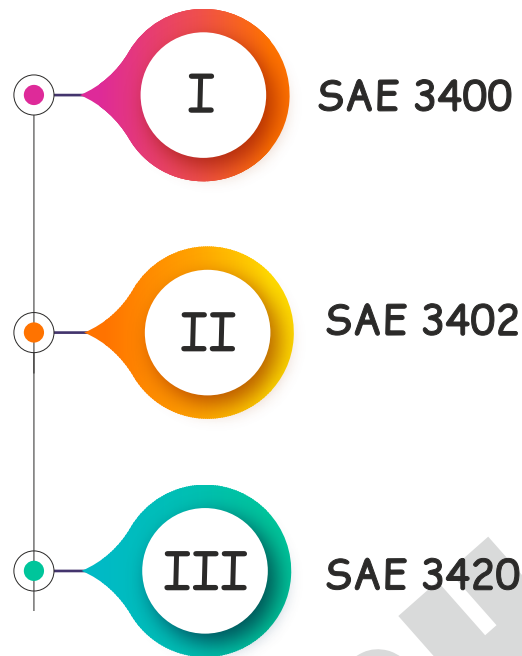


Chapter-11

Prospective Financial Information and Other Assurance Services

Chapter Overview



Standards on Assurance Engagements

- 1) An assurance engagement may **relate to** examination of subject matters other than examination of financial statements prepared on basis of **"historical financial information"**.
- 2) In such type of assurance engagements, examination may **relate to prospective financial information** or to providing assurance regarding **non-financial matters** like design and operation of internal control in an entity.
- 3) Standards on Assurance Engagements **deal with responsibilities of professional accountants in assurance engagements** dealing such matters. The level of assurance provided by these Standards on Assurance Engagements is moderate.
- 4) **Following Standards on Assurance Engagements have been issued: -**
 - a) **SAE 3400** - The Examination of Prospective Financial Information
 - b) **SAE 3402** - Assurance Reports on Controls at a Service Organisation
 - c) **SAE 3420** - Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus



The Examination of Prospective Financial Information

Scope of SAE-3400

- 1) The purpose of this Standard on Assurance Engagement (SAE) is to establish standards and provide guidance on engagements **to examine and report** on prospective financial information including examination procedures for **best-estimate and hypothetical assumptions**.
- 2) This SAE does **not apply** to the **examination of prospective financial information** expressed in general or narrative terms, such as that found in management's discussion and analysis in an entity's annual report, though many of the procedures outlined herein may be suitable for such an examination.
- 3) Further, the **principles** laid down in the other Standards on Auditing, issued by the Institute of Chartered Accountants of India, should be used by the auditor, to the **extent** practicable, in applying this SAE.
- 4) The term **"auditor"** is used throughout this SAE when describing services involving examination of prospective financial information. Such reference is **not intended** to imply that a member performing such services **need** necessarily be the **statutory auditor** of the entity's financial statements.

What is Prospective financial information?

- 1) **"Prospective financial information"** is financial information based on:
 - a) **Assumptions** about events that may occur in the future and
 - b) **Possible actions** by an entity.
- 2) It is highly **subjective** in nature and its preparation requires the exercise of considerable judgment. Prospective financial information can be in the **form of**:
 - a) A forecast,
 - b) A projection, or
 - c) A combination of both (for example a 1-year, forecast plus a 5-year, projection.)

What is Forecast?

Forecast means Prospective Financial Information **prepared** on the **basis of**:

- a) **Assumptions** as to **future events** which management expects to take place and
- b) The **actions** management expects to take as of the date the information is prepared. (Best estimate assumptions- An assumption that reflects anticipated experience with no provision for risk of adverse deviation.)

What is Projection?

Prospective Financial Information prepared on the **basis of**:

- Hypothetical assumptions** about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or
- A mixture** of best-estimate and hypothetical assumptions (imagined or suggested)

Nature of Assurance Regarding Prospective Financial Information

- Prospective financial information relates to **events and actions** that have **not yet occurred** and might **not occur**.
- While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally **future-oriented** and, therefore, **speculative** in nature, as distinct from the evidence ordinarily available in the examination of historical financial information.
- Therefore, **an opinion** as to whether the results shown in the prospective financial information will be achieved **cannot be expressed**.

Responsibility of Preparation and Presentation of Prospective Financial Information

Management is responsible for the **preparation and presentation** of the prospective financial information including the:

- Identification and disclosure** of Prospective Financial Information;
- Explaining** the basis of forecast;
- Underlying** assumptions.

Can Professional Accountants be associated with Prospective Financial Information?

