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DER
WIRTSCHAFTSPRÜFER
IDW

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Düsseldorf, 18 August 2005
435/467

Dear Saskia,

Re.: Discussion Paper Comfort Letters Issued in relation to Financial Information in a Prospectus

Regarding the above mentioned Discussion Paper we submit our responses to the questions raised.

The IDW welcomes the publication of the FEE paper on comfort letters and is certain that it will serve as a suitable basis for the discussions in respect of an International Standard by IFAC. However, in developing such a standard the IFAC should consider the international practise of comfort letters, including the existing standards, and the needs of the market participants. Taking this into account, the IDW also welcomes the explicit statement on page 7 of the paper, that the auditor should follow national professional standards relating to comfort letters, where available. Therefore the IDW will furthermore recommend the application of *IDW AuS 910* for the issuance of comfort letters by German professionals.

We would like to comment on the issues on discussion as follows:

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Issue for Discussion 1:

Which of the different reporting models do you prefer and why? Are there any other reporting models you think should be considered?

The development of each International Standard by IFAC will have to be aligned with the structure of the pronouncements issued by the IAASB (Engagement Standards) in its present form. This means that every standard has to recognize the system of "review" and "agreed-upon-procedures" engagements, and therefore a reporting in form of "negative assurance" and "factual findings".

However, any discussion of this issue should take account of the fact that the provision of comfort letters is already a normal part of the auditor's reporting process to both clients and the underwriters, respectively. This means that current practices and professional standards, such as, for instance, in Germany and the US, will have to be given full consideration in the development of an International Standard to ensure that an adequate degree of acceptance in the market can be attained.

In order to achieve this, the Comfort Letter Standard can perhaps be based on a reporting model adapted to cover both assurance and non-assurance engagements. This would enable the reporting in the form of a comfort letter to directly tie-in with the work performed. This would mean that, when a review is performed the comfort letter will report the results in terms of the relevant Standard (e.g., ISRE 2400), alternatively, when the work performed is solely determined by agreed upon procedures the factual findings will be reported.

Such a system would be compatible with IFAC's International Standards and in our opinion, would also satisfy the requirements of the interested parties.

Issue for Discussion 2:

Underwriters or other parties other than the issuer may be reluctant to enter into a written agreement with the auditor. As, by the nature of the engagement - agreed-upon procedures – the responsibility of the definition of the scope of work is with the underwriter, it is preferable to formalise the agreement of the scope of work in writing, especially on a liability standpoint.

Can the auditor only issue a comfort letter to the parties that have signed the engagement letter?

In our view, the engagement of an auditor is not necessarily connected in such a way to the determination of the procedures to be applied, that all recipients of a comfort letter have to sign the engagement letter. Therefore, we would like to propose a differentiation along the following lines:

1. Relevant national law should determine those parties constituting parties to the contract, i.e. parties signing the engagement letter, and those constituting beneficiary third parties, i.e. third parties receiving the comfort letter without being an engaging party. Since such determination will differ within the various jurisdictions, a standard should not prescribe any uniform rule on either a European on a worldwide basis.
2. We recommend that when a comfort letter engagement includes agreed upon procedures each recipient should be made fully aware of the fact that the auditor issuing the comfort letter does not select the relevant procedures, but that this is incumbent on another party. Such a statement is necessary to avoid any misunderstanding regarding such matters as the objectives and scope of the engagement and the extent of the auditor's responsibility. Such clarification may be achieved by both, through an engagement between the auditor and all recipients of a comfort letter or, alternatively, through the professional Standard to be applied. The latter has the advantage of ensuring a common understanding and is practice in some jurisdictions (compare SAS 72 and IDW PS 910 in this respect). The decision is, however, subject to the underlying law.

Issue for Discussion 3:

The fact that a private comfort letter is issued to banks/underwriters could raise the issue of the banks/underwriters having a different level of information compared to investors. However, the issuance of a comfort letter does not create differences in the level of information available to banks and investors, as (a)

the letter is sent to the bank in respect of their capacity as underwriter, not in their capacity as investors, (b) the comfort letter is part of the due diligence process that the bank hat to perform to accept its responsibility towards the investing public, and (c) it does not include other information than the information in the prospectus.

Does the issuance of a comfort letter create a different level of information?

