

BASIS FOR CONCLUSIONS
Commenting in a Comfort Letter on Pro Forma Financial Statements

This Basis for Conclusions has been prepared by staff of the Auditing and Assurance Standards Board (AASB). It relates to, but does not form part of, Section 7200, AUDITOR ASSISTANCE TO UNDERWRITERS AND OTHERS.

Purpose of this Basis for Conclusions

This Basis for Conclusions provides a brief summary of the AASB's objectives in adding new requirements and guidance to Section 7200, the public exposure and approval steps for this project and how the AASB dealt with significant matters arising from comments received in response to its Exposure Draft. This information is set out below.

Background

This project adds new requirements and guidance to Section 7200 relating to an auditor's responsibilities when he or she is commenting in a comfort letter on pro forma financial statements. These changes have been made as part of the AASB's five year project to revise the "7000 series of standards" that deal with the auditor's roles and responsibilities in the capital markets.

In May 2011, the AASB issued an Exposure Draft (ED) that proposed changes to Section 7200 to provide guidance to auditors who are requested by underwriters to comment in a comfort letter on pro forma financial statements.

There were 2 respondents to the ED (identified below). In addition to these responses, various stakeholders provided input on the ED to the AASB staff but did not submit formal responses.

The AASB approved the proposed revisions at its meeting in September 2011. The Auditing and Assurance Standards Oversight Council confirmed that the AASB followed due process in developing these revisions prior to their issuance in the CICA Handbook – Assurance.

AASB's Objectives in Adding Requirements and Guidance re: Commenting in a Comfort Letter on Pro Forma Financial Statements

Canadian securities regulations require an issuer to include in its offering documents pro forma financial statements giving effect to an acquisition of a business when there has been a significant acquisition (or when there is a probable significant acquisition). In the past, the pro forma financial statements were required to be accompanied by a compilation report from the issuer's auditor. The compilation report provides a description of the procedures followed by the auditor and the results of those procedures.

With changes to Canadian securities regulations, compilation reports on pro forma financial statements are no longer required. Consequently, underwriters will no longer have the results of the auditor's procedures communicated to them as a result of securities regulations. Therefore, underwriters may start requesting the auditor to include in a comfort letter comments on pro forma financial statements.

Accordingly, the AASB revised Section 7200 to provide guidance to auditors who are requested by underwriters to comment in a comfort letter on pro forma financial statements.

Significant Matters Arising from Comments in Response to the ED

Nature of the auditor's procedures on pro forma financial statements

1. Paragraph 7200.072B provides two reasons why the auditor's work on pro forma financial statements is normally confined to making inquiries about the pro forma adjustments and compliance of the statements with any regulatory requirements, and performing mechanical procedures on their compilation:
 - (a) It is generally not feasible for the auditor to audit the pro forma financial statements since this would entail performing an audit of all of the underlying historical financial statements, in addition to auditing the pro forma adjustments and compilation of the pro forma financial statements.
 - (b) There are no generally accepted standards in Canada regarding the preparation and presentation of pro forma financial statements that allow the auditor to assess the fairness of presentation of the pro forma financial statements.
2. With respect to paragraph 1(a), a respondent to the ED indicated that paragraph B64(q)(ii) of International Financial Reporting Standard (IFRS) 3, *Business Combination*, contains a requirement for the entity to disclose the "revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period." Given that pro forma disclosures are required by IFRSs, it appears that the pro forma disclosures would be covered by the auditor's opinion. The respondent raised a concern that there seems to be an inconsistency between the statement in Section 7200 that it is generally not feasible to audit the pro forma financial statements and the fact that auditors in Canada are required to audit the pro forma disclosures in the financial statements.
3. The AASB reaffirmed the statement that it is generally not feasible to audit the pro forma financial statements. In the view of the AASB, there is a key difference between auditing the pro forma financial statements and performing audit procedures on the pro forma disclosures in the context of the audit of the financial statements as a whole. In the former, the pro forma financial statements are the primary information on which the audit engagement is focused. Accordingly, the AASB is of the view that there is no inconsistency between the statement in Section 7200 that it is generally not feasible to audit the pro forma financial statements and the fact that auditors in Canada are required to audit the pro forma disclosures in the financial statements.
4. With respect to paragraph 1(b), the AASB staff received an informal comment that Canadian securities regulations contain requirements and guidance on various aspects of preparing and presenting pro forma financial statements, and these requirements and guidance may be considered by some to be generally accepted standards for presentation and preparation of pro forma financial statements.
5. In the view of the AASB, the material in Canadian securities regulations relating to the preparation and presentation of pro forma financial statements does not constitute an acceptable framework