- Traditionally, the **attest function** performed by a Chartered Accountant in practice has been in relation to "historical financial information".
- Recognizing the **professional skill and competence** of Chartered accountants, varied stakeholders like banks, financial institutions and prospective investors **intend** to place **greater reliance** on reports of projected cash flow and profitability statements examined and signed by Chartered accountants.
- Clause 3 of the Second Schedule to the Chartered Accountants Act, 1949** states that that a chartered accountant in practice shall be deemed to be **guilty of professional misconduct**, if **he permits** his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the

belief that he vouches for the accuracy of the forecast.

- 4) The above clause does **not preclude** a Chartered accountant from associating his name with prospective financial statements.
- 5) A **chartered accountant** can **participate** in the **preparation** of profit or financial forecasts and can review them, provided he **indicates clearly** in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and so long as he does **not vouch** for the accuracy of the forecasts.
- 6) The same also applies to **projections** made on the basis of hypothetical assumptions about **future events** and management actions which are not necessarily expected to take place so long as vouching for the accuracy of the projection is not made.

Duties of Member who is Examining the Prospective Financial Information

In an engagement to examine prospective financial information, the auditor should obtain sufficient appropriate evidence as to whether:

- 1) Management's **best-estimate assumptions** on which the prospective financial information is based are **not unreasonable** and, in the case of hypothetical assumptions, such assumptions are **consistent** with the purpose of the information;
- 2) The prospective financial information is **properly prepared** on the basis of the assumptions;
- 3) The prospective financial information is **properly presented** and all material assumptions are **adequately disclosed**, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions; and
- 4) The prospective financial information is **prepared on a consistent basis** with historical financial statements, using appropriate accounting principles.
- 5) While examining prospective financial information, principles laid down in other Standards on Auditing should be applied to the extent practicable.

Acceptance of Engagement: Precautions to be taken by Auditor Before Accepting such an Engagement

- 1) **Before** accepting an engagement **to examine** prospective financial information, the **auditor** would **consider**, amongst other things:
 - a) The **intended use** of the information;
 - b) Whether the information will be for **general or limited** distribution;
 - c) The nature of the assumptions, that is, whether they are **best estimates or hypothetical Assumptions**;
 - d) The **elements** to be included in the information; and
 - e) The **period covered** by the information.
- 2) Further, the auditor should **not accept, or should withdraw** from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

- 3) The auditor should **consider the extent** to which reliance on the entity's historical financial information is justified. Like in other engagements, it is necessary that terms of engagements should be agreed with client by sending an engagement letter.

Examination Procedures

- 1) **When determining the nature, timing and extent of examination procedures, the following matters should be considered such as: -**
 - a) the **knowledge obtained** during any previous engagements
 - b) **management's competence** regarding the preparation of prospective financial information
 - c) **the likelihood** of material misstatement
 - d) **the extent** to which the prospective financial information is **affected** by the management's judgment
 - e) the **sources of information** considered by the management for the purpose, their adequacy, reliability of the underlying data, including data derived from third parties, such as industry statistics, to support the assumptions
 - f) the **stability** of entity's business and
 - g) the **engagement team's experience** with the business and the industry in which the entity operates and with reporting on prospective financial information
- 2) In performing these procedures, **source and reliability** of the evidence supporting management's best-estimate assumptions needs to be **assessed**. Such evidence may be available from varied sources like entity's budgets, debt agreements, industry publications etc.
- 3) When **hypothetical assumptions** are used, all **significant implications** of such assumptions should have been taken into consideration.
- 4) **For Example** - if sales are assumed to grow beyond the entity's current plant capacity, the prospective financial information will need to include the necessary investment in the additional plant capacity or the costs of alternative means of meeting the anticipated sales, such as subcontracting production.
- 5) It needs to be verified that the hypothetical assumptions are **consistent** with the purpose of the prospective financial information and that there is **no reason** to believe they are **clearly unrealistic**.

Presentation and Disclosure

When assessing the presentation and disclosure of the prospective financial information and the underlying assumptions, in addition to the specific requirements of any relevant statutes, regulations as well as the relevant professional pronouncements, it needs to be considered whether: -

- 1) the **presentation** of prospective financial information is **informative and not misleading**
- 2) the accounting policies are **clearly disclosed** in the notes to the prospective financial information;
- 3) the assumptions are **adequately disclosed** in the notes to the prospective financial information. It needs to be **clear** whether assumptions represent management's best-estimates or are hypothetical and, when assumptions are made in areas that are material and are subject to a high degree of uncertainty, this uncertainty and the resulting sensitivity of results needs to be adequately disclosed
- 4) the **date** as of which the prospective financial information was **prepared is disclosed**. Management needs to confirm that the assumptions are appropriate as of this date, even though the underlying information may have been accumulated over a period of time
- 5) the **basis of establishing** points in a range is clearly **indicated** and the range is not selected in a **biased or misleading** manner when results shown in the prospective financial information are expressed in terms of a range and
- 6) if there is any **change** in the accounting policy of the entity from that disclosed in the **most recent historical financial statements**, whether reason for the change and the effect of such change on the prospective financial information has been **adequately disclosed**.

