CHAPTER 11

PROSPECTIVE FINANCIAL INFORMATION AND OTHER ASSURANCE SERVICES

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Gain knowledge about Standards on Assurance Engagements.
- Understand the meaning of Prospective financial information.
- Know about the responsibilities of professional accountants in examining and reporting on prospective financial information under SAE 3400.
- Understand the meaning of Service Organization.
- Understand the importance of controls of a service organization to a user entity's internal controls relating to financial reporting.
- Know about the responsibilities of professional accountants under SAE 3402.
- Understand the meaning of Pro forma financial information.
- Understand about responsibilities of practitioners in assurance engagements to report on the compilation of Pro forma financial information included in a prospectus under SAE 3420.

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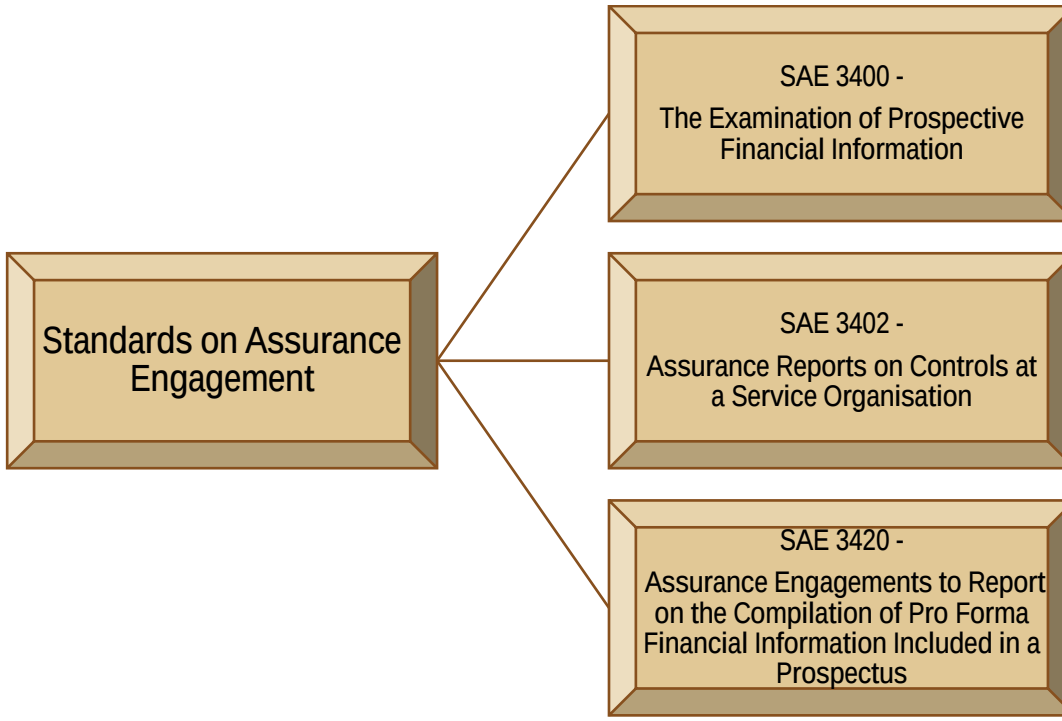
CHAPTER OVERVIEW



XP Limited, a company engaged in manufacturing of paints, is set to launch a new project for setting up a food processing plant at NOIDA lured by slew of investor friendly measures announced by state government in recently held Global Investors Summit. Being a new line of activity for the company, it asks Chirag (having MBA finance qualification) employed as a senior finance executive in the company to prepare detailed projection and feasibility of the said project. The company management wants him to make a detailed study conforming to acquisition of land, construction of plant building, procurement of plant machinery, projected targets of turnover, profits, sources of funds including financial assistance to be taken from banks etc. The said study is also to be used for submission to bankers for borrowing purpose.

Adept in preparing such studies, he prepared such a projection considering above factors highlighting expected sales, profits, key financial ratios, debt service coverage ratio over a period of seven years, payback period and IRR (Internal rate of return) replete with charts, bar graphs and diagrams. The said study was also submitted to bankers for providing financial assistance for upcoming project of the company.

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The bankers of the company now require an assurance report from a professional accountant on information contained in above study. Bewildered to know this, he wanted to understand reason of such a report from a professional accountant. Coming back to his office, he discussed the matter with CFO who asked him to meet CA. Dilip in this regard.