In our opinion, parts (a) and (b) of the text applicable to question 3 correctly explain that a comfort letter's addressees receive the information contained in a comfort letter solely in their specific capacity as (co-) responsible for the content of the prospectus[1]. However, any supposition that all information contained in a comfort letter (in such form) will form part of the prospectus will not be entirely accurate. In many instances a comfort letter will include statements with respect to changes in financial statement items during the change period, that are not included in a prospectus, but solely for the information of the underwriters to determine the overall (financial) situation of the issuer. According to the respective roles in a transaction, those parties responsible for the prospectus receive all the information available to determine that information, which is relevant in order to inform investors in an appropriate manner. In other words, an underwriter receives all information to determine the information relevant for the investor; an investor never receives all the information, but only the relevant information necessary for his own investment decisions. Therefore, a differentiation in information is inherent in the system and neither unacceptable nor avoidable.

Issue for Discussion 4:

Certain jurisdictions have professional secretary provisions; the auditor should assess if he is authorised, according to the applicable laws and regulations, to provide information to a third party. In particular, he should consider if the applicable law permits the issuer to relieve the auditor of its professional secrecy; in certain jurisdictions, nobody, including the issuer, can relieve an auditor of this obligation.

Should the issuer, being the auditor's, client relieve the auditor of his professional secrecy in all cases, if at all possible?

[1] The term prospectus is used here to include all prospectuses and other registration documents

The issue of release (of an auditor) from confidentiality obligations will vary according to the jurisdiction; in Germany such release is a prerequisite for the issuance of a comfort letter.

Issue for Discussion 5:

> *It is practice that the auditor only issues comfort letters to underwriters or other parties to the transaction that have a "due diligence defence" and that request such involvement as part of their own reasonable investigation and not as a substitute for their due diligence responsibility. For example, it is common in the US for other parties (such as a selling shareholder or sales agent) that receive the comfort letter to provide a representation letter that states:*
>
> *"This review process applied to the information relating to the issuer is substantially consistent with the due diligence review process that an underwriter would perform in connection with this placement of securities. We are knowledgeable with respect to the due diligence review process that an underwriter would perform in connection with a placement of securities registered pursuant to the [applicable law]."*
>
> *To which parties and under which conditions can the auditor issue a comfort letter?*

A comfort letter serves those responsible for the content of a prospectus as support that they have acted with necessary due diligence. For this reason a comfort letter should only be addressed to those persons who bear a legal responsibility for the prospectus (including a corresponding due diligence defence).

It is therefore appropriate to state that the issuance of a comfort letter does not diminish the responsibility of its addressees to carry out their own independent examinations (due diligence procedures). There still appears to be some doubt as to whether the text proposed is sufficiently clear in stating this. In the majority of jurisdictions the extent of procedures to be performed by underwriters in connection with the placement of securities is not fully clear.

In our opinion, the question relating to point no. 5 should be answered as follows: (1.) the addressees of a comfort letter are those persons who are legally responsible for the content of the prospectus. (2.) Respective responsibilities should be defined by clarifying, either within professional standards or within the comfort letter itself, that the issuance of a comfort letter does not represent a transfer of the obligations of those responsible for the prospectus. The comfort letter merely supports these parties in fulfilling their obligations in this respect. In addition, it should be clear to all par-

ties involved that the comfort letter is only one measure, among others, by which those responsible for the prospectus can fulfil their obligations to due diligence.

In this context we would like to emphasize that the list of persons under nos. 2 and 3 on page 9, does not clarify the potential recipients of a comfort letter adequately. As mentioned above, in our opinion a comfort letter provides those persons who are responsible for the content of a prospectus with support for their contention that they have exercised the necessary due diligence in preparing the prospectus. For this reason each of those persons listed under nos. 2 and 3 should only be entitled to receive a comfort letter if they have a legal responsibility for the prospectus (including a due diligence defence where appropriate). In respect of the persons listed under no. 3, it may be advisable to obtain proof that they hold such a position indeed.

Issue for Discussion 6:

> *Even if an audit base is preferable, the auditor can assess if his understanding of the entity's internal control is sufficient to allow him to issue a comfort letter. The extent of the matters that can be comforted need to be adapted to the circumstances, and it is likely that an auditor that has no audit base will be able to provide a different level of comfort compared with that provided by an auditor that has an audit base.*
>
> *This situation can exist in several circumstances:*
>
> - *First your of operations,*
> - *Change in statutory auditor, and*
> - *Information in the prospectus reviewed by a reporting auditor and not by the statutory auditor. This situation is not possible in certain countries (such as France), possible in others (such as United Kingdom) and mandatory in others (such as Greece).*
>
> *Is an audit base always possible or required?*

As with any other engagements an auditor issuing a comfort letter should have sufficient knowledge of the subject under consideration.

