

Assurance Reports on Proper Compilation of Pro Forma Financial Information Included in Prospectuses—Issues and IAASB Task Force Proposals

A. NATURE AND EXTENT OF THE PRACTITIONER’S WORK EFFORT WHEN THE SOURCE OF THE UNADJUSTED FINANCIAL INFORMATION HAS NOT BEEN AUDITED OR REVIEWED

Significant Comments from September 2009 IAASB meeting

1. At the March 2009 meeting, the IAASB agreed that it would not be practicable to mandate an audit or review of the source of the unadjusted financial information if it has not been audited or reviewed. Nevertheless, there was general agreement that the practitioner should perform at least some work on this source to be satisfied that it is appropriate for use in the compilation of the pro forma financial information. Accordingly, at the September 2009 meeting, the Task Force proposed that the practitioner be required to perform a specified list of procedures on the source.
2. It was noted that if the source has not been audited or reviewed, it would be important for the practitioner to consider whether these proposed procedures would enable the practitioner to be satisfied about the appropriateness of the unadjusted financial information as a basis for undertaking the engagement. Accordingly, it was suggested that this consideration be built into the ISAE as an engagement acceptance consideration. It was, however, pointed out that indications from investors show they are not seeking assurance on the starting point of the compilation and, instead, are looking for a level of assurance focused on the pro forma adjustments.
3. Consequently, it was observed that the key question was whether the objective of performing the specified procedures on the unadjusted financial information was to obtain sufficient information to understand the work needed on the pro forma adjustments or to obtain some assurance regarding the reliability of the unadjusted financial information. It was also noted that this situation might not be dissimilar to the circumstances addressed by ISA 510¹ where the practitioner is required to perform sufficient work on the opening balances to be comfortable with their impact on the current year’s financial statements.
4. The Task Force accepted the suggestion that as part of the engagement acceptance decision, the practitioner consider whether the practitioner would be able to perform the procedures required by the ISAE, including any necessary work on the unadjusted financial information when the source of this information has not been audited or reviewed (see paragraph 10(a)(v)).² With regard to the practitioner’s objective in performing the specified procedures on the source of the unadjusted financial information, the majority Task Force view is that the primary objective in performing these procedures should be to enable the practitioner to be satisfied that such a source is appropriate for the purposes of the compilation and within the context of the applicable criteria, and not to enable the practitioner to conclude that the source is in other senses “reliable”. The majority of the

¹ ISA 510, “Initial Audit Engagements—Opening Balances.”

² Paragraph numbers refer to the revised draft of the ISAE unless otherwise stated.

Task Force does not believe that a reliability test would be appropriate for engagements under this ISAE as it would require audit-level work.

5. Nevertheless, the Task Force reconsidered the appropriateness of mandating the performance of the specified procedures on the source. The Task Force felt that this approach not only would be inconsistent with the risk assessment principles set out in ISAE 3000 but also could be potentially onerous³ as not all the proposed procedures would need to be performed in all such cases.
6. Accordingly, the Task Force proposed in a revised draft that the specified list of procedures be moved to application material and guidance provided as to how the practitioner may consider them in the context of an assessment of risks. The Task Force circulated this draft to the IAASB in November 2009 in advance of the December 2009 meeting and asked for the IAASB's views on this approach.

Significant IAASB Comments on November 2009 Advance Draft

7. The Task Force received the following significant comments on this proposal:
 - The approach appeared too open-ended and will result in an inappropriately wide range of procedures being applied by different practitioners. Also, neither an audit nor a review of the source is required and, therefore, a level of work less than a review would be appropriate. Accordingly, it would be better to identify some of the specified procedures as essential and therefore elevate them to requirements.
 - The practitioner's work effort on the starting point (the unadjusted financial information, or "column 1") should only be necessary in order for the practitioner to be comfortable that all the pro forma adjustments are appropriate. While the nature and extent of the work effort on the starting point should be a matter of professional judgment, it is important that the objective of this work be clear. This objective should not be about establishing that the source of the starting point is misstated, which seemed to be a common theme in many of the procedures the Task Force proposed.
 - The practitioner's work effort on the starting point and any other underlying financial information should not be to obtain reasonable or limited assurance on such information but to obtain sufficient evidence on the information to enable the practitioner to express an opinion on proper compilation. Drawing on the requirements and guidance of ISA 510 would be helpful in this regard.
 - It seemed confusing that the proposed work effort focused on the concept of a "misstatement," as the purpose of the engagement is to report on a *process*. Also, the Task Force's use of the construct of "risks of material misstatement in the compilation of the pro forma financial information" seemed to focus the work effort on the risks of material misstatement in the final column. In addition, there is no requirement in ISAE 3000 for the practitioner to identify and assess the risks of the matter being material misstated, nor does ISAE 3000 use the ISA construct of "further audit procedures." Accordingly, it was suggested that it would be preferable to identify the specific procedures that would be appropriate in these circumstances instead of adopting a

³ ISAE 3000, "Assurance Engagements Other than Audits or Reviews of Historical Financial Information."

generic approach that leaves the details to the application material. In this regard, the practitioner's objective should be whether the source of the starting point is appropriate for the compilation and not whether the source is materially misstated.