Report on Examination of Prospective Financial Information

The report for an examination of prospective financial information should contain the following:

- a) **Title**
- b) **Addressee**
- c) **Identification** of the prospective financial information
- d) **Reference** to the Standards on Auditing applicable to the examination of prospective financial information
- e) **Statement** that **management is responsible** for the prospective financial information including the underlying assumptions
- f) When applicable, **a reference** to the purpose and/or restricted distribution of the prospective financial information
- g) **Statement** that the examination procedures included examination, on a test basis, of evidence supporting the assumptions, amounts and other disclosures in the forecast or projection

- h) **Statement of negative assurance** as to whether the assumptions provide a reasonable basis for the prospective financial information
- i) **Opinion** as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework
- j) **Appropriate caveats** concerning the achievability of the results indicated by the prospective financial information
- k) **Date of report** (which should be the date procedures have been completed)
- l) **Place of signature** and
- m) **Signature**.

Such a report would

- 1) State whether, based on the examination of the evidence supporting the assumptions, anything has come to attention, which causes the belief that the assumptions **do not provide a reasonable basis** for the prospective financial information.
- 2) **Express an opinion** as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework.
- 3) **State that:** -
 - a) Actual results are likely to be different from the prospective financial information since anticipated events frequently do not occur as expected and the variation could be material. Likewise, when the prospective financial information is expressed as a range, it would be stated that there can be no assurance that actual results will fall within the range and
 - b) In the case of a projection, the prospective financial information has been prepared for (intended use), using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur.
 - c) Consequently, readers are cautioned that the prospective financial information should not be used for purposes other than the abovementioned intended use.
- 4) When it is believed that the presentation and disclosure of the prospective financial information is not adequate, a qualified or adverse opinion in the report on the prospective financial information should be expressed or withdrawal from engagement should be made as appropriate.
- 5) An example would be where financial information fails to disclose adequately the consequences of any assumptions, which are highly sensitive.
- 6) When it is believed that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, an adverse

opinion setting out the reasons in the report on the prospective financial information should be expressed, or withdrawal from the engagement should be made.

- 7) When the examination is affected by conditions that preclude application of one or more procedures considered necessary in the circumstances, either withdrawal from the engagement or disclaimer of the opinion and describing the scope limitation in the report on the prospective financial information is considered.

Documentation

Matters, which are important in providing evidence to support report on examination of prospective financial information, and evidence that such examination was carried out in accordance with this SAE should be documented



Assurance Reports on Controls at a Service Organisation

Scope of SAE 3402

SAE 3402 applies only when the **service organization is responsible** for, or otherwise able to make an assertion about, the suitable design of controls. It does not deal with assurance engagements:

- a) **To report** only on whether **controls** at a service organization **operated** as described or
- b) **To report** only on **controls at a service organization** other than those related to a service that is likely to be relevant to user entities' internal control as it relates to financial reporting (**for example**, controls that affect user entities' production or quality control).

Objectives of Service Auditor in Accordance with SAE 3402

The **objectives** of the service auditor are: -

- a) To **obtain reasonable assurance** about whether, in all material respects, based on suitable criteria: -
 - i) The service organization's **description** of its system fairly presents the system as designed and implemented throughout the specified period (or in the case of a type 1 report, as at a specified date)
 - ii) The controls related to the control objectives stated in the service organization's description of its system were **suitably designed** throughout the specified period (or in the case of a type 1 report, as at a specified date)
 - iii) Where included in the scope of the engagement, the controls **operated effectively** to provide reasonable assurance that the control objectives stated in the service organization's description of its system were achieved throughout the specified period.
- b) **To report** on the matters in (a) above in accordance with the service auditor's findings.

What is a Service Organisation?

Service organization refers to a **third-party organization** (or segment of a third-party organization) that **provides services** to **user entities** that are likely to be relevant to user entities internal control as it relates to financial reporting. **User entity** refers to an entity that **uses a service organization**

Why controls of a service organization are important to a user entity's internal controls relating to financial reporting?

- 1) Controls related to a service organization's operations and compliance objectives may be relevant to a user entity's internal control as it relates to financial reporting.
- 2) Such controls may pertain to assertions about presentation and disclosure relating to



account balances, classes of transactions, or disclosures, or may pertain to evidence that the user auditor evaluates or uses in applying auditing procedures.

