the Arizona market where the values of the key assumptions are changed based on your comparison.
  - vii. Is the client's impairment assessment appropriate? Why or why not? If not, what does this indicate about the client's internal controls regarding impairments?
4. Consult SAS 101. What role would *specialists* play in help in determining the validity of management's assertions on fair market value issues?

5. What should be included in a set of working papers to be reviewed by the manager?

Assemble your work as a set of working papers to be reviewed by the manager.

**FIGURE 1 – OPERATIONS OF ROMAN HOLIDAY PIZZA PARADISE**



**EXHIBIT 1 – 2003 - 2004 SALES GROWTH FOR  
SELECTED U.S. PIZZA RESTAURANTS**

Restaurant	% Sales Change vs. 2003
Pizza Hut	4.5
Domino's	5.7
Papa John's	0.5
Little Caesars	3.9
Chuck E. Cheese's	9.2
California Pizza Kitchen	22.8
Uno Chicago Grill	8.0
Cici's Pizza	14.5
Round Table Pizza	3.1
Godfather's Pizza	3.0

SOURCE: Technomics (May 2006). Industry Facts: Sales and % Change for Top 100 Chain Restaurants.  
<http://www.technomics.com>. Chicago, IL.

## EXHIBIT 2 – BALANCE SHEETS

(Amounts in 000s)	DEC 31, 2004	DEC 31, 2005 Preliminary
Cash and cash equivalents	\$ 8,508	\$ 15,351
Short-term investments	6,772	0
Accounts receivable, less allowance for doubtful accounts of \$1,738 (2004) and \$1,555 (2005)	25,092	33,115
Accounts receivable, affiliates	8,720	17,011
Inventories	17,786	21,071
Prepaid expenses	2,539	4,131
Deferred income taxes	<u>8,605</u>	<u>10,531</u>
Total current assets	78,023	101,210
Property and equipment, net	147,867	157,843
Investments in unconsolidated joint ventures	8,917	14,626
Reacquired franchise rights	127,412	127,412
Other intangible assets, net	20,622	24,226
Other assets	<u>3,819</u>	<u>6,968</u>
Total assets	<u>\$386,662</u>	<u>\$432,285</u>
Accounts payable	\$ 10,260	\$ 13,948
Accrued expenses	30,245	23,013
Current maturities of long-term debt	<u>3,067</u>	<u>2,089</u>
Total current liabilities	43,572	39,050
Deferred income taxes	7,190	4,684
Long-term debt, net of current portion	41,747	48,591
Other long-term obligations	<u>3,809</u>	<u>8,153</u>
Total long-term liabilities	52,746	61,428
Commitments and contingencies		
Minority interest	3,791	1,696
Common stock, no par, 250,000 shares authorized; issued and outstanding 60,853 (2003) and 61,286 (2004)	212,884	214,643
Accumulated other comprehensive loss	(1,085)	(960)
Retained earnings	<u>74,754</u>	<u>116,428</u>
Total shareholders' equity	<u>286,553</u>	<u>330,111</u>
Total liabilities and shareholders' equity	<u>\$386,662</u>	<u>\$432,285</u>

### EXHIBIT 3 – STATEMENTS OF OPERATIONS

(Amounts in 000s except per share amounts)	DEC 31, 2003	DEC 31, 2004	DEC 31, 2005 Preliminary
Total revenues	287,878	358,831	485,882
Operating expenses	231,371	278,487	370,399
General and administrative expenses	20,120	21,095	26,946
Depreciation and amortization expenses	5,810	8,958	14,398
Arbitration award	<u>0</u>	<u>6,625</u>	<u>-383</u>
Income from operations	30,578	43,666	74,523
Interest income	2,175	1,435	672
Interest expense	-246	-1,300	-3,219
Equity loss in joint ventures	-439	-1,466	-1,340
Minority interest	-837	-1,670	-1,513
Other expense, net	-172	-682	-9
Income before income taxes	31,059	39,984	69,114
Provision for income taxes	<u>11,803</u>	<u>15,545</u>	<u>27,441</u>
Net income	<u>\$19,256</u>	<u>\$24,439</u>	<u>\$41,674</u>
Basic earnings per share	\$0.36	\$0.43	\$0.68
Diluted earnings per share	\$0.33	\$0.40	\$0.66

## **EXHIBIT 4 – SIGNIFICANT ACCOUNTING POLICIES**

### **(EXTRACTED FROM 2004 ANNUAL REPORT)**

GOODWILL, REACQUIRED FRANCHISE RIGHTS AND OTHER INTANGIBLE ASSETS. Effective fiscal 2003, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets," which addresses the accounting and reporting of goodwill and other intangible assets subsequent to their acquisition.

Goodwill represents the excess of the purchase price over the net assets acquired in connection with business acquisitions. In accordance with SFAS No. 142, goodwill has an indefinite life and is no longer amortized but is reviewed at least annually for impairment or whenever events or circumstances indicate the carrying amount of the asset may be impaired.

Reacquired franchise rights result from the acquisition of franchise markets from existing franchisees. The excess of the net amount assigned to identifiable assets and liabilities recorded upon the acquisition of franchise markets is assigned to the value of the asset representing the franchise right to the market acquired. Reacquired franchise rights have an indefinite life and are reviewed at least annually for impairment or whenever events or circumstances indicate the carrying amount of the asset may be impaired in accordance with SFAS No. 142.

The Company performs its annual test of impairment as of December 31. The Company completed its impairment test of goodwill, reacquired franchise rights and indefinite-lived other intangible assets each year and found no instances of impairment. Additionally, no events or circumstances indicated impairment of our definite-lived intangible assets.



**EXHIBIT 5 –CLIENT PREPARED SCHEDULE OF  
REACQUIRED FRANCHISE RIGHTS**

Senior Franchisee Market	Minimum Development Quota <sup>1</sup>	Restaurants Previously Opened by Senior Franchisee	Year Acquired	Book value of Reacquired Franchise Rights (in 000s)
New Jersey	20	2	2003	\$10,200
Southern Florida	30	7	2003	25,206
Arkansas	8	2	2004	12,034
Houston and Dallas	25	6	2004	16,186
Arizona	20	3	2004	20,777
Northern California	36	5	2004	43,011
Balance at end of year		1		\$127,412

<sup>1</sup> The minimum development quota is the minimum number of restaurants the Senior Franchisee is required to open over the duration of contract period, of which the Senior Franchisee had previously opened the indicated number of restaurants as of Roman Holiday’s acquisition of the Senior Franchisee’s operations.

**EXHIBIT 6 – CLIENT-PREPARED IMPAIRMENT ANALYSIS FOR REACQUIRED FRANCHISE RIGHTS FROM THE  
ARIZONA ACQUISITION**

(Amounts in 000s)

Book value \$20,777  
 Fair value estimate 22,320  
 Fair value is in excess of book value – no impairment

Projected Net Cash Flow

(\$ in 000s)	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
No. of Restaurants Open at the End of Year (1)	7	11	15	19	23	27	31	35	39	43	47	50	50	50
Projected Royalties (2)	728.00	1,144.00	1,560.00	1,976.00	2,392.00	2,808.00	3,224.00	3,640.00	4,056.00	4,472.00	4,888.00	5,200.00	5,200.00	5,200.00
Projected Franchise Fees (3)	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	30.00	-	-
Projected Expenses (4)	(153.60)	(236.80)	(320.00)	(403.20)	(486.40)	(569.60)	(652.80)	(736.00)	(819.20)	(902.40)	(985.60)	(1,046.00)	(1,040.00)	(1,040.00)
Projected Net Cash Flow	614.40	947.20	1,280.00	1,612.80	1,945.60	2,278.40	2,611.20	2,944.00	3,276.80	3,609.60	3,942.40	4,184.00	4,160.00	4,160.00
Discount Rate	6.0%													
Present value of net cash flows	22,320.00													

- (1) At the end of 2005, there are 3 restaurants opened under the Senior Franchisee agreement (all restaurants were opened by sub-franchisees; Roman Holiday therefore did not acquire any actual restaurants in Arizona). Annual growth in number of restaurants to be opened in the market is assumed to be 4, up to a maximum number of 50 restaurants.
- (2) Projected royalties equal the product of the number of opened restaurants, number of weeks in a year, the weekly revenue per restaurant of \$50,000, the royalty rate of 4%, and the number of restaurants open at the end of the year is based on the growth rate.
- (3) Projected franchise fees are based on the projected growth rate in number of restaurants opened per year and per restaurant franchise fee of \$10,000
- (4) Projected expenses equal 20% of total projected revenue (royalties and franchise fees).

