

THE LIMITATIONS OF THE ENGAGEMENTS TO PERFORM AGREED-UPON PROCEDURES REGARDING FINANCIAL INFORMATION ACCORDING TO ISRS 4400

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1. Introduction

In the area of Auditing and Assurance Services, the regulating authority is the International Auditing and Assurance Standards Board (IAASB), which develops the International Standards on Auditing and the International Standards on Review Engagements, standards that approach the subject of audits and reviews of historical financial information, such as International Standards on Assurance Engagements, which approach the subject of the assurance engagements other than the audits and reviews of the historical financial information, such as the ones regarding the examination of the prospective financial information and engagements to perform agreed-upon procedures regarding financial information. These standards serve as a reference point for the auditing and assurance standards, setting specific standards and providing recommendations and guidance for the auditors in specialized areas. In this respect, INTERNATIONAL STANDARDS ON ASSURANCE ENGAGEMENTS 3400 (ISRS 3400, namely the former 810) – **The examination of the prospective financial information**, as well as INTERNATIONAL STANDARD ON RELATED SERVICES 4400 (ISRS 4400, the former 920) – **Engagements to perform the agreed upon procedures regarding financial information** – are part of this set of standards issued by IAASB.

At the same time, IAASB develops quality control standards for those audits, which underlie the national regulations in accordance with these standards (in our case, Decision no. 73 of September 20, 2006 regarding the approval of the procedures for quality control of the financial audit activity and related services) issued by the national professional body (in our case, the Chamber of Financial Auditors Romania).

2. Status of knowledge

The studies about agreed-upon procedures regarding financial information and about the examination of the prospective financial information are relatively limited; articles prefer approaches of the basic or non-audit services.

The assurance provided by auditors' reports regarding prospective financial information is studied by Peter Schelluch and Grant Gay, who published in 2006 a study that indicates the significant differences of opinion between auditors, users and preparers of prospective financial information in terms of reliability and prognosis, the role and responsibilities of auditors and management. Unlike the published studies about the gap between expectations, the auditors believe that forecasts are more reliable than users and preparers. At the same time, auditors believe they have a higher level of responsibility than they are given by users or preparers. The beliefs were affected by the type of the report issued

by the auditor, and the subjects were able to discriminate between the assurance levels provided by positive or negative assurance opinions. However, based on the response of the shareholders, it seems the negative assurance opinion on assumptions made for an audit might mislead users and might not meet the demands of the market (Peter Schelluch and Grant Gay, Assurance provided by auditors' reports on prospective financial information: implications for the expectation gap, *Accounting & Finance*, Vol. 46, Issue 4, 2006, pp. 653-676).

The effect of non-audit fees on audit quality is conditional an auditor industry specialization by Chee-Yeow and Tan Unga-Tong. The authors found evidence that audit quality is measured by a growing tendency to issue concerned opinions, by increased propensity of the analysts to miss forecasts, as well as higher earnings-response coefficients increases with the level of non-audit services acquired from industry specialist auditors compared to non-specialist auditors (Chee-Yeow Lim and Hun-Tong Tan, Non-Audit Service Fees and Audit Quality: The Impact of Auditor Specialization, *Journal of Accounting Research*, Vol. 46, No. 1, 2008, pp. 199-246).

For audit and non-audit services, Laura J. Kornish and Carolyn B. Levine studied the interactions of a "utility-maximizing" auditor with managers and auditors by using a common agency model. Their results show that in a single-period model, a less restrictive approach may lead to the result targeted by truthful reports by lifting the restriction regarding contingent audit fees. In a multi-period framework model, they prove the existence of a truth balance with or without the contingent audit fees (Laura J. Kornish and Carolyn B. Levine, Discipline with Common Agency: The Case of Audit and Nonaudit Services, *The Accounting Review*, Vol. 79, No. 1, 2004, pp. 173-200).

3. Research methodology

To achieve this research, a critical documentation was conducted on the basis of the international standards of auditing issued by IAASB (International Auditing and Assurance Standards Board), the professional norms issued by the Chamber of Financial Auditors of Romania regarding the approval of the procedures for quality control of the financial audit activity and related services, as well as on the basis of the existing literature.

The research aimed to identify the key elements regarding the related services of financial audit, mainly the ones regarding the terms of the engagement in order to identify the engagement's nature and the risks related to these missions. The research was based on an audit engagement for related services located at the limit between the two adjacent audit standards, namely the standard for engagements to perform agreed-upon procedures regarding financial information and the standards for the examination of the prospective financial information.