- 3) "Controls at the service organization" includes aspects of user entities' information systems maintained by the service organization, and may also include aspects of one or more of the other components of internal control at a service organization.
- 4) **For Example-**
 - a) Such controls at a service organization may include aspects of a service organization's control environment, monitoring, and control activities when they relate to the services provided. It does not, however, include controls at a service organization that are not related to the achievement of the control objectives stated in the service organization's description of its system,
 - b) Controls related to the preparation of the service organization's own financial statements.
- 5) The **determination** of whether controls at a service organization related to operations and compliance are likely to be relevant to user entities' internal control as it relates to financial reporting is a matter of **professional judgment**, having regard to the control objectives set by the service organization and the suitability of the criteria.

User Auditor and Service Auditor

- 1) **User auditor** refers to an auditor who **audits and reports** on the financial statements of a user entity.
- 2) **Service auditor** refers to a **professional accountant** in public practice who, at the request of the service organization, provides an assurance report on controls at a service organization.

Type 1 Report & Type 2 Report

Type 1 report is a report that comprises:

- 1) The **service organization's description** of its system;
- 2) A **written assertion** by the service organization that, in all material respects, and based on suitable criteria:
 - a) The **description** fairly presents the service organization's system as designed and implemented at the specified date
 - b) The **controls related** to the control objectives stated in the service organization's description of its system were **suitably designed** as at the specified date and
- 3) A **service auditor's assurance report** that conveys reasonable assurance about the matters referred to in (2)

Type 2 report is a report that comprises:

- 1) The **service organization's description** of its system
- 2) A **written assertion** by the service organization that, in all material respects, and based on suitable criteria:

- a) The **description fairly** presents the service organization's system as designed and implemented throughout the specified period
 - b) The **controls** related to the control objectives stated in the service organization's description of its system were **suitably designed** throughout the specified period and
 - c) The **controls** related to the control objectives stated in the service organization's description of its system **operated effectively** throughout the specified period and
- 3) A **service auditor's assurance report** that: -
- a) Conveys **reasonable assurance** about the matters in (ii) and
 - b) Includes a **description** of the tests of controls and the results thereof.
- 4) **Type 1 report** is a report on the description and design of controls at a service organization whereas **type 2 report** is a report on the description, design and operating effectiveness of controls at a service organization

How such an Engagement is Proceeded with?

1) **Compliance with ethical requirements:**

The service auditor shall comply with **relevant ethical requirements**, including those pertaining to independence, relating to assurance engagements.

2) **Determination of Management and those charged with governance and communication with them:**

The service auditor shall **inquire of, request** representations from, **communicate** with, or otherwise interact with the service organization wherever required. The service auditor shall determine the appropriate persons within the service organization's management or governance structure with whom to interact.

3) **Acceptance and changes in terms of engagement:**

a) Before, accepting such an engagement, it has to be ensured by service auditor that necessary **capabilities and competence** to carry out such engagement are possessed by him.

b) It also **needs** to be ensured that the criteria to be applied by the service organization to prepare the description of its system will be **suitable and available** to user entities and their auditors and the scope of the engagement and the service organization's description of its system will not be so limited that they are unlikely to be useful to user entities and their auditors.

c) If the service organization **requests a change** in the scope of the engagement before the completion of the engagement, the service auditor shall be satisfied that there is a **reasonable justification** for the change.

4) **Assessing of suitability of the Criteria:**

The service auditor shall **assess** whether the service organization has used **suitable** criteria in preparing the description of its system, in evaluating whether controls are **suitably designed**, and, in the case of a **type 2 reports**, in evaluating whether controls are **operating**

effectively.

5) Determination of Materiality:

When planning and performing the engagement, the service auditor shall **consider materiality** with respect to the fair presentation of the description, the **suitability** of the design of controls and, in the case of a **type 2 report**, the **operating effectiveness** of controls.

6) Obtaining an understanding of the Service organization's system:

The service Auditor shall **obtain** an understanding of the service organization's system, including controls that are included in the scope of engagement.

7) Obtaining evidence regarding the description:

The service auditor shall **obtain and read** the service organization's description of its system and evaluate whether those aspects of the description included in the scope of engagement are fairly presented.

8) Obtaining evidence regarding the design of controls:

The service auditor shall **determine** which of the controls at the service organization are necessary to achieve the control objectives stated in the service organization's description of its system and shall **assess** whether those controls were **suitably designed**.

9) Obtaining evidence regarding operating effectiveness of controls:

When providing a **type 2 report**, the service auditor shall **test** those **controls** that the service auditor has **determined** are necessary **to achieve** the control objectives stated in the service organization's description of its system, and **assess** their **operating effectiveness** throughout the period.