During discussions with CA, it transpired that for issuance of such an assurance report, it would be examined whether prospective financial information is prepared on the basis of assumptions; whether such assumptions are not unreasonable and are consistent with purpose of study. Not only this, it would also be looked into whether such information is consistent with past financial statements and uses appropriate accounting principles. He started ground work in these areas as instructed by CFO before engaging services of professional accountant.

Learning about assurance report on prospective financial information, he was also wondering whether professional accountants can also provide such reports intended to enhance degree of confidence of users in respect of non-financial matters. What could be such circumstances? What could be such type of matters?

1. INTRODUCTION

Traditionally, the attest function performed by a Chartered Accountant in practice has been in relation to past events. However, growing and dynamic society has now started seeking professional association in its exercises relating to future. A manifestation of this is the requirement of banks, financial institutions and prospective investors regarding the preparation of projected cash flow and profitability statements by intending borrowers or investees for the purpose of making an appropriate appraisal of their loan applications and equity proposals. These institutions place a greater reliance on such statements if they are prepared or reviewed by chartered accountants. These future oriented financial statements are generally known as Prospective Financial Statements.

For example - The shareholders of X Limited have given consent to board of directors to plan to raise funds from the prospective equity investor and have asked your firm to report on the accuracy of the profit forecast and Statements of Financial Position of the entity for the following five years so that it could be placed before the equity investor.

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1.1 Standards on Assurance Engagements

An assurance engagement may relate to examination of subject matters other than examination of financial statements prepared on basis of "historical financial information". 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.

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.

Following Standards on Assurance Engagements have been issued: -
• SAE 3400 The Examination of Prospective Financial Information
• SAE 3402 Assurance Reports on Controls at a Service Organisation
• SAE 3420 Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

2. SAE 3400 THE EXAMINATION OF PROSPECTIVE FINANCIAL INFORMATION

SAE 3400 provides guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions. Examination of prospective financial information need not necessarily be performed by statutory auditor of the entity's financial statements.

What is Prospective financial information?

"Prospective financial information" is Financial information based on:

- Assumptions about events that may occur in the future and
- Possible actions by an entity.

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 forecast,
- a projection,
- or a combination of both (for example a 1-year, forecast plus a 5-year, projection.)

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What is Forecast?

Forecast means Prospective Financial Information prepared on the basis of:

- Assumptions as to future events which management expects to take place and
- 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.).

In present market conditions, supply availability, historical buying patterns and seasonal trends, the CFO of a X ltd a expects sales to increase by 5% over the next quarter. Therefore, a 5% sales increase is his financial forecast for the period.

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)

1. X Ltd may project a course of action to take when one or more hypothetical situations arise, such as creating a new product to meet the demand of expected market growth. As a result of assuming the possibility of different events occurring, financial projections typically serve as an outline for evaluating the desired outcomes x ltd. is expects to see, including its financial, cash flow and operational outcomes.

2. A company plans to raise funds from a prospective equity investor and has asked a firm of Chartered Accountants to examine the profit forecast for placing it before prospective equity investor.

3. A company is in the process of setting up a new plant. It needs financial assistance from bank in shape of term loan and working capital credit facilities. The company has prepared a projection of its profits, cash flows for next seven years along with its underlying assumptions.

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2.1 Scope of SAE-3400

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.

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. 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.

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.

2.2 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.

2.3 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.

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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.*

The above clause *does not preclude* a Chartered accountant from associating his name with prospective financial statements. 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.*

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.*

2.4 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:	
(a)	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;
(b)	the prospective financial information is properly prepared on the basis of the assumptions;
(c)	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
(d)	the prospective financial information is prepared on a consistent basis with historical financial statements, using appropriate accounting principles.

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While examining prospective financial information, principles laid down in other Standards on Auditing should be applied to the extent practicable.

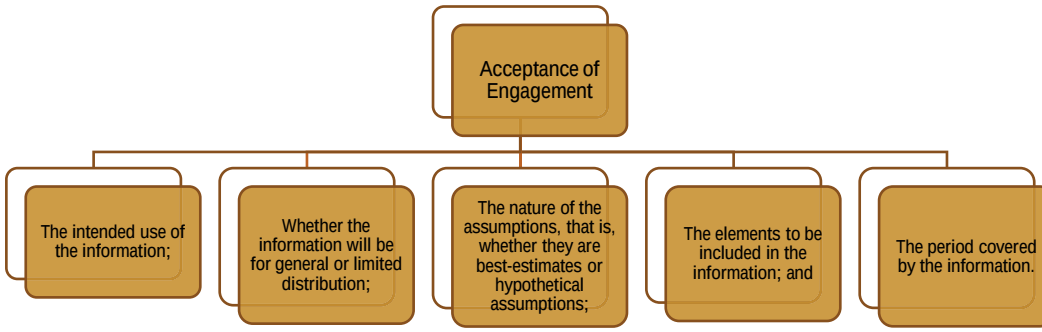
2.5 Nature of Assurance regarding Prospective Financial Information

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.