## REFERENCES

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**AUDITING INTANGIBLE ASSETS AND EVALUATING FAIR MARKET  
VALUE – THE CASE OF REACQUIRED FRANCHISE RIGHTS  
LEARNING OBJECTIVES, IMPLEMENTATION GUIDANCE,  
AND EVIDENCE OF EFFICACY**

**Overview of Case**

The Roman Holiday case addresses the current issue of auditing fair values. Fair market values are a topic of perennial interest to accountants and auditors (Martin et al. 2006). Recent speeches and presentations make it clear that the FASB is moving inexorably toward a fair value-based reporting system (SFAS 157 [FASB 2006]). As a consequence, auditors will need to know how to audit such amounts whether reported in the balance sheet, used to determine changes in income, or disclosed in the financial statements. The Roman Holiday case provides instructors with an in-depth case that address the importance and complexity of fair value issues and requires student to exercise significant audit judgment.

The case is derived and adapted from a highly-publicized transaction involving a series of franchise acquisitions wherein Krispy Kreme Doughnuts, Inc. recognized a significant reacquired franchise rights intangible.<sup>1</sup> This case involves performing

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<sup>1</sup> This case overlaps with Holder-Webb and Kohlbeck (2006) in its focus on the reacquired franchise rights intangible, but provides a substantially different focus. Holder-Webb and Kohlbeck (2006) emphasize the development of student awareness of the economic benefits arising from this contractual asset and the effects of Krispy Kreme’s use of the residual value approach to value the asset during the numerous acquisitions made in the early 2000s. In this case, we assume that the initial value of the asset is

planning procedures for the audit of the reacquired franchise rights (Part 1) and substantive procedures concerning a potential impairment of these rights related to one market – Arizona (Part 2). The determination and audit of a fair value estimate is the cornerstone of the impairment analysis.

### **Learning Objectives**

The case promotes five learning objectives related to the audit process. First, students develop an understanding of the importance of using financial information in completing specific audit procedures. Second, students also increase their understanding of how industry and competitor information is used in the audit process. Third, students are exposed to a critical auditing skill, developing an information search. Fourth, students are provided the opportunity to appreciate the importance of fair values in the audit process. Finally, students are able to immerse themselves in a real-world illustration of auditing in the complex and evolving fair value issue.

### **Implementation Guidance**

The Roman Holiday case provides material to be used in either undergraduate or graduate auditing classes. It is most effective as a group project so that students are exposed to multiple viewpoints and reach a consensus before the class discussion of the case. Instructors should consider assigning the case as a collaborative project and

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appropriate, and consider the ramifications of the difficulty in valuing this item as the business reporting cycle moves forward from the acquisition date.

schedule a class discussion after each part of the project is submitted. Instructors should allow a minimum of 45 minutes for class discussion of each part.

The case was developed so that the instructor could assign Part 1, Part 2, or both parts of the case. The first part of the case involves planning the intangible asset audit and is not specific to the primary fair value issues. The instructor may want to skip this part if time is limited. In this situation, the instructor should provide the students with a materiality level to use in Part 2. Alternatively, the instructor may want to use this part independently as an illustration of the audit planning process.

Part 2 of the case involves substantive year-end auditing procedures related to the intangible assets and incorporates the fair value issues in auditing the assessment of the intangible asset impairment. Specifically, the bulk of the fair value audit issues in this case are in Requirement 3. This requirement guides the students in a step-by-step fashion through the complete audit of the year-end impairment assessment.

An important part of this requirement is the acquisition of information from the client and external sources to complete the audit. As structured in the case, students are required to prepare a document request to the client (i.e. the instructor) in requirement 3(f) (iii) before Part 2 can be completed. Students are also asked to identify external sources (Internet, industry guides, etc.) in requirement 3(f) (iv). At this point, instructors may wish to instruct students to attempt obtaining the external data. While this proved to be a very difficult task for students in the class-test, the importance of this procedure cannot be over-emphasized. This requirement provides students an opportunity to obtain information in an unstructured, yet realistic setting (which is similar to most work-based experiences) where skills are many times lacking. Once these two requirements are

completed, Exhibit 2 to the Teaching Notes has been prepared that the instructor can distribute to students in response to their client document request.<sup>2</sup> This Exhibit also includes sufficient external information so that the search in requirement 3(f) (iv) is not required to be completed. Upon receipt, the students should be able to complete the balance of Part 2.

Class-testing the case (see the following section) identified a number of implementation issues. First, the case is complex and incorporates a number of audit issues in addition to the fair value procedures. The case is therefore best assigned late in the semester, with students permitted an extended period of time during which to formulate answers. Students should be given at least one week for Part 1 and two weeks for Part 2. Second, some students (such as undergraduates, students less familiar with the financial accounting issues pertaining to fair values, or those enrolled in intensive courses where time constraints are significant) may require additional guidance on completing case requirements. Exhibits 4 and 5 to the Teaching Notes provide this additional guidance. Students in an undergraduate class where the instructor used earlier versions of these handouts indicated that the case would have been difficult to complete without them.

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<sup>2</sup> For advanced students, the instructor may wish to provide the client information in response to student demands for particular pieces of information. While this adds significantly to the degree of realism in the case, the differing levels of information may make subsequent classroom discussions more difficult. It therefore recommended that the same amount of information be provided to all students. The differing requests can then be used to illustrate how the audit may be compromised by inadequate information.

Students also encountered difficulties in the external search for information (Requirement 3(f)(iv) of Part 2) due do a combination of inexperience in focused Internet-based searches and the lack of specific directions in the requirement. As discussed in more detail above and in the Teaching Notes, instructors may not want to require the actual search in this requirement. To preserve the search requirement for more instructors in more advanced courses, the case requirement has been stated so that the instructor must proactively request that students complete the search.

### **Evidence of Efficacy**

This case has been used in both undergraduate and graduate auditing classes at two different schools by three different professors. It has been used in the module on audit planning and testing sections of the courses as a means of integrating the important topic of auditing fair market values. Instructors found the case an effective instructional tool that 1) links theory and practice, and 2) addresses a current topic (auditing fair value measurements) that lacked adequate resources.

As a vehicle to assess students learning, each student was asked to complete the student survey instrument included in the appendix. We asked students to respond to their perceived learning on five different questions. On a five point Likert-type scale anchored by (1) “Strongly Disagree” and (5) “Strongly Agree,” the results from the 42 student responses (means with standard deviations in parentheses) of students are as follows:<sup>3</sup>

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<sup>3</sup> Nineteen of the students were from an undergraduate auditing class at one university and 23 were graduate students in two separate classes at a second university. The results from all classes are reported on a combined basis as there were no discernable differences in the survey responses.



1. Importance of considering financial information in the audit process. 4.24 (0.82).
2. Importance of considering industry and competitor information in the audit process. 4.10 (0.82).
3. Importance of information search in the audit process. 4.38 (0.70).
4. Importance of fair market values in the audit planning process. 4.24 (0.98)
5. Provided a real world illustration of auditing issues. 4.29 (0.99).

These responses suggest that the case achieved the learning objectives that we attempted to illustrate.

We also asked students two open-ended qualitative questions on the overall case objectives. Specifically, the first question asked, “What parts of the case do you think were most useful in furthering your understanding of the importance of fair market values in the audit process?” One respondent stated “The dialogue between the senior and the manager,” while another respondent wrote, “Analyzing the associate/franchisee relationship and how you value that if the company were to buy it back.”

The second question was “What parts of the case do you think were most useful in furthering your understanding of the importance of information search in the audit process?” One student answered, “Looking at how to determine what accounts to examine more in-depth and how to establish corroborating evidence that gives reasonable assurance,” while another respondent stated, “searching for the right discount rate and studying competitors and the growth and expansion of the market.”

Finally, we asked students whether “you would recommend that instructors at other universities use this case” and why or why not. The students overwhelmingly recommended the case (over 85% of respondents). Those not recommending the case did

so because they felt the case was too difficult. The overall recommendation can be summarized in one student response that stated, “the case is a little complex but once you start applying and putting together the auditing concepts, you really surprise yourself about how much knowledge you really gathered from the course.”

## REFERENCES

- Financial Accounting Standards board (FASB). 2006. *Fair Value Measurements. Statement of Financial Accounting Standards No. 157*. Norwalk, CT: FASB.
- Holder-Webb, L. and M. Kohlbeck. 2006. The Hole in the Doughnut: Accounting for Acquired Intangibles at Krispy Kreme. *Issues in Accounting Education* 21(3): 297-312.
- Martin, R. D., J. S. Rich and T. J. Wilks. 2006. Auditing fair value measurements: a synthesis of relevant research. *Accounting Horizons* (September): 287-303.