for the auditor to assess the fairness of presentation of the pro forma financial statements. Therefore, the AASB concluded that no changes to the exposed material regarding the nature of the auditor's procedures on pro forma financial statements are necessary.

Lack of clarity in the auditor's procedures

6. Paragraph 7200.072D provides a list of procedures which the auditor is likely to be asked to perform on the pro forma financial statements. The list includes the following two procedures:
 - (a) Make inquiries about whether the pro forma statements comply as to form in all material respects with applicable regulatory requirements.
 - (b) Recalculate the application of the pro forma adjustments to the amounts in the underlying historical financial statements.With respect to the first procedure, the AASB staff received an informal comment that it is unclear as what the words "as to form" means. With respect to the second procedure, the AASB staff received an informal comment that the description of the auditor's procedure is unclear.
7. Regarding the procedure in paragraph 6(a), the AASB is of the view that the words "as to form" are required because the applicable regulatory requirements relating to the preparation and presentation of pro forma financial statements do not constitute an adequate framework for the auditor to assess the fairness of presentation of the pro forma financial statements. Therefore, the auditor is only able to comment on whether the manner in which the pro forma financial statements are presented complies with securities regulations. Since the phrase "as to form" is retained, to ensure consistency between the auditor's procedure in paragraph 7200.072D(c)(ii) and the auditor's response in paragraph 7200.072E, the words "as to form" are added to paragraph 7200.072E.
8. Regarding paragraph 6(b), the procedure described has been in use for many years in both the Canadian and US capital markets and underwriters are likely to request auditors to perform such a procedure. The nature and extent of the procedures to be applied are determined by the terms of the engagement between the issuer and the auditor. Given the market participants' familiarity with this procedure, it is likely that underwriters would request the auditor to perform such a procedure. In the view of the AASB, a change of the description of the procedure at this time may cause unnecessary confusion.
9. Paragraph 7200.077 in the Exposure Draft (paragraph 7200.072E of final Section) proposed to require the auditor to advise the underwriter if the auditor finds that the pro forma financial information is not properly compiled or does not meet the requirements of securities legislation. The auditor's obligation to advise the underwriter is intended to arise only if the auditor becomes aware that the pro forma financial statements are not properly compiled or do not meet as to form the requirements of securities legislation. To clarify the AASB's intention, a change was made to replace the word "finds" with "becomes aware".
10. Various paragraphs in Section 7110 contain wording similar to that in the ED. To improve clarity, conforming amendments to paragraph 7110.36 have been made to reflect the wording changes indicated in paragraphs 7 and 9.

Additional guidance on likely procedures and wording in the comfort letter

11. In finalizing Section 7200, the AASB added a procedure to paragraph 7200.072D(a) referring to “reading the pro forma financial statements.” In the view of the AASB, this is a procedure likely to be requested by underwriters.
12. Lastly, the AASB noted that the proposed illustrative example of paragraphs that could be inserted in a comfort letter (i.e., to report on the results of applying specified procedures to the pro forma financial statements in the ED) may be too vague. Therefore, the AASB developed more comprehensive guidance on the content of the comfort letter.

List of respondents to the ED

Deloitte

PwC