- Reasonable assurance on the pro forma financial information can only be obtained when the practitioner has obtained reasonable assurance on the source information. Accordingly, a risk-based approach would seem appropriate.
- Because of the risk of the practitioner being associated with misleading information and the potential for users to misunderstand the nature of the work performed, there should be some minimum procedures the practitioner should perform when the source of the starting point has not been audited or reviewed.
- It is difficult to see how the practitioner can determine whether the pro forma adjustments have been properly applied without a reasonable degree of comfort with the starting point. In this regard, a risk-based approach would be appropriate as opposed to mandating a list of procedures in all cases. However, it was unclear whether the Task Force's proposal would help the practitioner determine "how much is enough." Without an audit or review base, inquiry alone would not seem sufficient and some (but perhaps limited) procedures to understand the business, internal control, and the financial reporting process would seem to be necessary.

Task Force Response and Revised Proposals

8. First, the Task Force did not believe that adopting the ISA 510 approach would be appropriate for engagements performed under this ISAE. The Task Force noted that ISA 510 is set in the context of an audit of financial statements, where the practitioner's objective is to express an opinion on the fair presentation of the financial statements (assuming a fair presentation framework). In engagements performed under this ISAE, the practitioner's objective is not to express an opinion on the fair presentation of the pro forma financial information. Further, the auditor's objective with respect to opening balances under ISA 510 is to "obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements."⁴ The majority of the Task Force does not believe that the purpose of the practitioner's work effort on the starting point under this ISAE should be to obtain sufficient appropriate evidence about whether this information contains misstatements that materially affect the pro forma financial information. Finally, ISA 510 calls for the auditor to perform *any specific audit procedures necessary to obtain sufficient appropriate audit evidence* about whether the opening balances contain such misstatements.⁵ The majority of the Task Force did not believe that it would be appropriate to impose an obligation on the practitioner to obtain such reasonable assurance on the starting point with respect to engagements performed under this ISAE.

⁴ ISA 510, paragraph 3(a).

⁵ ISA 510, paragraph 6(c)(iii) requires the practitioner to perform any specific audit procedures that may be necessary to obtain sufficient appropriate audit evidence regarding the opening balances if such evidence cannot be obtained from reviewing the predecessor auditor's working papers or evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances.

9. The majority of the Task Force agreed with some of the IAASB views above that the practitioner’s objective in performing work on the starting point is not to identify misstatements in the information, but to be satisfied that this information is appropriate for purposes of the *process of compiling* the pro forma financial information. The majority of the Task Force believes that this is the general IAASB consensus. Accordingly, the Task Force generally agreed that the practitioner’s procedures need not amount to a review-level assurance on the starting point but need to be sufficient to enable the practitioner to achieve this lower level of comfort consistent with the practitioner’s objective to report on the *process* and not on the pro forma financial information – an objective that is embodied in the proposed definition of “proper compilation,” on which there has been broad IAASB support.
10. However, the Task Force did not agree that it would be appropriate to mandate a minimum level of work effort on the starting point in all cases because circumstances will vary in practice. Therefore, it would seem only appropriate that the practitioner should be called to exercise some judgment on the nature and extent of work that would be necessary to enable the practitioner to be satisfied that the starting point is appropriate for purposes of the process.
11. Accordingly, the Task Force believes that the nature and extent of this work effort should be subject to appropriate risk considerations. While the risk assessment terminology the Task Force used in the advance draft clearly referred to the *process* and not the outcome (i.e. “risk of material misstatement in the *compilation* of the pro forma financial information” as opposed to “risk of material misstatement in the pro forma financial information”), a number of the comments received from the IAASB indicated confusion with this terminology. Accordingly, the Task Force proposes that this terminology be revised in terms of the “risk that the pro forma financial information may not be properly compiled.” This revised terminology, which the Task Force believes is clearer, addresses directly the process of compilation and avoids any possible misinterpretation that it deals with misstatements in the pro forma financial information.
12. Consistent with this revised approach, the Task Force has reconsidered the suggested list of specified procedures on the source of the starting point (old paragraph 20 in the September draft and now paragraph A45) and made two changes:
 - (a) The majority of the Task Force agreed that this list should not include procedures that would be more appropriate in the context of a full scope review or audit of the source. Accordingly, a number of these procedures have been deleted (for example, the procedures in old paragraph 20(e) in the September draft (page 10 in Agenda Item 2-B)).
 - (b) The Task Force believes that the (remaining) procedures represent a level of work effort on the source that would be appropriate where the entity has had its financial information for the immediately preceding prior period audited or reviewed, which would be the situation in the overwhelming majority of cases. Accordingly, the guidance explains the applicability of these procedures in this context (see paragraph A45).