## APPENDIX - STUDENT SURVEY INSTRUMENT

The purpose of this survey is to accumulate your reactions to the Roman Holiday case. Your feedback will be used to revise this case and submit it for publication in an accounting journal. Your comments below are anonymous (i.e. the survey does not include any method to identify you). However, your comments may be quoted in the teaching notes that accompany the case.

Your Opinion - The case was written with several objectives in mind. Rate how well these objectives were achieved by checking the column that indicates your level of agreement for each of the following statements.

	Strongly Disagree	Disagree	Neither Agree nor Disagree	Agree	Strongly Agree
The case helped me understand the importance of considering financial information in the audit process	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
The case helped me understand the importance of considering industry and competitor information in the audit process.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
The case helped me understand the importance of information search in the audit process	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
The case helped me understand the importance of fair market values in the audit process	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
The case provided a real-world illustration of auditing issues.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

What parts of the case do you think were most useful in furthering your understanding of the importance of fair market values in the audit process?

What parts of the case do you think were most useful in furthering your understanding of the importance of information search in the audit process?

What other information would have been useful to provide to enhance the learning experience of the case?

Did you find anything in the case unclear or unrealistic? If so, what specific part(s) of the case were unclear or unrealistic?

Would you recommend that instructors at other universities use this case? Why or why not?

**AUDITING INTANGIBLE ASSETS AND EVALUATING FAIR MARKET  
VALUE – THE CASE OF REACQUIRED FRANCHISE RIGHTS  
TEACHING NOTES**

**Overview**

The Roman Holiday case provides material to be used in either undergraduate or graduate auditing classes and addresses the current issue of auditing fair values. The case should be assigned to groups for out-of-class preparation, followed by in-class discussion. The case is derived and adapted from a highly-publicized transaction involving a series of franchise acquisitions wherein Krispy Kreme Doughnuts, Inc. recognized a significant reacquired franchise rights intangible.

This case involves performing planning procedures for the audit of the reacquired franchise rights and substantive procedures concerning a potential impairment of these rights related to one market – Arizona. These teaching notes provide answers to the case requirements, followed by a wrap up of why auditors need to look at both financial and non-financial information (Cohen et al. 2000) when evaluating fair market value issues.

The teaching notes are organized in two parts according to the case requirements. Exhibits provide supplementary data that may be relevant to estimating the fair value of the rights and represent the information that the client may provide the auditor in part 2 of the case. This data may be provided as a single burst for use in an undergraduate course or provided on-demand to students in a graduate course. In the latter case, students should be informed that some additional information about the company and its markets is available from the client, and that requests for specific types of information should be

directed toward the instructor. The need for students to determine what additional information is required increases both the difficulty and the realism of the case.

Finally, Exhibits 4 and 5 provide handouts for the instructor who wishes to offer additional guidance to the students when completing the requirements. These handouts are discussed in more detail in the Implementation Guidance.

### **Suggested Solutions to Requirements: Part 1 - Planning**

*1. Identify client assertions with respect to reacquired franchise rights. Some of these assertions may have been identified as part of the internal control audit. Specify which of these assertions may possibly have been identified as part of the control environment.*

The client makes a number of assertions with respect to the reporting of the reacquired franchise rights in the balance sheet.

- Existence – the reacquired franchise rights exist as of the balance sheet date and the transaction that led to their recording occurred prior to the balance sheet date.
- Completeness – the amount reported as reacquired franchise rights include all such amounts.
- Ownership – the company owns the rights.
- Valuation – the reacquired franchise rights are properly valued on the balance sheet, i.e. no impairment valuation is required.
- Presentation and/or disclosure – the reacquired franchise rights are properly presented on the balance sheet as a non-current indefinite-life intangible asset.

Students are then asked which of these assertions may be identified during the internal control audit. Each of the assertions could potentially be identified in this internal control audit. For example, auditors could potentially evaluate the need to examine the controls and procedures in place to appropriately value the reacquired franchises.

- 2. Determine the audit risks associated with the reporting of reacquired franchise rights (specific to the audit of reacquired franchise rights). Consider the risks associated with each assertion identified in question 1, above.*

The audit risks that the auditor should most be concerned with during the audit of the required franchise rights are centered on their existence, ownership, classification in the balance sheet, and valuation. First, the reacquired franchise rights must exist and the client must possess the rights as the result of a past transaction in order to be considered an asset. This risk drives from whether an asset / transaction should even be recorded (bon-a-fide vs. fictitious). Second, the client has asserted that the reacquired franchise rights are an indefinite-life intangible asset. The identification of the asset as having an indefinite life determines that it will not be amortized and only tested for impairment (FASB 2001b, para. 16-17); risks therefore arise through the determination of appropriate fair values to be used in the impairment tests. As a result, there is a risk that the reacquired franchise rights are overstated (that is, they should be impaired).

- 3. Identify possible controls pertaining to reacquired franchise rights that may increase the likelihood that management's assertions identified in question 1, above are correct and map the controls to the audit risks you identified in question 2 above. Consult SAS 101, paragraph 12 (AICPA 2003) for information on controls.*



Requiring a contract for the acquisition of franchise rights that is properly approved by the Board of Directors combined with the standard cash disbursement procedures represent the controls that are in place with respect to the existence and ownership of the rights. Classification issues are addressed through an annual review of classifications of all intangible assets by an experienced individual. The final audit risk, valuation, is clearly the most important in this setting. The standard for what controls are relevant are contained in SAS 101 (AICPA 2003). Paragraph 12 of SAS 101 provides examples of what the auditor should consider when obtaining an understanding of the client's process for determining fair value measurements. The following are items from the standard that perhaps can be used to evaluate controls:

- Controls over the process used to determine fair value measurements (controls over data and segregation of duties)
- Experience and expertise of individuals determining the fair value measurements
- Role of information technology in the process
- Extent of reliance on a service organization to provide the fair value measurement or the related data
- Extent to which specialists are employed to determine fair value measurements and disclosures
- Documentation supporting management's assumptions
- Process used to develop and apply management assumptions
- Process used to monitor changes in management's assumptions
- Integrity of change controls and security procedures for valuation models and relevant information systems

- Controls over consistency, timeliness, and reliability of the data used in the valuation models

4. *What is your preliminary assessment of the audit risk associated with the audit of reacquired franchise rights? Make a qualitative assessment of audit risk as high, moderate, or low and then indicate why you chose that level of risk assessment.*

Based on the limited information presented in the case, the magnitude of the amounts involved and the subjective nature of the impairment analysis most probably support an assessment of “moderate” risk. However, given the pressure management is under to meet earnings expectations, it is not unreasonable for students to identify the audit risk as “high.”

5. *Use the preliminary financial 2005 financial information provided in the Exhibits and other qualitative information about the client to determine an overall quantitative materiality level as well a materiality level that should be used for the audit of reacquired franchise rights. How does this differ from a qualitative materiality level?*

To evaluate materiality, you need to establish a preliminary judgment about materiality, determine tolerable misstatement and then estimate likely misstatements and compare totals to the preliminary judgment about materiality (Messier et al. 2006).

Establishing a quantitative materiality level requires identifying an aggregate value to serve as a basis for comparison. Commonly-used bases are total assets, total revenue, income before taxes, income from continuing operations, gross profit, and three-year average of income before taxes. After the basis has been identified, auditors should determine a tolerable level of misstatement, relative to the basis. Frequently this is framed in terms of a percentage of the aggregate, such as 5 percent of total assets, or 3

percent of net income. Next, auditors must estimate likely misstatements and compare totals to the preliminary judgment about materiality.

For example, if planning materiality is to be based on 5 percent of total assets, planning materiality for Roman Holiday would be approximately \$21.6 million. However, the planning materiality must then be allocated to individual accounts and transactions. According to Messier et al. (2006: 114), “In conjunction with qualitative factors, common computational benchmarks used in practice to determine tolerable misstatement are two to 15 percent of the account (but never greater than materiality) or 50 to 75 percent of preliminary or planning materiality.” Since reacquired franchise rights in this case are large, it is likely that this account would have a substantial materiality level overall. If the audit team was being conservative and using a two percent of the account as a materiality threshold then for reacquired franchise rights materiality would be called into question if the likely misstatement is greater than two percent of the preliminary account balance of \$127,412,000 which is \$2,548,240.

SAB 99 requires the consideration of both qualitative and quantitative factors in determining whether something is material or not (SEC 1999). A qualitative assessment is situation-specific and cannot be planned. Qualitative factors to consider are the presence of control weaknesses, management turnover, high market pressures, irregularities or illegal acts, potential to violate debt covenants or other agreements, and amounts that might affect earnings trends or ability to meet and/or beat analysts’ forecasts.