4. Describing the mission in terms of the audit standards' content

If we examine the two audit standards, meaning ISRS 3400 (former IAS 810) and 4400 (former IAS 920) in terms of the TERMS OF ENGAGEMENT, we notice that, according to the AUDIT STANDARD no. 810 – EXAMINATION OF THE PROSPECTIVE FINANCIAL INFORMATION, paragraphs 10-12 regarding the acceptance of the engagement are unchanged in their content compared to ISRS 3400 (the later version, which is now in force), so that the following aspects must be taken into account:

10. Before accepting an engagement to examine prospective financial

information, the auditor would consider, amongst other things:

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

11. 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.

12. The auditor and the client should agree on the terms of the engagement. It is in the interests of both entity and auditor that the auditor sends an engagement letter to help in avoiding misunderstandings regarding the engagement. An engagement letter would address the matters in paragraph 10 and set out management's responsibilities for the assumptions and for providing the auditor with all relevant information and source data used in developing the assumptions.

According to paragraph 2 of ISRS 3400, 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. According to paragraph 4 of the same ISRS 3400 standards, A "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).

Unlike the provisions mentioned above, we notice that the engagement's type for related services analysed by us, consisting of examining the level of the financial indicators that underlie a bank loan application with the help of the financial information, and, on the other hand, seeking to issue proposals for the Board of Directors of a company to have these financial indicators reach the minimum level accepted by banking institutions for granting refinancing loans, is not found within the applicability of this standards, although it has a forecasting component of the indicators, but it is rather found within ISRS 4400. The reasons why this mission doesn't fit with ISRS 3400 are mainly the following:

- the management doesn't prepare prospective financial information and doesn't define the associated assumptions according to the requirements of paragraph 2 let. a) – d) of ISRS 3400;

- it doesn't present the measures that the management intends to take at the date when the information is prepared according to the requirements in paragraph 4 of ISRS 3400.

The reasons why we believe that this type of mission fits to a greater extent, although not completely, with the ISRS 4400 provisions are found in the paragraph concerning the definition of the engagement's terms within this

standard, reasons that mainly rely on the following:

- the auditor may be mostly assured by the engagement letter that there is a clear understanding of the established procedures and of the terms of engagement that mainly refers to:

- ▶ The nature of the engagement, including the fact that the performed procedures will not constitute an audit or a revision and, consequently, no assurance will be expressed.

- ▶ The stated purpose of the engagement.

- ▶ Identifying the financial information for which the agreed-upon procedures will be applied.

- ▶ The nature, timing and scope of the specific procedures that will be applied.

- ▶ The anticipated form of the factual findings' report.

- ▶ The limitations in distributing the factual findings' report.

The arguments regarding the impossibility of assuming the engagement in terms of applying ISRS 4400 refers to the case when, in accordance with the requirements of this standard, in certain circumstances (for example when the procedures that have been established between the regulating authority – in this case, the refinancing

institution (the bank) and the accountants) the auditor may not be able to discuss the procedures with all the sides that will receive the report – in our case, the bank, because there is no signed contract in this regard. In these cases, the auditor may consider necessary, for example, to discuss the procedures that must be implemented with the adequate representatives of the involved parties, to review the relevant correspondence received from these parties or to send them a preliminary draft of the report – requirements that could not be met in this case study because the contract doesn't stipulate it and the standard doesn't allow it, namely it doesn't regulate the acceptance of the mission towards two or several involved entities.

If we refer to ANNEX no. 4 – List of objectives for quality control of audit related services of Decision no. 73 of September 20, 2006 of the Chamber of Financial Auditors Romania regarding the approval of the procedures for quality control of the financial audit activity and related services, we notice in relation to this document there is a series of unconformities that can't be overcome in terms of the studied type of engagement, which will be detailed in the next part of the study.

Table no.1 - Terms of the engagement

B	TERMS OF THE ENGAGEMENT	OBSERVATIONS
1	Were the auditor, the entity's representatives and the mentioned parties assured that they will receive copies of the factual findings' report and that there is a clear agreement regarding the established procedures and the conditions of the engagement, according to the provisions in paragraph 9 of ISRS 4400? The issues on which they must agree are:	<ul style="list-style-type: none"> ▪ Yes – in terms of the existence of a clear agreement regarding the established procedures and the conditions of the engagement, in regard to the company; ▪ No – in terms of the existence of a clear agreement regarding the established procedures and the conditions of the engagement, in regard to the bank;

We will illustrate in the annexes the engagement on which our study was based, citing the main elements of the engagement letter and of the factual findings report, which confirms the arguments above.