In the rare circumstances where the entity has never had its financial information audited or reviewed, the Task Force believes that the practitioner may likely to need to perform additional procedures to obtain the necessary level of comfort that the source is appropriate. The Task Force therefore proposes guidance that explains this consideration and provides illustration of what some of these additional procedures might be (see paragraph A46). One member of the Task Force was of the view that further illustrative procedures should be provided for such cases.

13. As mentioned above, whether the practitioner should perform some or all of these procedures, or additional procedures, should, in the Task Force’s view, be a matter of the practitioner’s judgment in the circumstances. For example, the practitioner should have greater comfort regarding the appropriateness of the source, and therefore might feel a need to perform less work on it, if the practitioner is retained by the entity to review its periodic financial information for regulatory filing purposes than if this were not the case. Accordingly, the Task Force proposes guidance on such “risk considerations” to help guide the practitioner in making this judgment (see paragraph A44).
 14. Finally, with regard to the question of “how much is enough,” the Task Force believes that a “one size fits all” approach would not be appropriate, for the reasons stated above. While it was suggested that inquiry alone would not seem sufficient and that some limited procedures to understand the business, internal control, and the financial reporting process would seem necessary, the Task Force noted that the draft already dealt with this (see paragraphs 15-19).
 15. Accordingly, the Task Force generally believes that its revised proposal strikes an appropriate balance between the polar views that have been expressed: that on the one hand, the practitioner should not be concerned with the starting point in this type of engagement and, on the other hand, that the practitioner should perform audit- or review-level work on the source of the starting point without which the practitioner would be unable to report on the process of compilation.
- B. OBTAINING AN UNDERSTANDING OF ANOTHER PRACTITIONER’S INDEPENDENCE AND COMPETENCE IF THE SOURCE OF THE UNADJUSTED FINANCIAL INFORMATION HAS BEEN AUDITED OR REVIEWED BY THE OTHER PRACTITIONER
16. Along with the above issue, the Task Force had sought the IAASB’s advance views on the issue of whether and, if so, how and to what extent the practitioner should obtain an understanding of the independence and competence of another practitioner if that other practitioner has audited or reviewed the source of the starting point. The Task Force believed that in such a situation, the principle should be that the practitioner obtains an understanding of the other practitioner’s independence and competence to determine whether there is a sufficient basis for accepting the source as appropriate. The Task Force noted that while the practitioner may obtain some comfort about the work that has been performed by another practitioner whom the practitioner knows well, this may not necessarily be so in other cases. For example, if the other practitioner is based in an overseas jurisdiction, it may be unclear by which ethical standards the other practitioner is required to abide. Accordingly, the Task Force proposed that the practitioner perform procedures to obtain this understanding and that these procedures should be less than that

which would be required in a group audit situation, where the group engagement team is required to obtain an understanding of a component auditor's independence and competence.

17. The Task Force received the following significant comments from the IAASB on this proposal:
- The Task Force's proposal appears appropriate as the practitioner is not required to express an audit opinion on the starting point.
 - If we accept the premise that the unadjusted numbers need not be audited or reviewed as a basis for undertaking the engagement to provide assurance on the compilation, then the task force is correct in its position that the procedures to obtain evidence on the independence and competence of the other practitioner need not be as onerous as that required in a group audit.
 - The model of relying on disclosure rather than checking that the starting point is "right" also extends to where the source is audited by another practitioner. As the practitioner's opinion does not extend to the first column or the final column, there should be no need to probe the independence and competence of the other practitioner.
 - While the principle of obtaining an understanding of the other practitioner's independence and competence is appropriate, it is unclear on what grounds such understanding should be less than that which would be required in a group audit situation.
 - Drawing on the ISA 600⁶ requirements is not quite the right analogy. In a group audit situation, the group engagement team obtains this information because the group engagement partner is ultimately expressing an opinion on the group financial information, i.e. the group engagement partner has to "own" the assurance on the overall group financial statements, including the audit evidence on the component. This parallel does not apply in the context of this ISAE because the practitioner is not expressing an opinion on the final column. Instead, it is a question of addressing the risk of being associated with misleading information and being satisfied as to whether the starting point is appropriate for the compilation.
 - Because of the risk of association with misleading information, the practitioner should consider the independence and competence of another practitioner if this other practitioner has audited or reviewed the source of the starting point.
 - The question is not whether the understanding of independence and competence should be "less" but providing guidance to practitioners that the type of procedures to obtain this understanding are similar to (but do not include all of) those performed under ISA 600. What is important is the requirement to obtain the understanding of the other practitioner and this is the principle that should be clear.
18. The Task Force believes that because of the risk of association with misleading information, the practitioner should have at least a responsibility to understand the