6. *Explain how your assessment of the risk associated with the audit of reacquired franchise rights affects the nature, extent, and timing of audit testing. In what ways will this assessment affect the allocation of professional staff by rank and expertise?*

We suggest that there is a need to modify testing for intangibles. For example, sophisticated market valuation testing is necessary in order to determine if the value of the rights have been impaired. The extent of testing should be modified to expand the quantity of valuation tests we may employ to ensure that we have a proper valuation of the rights. The timing of testing should be altered by doing more year-end testing for the franchised rights whereby we will have more confidence in the results of the testing if we perform the tests closer to year-end. Finally, to properly conduct the valuations, the auditor should use industry specialists with a greater degree of expertise thus making the audit perhaps more costly than originally anticipated.

### **Suggested Solutions to Requirements: Part 2 – Year-end Procedures**

1. *Obtain the client-prepared schedule of reacquired franchise rights during the year (Exhibit 5) and verify the mathematical accuracy of the schedule and reconcile the total to the preliminary balance sheet. Assume that all amounts are unchanged from prior years and that all amounts agree with last year's audit work papers. Indicate all procedures performed.*

Exhibit 5 from the case materials serves as a client prepared working paper. This procedure requires the student to sum the book values of the required franchise rights listed for each market and agree the amount to the total listed. The total should also be agreed to the preliminary balance sheet. Finally, the individual amounts of reacquired

franchise rights capitalized in prior years should be agreed to the prior year working paper. All procedures should be indicated on the working paper through use of a tick mark or in some other suitable manner.

2. *Evaluate the client's determination of an indefinite life classification for the reacquired franchise rights in accordance with SFAS 142. Is the indefinite life correct? If not, what should be the asset life?*

The client classifies reacquired franchise rights as an indefinite life intangible asset. Although senior and associate franchisee agreements have stated terms, the client is both the grantor and holder of these rights. In this instance, the Company both holds the contractual rights and determines their terms and therefore the Company ultimately determines the life-expectancy of the asset. The Company can determine the expiration of the rights; independent of the potential expiration of the rights, their useful life is dependent on the viability of the Company as this determines the Company's ability to re-franchise or operate its own restaurants in the reacquired markets.

As a going concern, indefinite life appears appropriate. However, the auditor may appropriately question the client's methodology and raise the question of the ability of the firm to re-franchise. This will result in more testing as the auditor must directly address the ability of the firm to re-franchise on a regular basis. If concerns about the client's continued viability surface, the definite life classification may be appropriate. Further, Exhibit 6 (see next requirement) and information to be received from the client (see requirement 3 (f) (v)) suggest the client may consider the intangible asset's life limited to 14 years consistent with a definite life classification.

3. *In past years, the Company executed a number of acquisitions. You assigned different members of the audit team to audit the impairment analysis for the various markets in which the Company made acquisitions and recorded reacquired franchise rights. Your retained responsibility to analyze the Arizona market. Obtain and evaluate the client's impairment assessment for the reacquired franchise rights related to the Arizona market (Exhibit 6). Supporting details for the calculations are found in the notes to the Exhibit 6.*
- a. *Review SFAS 142 and SFAS 144 to determine which standard is applicable in the current situation and establish the type of analysis required to determine whether an intangible asset is to be impaired.*

SFAS 142 requires that an intangible asset not subject to amortization (an indefinite life intangible assets such as reacquired franchise rights), should be tested annually for impairment (FASB 2001b, para. 17). The impairment test is the comparison of the book value and fair value of the intangible asset. Impairment is recognized for the excess of the book value of the intangible asset over its fair value. Para. 23-25 are referred to for guidance in estimating the fair value of the intangible asset.

The definition of fair value should be addressed early in the discussion of this item. The "fair value" of an asset is the amount at which that asset could be bought or sold in a current arms' length transaction between two willing parties (FASB 2001b, para. 23). The two key components of this definition are that the transaction be current (the information is timely and relevant) and the transaction is between willing parties (the price is not based on a forced sale or liquidation).

A quoted market price is the most common primary source of a fair value.<sup>1</sup> However, quoted market prices may not be available, as in Roman Holiday's franchise situation. When market prices are not available, accountants must develop estimates based on the best available information. Often these estimates are based on quoted market prices of similar assets or the use of a valuation model. Due to the niche character of the Roman Holiday franchise market, it is difficult to determine what constitutes a "similar asset", and even if a similar asset can be agreed upon it is likely to be difficult to obtain a quoted market price. Therefore, the development of a fair market value for the Roman Holiday franchises must be based on a valuation technique such as present value analysis.

When employing a present value analysis, estimates of future cash flows are based on reasonable and supportable assumptions that are consistent with the market's view. The present value measurement techniques used for accounting measurement are discussed in SFAC 7 (FASB 2000). The traditional present value approach starts with determining a best (most likely) estimate of future cash flows. This single set of cash flows is then discounted using a risk-adjusted interest rate. Risk and uncertainty are incorporated through adjustment of the discount rate.

SFAC 7 also presents an expected present value approach that the FASB contends is more appropriate when estimating fair values in complex situations such as the measurement of non-financial assets (FASB 2000, para. 45). This approach focuses on determining multiple estimates of cash flows, each of which is assigned a probability

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<sup>1</sup> The general framework for measuring fair values for accounting purposes (such as an impairment analysis) is based on SFAC 7 (FASB 2000) and is formally adopted by SFAS 157 (FASB 2006) for fiscal years beginning after November 15, 2007.

(likelihood) of occurrence. Each cash flow scenario is weighted by its probability of occurrence, and these weighted estimates are combined into a single estimate of expected cash flows which, unlike the estimate derived under the traditional method, incorporates the likelihood of occurrence for all components. Risk and uncertainty are thus incorporated into the future cash flow estimate through this expectation model. This set of cash flows is then discounted using the risk-free rate of return to obtain an estimate of the present value.

SFAS 144 is not applicable to intangible assets not being amortized (FASB 2001c, para. 5); because the reacquired franchise rights are not amortized, it is therefore not applicable to this case.

*b. Review SAS 101 (AU section 328) and identify the types of auditing procedures necessary in order to evaluate management's assertions in estimating the fair value of the reacquired franchise rights.*

SAS 101 provides guidance on auditing fair value measurements (AICPA 2003). The guidance can be categorized into 1) understanding the entity's process for measuring the fair values and related controls, and assessing audit risk, 2) evaluating conformity with GAAP, 3) determining whether to engage a specialist (discussed in requirement 3.g. below), and 4) testing the client's measurement of fair values. The assessment of controls and risks was addressed in part 1 of the requirements.

SFAS 142 requires an estimate of fair value of the reacquired franchise rights in order to determine if impairment exists. The use of a fair value measurement in this situation is appropriate and consistent with GAAP. The key factor is then auditing the determination of the fair value estimate.



First, the client's estimation must be considered. The auditor must evaluate 1) whether the client's assumptions are reasonable and consistent with market information, 2) the client used an appropriate model, and 3) the client used relevant information that one would expect to be available at the time of the estimation.

Assumptions are an important input to the valuation process. The significant assumptions should be identified, after which the auditor should consider available evidence with which to support those key assumptions and evaluate whether they are reasonable, realistic, and consistent. The auditor should also consider the sensitivity of the valuation to changes in these assumptions. Alternatively, the auditor may develop an independent estimation of the fair value to corroborate the client's estimate.

- c. Compare the client's methodology to those discussed in SFAS 142 and SFAS 144. Is the client methodology in estimating the fair value of the reacquired franchise rights acceptable based on the methodologies suggested by SFAS 142 or SFAS 144? Why or why not? If you do not believe that the client's methodology is appropriate, what course of action would you take?*

As discussed in requirement 3(a) above, the applicable standard in this situation is SFAS 142. The following therefore focuses on this standard.

The client uses the traditional present value approach to estimate fair value. While this approach is acceptable, SFAS 142 (FASB 2001b) indicates that the expected present value method discussed in SFAC 7 (FASB 2000) is preferred. The following discusses the client's application of the traditional present value approach.

The client also does not factor in inflation (franchise fees would increase over time as price increases are made). This is not a problem if the discount rate excludes an

inflation factor. However, it appears that the client did not do this as the discount rate used is 6% (later information provided by the client confirms this – see Exhibit 2).

The client also determines royalties based on the number of restaurants opened at the end of the year. This implicitly assumes that all of the restaurants were open since the first of the year. A more reasonable assumption is that the restaurants were opened evenly throughout the year, in which case the average number of restaurants opened during the year would provide a more reasonable estimate for royalties.