5. Conclusions

The conclusion of the study lies in the fact there are types of audit missions for related services, such as the ones that have been studied, where the specific international audit standards can't be fully complied with, as well as the decisions of the professional body regarding quality control, so that these standards and these decisions of the professional body must be amended, even if they are relatively recent. In such situations, professional reasoning, namely the caution of the financial auditor must prevail, we may conclude, as a recommendation, that these missions must not be accepted under a direct form through a bilateral contract signed between the auditor and the entity, but should be accepted as a contract signed between the auditor and the audited entity, next to the financing entity that enforces the credit indicators that must be examined and assessed. In this context, we may draw the conclusion that the analysed standards (ISRS 3400 and ISRS 4400) must be substantially amended.

Annex no. 1- Engagement letter:

To the Board of Directors of XXX Company (address)

This letter is to confirm our understanding of the terms and objective of our engagement, as well as the nature and limitations of the services that we will provide. Our engagement will be conducted in accordance with the INTERNATIONAL STANDARD ON RELATED SERVICES 4400 – ENGAGEMENTS TO PERFORM THE AGREED UPON PROCEDURES

REGARDING FINANCIAL INFORMATION, applicable to the agreed-upon procedures engagements and we will indicate so in our report.

The objective of such an engagement is represented by the financial audit procedures and techniques that have been agreed with the client and other interested parties, applicable over an audit object that was also established jointly, followed by the returning of the results of their application. After going through the specific stages, the auditor prepares and presents an audit report regarding the findings resulted after performing the agreed-upon procedures, without issuing an opinion or assurance regarding the audited object. The beneficiaries of the audit report and other interested parties draw their own conclusions regarding the results of applying the audit procedures and techniques concerning the engagement's object.

We have agreed to perform the following procedures and report to you the factual findings resulting from our work:

1.) To determine, based of the financial statement of XXX Company on August 30, 2010, the level of the financial indicators included in the XXX Bank's letter no. Xxx for: EBITDA, total debt/EBITDA, corporate equity/total assets, EBITDA/interest and reimbursements, as well as to identify the main factors that determine their level;

2.) To make proposals for the Board of Directors, based on the analysis of the financial statement of XXX Company, that beginning with December 31, 2010 the financial indicators described in the bank's letter no. xxx will achieve the following minimum levels:

- a. The ratio between total debts/EBITDA, calculated on the basis of the financial data on December 31, 2010 and June 30, 2011, should not exceed 3.
- b. The between total

debts/EBITDA, calculated on the basis of the financial data on December 31, 2011 and December 31, 2012, should not exceed 2.5;

c. Starting with 2013, the ration between total debt/EBITDA should not exceed 2.

d. During 2011, the ratio between corporate equity/total assets should not drop below 0.3;

e. Starting with 2012, the ratio between corporate equity/total assets should not drop below 0.4.

f. During 2010, the ratio between EBITDA/ interest and reimbursements should not drop below 1.

g. During 2011 and 2012, the ratio between EBITDA/ interest and reimbursements should not drop below 2.

h. Starting with 2013, the ratio between EBITDA/interest and reimbursements should not drop below 4.

i. The company's turnover shouldn't fall by more than 10% from the previous year.

j. During the whole period, the EBITDA margin shouldn't drop below 13%.

The definition of the customary terms is written in the Bank's letter no. xxx.

Determining the financial indicators above will be done on the basis of the accounting documents for the period between June 30, 2010 and August 30, 2010 – prepared by XXX Company under its responsibility.

3.) The contact persons for this engagement unit are:

- the members of the Board of Directors
- the chartered accountant office - in charge with managing the accounting of XXX Company.

The procedures that we will perform are exclusively to support you to:

- compare the level of the financial indicators achieved by XXX Company during the mentioned periods at the

demanded level for these indicators, mentioned in the Bank's letter no. xxx;

- identify the factors that influence the level of the mentioned indicators;

- in addition to the Board of Directors' own proposals, to provide a set of measures suggested by the auditor for making the most adequate managerial decisions so that the level of the mentioned financial indicators will achieve the level requested within the bank's letter starting with December 31, 2010.

Our report is not be used for any other purpose and is solely for your information.