10) Understanding the internal audit function:

If the service organization has an internal audit function, the service auditor shall obtain an understanding of the nature of the responsibilities of the internal audit function and of the activities performed in order to determine whether the internal audit function is likely to be relevant to the engagement in order for the service auditor to use specific work of the internal auditors.

11) Asking for Written Representations:

The **service auditor** shall **request** the service organization to provide **written representations**: -

- a) That **reaffirm** the assertion accompanying the description of the system
- b) That it has provided the service auditor with all relevant **information and access** agreed to and
- c) That it has **disclosed** to the service auditor any of the following of which it is aware:-
 - (i) **Non-compliance** with laws and regulations, fraud, or uncorrected deviations attributable to the service organization that may affect one or more user entities
 - (ii) **Design** deficiencies in controls
 - (iii) **Instances** where controls have not operated as described and

- (iv) Any **events** subsequent to the period covered by the service organization's description of its system up to the date of the **service auditor's assurance report** that could have a significant effect on the service auditor's assurance report.

12) Subsequent Events:

The service auditor shall **inquire** whether the service organization is aware of any **events subsequent** to the period covered by the service organization's description of its system up to the date of the service auditor's assurance report that could have a significant effect on the **service auditor's assurance report**.

Reporting

The **service auditor's assurance report** shall include the following basic elements: -

- 1) A **title** that clearly indicates the report is an independent service auditor's assurance report.
- 2) An **addressee**.
- 3) **Identification of:**
 - a) The service organization's description of its system, and the service organization's assertion, which includes the matters for a **type 2 report, or for a type 1 report**.
 - b) Those parts of the service organization's description of its system, if any, that are **not covered** by the service auditor's opinion.
 - c) If the description refers to the need for **complementary user entity controls**, a statement that the service auditor has not **evaluated the suitability of design or operating effectiveness of complementary user entity controls**, and that the control objectives stated in the service organization's description of its system can be achieved only if complementary user entity controls are suitably designed or operating effectively, along with the controls at the service organization.
 - d) If services are **performed** by a **subservice organization**, the nature of activities performed by the subservice organization as described in the service organization's description of its system.
- 4) **Identification** of the criteria, and the party specifying the control objectives.
- 5) A **statement** that the report and, in the case of a type 2 report, the description of tests of controls are intended only for user entities and their auditors, who have a sufficient understanding to consider it, along with other information including information about controls operated by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements.
- 6) A **statement** that the service organization is responsible for: -
 - a) **Preparing** the description of its system, and the accompanying assertion, including the completeness, accuracy and method of presentation of that description and that assertion;
 - b) **Providing** the services covered by the service organization's description of its system;

- c) **Stating** the control objectives (where not identified by law or regulation, or another party, for example, a user group or a professional body) and
 - d) **Designing and implementing** controls to achieve the control objectives stated in the service organization's description of its system.
- 7) **A statement** that the service auditor's responsibility is **to express an opinion** on the service organization's description, on the **design of controls** related to the control objectives stated in that description and, in the case of a **type 2 report**, on the **operating effectiveness** of those controls, based on the service auditor's procedures.
- 8) **A statement** that the engagement was **performed** in accordance with **SAE 3402, "Assurance Reports on Controls at a Service Organization,"** which requires that the service auditor **comply with ethical requirements** and plan and perform procedures to obtain reasonable assurance about whether, in all material respects, the service organization's description of its system is **fairly presented** and the controls are **suitably designed** and, in the case of a **type 2 report**, **are operating effectively**.
- 9) **A summary** of the service auditor's **procedures to obtain reasonable assurance** and **a statement** of the service auditor's belief that the evidence obtained is sufficient and appropriate to provide a basis for the service auditor's opinion, and, in the case of a **type 1 report**, a statement that the service auditor has **not performed** any procedures regarding the **operating effectiveness** of controls and therefore **no opinion is expressed** thereon.
- 10) **A statement** of the **limitations** of controls and, in the case of a **type 2 report**, of the risk of projecting to future periods any evaluation of the **operating effectiveness of controls**.
- 11) The **service auditor's opinion**, expressed in the positive form, on whether, in all material respects, based on suitable criteria:
- a) In the case of a **type 2 report**: -
 - i) The description **fairly presents** the service organization's system that had been designed and implemented throughout the specified period;
 - ii) The **controls** related to the control objectives stated in the service organization's description of its system were **suitably designed** throughout the specified period; and
 - iii) The **controls tested**, which were those necessary to provide reasonable assurance that the control objectives stated in the description were **achieved, operated effectively** throughout the specified period.
 - b) In the case of a **type 1 report**: -
 - i) The description **fairly presents** the service organization's system that had been designed and implemented as at the specified date and
 - ii) The **controls** related to the **control objectives** stated in the service organization's description of its system were **suitably designed** as at the specified date.
- 12) The **date of the service auditor's assurance report**, which shall be no earlier than the date on which the service auditor has obtained sufficient appropriate evidence on which to base the opinion.
- 13) **Signature**-The report should be signed by the practitioner.