From an audit perspective, the auditor has three options. First, the auditor can request the client to prepare the appropriate analysis, pursuant to SFAS 142 (FASB 2001b) and SFAC 7 (FASB 2000) that addresses the above concerns. Second, the auditor can develop an independent estimate of the fair value using either the traditional or expected present value method. Third, the auditor can incorporate the essence of the appropriate present value approaches in the sensitivity analysis to evaluate the client's estimate.

- d. Verify the mathematical accuracy of the client's estimation of the fair value of the reacquired franchise rights associated with the Arizona market (Exhibit 6). Indicate the procedure(s) performed.*

Exhibit 6 from the case materials serves as a client-prepared working paper. This procedure requires the auditor to review the spreadsheet supporting the Exhibit or recalculate the amounts. All procedures should be indicated on the working paper through use of a tick mark or in some other suitable manner.

- e. *Based on your review of the client's valuation of the reacquired franchise rights, identify the key assumptions made by the client in preparing the fair value estimate.*

The client's analysis clearly indicated in the notes to their analysis the assumptions that were made by the client in preparing the fair value estimate. The key assumptions identified include 1) maximum number of restaurants in the market, 2) annual growth rate of four restaurants, 3) weekly revenue of \$50,000 per restaurant, 4) expense ratio of 20% of revenue, and 5) 6.0% discount rate.<sup>2</sup> In addition, imbedded in this analysis is the assumption that the scenario presented is the most likely scenario consistent with the traditional present value approach used by the client.

- f. *Evaluate the client's key assumptions in arriving at the estimated fair value for the reacquired franchise rights by comparison to external and internal information.*

- i. *Which provides the greatest level of assurance: internal or external information? Why?*

The type of information that provides the greatest level of assurance is generally external; however, depending on the assumptions, internal data may provide greater assurance. For example, the annual growth rate is based both on past history and market conditions, as is the probability of scenarios based on the growth rate. Historical

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<sup>2</sup> The client analysis is also over a 14-year horizon. A finite horizon, while inconsistent with the indefinite life classification, is used by the client to facilitate fair value estimation. Students are provided this information with the client information.

operations of similar restaurants provide the best evidence for both weekly revenue and expense ratios. However, the discount rate is more market-based.

*ii. Identify information sources from which to obtain the information required to audit each assumption.*

The information sources other than the company’s financial statements for the key assumptions discussed in the preceding requirements are presented below. All information would be obtained from the client unless indicated otherwise.

<b>Assumption</b>	<b>Information Sources</b>
Annual growth rate	Current restaurants in Arizona Senior Franchisee agreements Senior Franchisee performance on meeting targets Growth analysis by markets Competitor analysis (client analysis and independent analysis based on industry studies, Moody’s, and S&P)
Probability for each scenario	Senior Franchisee performance on meeting targets
Weekly revenue	Weekly revenue statistics for past year (including mean, median, variability) – system wide, franchised restaurants, new restaurants, Arizona, Senior Franchisee restaurants Analysis of seasonality
Expense ratios	Expense breakdown by franchise and owned restaurant operations and by type of expense
Discount rate	Risk-free rate (Wall Street Journal or other business press) Market risk adjustments (Industry studies, Ibbotson, Moody’s, and S&P) Debt agreements

*iii. Prepare a document request to the client to a) obtain the information the client relied on in determining the assumptions, and b) other client-specific information that you may reasonably use to evaluate the assumptions and information supporting the assumptions (the client / instructor acting for the client will then provide the requested information that is available from the client).*

A sample information request to the client is included in Exhibit 1 to the Teaching Notes.

*iv. Identify Internet and other external sources to obtain additional evidence in order to evaluate the key assumptions. This external evidence may include information on the Arizona pizza market from industry sources to evaluate growth rates and revenue levels and financial market information to support discount rates.*

This requirement provides 1) realism in the case; and 2) variability in potential solutions (if the actual search is required). The requirement is written so that this variability is limited by asking students to list possible sources of external information, but not actually to perform the research. External sources include industry guides, interest rate data from the Federal Reserve, population demographics for Arizona from U.S. Census Bureau, and trade groups (such as [www.pizzatoday.com](http://www.pizzatoday.com)). However, the supplementary information from the client (Exhibit 2 to the Teaching Notes) that is provided to all students contains sufficient information to complete the case.

In-class discussions should highlight the potential differential information sources considered by the various student groups / individuals. This practice may help sensitize

students to the profound relevance of the information-search process in employing professional judgment, as well as the real-world possibility of different groups (including creditors, investors, auditors, and analysts) arriving at justifiable yet different conclusions.

If the primary purpose is to engage students in locating information on the Internet, the search should also be required. The downside will be that students will obtain different information based on the timing and veracity of the search. The different information will likely result in different evaluations of the fair value estimates. The two areas that this will likely affect the most is the competitor information used to evaluate the annual growth, and the financial market information to evaluate the discount rate.

In the event that students have obtained sufficiently different information to warrant different conclusions, they should be challenged to identify a set of criteria against which the evidence and conclusions can be objectively evaluated. This exercise is of particular use with graduate-level auditing students who have professional experience or with undergraduate students who have completed recent auditing internships.

- v. Use the information obtained from the client and on your individual search to complete your evaluation of the appropriateness of the key assumptions identified in requirement 3(e).*

Five key assumptions were identified in requirement 3(e), above. An evaluation of each of these key assumptions is provided in turn. Students may provide evaluations of other, less significant assumptions.

- Annual growth rate of four restaurants. The Senior Franchisee agreement that was acquired in the Arizona market included a schedule of restaurant opening that were

required as part of the agreement. The annual growth contained in this agreement is that four restaurants should be opened per year. Past history suggests that the target growth is only met 70 percent of the time. The expected growth is therefore 3.4 restaurants per year ( $0.70 \times 4 + 0.30 \times 2$ ). Further, the impact of planned expansion by a major competitor in the Arizona market may negatively affect the growth increasing the probability that the target would not be reached. Although the target of four restaurants per year is the most likely growth rate (70 percent probability), this growth rate is somewhat aggressive.<sup>3</sup>

- Weekly revenue of \$50,000 per restaurant. The weekly revenue of \$50,000 per restaurant is based on the average of the 60 percent of system-wide restaurants that exceeded the system-wide average of \$45,800 per week. The \$50,000 therefore represents the most likely weekly revenue based on the 60 percent probability. Using system-wide statistics rather than franchised restaurants only is reasonable given that franchised restaurants comprise approximately 87 percent of the system restaurants. However, ignoring the potential for under-performing restaurants (the 40 percent that average only \$40,000 in weekly restaurants) is aggressive especially as the market leader appears to believe this market is mature and another major competitor is planning extensive expansion in the coming years. This revenue amount also significantly exceeds that currently earned by the restaurants located in Arizona (\$41,400 overall, and \$38,700 for the Arizona restaurants under Senior Franchise agreements). However, management indicated that the existing Arizona restaurants

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<sup>3</sup> Only one other growth alternative is provided by the client in Exhibit 2. Client information concerning this assumption as well as others is limited in the number of alternatives to simplify the case.

were underperforming and significant improvement is expected. Based on the contradicting evidence discussed in this paragraph, using system-wide information is more appropriate.

- Expense ratio of 20% of revenue. The growth in the Arizona market is projected to be in franchisee-operated restaurants. Expenses of the Company's franchise operations are therefore the relevant cost center associated with the increased royalty revenue from the franchises. The analysis of expenses provided by the client indicates that 2005 franchise operations incurred expenses of 32 percent of revenue (royalty fees earned). Variable expenses consist of 60% of these costs or 19 percent of revenue. To make the case more tractable, our experience has been that it is expedient to give students the assumption that the fixed costs relate to the client's franchising operations as a whole. Using only the variable portion in the analysis therefore seems appropriate as it captures the incremental expense and excludes corporate allocations (fixed costs). The expense ratio is reasonable.
- Discount rate of 6.0%. The client uses the traditional present value approach where the most likely cash flows should be discounted using a risk-adjusted discount rate. The rate used by the client is its cost of debt capital and is not a risk-adjusted discount rate. The client claims that the cost of debt is appropriate since they would use debt to finance the acquisition and the cost of debt includes a risk adjustment. The cost of debt does indeed include a risk premium, but, the discount rate should be project-specific and not based on debt financing. Market information suggests that a risk premium of 8 to 12 percent is appropriate (see Exhibit 2). The client significantly underestimates the discount rate in its traditional present value approach.



On the other hand, if the client estimates the fair value in accordance with the expected cash flow method preferred by SFAC 7 (FASB 2000), the discount rate should be a risk-free rate. A risk-free rate would be less than that used by the client as the risk is captured by the scenario probabilities. In this case, information from the client indicates that LIBOR is 3 percent. The LIBOR rate represents a good proxy for the risk-free rate of return that should be used in this analysis.