The procedures that we will perform will not constitute an audit or a review made in accordance with the International Standards on Auditing or International Standards on Review Engagements and, consequently, no assurance will be expressed.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentations and other information requested in connection with our engagement.

Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses.

Individual hourly rates vary according to the degree of responsibility involved and the experience and skills required. Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit, including the specific procedures on which we agreed-upon to be perform.

Annex no. 2- To the Board of Directors of XXX Company (address)

REPORT OF FACTUAL FINDINGS

We have performed the procedures agreed with you and enumerated below with respect to the

level of the financial indicators included in XXX Bank's letter no. xxx and the measures that must be taken by XXX Company in order to reach the level of the financial indicators according to XXX Bank's letter no. xxx, as they were on August 30, 2010, presented in the current report of factual findings and in the accompanying annexes.

Our engagement was conducted in accordance with the **International standard on related services 4400 – engagements to perform the agreed upon procedures regarding financial information**, applicable to the agreed-upon procedures engagements. The procedures were conducted exclusively with the purpose to support you in assessing the financial indicators on August 30, 2010 according to the requirements and terms used in the XXX Bank's letter no. xxx and in taking measures so that these indicators will achieve the levels mentioned in the bank's letter starting with December 31, 2010 as follows:

- based on the balance sheets for the period between June 30, 2010 and August 30, 2010, prepared by XXX Company, we obtained and checked the level of the financial indicators regarding EBITDA, total debt/EBITDA, corporate equity/total assets and EBITDA/ interest and reimbursements, and we recorded the levels included in annex no. 2/1.

- We analyzed and identified the main factors that influence their level, as mentioned in annex no. 2/3.

- We made proposals for the Board of Directors, based on the analysis of the financial statement of XXX Company, that beginning with December 31, 2010 the financial indicators described in the bank's letter no. xxx will achieve the following minimum levels:

a. The ratio between total debts/EBITDA, calculated on the basis of the financial data on December 31, 2010 and June 30, 2011, should not exceed 3.

b. The between total debts/EBITDA, calculated on the basis of

the financial data on December 31, 2011 and December 31, 2012, should not exceed 2.5;

c. Starting with 2013, the ration between total debt/EBITDA should not exceed 2.

d. During 2011, the ratio between corporate equity/total assets should not drop below 0.3;

e. Starting with 2012, the ratio between corporate equity/total assets should not drop below 0.4.

f. During 2010, the ratio between EBITDA/ interest and reimbursements should not drop below 1.

g. During 2011 and 2012, the ratio between EBITDA/ interest and reimbursements should not drop below 2.

h. Starting with 2013, the ratio between EBITDA/interest and reimbursements should not drop below 4.

i. The company's turnover shouldn't fall by more than 10% from the previous year.

j. During the whole period, the EBITDA margin shouldn't drop below 13%.

The definition of the customary terms is written in the Bank's letter no. xxx – present in the annex.

Because the above procedures do not constitute either an audit or a review made in accordance with the International Standards on Auditing or International Standards on Review Engagements, we will not express an assurance in regard to the financial indicators achieved by XXX Company on August 30, 2010, as defined by the Bank's letter no. xxx.

Had we performed additional procedures, an audit or a review of the financial statements in accordance with the International Standards on Auditing or International Standards on Review Engagements, other matters might have come to our attention that would have been reported to you.

Our report is solely for the

purpose set forth in the first paragraph of this report and for your information, and is not to be used for any other purpose or be distributed to any other parties. This report relates only to the financial indicators included in the bank's letter no. xxx, and to the measures that must

be taken by the Company's Board of Directors in order to achieve the level of these indicators starting with December 31, 2010 and does not extend to any financial statements of the XXX Company, taken as a whole.

Annex no.2/1 Financial indicators – three months' evolution 2010 ESAROM ROMANIA SRL

Indicators	30.06.2010	30.07.2010	30.08.2010	Agreed values	Resulted comments ESAROM
EBITDA (<i>earnings before interest, taxes, depreciation, and amortization</i>)	3184504	3607324	4091451	As high as possible	Positive evolution – on the rise
EBITDA margin	10%	9,60%	9,50%	> =13%	Negative evolution - dropping; below recommended limit
EBIT(<i>earnings before interest and taxes</i>)	1832046	2026621	2285152	on the rise	Positive evolution - on the rise
EBIT margin	5,70%	5,40%	5,30%	on the rise	Negative evolution - dropping
TD/EBITDA(total debt/EBITDA)	7	5	5	<=3	Positive evolution - dropping; below recommended limit
ICR (interest coverage ratio)	6	5	5	As high as possible	Negative evolution - dropping; below recommended limit
ND/EBITDA(net debt to equity)	7	5	4	As high as possible	Negative evolution - dropping; below recommended limit

Annex no. 2/2

Set of proposals to accommodate the level of the financial indicators within the levels recommended by the Bank's letter no. xxx

The premise:

Considering that the prices of raw materials and goods depend on the supply of the external market, but also on the currency exchange, the possibility of increasing the profit, namely the EBITDA, consists of increasing the gross margin

through two methods: reducing the operating and financial expenses, and increasing the sales volume.