- 14) The **place of signature** - the report should name specific location, which is ordinarily the city where the report is signed.

Additional matters requiring reporting in type 2 report

- 1) In the case of a **type 2 report**, the service auditor's assurance report shall include a **separate section** after the opinion, or an attachment, that **describes the tests of controls** that were performed and the results of those tests.
- 2) In **describing** the tests of controls, the service auditor shall **clearly state** which controls were tested, **identify** whether the items tested represent all or a selection of the items in the population, and **indicate** the nature of the tests in sufficient detail to **enable user auditors** to determine the **effect** of such tests on their risk assessments.
- 3) If **deviations** have been **identified**, the service auditor shall include the extent of testing performed that led to identification of the deviations (including the sample size where sampling has been used), and the **number and nature** of the deviations noted.
- 4) The service auditor shall **report deviations** even if, on the basis of tests performed, the service auditor has concluded that the related control objective was achieved.

Modified Opinions

If the service auditor **concludes** that:

- 1) The service organization's description **does not fairly present**, in all material respects, the system as designed and implemented;
- 2) The controls related to the control objectives stated in the description were **not suitably designed**, in all material respects
- 3) In the case of a **type 2 report**, the controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the service organization's description of its system were achieved, **did not operate effectively**, in all material respects or
- 4) The service auditor is **unable to obtain sufficient appropriate evidence**, the **service auditor's opinion** shall be **modified**, and the service auditor's assurance report shall contain **a clear description of all the reasons for the modification**.

Documentation

The service auditor shall prepare documentation that is **sufficient to enable an experienced service auditor**, having no previous connection with the engagement, **to understand**:

- a) The **nature, timing, and extent of the procedures performed** to comply with this SAE and applicable legal and regulatory requirements
- b) The **results of the procedures performed**, and the **evidence obtained** and
- c) **Significant matters** arising during the engagement, and the **conclusions** reached thereon and **significant professional judgments** made in reaching those conclusions



Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

Scope

- 1) **SA 3420** deals with **reasonable assurance** engagements undertaken by a **practitioner to report** on the responsible party's compilation of pro forma financial information included in a prospectus.
- 2) It applies where such reporting is **required by securities law or regulation** of the security exchange in the jurisdiction in which the prospectus is to be issued or this reporting is generally accepted practice in such jurisdiction.

Objectives in Accordance with SA 3420

The objectives of the practitioner in accordance with **SA 3420** are: -

- a) **To obtain reasonable assurance** about whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria and
- b) **To report** in accordance with the practitioner's findings.

What is Pro Forma Financial Information?

- 1) **Pro forma financial information** refers to **financial information** shown **together** with **adjustments** to illustrate the **impact of an event or transaction** on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration.
- 2) The Pro forma financial information is, normally, **used** in the **offer documents** to demonstrate the **effect of a transaction** on the financial statements of a company as if those **transactions had occurred at an earlier date**.
- 3) The Pro forma financial information may take the **form of Statement of Profit and Loss** and **Balance Sheet** to illustrate how the transactions might have **affected** the assets, liabilities and earnings of the Issuer. They also include **notes** in relation to the significant aspects of the transactions, assumptions used to prepare the Pro forma financial information and the adjustments made.
- 4) The **purpose** of pro forma financial information included in a prospectus is **solely to illustrate the impact** of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration.
- 5) This is **achieved** by applying pro forma adjustments to the **unadjusted financial information**. Pro forma financial information does not represent the entity's actual financial position, financial performance, or cash flows.

Compilation of Pro forma financial information

- 1) The **compilation of pro forma financial information** involves the responsible party gathering, **classifying, summarising** and **presenting** financial information that **illustrates** the impact of a significant event or transaction on the unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at the selected date.
- 2) **Steps involved in this process include:-**
 - a) **Identifying** the **source** of the **unadjusted** financial information to be used in compiling the pro forma financial information, and extracting the unadjusted financial information from that source
 - b) **Making pro forma** adjustments to the unadjusted financial information for the purpose for which the pro forma financial information is presented and
 - c) **Presenting** the resulting pro forma financial information with accompanying disclosures.

Nature of the Practitioner's Responsibility

- 1) In such an engagement performed under this SAE, the **practitioner** has **no responsibility** to compile the pro forma financial information for the entity. Such responsibility rests with the responsible party.
- 2) The **practitioner's sole responsibility** is to report on whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria.
- 3) It is a reasonable assurance engagement **to report** on the compilation of pro forma financial information involving performing the procedures **to assess** whether the applicable criteria used by the responsible party in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction.