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

Before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:

- The intended use of the information;
- Whether the information will be for general or limited distribution;
- The nature of the assumptions, that is, whether they are best estimates or hypothetical Assumptions;
- The elements to be included in the information; and
- The period covered by the information.



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. The auditor should consider the extent to which

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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.

2.7 Examination Procedures

When determining the nature, timing and extent of examination procedures, the following matters should be considered such as: -

Examination Procedures	(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

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.

When hypothetical assumptions are used, all significant implications of such assumptions should have been taken into consideration. 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. 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.

2.8 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: -

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(a) the presentation of prospective financial information is *informative and not misleading*

(b) the *accounting policies are clearly disclosed* in the notes to the prospective financial information;

(c) 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*

(d) 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

(e) *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

(f) 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.

2.9 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

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(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.

(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: -

- 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.

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- 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.
- state that: -

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

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. Consequently, readers are cautioned that the prospective financial information should not be used for purposes other than the abovementioned intended use.

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.

An example would be where financial information fails to disclose adequately the consequences of any assumptions, which are highly sensitive.

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.

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.

2.10 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.

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TEST YOUR UNDERSTANDING 1

A company has approached CA. Hemant for an assurance report in respect of prospective financial information of a project. On going through the project details, it is noticed that depreciation reflected on proposed fixed assets to be acquired in prospective financial information has been calculated in accordance with provisions of the Income Tax Act. No disclosure is made in this respect too. How the matter should be proceeded with?

3. SAE 3402 Assurance Reports on Controls at a Service Organisation

SAE 3402 deals with assurance engagements undertaken by a professional accountant in public practice to provide a report for use by user entities and their auditors on the controls at a service organization that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting. It complements SA 402, in that reports prepared in accordance with this SAE are capable of providing appropriate evidence under SA 402.

3.1 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).

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.

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

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. 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.

For example, a company has outsourced its payroll processing functions to a service organization. The service organization is responsible for the accurate preparation of payrolls and timely remittance of statutory dues to government authorities on behalf of the company. Payroll processing service organization's controls related to the timely remittance of payroll deductions to government authorities may be relevant to the company (user entity) as late remittances could result in interest and penalties resulting in liabilities for the user entity.

"*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.

For example, 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, for example, controls related to the preparation of the service organization's own financial statements.*

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

User auditor refers to an auditor who audits and reports on the financial statements of a user entity.

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.

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3.2 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.

3.3 Type 1 Report & Type 2 Report

Type 1 report is a report that comprises:	*Type 2 report is a* report that comprises:
(i) The service organization's description of its system; (ii) 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	(i) The service organization's description of its system (ii) 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

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(iii) A service auditor's assurance report that conveys reasonable assurance about the matters referred to in (ii)	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 (iii) 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.
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.	

3.4 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: 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. It also needs to be ensured that the criteria to be applied by the service organization to prepare the description of its

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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.