⁶ ISA 600, "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)."

independence and competence of the other practitioner before concluding whether the source is appropriate for purposes of the compilation. However, the Task Force accepted that the work the practitioner needs to perform to obtain this understanding should be significantly less than that necessary in a group audit context because the practitioner is *not* relying on the other practitioner’s work on the source as a basis for expressing an opinion on the fair presentation of the pro forma financial information. Accordingly, the Task Force has pared down the proposed work effort further (see paragraphs A40-A42). In the Task Force’s view, the practitioner’s understanding need only be sufficient to enable the practitioner to obtain a level of comfort that the other practitioner’s audit or review of the source is appropriate as a basis for determining that the source is appropriate for purposes of the compilation. The Task Force believes that the proposed work effort should not be unduly burdensome in practice.

C. WORK EFFORT IN A BUSINESS COMBINATION

19. At the September 2009 meeting, the Task Force proposed that the practitioner should perform the same procedures on the source of the financial information of an acquired business as those on the unadjusted financial information. It was, however, noted that while in most cases the practitioner will be the reporting entity’s auditor, this may not be the case with respect to the acquired business. Accordingly, it was suggested that a different set of procedures may need to be specified for the practitioner’s work on the financial information of the acquired business (defined as “target financial information” in the proposed ISAE).
20. The Task Force believes that for the practitioner to be able to report on the proper compilation of the pro forma financial information, the practitioner should be satisfied that the source of the target financial information provides factual support for the target financial information, consistent with the need for this information (by definition, a pro forma adjustment) to be factually supportable in accordance with the applicable criteria (see paragraphs 11(c)(ii) and A22). This objective is consistent with the practitioner’s objective to be satisfied that the source of the unadjusted financial information is appropriate in accordance with the applicable criteria (see paragraphs A17-A18).
21. The Task Force believes that for the practitioner to be able to achieve this objective of being satisfied that the source of the target financial information provides factual support, it would be necessary for the practitioner to have unrestricted access to the acquired business. For this reason, the Task Force has proposed that unrestricted access to individuals within the acquired business be a precondition for engagement acceptance (see paragraph 10(d)(iv)).
22. Given this presumption of unrestricted access, the Task Force believes that the practitioner should perform procedures on the target financial information similar to those on the unadjusted financial information. Accordingly, the proposed ISAE reflects this approach (see paragraphs 25-29).

D. OTHER ISSUES

Profit Forecasts as the Unadjusted Financial Information

23. At the September 2009 meeting, the IAASB generally did not agree with the Task Force’s proposal that the ISAE stay silent on whether profit forecasts may be used as the unadjusted financial information. It was noted that remaining silent on the matter would add to confusion on a matter that is expected to be rare in practice. It was suggested that one solution may be to provide guidance explaining that while the use of profit forecasts should be a matter for jurisdictions to decide, practitioners should be reminded that part of their work on the proper compilation of the pro forma financial information is to obtain evidence that the responsible party has factual support for the pro forma adjustments. In addition, for the avoidance of doubt, it was noted that it would be helpful to emphasize that engagements to report on prospective financial information are addressed by ISAE 3400.⁷ As an alternative, it was suggested that the scope of the ISAE could be limited to historical financial information. This would then obviate the need to make any reference to whether profit forecasts may be used in the compilation of the pro forma financial information.
24. The Task Force agreed that it would be appropriate to provide guidance along the lines in the first suggestion (see paragraph A7). The Task Force did not agree that the scope of the ISAE should be limited to historical financial information as doing so would inappropriately limit practice in jurisdictions that may permit the use of profit forecasts.