One other factor that affects the discount rate used is inflation. Inflation is ignored by the client in estimating cash flows. Since inflation is ignored in the cash flows, inflation should also be ignored in determining the discount rate. Students are provided information that inflation has averaged 1 percent suggesting that the discount rate should be reduced by 1 percent to remove the effects of inflation.

- Scenario probability. The analysis of assumptions suggests at least four scenarios for which probabilities can be derived.

	<b>Growth</b>	<b>Revenue</b>	<b>Probabilities</b>
Scenario 1	4	\$50,000	$0.70 \times 0.60 = 0.42$
Scenario 2	4	40,000	$0.70 \times 0.40 = 0.28$
Scenario 3	2	50,000	$0.30 \times 0.60 = 0.18$
Scenario 4	2	40,000	$0.30 \times 0.40 = 0.12$

The client's scenario (growth rate of 4, weekly revenue of \$50,000) is the most likely with the highest probability of 42 percent, but it is less than 50 percent. Scenario 1 also provides the highest valuation. Not properly considering the probability of the other scenarios in the analysis is aggressive and results in over-stating the fair value estimate and limiting the potential for impairment if the risk is not properly considered in the discount rate as in the client's approach. The expected cash flow approach directly incorporates each scenario and related probabilities.

A review of the assumptions based on the analysis contained in these teaching notes is summarized in the working papers included in Exhibit 3.

*vi. Based on comparisons with applicable evidence and your assessment of the individual assumptions, determine acceptable value ranges for the key assumptions. Prepare a sensitivity analysis of the estimated fair value (and potential basis for impairment) of the reacquired franchise rights for the Arizona market where the values of the key assumptions are changed based on your comparison.*

This analysis will vary substantially by student as to which assumptions are altered and by how much because the external evidence collected by each student will likely differ to a certain extent. For purposes of this teaching note, we are providing an analysis that determines royalties on the average number of restaurants opened during the year (not the year-end number used by the client) and varies four key assumptions: weekly revenue, growth rate, expense ratio, and discount rate. The choices for the sensitivity analysis are based on the results of the evaluation in the preceding question. This analysis is consistent with the traditional present value approach prepared by the client and is based on the most likely scenario (weekly revenue of \$50,000 and an annual growth rate of 4 restaurants per year). The fair value estimate as each assumption is changed is indicated.

<b>Assumption</b>	<b>Change</b>	<b>Sensitivity</b>
Base using average number of restaurants		\$ 20,945
Weekly revenue of \$50,000	+/- 10%	18,877 / 23,014
Growth rate of 4 restaurants per year	+/- 1 restaurant	16,610 / 23,943
Expense ratio of 20%	+/- 2%	20,422 / 21,469
Discount rate (add 8% market risk premium)	14%	12,415
Discount rate (add 10% franchisor risk premium)	16%	10,050
Discount rate (add 12% restaurant risk premium)	18%	8,851

The following analysis assumes the scenario presented by the client has a 42% probability of success and incorporates the other three scenarios discussed in the preceding question (incorporation of weekly revenue and growth probabilities). The set of expected cash flows are discounted using a risk-free rate excluding the effect of inflation. The risk-free rate of 2% is based on the LIBOR rate of 3% less the 1% estimated inflation rate. This second set of analysis approximates the expected present value approach of SFAC 7. The sensitivity analyses are summarized as follows:

<b>Assumption</b>	<b>Change</b>	<b>Sensitivity</b>
Base using average number of restaurants		\$ 23,682
Weekly revenue of \$50,000	+/- 10%	21,343 / 26,022
Growth rate of 4 restaurants per year	+/- 1 restaurant	17,865 / 28,114
Expense ratio of 20%	+/- 2%	23,090 / 24,274
Change in growth probability	+/- 10%	22,492 / 24,873
Change in revenue probability	+/- 10%	23,174 / 24,191
Discount rate	+/-1%	21,661 / 25,946

The sensitivity analysis illustrates that three assumptions are very important – growth rate, weekly restaurant revenue, and discount rate. The auditor must obtain comfort that the client’s assumptions are reasonable in order to assess the impairment potential. The instructor can also alter the information provided by the client with respect to these assumptions to provide variability between semesters. For example, the LIBOR rate or risk premium – an easy assumption to change - can be altered to demonstrate the dramatic differences that a change in this assumption would have on the analysis.

The results of the sensitivity analysis discussed above are summarized in the working papers included in Exhibit 3. For purposes of completing this type of analysis, the use of a spreadsheet is essential. The spreadsheet should be based on the client

analysis and can be set up to separate key assumptions from the fair value estimation and the incorporation of scenarios providing an easier approach to the analysis. A copy of the file used by the authors is available upon request.

*vii. Is the client's impairment assessment appropriate? Why or why not? If not, what does this indicate about the client's internal controls regarding impairment?*

Based on the analysis provided in these teaching notes, the overall conclusion should be that the client's impairment analysis is incomplete. The validity of key assumptions is questionable. For example, the client based revenue on year-end number of restaurants opened rather than the average for the year. These issues suggest that their internal control system contains certain weaknesses that may need to be communicated to the client as appropriate. One possibility is that the client personnel who are responsible for conducting the analysis may lack the financial sophistication to conduct their work properly and the supervision is inadequate.

The optimism in the client's assumptions must be addressed. In the traditional present value approach, this is commonly incorporated through the discount rate. However, as demonstrated above, the client's discount rate does not properly incorporate a risk premium and is thus understated in the context of the traditional present value approach. The sensitivity analysis of the client's approach indicates a potential problem exists and more work is required, especially with respect to incorporating risk.

If the auditor relies on its own expected cash flow approach, it appears that the reacquired franchise rights for the Arizona market are not impaired (see the analysis included in the sample working papers). The auditor's fair value estimate is based on the

SFAC 7 approach incorporating the four scenarios based on growth rate and weekly revenue. This approach addresses the shortcomings identified in the client's analysis and properly incorporates risk. The estimated fair value under this approach is \$23.6 million, exceeding the right's net book value by almost \$3 million. Only one sensitivity test (decreasing the annual growth in restaurants opened by 1 per year) indicated a potential for impairment. Based on the client's experience over the past five years and the current market conditions (Arizona pizza market), the possibility of such a decline is remote. The evidence presented therefore supports that the asset is not impaired.

It is possible that individual students may come to a different conclusion based on their analysis. A sample working paper has been prepared to document this assessment (see Exhibit 3).

*4. Consult SAS 101. What role would specialists play in help in determining the validity of management's assertions on fair market value issues?*

SAS 101 discusses the use on engaging a specialist in the audit of fair values (AICPA 2003). A specialist should be considered when the auditor does not have the necessary skill or knowledge to plan and perform the audit of a fair value measurement. In this situation, the specialist is used to perform the necessary procedures to assess fair market value and the auditor must be satisfied as to the assumptions and methods used by the specialist.

*5. What should be included in a set of working papers to be reviewed by the manager?*  
*Assemble your work as a set of working papers to be reviewed by the manager.*

There is no definite approach to assembling working papers. The following is one suggestion based on the authors' experience that instructors may find useful.

- Summary of reacquired franchise rights
- Client impairment analysis
- Analysis of key assumptions
- Sensitivity analysis
- Auditor impairment analysis

A sample set of working papers based on the suggested solutions is included in Exhibit 3.

### **Case Conclusion**

Upon completion of this question, it may be appropriate to end the discussion with a re-emphasis of the need for auditors to understand non-financial as well as financial information throughout the audit process. Even with experienced auditors, there is a tendency to underweight the importance of non-financial information during the audit process (Cohen, et al. 2000). In this case, for auditors to provide reasonable assurance of the validity of the proposed account balance it is essential that they have a thorough understanding of market conditions, the competitive environment, and the breadth of practice in the industry. This information is crucial to understanding and testing the reasonableness of the assumptions underlying the expected profitability of the franchises in question.

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## **EXHIBIT 1**

### **INFORMATION REQUEST TO CLIENT**

- Number of current restaurants operating in Arizona (in total, and by type of restaurant – company owned vs. franchisee)
- Schedule of required restaurant openings as contained in the Arizona Senior Franchisee agreement
- The percentage of markets where the Senior Franchisee was able to successfully meet restaurant opening targets (overall, by market, and by year)
- Historical and projected growth in number of restaurants and sales overall and by type in Arizona, markets considered similar to Arizona, and system-wide
- Competitor analysis for the Arizona market including key competitors, their market share, their recent growth, and proximity to existing Roman Holiday restaurants.
- Statistics for weekly restaurant revenue for the past year
  - System-wide (in total and by type of restaurant)
  - Arizona (in total and by type of restaurant)
  - New restaurants opened during the past year (in total and by type of restaurant)
  - Seasonality
- Expense detail for franchise operations for the past year
  - Include a breakdown of fixed vs. variable
- Basis for 6% discount rate



## EXHIBIT 2

### SUPPLEMENTARY INFORMATION RECEIVED FROM THE CLIENT

Note: The information below is provided by management and is derived from the internal accounting records of the client or represents management's opinion on the issues.