Steps involved in such an Engagement



Engagement Acceptance

- 1) Before agreeing to accept an engagement to report on whether pro forma financial information included in a prospectus has been compiled, in all material respects, on the basis of the applicable criteria, the practitioner shall consider matters stated below.
- 2) **"Applicable criteria"** are criteria used by the responsible party when compiling the pro forma financial information.

- 3) Criteria may be **established** by an authorized or recognized standard-setting organization or by law or regulation. Where established criteria do not exist, they will be developed by the responsible party.
- a) **Determine** that the practitioner has the **capabilities and competence** to perform the engagement
 - b) On the basis of a preliminary knowledge of the engagement circumstances and discussion with the responsible party, **determine** that the **applicable criteria are suitable** and that it is unlikely that the pro forma financial information will be misleading for the purpose for which it is intended.
 - c) **Evaluate** the **wording of the opinion** prescribed by the relevant **law or regulation**, if any, to **determine** that the **practitioner** will likely be able to **express the opinion** so prescribed based on performing the procedures specified in this SAE
 - d) Where the **sources** from which the **unadjusted financial information** and any acquiree or divestee financial information have been **extracted** have been **audited or reviewed** and a **modified audit opinion or review** conclusion has been **expressed**, or the report contains an **Emphasis of Matter paragraph**, consider whether or not the relevant law or regulation permits the **use of, or reference** in the practitioner's report to, the **modified audit opinion or review conclusion** or the report containing the Emphasis of Matter paragraph with respect to such sources
 - e) If the entity's historical financial information has **never** been **audited or reviewed**, consider whether the practitioner can obtain a sufficient understanding of the entity and its accounting and financial reporting practices to perform the engagement
 - f) If the **event or transaction** includes an acquisition and the acquiree's historical financial information has **never** been **audited or reviewed**, consider whether the practitioner can obtain a sufficient understanding of the acquiree and its accounting and financial reporting practices to perform the engagement and
 - g) Obtain the agreement of the responsible party that it **acknowledges and understands** its responsibility for:
 - (i) **Adequately disclosing and describing** the applicable criteria to the intended users if these are not publicly available
 - (ii) **Compiling** the pro forma financial information on the basis of the applicable criteria and
 - (iii) **Providing the practitioner** with:-
 - ⇒ **Access to all information** (including, when needed for purposes of the engagement, information of the acquiree(s) in a business combination), such as records, documentation and other material, relevant to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria
 - ⇒ **Additional information** that the practitioner may request from the responsible party for the purpose of the engagement
 - ⇒ **Access to those within the entity** and the **entity's advisors** from whom the practitioner determines it necessary to obtain evidence relating to evaluating

whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria; and

- ⇒ When needed for purposes of the engagement, **access to appropriate individuals** within the acquiree(s) in a business combination.

Planning and Performing the Engagement

- 1) The practitioner shall **assess** whether the applicable criteria are **suitable**, as required by the Framework for Assurance Engagements.
- 2) When planning and performing the engagement, the **practitioner** shall consider **materiality** with respect **to evaluating** whether the pro forma financial information has been **compiled**, in all material respects, on the basis of the applicable criteria.
- 3) An **understanding** of how the responsible party has compiled the pro forma financial Information and other engagement circumstances
- 4) The **practitioner** shall obtain evidence about the **appropriateness** of the source from which the unadjusted financial information has been extracted
- 5) If there is **no audit or review report** on the source from which the unadjusted financial information has been extracted, the practitioner shall **perform procedures** to be satisfied that the source is appropriate.
- 6) **The practitioner** shall determine whether the **responsible party** has **appropriately** extracted the unadjusted financial information from the source.
- 7) The practitioner shall obtain evidence about the **appropriateness** of the pro forma adjustments.
- 8) In relation to unadjusted financial information, Pro forma adjustments **include**:
 - a) **Adjustments to unadjusted financial information** that **illustrate** the **impact** of a significant event or transaction as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration and
 - b) **Adjustments to unadjusted financial information** that are **necessary** for the pro forma financial information to be **compiled** on a basis consistent with the applicable financial reporting framework of the reporting entity and its accounting policies under that framework.
- 9) The practitioner shall **evaluate** the **presentation** of pro forma financial information.
- 10) The practitioner shall **read** the other information included in the Prospectus containing the pro forma financial information **to identify material inconsistencies**, if any, with pro forma financial information.