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

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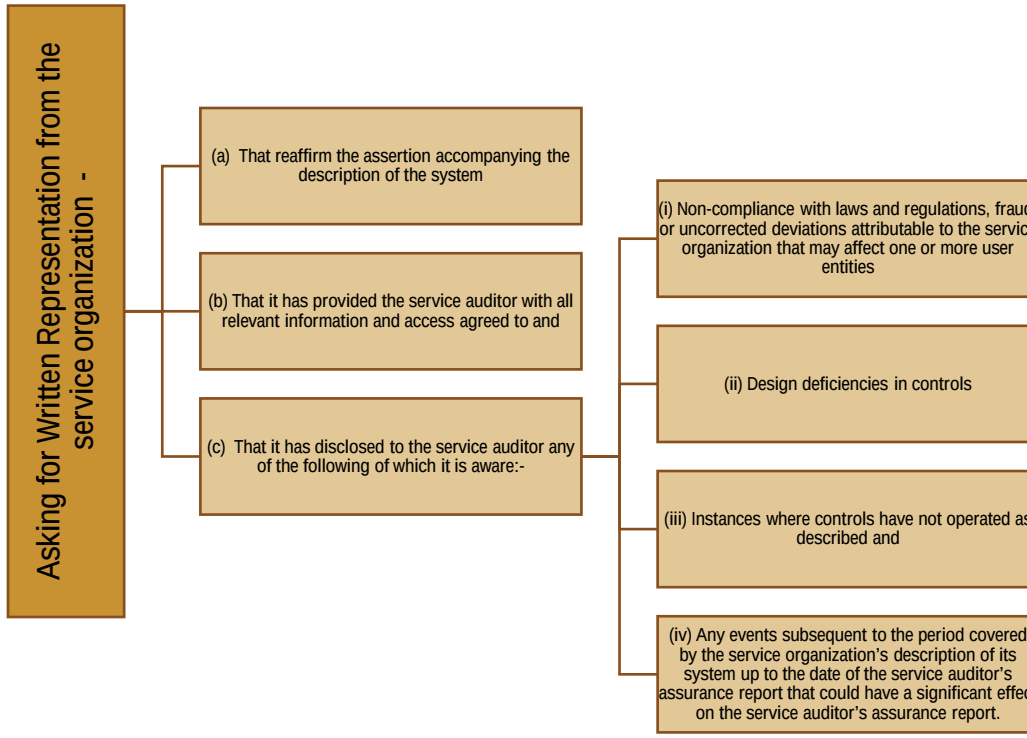
internal audit function is likely to be relevant to the engagement in order for the service auditor to use specific work of the internal auditors.

11) Asking for Written Representations: The service auditor shall request the service organization to provide written representations: -



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.

3.5 Reporting

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

(a) A title that clearly indicates the report is an independent service auditor's assurance report.

(b) An addressee.

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(c) Identification of:

(i) 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.

(ii) Those parts of the service organization's description of its system, if any, that are not covered by the service auditor's opinion.

(iii) 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.

(iv) 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.

(d) Identification of the criteria, and the party specifying the control objectives.

(e) 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.

(f) A statement that the service organization is responsible for: -

(i) Preparing the description of its system, and the accompanying assertion, including the completeness, accuracy and method of presentation of that description and that assertion;

(ii) Providing the services covered by the service organization's description of its system;

(iii) Stating the control objectives (where not identified by law or regulation, or another party, for example, a user group or a professional body) and

(iv) Designing and implementing controls to achieve the control objectives stated in the service organization's description of its system.

(g) 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.

(h) A statement that the engagement was performed in accordance with SAE 3402, "Assurance Reports on Controls at a Service Organization," which requires that the

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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.

(i) 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.

(j) 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.

(k) The service auditor's opinion, expressed in the positive form, on whether, in all material respects, based on suitable criteria:

(i) In the case of a type 2 report: -

a. The description fairly presents the service organization's system that had been 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 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.

(ii) In the case of a type 1 report: -

a. The description fairly presents the service organization's system that had been designed and implemented as at the specified date and

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.

(l) 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.

(m) Signature-The report should be signed by the practitioner.

(n) The place of signature – the report should name specific location, which is ordinarily the city where the report is signed.

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Additional matters requiring reporting in type 2 report: 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.

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.

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.

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:			
(a) The service organization's description does not fairly present, in all material respects, the system as designed and implemented;	(b) The controls related to the control objectives stated in the description were not suitably designed, in all material respects	(c) 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	(d) 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.

3.6 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

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TEST YOUR UNDERSTANDING 2

Bansi Group is a leading institution running prestigious post graduate courses in the field of management. Its financial statements are audited by an independent auditor. Before the start of this academic session, the Board of the institution had outsourced its entire process of inviting student applications, submission of applications, and collection of application fees including late fees and such matters to Easy Solutions Limited.

The auditors of Bansi Group want to be sure about the design and operating effectiveness of controls at Easy Solutions Limited. What should be the nature of the report to be provided by auditors of Easy Solutions Limited specifically for use by Bansi Group and its auditors in this regard in terms of SA 3402?

4. SAE 3420 Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

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. 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.

What is Pro forma financial information?

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.

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. 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.

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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. 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.

4.1 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.

4.2 Compilation of Pro forma financial information

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.