Emphasis of Matter Paragraph

25. At the September 2009 meeting, it was suggested that the ISAE should provide for practitioners to be able to use an emphasis of matter paragraph in their reports to highlight any specific matters to which, in their judgments, users’ attention should be drawn.
26. The Task Force has given this matter due consideration and, for the reasons set out below, believes that it would not be appropriate to do so in the context of engagements under this ISAE:
- The objective of an engagement under the ISAE is not to report on whether the subject matter information is fairly presented, as would be the case for an engagement performed in accordance with the ISAs.
 - Given the hypothetical nature of the pro forma financial information, the Task Force could not identify any specific matters that would warrant the use of an emphasis of matter paragraph in practice.
 - The Task Force believes that for an engagement under this ISAE, it would be difficult to distinguish between a matter that is so fundamental to users as to necessitate an emphasis of matter in the practitioner’s report, and a matter that would require an adverse opinion or disclaimer of opinion.
 - The use of emphasis of matter paragraphs could be open to abuse in practice; in addition, in situations requiring modified opinions, they might inappropriately be used to avoid issuing such opinions.

⁷ ISAE 3400, “The Examination of Prospective Financial information.”

- The inclusion of an emphasis of matter paragraph in the practitioner’s report may conflict with applicable regulatory requirements or guidance, or result in the relevant regulatory authority not accepting the prospectus for filing.

27. Accordingly, the proposed ISAE does not provide any option for the practitioner to use an emphasis of matter paragraph in the practitioner’s report.

E. PROVISIONAL EFFECTIVE DATE

Need for an Effective Date

28. At the March 2008 IAASB-National Auditing Standard Setters meeting, participants considered the matter of effective dates for future IAASB standards. There was general support for considering effective dates at the time of exposure of a standard and for seeking comments thereon. One particular question that was considered was whether non-audit standards should have a different effective date model than the ISAs. Some participants suggested that non-audit standards need not have effective dates while others were of the view that they are important to encourage use of, and compliance with, the standards.

29. The principal arguments for not having an effective date for a non-audit standard are that setting such a date would:

- Impose an artificial timeframe that may not be meaningful where there is no legal or regulatory requirement for practitioners to apply the standard to engagements addressed by the standard; and
- Prevent users, and therefore the public interest, from receiving the full benefit of the new standard as soon as it is released.

30. On the other hand, setting an effective date allows for an effective transition for national standard setters that may have existing standards dealing with the same subject matter and that wish to adopt or converge with the international standard. This allows time for essential preparatory work at the national level for effective introduction of the international standard, including any necessary translation, due process and implementation activities. Doing so thus enables each adopting jurisdiction to have a standard that is fully compliant with the IAASB’s. It also provides for clarity relative to the applicability of the international standard to engagements that may already be in progress when the standard is issued.

31. In addition, setting an effective date should not necessarily prevent users from receiving the benefits of the new standard early, as the *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services* permits application of an IAASB standard before its effective date.

32. For the latter reasons, the Task Force believes that an effective date should be set for the proposed ISAE 3420, consistent with the approach taken with the final ISAE 3402⁸ and extant ISAE 3000.

⁸ ISAE 3402, “Assurance Reports on Controls at a Service Organization.”

What Would be an Appropriate Effective Date?

33. The nature of the standard dictates in large measure the extent of the required implementation activities. This is not only in relation to the complexity or impact of the standard but also its subject matter. There is also the question of whether there is a strong need for the standard to come into effect in a relatively timely manner. This would depend on the public interest need being addressed by the standard.
34. The Task Force believes that the proposals in the proposed ISAE 3420 do not represent fundamentally new or complex assurance principles, and that the subject matter of the standard does not represent fundamentally new ground for practitioners. Accordingly, it is unlikely that the development of extensive new training, implementation guidance and new methodologies would be required in support of effective implementation of the standard. In addition, given the present diversity and inconsistency of practice around the world in this area, there is a strong public interest need for the standard to be applicable at the earliest opportunity.
35. Given these considerations, and subject to any effect the revision of ISAE 3000 may have on ISAE 3420, the Task Force believes that an appropriate effective date for the standard would be 18 months after its expected date of final approval (December 2010), i.e. for assurance reports dated on or after July 1, 2012.
36. Subject to the IAASB's views, the Task Force recommends that comments be sought specifically on this proposed effective date on exposure.

F. CONSIDERATION BY IAASB OF SIGNIFICANT MATTERS IDENTIFIED BY TASK FORCE

37. In the Task Force's view, the significant matters the Task Force has identified as a result of its deliberations since the start of this project, and the Task Force's considerations thereon, have all been reflected in the issues papers presented at the IAASB meetings in March and September 2009, and this meeting. The Task Force does not believe that there is any significant matter discussed within the Task Force on this project that has not been brought to the IAASB's attention.