Written Representations

The practitioner shall request **written representations** from the responsible party that:-

- 1) In compiling the pro forma financial information, the responsible party has **identified** all appropriate pro forma adjustments necessary **to illustrate** the **impact** of the event or transaction at the date or for the period of the illustration and

- 2) The pro forma financial information has been **compiled**, in all material respects, on the basis of the applicable criteria.

Forming the Opinion

1) Unmodified Opinion

The practitioner shall **express an unmodified opinion** when the practitioner **concludes** that the pro forma financial information has been **compiled**, in all material respects, by the responsible party on the basis of the applicable criteria.

2) Modified Opinion

a) Where the **relevant law or regulation precludes** publication of a prospectus that contains a modified opinion with regard to whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria and the **practitioner concludes** that a **modified opinion** is nevertheless **appropriate** in accordance with the Framework for Assurance Engagements, the practitioner shall **discuss the matter** with the **responsible party**.

b) Where the **relevant law or regulation may not preclude** publication of a prospectus that contains a modified opinion with regard to whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria and the **practitioner determines** that a **modified opinion** is **appropriate** in accordance with the Framework for Assurance Engagements, the **practitioner shall apply** the requirements in the Framework for Assurance Engagements regarding modified opinions.

3) Emphasis of Matter Paragraph

a) In some circumstances, the practitioner may consider it necessary **to draw the user's attention** to a matter presented or disclosed in the pro forma financial information or the accompanying explanatory notes.

b) This would be the case when, in the practitioner's opinion, the matter is of such importance that it is fundamental to the user's understanding of whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria.

c) In such circumstances, the practitioner shall include an **Emphasis of Matter paragraph** in the practitioner's report provided that the practitioner has obtained sufficient appropriate evidence that the matter does not affect whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria.

d) Such a paragraph shall refer only to information presented or disclosed in the pro forma financial Information or the accompanying explanatory notes.

Preparing the Assurance Report

The practitioner's report shall include the following basic elements: -

Basic elements of Assurance Report

- 1) **A title** that clearly indicates that the report is an independent assurance report
- 2) **An addressee(s)**, as agreed in the terms of engagement
- 3) **Introductory paragraphs** that **identify**: -
 - a) The pro forma financial information
 - b) The source from which the unadjusted financial information has been extracted and whether or not an audit or review report on such a source has been published
 - c) The period covered by, or the date of, the pro forma financial information and
 - d) A reference to the applicable criteria on the basis of which the responsible party has performed the compilation of the pro forma financial information, and the source of the criteria
- 4) **A statement** that the responsible party is responsible for **compiling** the pro forma financial information on the basis of the applicable criteria
- 5) **A description** of the **practitioner's responsibilities**, including statements that: -
 - a) The practitioner's responsibility is **to express an opinion** about whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria
 - b) For purposes of this engagement, the **practitioner is not responsible** for **updating** or **reissuing** any reports or opinions on any historical financial information used in compiling the pro forma financial information, nor has the practitioner, in the course of this engagement, performed an audit or review of the financial information used in compiling the pro forma financial information and
 - c) The purpose of pro forma financial information included in a prospectus is solely **to illustrate the impact** of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration. Accordingly, the practitioner does **not provide any assurance** that the actual outcome of the event or transaction at that date would have been as presented
- 6) **A statement** that the engagement was **performed** in accordance with **SAE 3420, 'Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus'**, which requires that the practitioner **comply with ethical requirements** and plan and perform procedures **to obtain reasonable assurance** about whether the responsible party has **compiled**, in all material respects, the pro forma financial information on the basis of the applicable criteria
- 7) **Statements** that: -
 - a) **A reasonable assurance** engagement to report on whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria involves performing procedures to assess whether the applicable criteria used

by the responsible party in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction and to obtain sufficient appropriate evidence about whether: -

- i) The related pro forma adjustments give appropriate effect to those criteria; and
 - ii) The pro forma financial information reflects the proper application of those adjustments to the unadjusted financial information
- b) The procedures **selected** depend on the practitioner's judgment, having regard to the practitioner's understanding of the nature of the entity, the event or transaction in respect of which the pro forma financial information has been compiled, and other relevant engagement circumstances and
- c) The engagement also involves evaluating the **overall presentation** of the pro forma financial information
- 8) Unless otherwise required by **law or regulation**, the practitioner's opinion using one of the following phrases, which are regarded as **being equivalent**: -
- a) The pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria or
 - b) The pro forma financial information has been properly compiled on the basis stated.
- 9) The **practitioner's signature**
- 10) The **date of the report** and
- 11) The **place of signature**.

Documentation

As in case of all assurance engagements, documentation has to be ensured by the practitioner while performing engagement under SAE 3420.

CA RISHABH JAIN