A. Proposals to reduce costs and increase sales, as follows:

1. Reducing the operating and financial expenses, meaning:

○ Wage expenses: considering that these expenses have increased in August 2010 compared to August 2009 by an average of 2% (according to the attached statement named *Comparative*

statement on wage expenses) and considering the fact that a reduction of manning can't be operated, the reduction of these expenses may only be achieved by reducing the number of directly productive personnel and of the administrative personnel (including management) by at least 10% and by an additional stimulus for the remaining personnel by at least 2% / year, taking into account the following possibilities:

- Restructuring all the current vacant positions according to the approved organizational chart, by reducing them; restructuring the held positions by redistributing tasks – depending on the nature of the job (positions that may be included in this category: product manager – marketing assistant; investments manager – transport manager; financial manager – fixed assets' manager – information security manager, etc); reducing the working hours; naming a person responsible for debt recovery and for expanding on external markets; outsourcing some services (for example, internal audit) and so on. The proposition to restructure the occupied positions by distributing their tasks to other positions must be based on an individual analysis of the tasks of each position, analysis that must be conducted by the human resources department together with the managers of the departments. The final decision regarding the approval of the new organizational chart is taken within the Boards of Directors – followed by the Decision of the General Meeting of Shareholders.

- The additional stimulus should be made on the basis of incentive criteria based solely on indicators such as (depending on the personnel's structure – production, sales, management):

- increasing work productivity by at least 5% / year;
- increasing sales by at least 10% / year;
- reducing total operating expenses by at least 15% / year, out of

which the provisions with a minimum of 7% / year;

- Spending on supply of services by at least 15% / year;
- Travel expenses by at least 20% / year;
- reducing financial expenses by at least 15% by refinancing the existent credits and through an adequate credit reimbursement policy, so that TD/EBITDA (total debt/Ebitda) is under 3; Note: in order to monitor the compliance of these indicators, it's is recommended to set-up an internal audit compartment.

2. Increasing the sales volume by at least 15% / year by:

- Expansion on other foreign markets (Ukraine, Russia etc.);
- Changing the activity profile by reducing trade and increasing production, by increasing the production capacity through the financing opportunity called Measure 123 RDP – “Adding value to agricultural and forestry”; the project's financing should be made with new inputs from the shareholders.

B. Other proposals on the improvement of some financial indicators:

1. To improve reliability it's necessary to reassess the company owned land on December 31, 2010 on the basis of a specialized assessment report. The result of this reassessment might be a positive difference (assimilated to corporate equity) of at least 5.190.000 lei, meaning 18.684 square meters x (reassessed price 65 euro x 4.3/sqm – 1.7 lei/sqm).

2. In order to reduce operating and financial costs, there is a proposition to change accounting policies in accordance with the Order of the Ministry of Public Finance no. 3055 of October 29, 2009 approving Accountant regulations compliant with European directives. These changes will be made in terms of the following:

- a. Charging to expenses the inventory items (half when putting it into use and half when removing it from use);

b. The recording of the tangible assets' depreciation, in terms of reassessing and readmitting the durations of use for tangible assets based on proposals made by a technical commission appointed for this purpose, considering their physical state and in relation to the use frequency (min. – max.) stipulated in GD no. 2139 of November 30, 2004 for the approval of the Catalogue regarding the classification

and normal functioning periods of fixed assets.

c. Registering the interests on loan by capitalizing on their investment. Reviewing the capital repair works related to improving the technical performances of the fixed assets that have been repaired and registering these works - where the knowledge criterion allows it – as modernization works (assimilated to fixed assets) and not as operating expenses.

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*****	INTERNATIONAL STANDARDS ON ASSURANCE ENGAGEMENTS 3400 – THE EXAMINATION OF THE PROSPECTIVE FINANCIAL INFORMATION, www.cafr.ro .