#### Company Information

Franchised restaurant locations in Arizona market (December 31, 2005):

Sub-franchisees of Senior Associate: Tucson (2), Tempe

Independent Associates: Phoenix (3), Scottsdale, Mesa

Revenue: Revenue per restaurant information (for the week ending December 5, 2005)

System-wide (1,133)	\$ 45,800
Franchised restaurants (986)	46,300
Arizona (8)	41,400
Arizona under Senior Franchise Agreement (3)	38,700
First year of operation (206)	52,300

Approximately 60 percent of the restaurants on a system-wide basis meet / exceed the weekly mean sales (average sales for these restaurants equals \$50,000). The average weekly sales for the 40 percent of the restaurants that perform less than average are \$40,000.

Royalty rate: The royalty rate represents the rate charged to the sub-franchisees in this market in excess of the 4% Senior Associate rate. The Arizona Senior Associate required an 8% royalty rate in its agreements with sub-franchisees.

Performance: The Arizona restaurants are poorly performing, but management believes that their performance will be improved based on corporate marketing efforts and new management. There is no reason to believe that new restaurants in this market will be any different for other restaurants in the system.

Seasonality: Roman Holiday restaurants do not have any significant seasonality in their operations

Growth assumptions: Annual growth in number of restaurants opened in the Arizona market is based on the schedules stated in the Senior Franchisee contracts that were acquired. All growth will be in the form of franchise restaurants (no increased in company-owned restaurants). Management has no reason to believe that this schedule will not be met in this situation. In the past, Senior Franchisee met these growth schedules 70 percent of the time. Growth was approximately one-half of the scheduled amounts for the other 30 percent.

Inflation is ignored in the analysis.

Detail of 2005 revenue and expense data

	<b>Number of Restaurants</b>	<b>Revenue</b>	<b>Operating Expenses</b>
Company restaurants	147	\$ 312,658	\$ 283,108
Franchise operations	986	79,526	25,683
Regional commissary		93,698	61,608
Total		\$ 485,882	\$ 370,399

The fixed portion of the operating expenses indicated above for company restaurants, franchise operations, and regional commissary are approximately 20%, 40%, and 25% of total operating expenses.

Cost of debt capital: The weighted average interest rate on the company's long-term debt is 6.2 percent (all of which is fixed rate and matures over the next ten to twenty years.

The company also has a \$75 million revolving line of credit with interest at LIBOR plus 2.5% (LIBOR currently equals 3%). The line of credit is subject to annual renewals. The Company currently has \$22 million outstanding under the credit facility.

Risk assessment: Roman Pizza's operations are less risky than others in the pizza business and franchising business due to our product line and positioning. Our discount rate is therefore based on our cost of debt capital which represents our incremental financing cost if we were to go to the debt markets to fund our acquisitions.

Other services provided to franchisees: Primarily pertain to the planning and development of a restaurant and include site selection, layout and design, and training. On average, associates purchase approximately \$5,000 of these services per restaurant. Senior Associates provide the majority of these services for their sub-franchisees.

Estimation period: Our analysis is based on 14 years (through the end of the underlying Senior Franchisee agreement). A finite horizon is used to facilitate fair value estimation. It is felt that incorporating beyond 14 years would introduce significant uncertainty and potentially overstate our estimate.

### **Competitor Information – Marketing Issues**

The industry leader has extensive operations throughout Arizona. Although, some growth is anticipated, Arizona is not a primary growth market for the industry leader as no major location expansion is planned. This lack of planned growth suggests the industry leader may consider this market mature.

In contrast, another major competing franchisor launched an aggressive expansion program in the Phoenix area in late 2005 with stated intentions to develop 40 restaurants over the next five years. This expansion suggests that profitable markets have drawn new entrants.

However, these two competitors' markets are not identical to the Roman Holiday market. Roman Holiday is a premium deep-dish pizza with a large dine-in business. The industry leader, while offering full service dine-in, markets more to families as a good pizza for a low price. The other major competitor offers standard pizza fare and focuses on carryout and delivery options only.

If the consumer is price conscientious or indifferent to quality or the market is mature, Roman Holiday may have to offer discounts, coupons, or other promotions in order to compete.

### **Industry Information – Risk**

In general, restaurant operations are considered riskier than the market overall (assuming an average market premium of 8 percent). The overall risk premium for restaurant operations is approximately 12 percent. Franchisors such as Roman Holiday are considered less risky due to their size and diversification and normally are assigned a risk premium of 10 percent.

**EXHIBIT 3 – SAMPLE WORKING PAPERS**

**CLIENT PREPARED SCHEDULE OF REACQUIRED FRANCHISE RIGHTS**

Year ended December 31, 2005

Senior Franchisee Market	Minimum Development Quota	Restaurants Previously Opened by Senior Franchisee	Year Acquired	Book value of Reacquired Franchise Rights (in 000s)
New Jersey	20	2	2003	\$10,200 PY
Southern Florida	30	7	2003	25,206 PY
Arkansas	8	2	2004	12,034 PY
Houston and Dallas	25	6	2004	16,186 PY
Arizona	20	3	2004	20,777 PY
Northern California	36	5	2004	43,011 PY
Balance at end of year				\$127,412 BS



- ▽ Footed
- PY Agreed to prior year workpapers
- BS Agreed to preliminary balance sheet

## CLIENT PREPARED IMPAIRMENT ANALYSIS FOR REACQUIRED FRANCHISE RIGHTS FROM THE ARIZONA

### ACQUISITION

Year ended December 31, 2005

(Amounts in 000s)

Book value	\$20,777	BS
Fair value estimate	22,320	
Fair value in excess of book value – no impairment		

#### Projected Net Cash Flow

(\$ in 000s)	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
No. of Restaurants Open at the End of Year (1) √	7	11	15	19	23	27	31	35	39	43	47	50	50	50
Projected Royalties (2) √	728.00	1,144.00	1,560.00	1,976.00	2,392.00	2,808.00	3,224.00	3,640.00	4,056.00	4,472.00	4,888.00	5,200.00	5,200.00	5,200.00
Projected Franchise Fees (3) √	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	30.00	-	-
Projected Expenses (4) √	(153.60)	(236.80)	(320.00)	(403.20)	(486.40)	(569.60)	(652.80)	(736.00)	(819.20)	(902.40)	(985.60)	(1,046.00)	(1,040.00)	(1,040.00)
Projected Net Cash Flow √	614.40	947.20	1,280.00	1,612.80	1,945.60	2,278.40	2,611.20	2,944.00	3,276.80	3,609.60	3,942.40	4,184.00	4,160.00	4,160.00
Discount Rate	6.0%													
Present value of net cash flows	22,320.00	√												

√ Recalculated

BS Agreed to preliminary balance sheet

- (1) At the end of 2005, there are 3 restaurants opened under the Senior Franchisee agreement (all restaurants were opened by sub-franchisees; Roman Holiday therefore did not acquire any actual restaurants in Arizona). Annual growth in number of restaurants to be opened in the market is assumed to be 4, up to a maximum number of 50 restaurants.
- (2) Projected royalties equals the product of the number of opened restaurants, number of weeks in a year, the weekly revenue per restaurant of \$50,000, the royalty rate of 4%, and the number of restaurants open at the end of the year is based on the growth rate.
- (3) Projected franchise fees are based on the projected growth rate in number of restaurants opened per year and per restaurant franchise fee of \$10,000
- (4) Projected expenses equal 20% of total projected revenue (royalties and franchise fees).

## ANALYSIS OF ASSUMPTIONS

Year ended December 31, 2005

<b>Assumptions</b>	<b>Analysis</b>
Growth rate of four restaurants per year	Growth rate is based on the scheduled openings contained in the Senior Franchisee agreements. The client's experience is that these targets are only met 70% of the time. The expected growth rate is only 3.4 restaurants per year.
Revenue of \$50,000 per week	The weekly revenue is the most likely revenue. However, the client's experience is that only 60% of the restaurants report this level of revenue. The other 40% report an average of \$40,000. The expected revenue approaches the system average of \$45,800.
Expense ratio of 20% of revenue	Expense ratio is consistent with the client's overall variable expense rate for its franchise operations in 2005 (19%).
Discount rate of 6%	The traditional present value approach used by the client should use a risk-adjusted discount rate. The client is using the lower cost of debt capital. A risk-adjusted discount rate should be based on the risk-free rate plus a risk premium of 8-12%
Scenario probability	Client analysis is based on most likely scenario, which based on data received from the client has only a 42% probability. The other scenarios have lower growth rates, lower weekly revenue, or both. These other scenarios are not considered by the client in the development of the cash flows or the discount rate. Result is that the client's fair value estimate is optimistic.