Steps involved in this process include:-
❖ 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
❖ Making pro forma adjustments to the unadjusted financial information for the purpose for which the pro forma financial information is presented and
❖ Presenting the resulting pro forma financial information with accompanying disclosures.

4.3 Nature of the Practitioner's Responsibility

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. The practitioner's sole responsibility is to report on whether the pro forma financial information has

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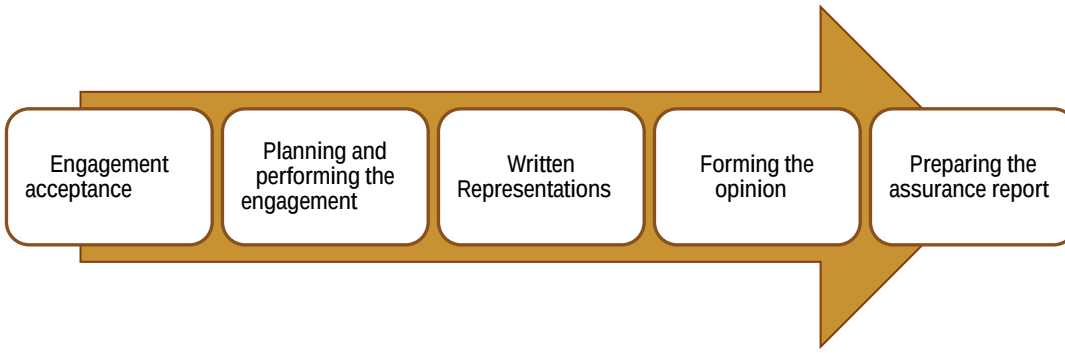
been compiled, in all material respects, by the responsible party on the basis of the applicable criteria.

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.

4.4 Steps involved in such an Engagement



4.4.1 Engagement Acceptance

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. “Applicable criteria” are criteria used by the responsible party when compiling the pro forma financial information. 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

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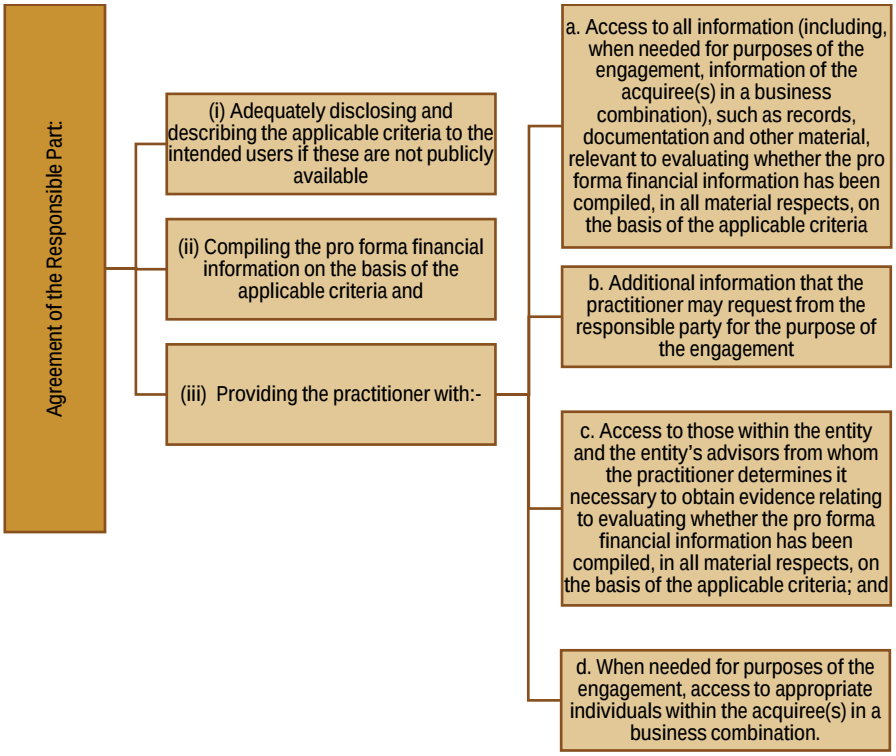
(d) Where the sources from which the unadjusted financial information and any acquiree or divestee financial information have been extracted have been audited or reviewed and a modified audit opinion or review conclusion has been expressed, or the report contains an Emphasis of Matter paragraph, consider 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:



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4.4.2 Planning and Performing the Engagement

- The practitioner shall assess whether the applicable criteria are suitable, as required by the Framework for Assurance Engagements
- 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.
- An understanding of how the responsible party has compiled the pro forma financial Information and other engagement circumstances
- The practitioner shall obtain evidence about the appropriateness of the source from which the unadjusted financial information has been extracted
- 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.
- The practitioner shall determine whether the responsible party has appropriately extracted the unadjusted financial information from the source.
- The practitioner shall obtain evidence about the appropriateness of the pro forma adjustments.