## SENSITIVITY ANALYSIS

Year ended December 31, 2005  
(Amounts in 000s)

### Traditional Present Value

Assumption	Change	Sensitivity
Base using average number of restaurants		20,945
Weekly revenue of \$50,000	+/- 10%	18,877 / 23,014
Growth rate of 4 restaurants per year	+/- 1 restaurant	16,610 / 23,943
Expense ratio of 20%	+/- 2%	20,422 / 21,469
Discount rate (add 8% market risk premium)	14%	12,415
Discount rate (add 10% franchisor risk premium )	16%	10,050
Discount rate (add 12% restaurants risk premium )	18%	8,851

### Expected Present Value

Assumption	Change	Sensitivity
Base using average number of restaurants		23,682
Weekly revenue of \$50,000	+/- 10%	21,343 / 26,022
Growth rate of 4 restaurants per year	+/- 1 restaurant	17,865 / 28,114
Expense ratio of 20%	+/- 2%	23,090 / 24,274
Change in growth probability	+/- 10%	22,492 / 24,873
Change in revenue probability	+/- 10%	23,174 / 24,191
Discount rate of 2%	+/-1%	21,661 / 25,946



## IMPAIRMENT ANALYSIS

Year ended December 31, 2005  
(Amounts in 000s)

Book value of reacquired franchise rights for Arizona acquisition	\$20,777
Assessment of fair value estimate	23,682 √

√ The fair value estimate is based on the SFAC 7 approach incorporating the four scenarios based on growth rate and weekly revenue. The cash flow scenarios are weighted based on their respective probabilities and discounted at the risk-free rate of return. Only one sensitivity test (decreasing the annual growth in restaurants opened by 1 per year) indicated a potential for impairment. Based on the client's experience over the past five years and the current market conditions (Arizona pizza market), the possibility of such a decline is remote.

Note: The client's impairment analysis is incomplete. The validity of key assumptions is questionable. For example, the client based revenue on year-end number of restaurants opened rather than the average for the year. These issues suggest that their internal control system contains certain weaknesses that may need to be communicated to the client as appropriate. One possibility is that the client personnel who are responsible for conducting the analysis may lack the financial sophistication to conduct their work properly and the supervision is inadequate. A separate analysis was therefore prepared as discussed above and serves as the basis for our conclusion.

Conclusion: No impairment exists

## EXHIBIT 4 – PART 1 GUIDANCE HANDOUT

- Requirement 1 - Recall the assertions discussed in the text. To answer this requirement, customize the assertions and change the wording to specifically address reacquired franchise rights. For example, consider the assertion for presentation/disclosure.

Presentation and/or disclosure – the reacquired franchise rights are properly presented on the balance sheet as a non-current indefinite-life intangible asset.

- Requirement 2 - The audit risks represent the assertions that the auditor is most concerned about when she audits reacquired franchise rights. Not all assertions are of equal importance when auditing specific assets, liabilities, equity, and income/expense items. In this requirement, you should first determine which of the assertions you discussed in requirement 1 are most important and then explain why.
- Requirement 3 - Paragraph 12 of SAS 101 (AICPA 2003) provides examples of controls that the auditor should consider.
- Requirement 5 - Recall that you should identify a base to use, such as total assets, total revenue, income before taxes, income from continuing operations, gross profit, and three-year average of income before taxes. After identifying the base you wish to use, choose a percentage of the base to calculate the materiality amount. Typically, this is a percentage of 3, 4, or 5% of the base you chose. After arriving at this amount, a portion of it must be allocated to the reacquired franchise rights. You could do this based on some reasonable approach, such as the percentage the reacquired rights are, relative to total assets. This amount can be adjusted, based on qualitative

considerations such as the possibility of violating debt covenants (or other agreements), a change in earnings trends, as well as the existence of control weaknesses, management turnover, high market pressures, the possibility that irregularities or illegal acts have occurred, or ability to meet or exceed analysts' forecasts.

- Requirement 6 - Based on your identification of important assertions (in requirement 2) and your assessment of audit risk (requirement 4), you may believe that the nature, timing, and extent of testing should be modified for this asset. For example, should the amount (i.e., extent) of testing be increased? Would you want to perform more of your tests at the year-end or would you gain reasonable assurance and comfort conducting the testing during an interim period? Do you as an auditor have the expertise to determine the value of these rights or will you have to rely on others to assist you in determining the amount that should be shown in the balance sheet?

## EXHIBIT 5 – PART 2 GUIDANCE HANDOUT

- Requirement 1 – Verifying the mathematical accuracy of a client prepared schedule is a standard auditing procedure to verify that all amounts are properly calculated and agree to related work papers. Use tick marks (any symbol you wish to use) to indicate the procedure performed. This means that you should provide a legend (on the client-prepared working paper) that defines the tick marks that you use. Note that the beginning balance of reacquired franchise rights was audited last year. Therefore, changes to this account are audited in the current year so that you can give an opinion on the balance of this asset. Refer to SFAS 141 for guidance on the amounts that should be capitalized (FASB 2001a). Reductions to this asset are likely to be due to a sale, other disposal, or impairment. However, there are no changes in the current year.
- Requirement 2- The client classifies reacquired franchise rights as an indefinite life intangible asset. Although the rights have a fixed term, the company both granted these rights and holds them. The useful life of the asset is therefore dependent on the continued existence of the company and the success of the company in refranchising the reacquired markets. The ability of the company to refranchise the rights is critical, and one of great perennial importance to the auditor. Also, if the auditor ever becomes concerned about the client's continued existence, the definite life classification may be called into question. Is there any evidence to suggest that the indefinite life is inappropriate?

- Requirement 3(a) – You should specifically review paras. 17 and 23 – 25 of SFAS 142 and para. 5 of SFAS 144. After your review, you should be able to answer the following questions.
  - What, if anything, should be done regarding these assets?
  - What does this SFAS say about fair value?
  - What, if anything, are the critical aspects of the definition of fair value?
  - What is the most common primary source of a fair value?
  - What if this primary source is not available? What should be done then?
  - Is SFAS 144 applicable to the reacquired franchise rights discussed in this case? Why or why not?
  
- Requirement 3(b) - You should specifically review SAS 101 to understand how the guidance in SAS 101 is relevant to Roman Holiday.
  
- Requirement 3(c) - This determination is important because if the client is not using the appropriate method, the value of the reacquired franchise rights may not be correct.
  
- Requirement 3(d) – Verifying the mathematical accuracy includes recalculating that
  - 1) the fair value estimate of \$22,320,000 based on the present value of the projected net cash flows,
  - 2) the annual projected net cash flow equals the sum of projected royalties, projected franchise fees, and projected expenses,
  - 3) the projected expense equal 20% of total projected revenue (royalties and franchise fees),
  - 4) the projected franchise fees is consistent with projected growth rate and per restaurant franchise fee,
  - 5) the projected royalties equals the product of the number of opened restaurants, number of weeks in a year, the weekly revenue per restaurant, and the royalty rate,

and 6) the number of restaurants open at the end of the year is consistent with the growth rate.

- Requirement 3(e) – Most of these assumptions are found in Exhibit 6. Are there any other assumptions that the company has made?
- Requirement 3(f)

i. In what situations would external or internal information be preferred?

While external is generally preferred, internal evidence can also be very important when the required information must be company-specific.

ii. What sources of information would be helpful in determining whether the company assumptions you identified in requirement 3(e) are correct? For example, what type of information would you want to obtain to evaluate 1) management's growth rate assumption, or 2) management's discount rate assumption?

v. The information received from the client includes company-specific information and selected external sources of evidence to supplement any information obtained in Requirement 3(f) (iv).

vi. A spreadsheet will be useful in completing this requirement. First, prepare a spreadsheet that replicates the client analysis (Exhibit 6) with the key assumptions easily identifiable and changeable. Second, change the values of the key assumptions based on your analysis in requirement 3(f) (v).

Summarize the impact on the estimated fair value and impairment for each change in assumption that you made.

vii. Questions to consider when evaluating the impairment assessment include: Did the client use an inappropriate methodology to derive a fair value estimate for accounting purposes? What about the probability-based approach outlined in SFAC 7? Are the key assumptions made by management appropriate? What is your estimate of the fair value and impairment potential?