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.

- The practitioner shall evaluate the presentation of pro forma financial information.
- 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.

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4.4.3 Written Representations

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

(a) 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

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

4.4.4 Opinion

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.

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.

If the responsible party does not agree to make the necessary changes, the practitioner shall: -

- Withdraw from the engagement or
- Consider seeking legal advice.

(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.

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Emphasis of Matter Paragraph

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. 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.

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

4.4.5 Preparing the Assurance Report

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

Basic elements of Assurance Report		
(a)	A title that clearly indicates that the report is an independent assurance report	
(b)	An addressee(s), as agreed in the terms of engagement	
(c)	Introductory paragraphs that identify: -	
	(i)	The pro forma financial information
	(ii)	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
	(iii)	The period covered by, or the date of, the pro forma financial information and
	(iv)	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
(d)	A statement that the responsible party is responsible for compiling the pro forma financial information on the basis of the applicable criteria	

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(e) A description of the practitioner's responsibilities, including statements that: -

(i) 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

(ii) 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

(iii) 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

(f) 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

(g) Statements that: -

(i) 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: -

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The related pro forma adjustments give appropriate effect to those criteria; and

The pro forma financial information reflects the proper application of those adjustments to the unadjusted financial information

(ii) 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

(iii) The engagement also involves evaluating the overall presentation of the pro forma financial information

(h) Unless otherwise required by law or regulation, the practitioner's opinion using one of the following phrases, which are regarded as being equivalent: -

(i) The pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria or

(ii) The pro forma financial information has been properly compiled on the basis stated.

(i) The practitioner's signature

(j) The date of the report and

(k) The place of signature.

4.5 Documentation

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

TEST YOUR UNDERSTANDING 3

The management of S Ltd. requests you to accept an engagement to report on the compilation of pro forma financial information to be included in a prospectus. In light of SAE 3420, what factors you will consider regarding the company acknowledging and understanding its responsibility in this matter before accepting engagement?

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Integrated Case Scenario

Below is given draft text of the *"Report on Examination of Prospective Financial Information"* of Top Edge Limited in relation to the company's upcoming project prepared by a staff member in a CA firm *unfamiliar with drafting such reports. The report has been drafted in a casual manner and may consist of omissions and errors.*

Report on Examination of Prospective Financial Information

To

The Board of Directors

Top Edge Limited

We have examined the projection of the *upcoming project to come up at* Ratnagiri of Top Edge Limited for the period from April 2023 to March 2030 as given in the Prospective Financial Information from page 1 to 250 in accordance with *Standard on Assurance Engagement 3400, "The Examination of Prospective Financial Information",* issued by the Institute of Chartered Accountants of India.

The preparation and presentation of the projection is the responsibility of the Management and has been approved by the Board of Directors of the company.

Our responsibility is to examine the evidence supporting the assumptions (excluding the hypothetical assumption) and other information in the prospective financial information.

The projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur.

We have carried out our examination of the prospective financial information thoroughly.

Further, in our opinion the projection is properly prepared on the basis of the assumptions as set out in Note 1 to 50 to the Prospective Financial Information and on a consistent basis with the historical financial statements, using appropriate accounting principles. Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

For PCK & Co.

Chartered Accountants

Signature

Designation

Membership number

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Based on your knowledge and description of the case, answer the following questions: -

1. Whose responsibility is to list out assumptions underlying prospective financial information?

(a) Professional Accountant issuing report on prospective financial information.

(b) Auditor of Company issuing report on prospective financial information.

(c) Management of company.

(d) Banker of company.

2. Which of the following statements is most appropriate regarding "use of prospective financial information" to be included in such a report?

(a) Intended use of projection is required to be disclosed. It is further necessary to caution the users regarding inappropriateness of projections for other purposes.

(b) It is discretionary to state intended use of projection in such a report.

(c) Intended use of projection is required to be disclosed. It is not necessary to caution the users regarding inappropriateness of projections for other purposes.

(d) It is prerogative of management to use report in the manner it deems fit.

3. What should be language of such an unmodified assurance report regarding underlying assumptions?

(a) Positively worded to suggest assumptions are a reasonable basis.

(b) Negatively worded to suggest assumptions are not on a reasonable basis.

(c) Neither positively worded nor negatively worded about assumptions.

(d) Depends upon the professional judgment of the Chartered Accountant.

4. Which of the following statements is most appropriate regarding the examination of prospective financial information by a Chartered accountant in accordance with SAE 3400?

(a) Accuracy of projections is vouched for based upon performing procedures thoroughly.

(b) Projections can go haywire; It depends upon the professional judgment of the Chartered Accountant to vouch for the accuracy of projections.

(c) Accuracy of projections is not at all vouched for in an assurance report on prospective financial information.

(d) The matter of accuracy of projections or otherwise is not domain of such an examination. Therefore, there is no reporting requirement under SAE 3400.

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5. Which of the following statements is most appropriate regarding UDIN in context of examination of prospective financial information by a Chartered Accountant?

(a) It is mandatory to state UDIN in such type of reports.

(b) It is desirable to state UDIN in such type of reports.

(c) It is not required to state UDIN in such type of reports as it is not an audit engagement.

(d) It is not required to state UDIN in such type of reports as it is not an engagement related to historical financial information.

Key Takeaways

- An assurance engagement may relate to the examination of subject matters other than an examination of financial statements prepared on the basis of "historical financial information". In such types of assurance engagements, the examination may relate to prospective financial information or to providing assurance regarding non-financial matters like the design and operation of internal control in an entity. Standards on Assurance Engagements deal with the responsibilities of professional accountants in assurance engagements dealing with such matters.
- "Prospective financial information" means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It can be in the form of a forecast, a projection, or a combination of both.
- SAE 3400 provides guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions.
- 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.
- 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.
- SAE 3402 deals with assurance engagements undertaken by a professional accountant in public practice to provide a report for use by user entities and their auditors on the controls at a service organization that provides a service to user entities that is likely to be relevant to user entities internal control as it relates to financial reporting.

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- 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.
- 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.
- 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.
- SA 3420 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.

TEST YOUR KNOWLEDGE

Theoretical Questions

1 *Ayurda Ltd.is a fast-growing and award-winning SaaS software company which is headquartered in Mumbai. It also has offices in the UK and provides cloud-based professional services automation (PSA) software solutions to professional services organizations around the world. They want to engage you to provide an assurance report for one of its major clients over the controls it operates as a service organisation. Can you provide such an assurance report?*

2. *Discuss the significance of Pro forma financial information included in prospectus of a company.*

3. *Discuss the term "Pro forma adjustment" under SAE 3420.*

4. *Discuss, how, a Chartered Accountant can be associated with prospective financial information without violating relevant provisions of the Chartered Accountants Act, 1949.*

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Answers to Test Your Understanding

1. In such types of engagements, it is the duty of a professional accountant to see that prospective financial information is based on a consistent basis with historical financial statements using appropriate accounting principles.

   In the case of a company, historical financial statements are prepared considering the requirements of the Companies Act, and depreciation is calculated accordingly. However, in the given situation, depreciation has been calculated in accordance with Income Tax Act which is not consistent with historical financial statements. Therefore, it is not proper.

   The fact that the projection has not been prepared on a consistent basis with the historical financial statements, using appropriate accounting principles needs to be stated.

   Further, when presentation and disclosure are not adequate, a qualified or adverse opinion should be given or withdrawal from engagement should be made as appropriate.

2. In such a case, the auditors of Bansi Group want to be sure about the design and operating effectiveness of controls at the organization which is providing services to their client. Type 2 report is a report on the description, design and operating effectiveness of controls operating at the service organization. Auditors of Easy Solutions Limited should provide such a report giving assurance on these matters. It should also include details of tests of controls performed and details of deviations, if any.

3. The company's responsibility has to be acknowledged for the following matters:-

   (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:-

      a. 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

      b. Additional information that the practitioner may request from the responsible party for the purpose of the engagement

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c. 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

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

Answers to Integrated Case Scenario

1. (c)
2. (a)
3. (b)
4. (c)
5. (a)

Hints /Answers to Theoretical Questions

1. Assurance report can be provided under SAE 3402. Refer to Para 3.

2. Refer to Para 4.

3. Refer to Para 4.4.2

4. Refer to Para 2.3.

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