This means that, with respect to the issuance of a comfort letter, it will be necessary to decide the extent of the knowledge or understanding of the issuer that the auditor will need for the individual engagement. In particular, for an assessment of financial information, as a minimum, the auditor will have to possess or obtain an understanding of the issuers internal control system relevant to its accounting function to facilitate an assessment of its appropriateness and effectiveness relevant to the engage-

ment. This applies irrespective of whether the previous annual financial statements have been audited by the auditor issuing the comfort letter or by another auditor.

Issue for Discussion 7:

> *The Independence Section of the IFAC Code of Ethics strictly is not required for agreed-upon procedures work where only factual findings are reported. Given that the procedures carried out are of an audit nature and are often combined with assurance work in practice, we recommend that auditors should be required to respect the independence requirements for comfort-letter types of engagement.*
>
> *Should explicit independence requirements be introduced? Should the comfort letter contain a section on independence?*

As jurisdictions and professional standards vary worldwide, a comfort letter should clearly state in accordance with which professional standard that comfort letter has been prepared. This should also encompass a statement of the relevant independence regulations.

Issue for Discussion 8:

> *This discussion paper takes the position that any interim financial information that has be reviewed should be put in the prospectus, together with the review report. Keeping the review report private in a comfort letter would result in supplying more information to the underwriter than to the users of the prospectus, which in our view is not acceptable.*
>
> *However, the Regulation seems to allow the issuer to choose not to publish the interim financial information (if they were not otherwise required to).*
>
> *How do you think the requirement in the Regulation (Annex I, item 20.6.1) should be understood?*

Contrary to the position taken in the FEE paper, we are of the opinion that it should not be necessary to include each review report in a prospectus. Essentially, the prospectus directive solely requires as a principle, that all previously published information should be presented to investors in a prospectus. In respect of performance of a review engagement, this means that it will only be necessary to refer to the performance of such an engagement in a prospectus when the review report has actually been published before the prospectus is compiled. A review solely for the entity's in-

ternal purposes and not to provide information to the capital markets is, as has been the case up to now, outside the scope of the prospectus directive.

Interim financial statements provide a good example to demonstrate this: (1) According to the prospectus directive published interim financial statements are required to be included in a prospectus. If these financial statements have been subject to a review and the corresponding review report has previously been published, this review report is required to be included in the prospectus. However, if the corresponding report was prepared for internal purposes only, no such requirement exists. (2.) As regards those financial statements published in the prospectus for the first time, the prospectus directive requires only a statement as to whether they are audited or unaudited. In such case neither the review itself has to be mentioned nor the respective review report has to be included in the prospectus. This corresponds to current international practice, differentiating between audited and unaudited financial statements.

Accordingly, since the prospectus regulation does not require unpublished review reports to be included in a prospectus and in case that the prospectus does not contain such reports, the comfort letter may include a statement with respect to such reviews.

Issue for Discussion 9:

> *Underwriters sometimes require comfort as to subsequent changes up to the cut-off date. Such comfort can be given by means of specific procedures performed or in the form of limited assurance. Where the latter is required, the auditor needs to apply the procedures of a review (ISRE 2400), which requires interim information to be available at a date as close as possible to the cut-off date. No limited assurance can be given for the period after that date.*
>
> *In which circumstances can the auditor give assurance through the date of a prospectus?*
>
> *Do you agree that any review or audit carried out for the purposes of providing comfort should lead to the auditor's assurance engagement being included in the prospectus together with the interim financial information that is being reported on?*

As noted above, within the structure of IFAC's International Standards it will be necessary to differentiate between "review" and "agreed upon procedures" in respect of comfort letter engagements and between a "negative assurance" report and a "report on factual findings" in respect of the reporting thereon (refer to Issue for Discussion 1 above).

Within this structure, negative assurance can only be given when the auditor has performed procedures in accordance with ISRE 2400. In all other cases the report will be limited to reporting factual findings.

Bearing this in mind, within a broader international discussion of this issue, it remains necessary to consider under what criteria elements of financial statements (such as a balance sheet or an income statement) can be subject to a review.

In respect of the second part of the question we refer to Issue for Discussion 8 above.

Issue for Discussion 10:

> *In some circumstances, the auditor needs to derive comfort from internal monthly financial reporting.*
>
> *Which criteria should be met to make internal management reporting a useful basis for giving (limited) comfort provided it is performed in line with the IAASB Assurance Framework?*

Irrespective of the type of engagement to be performed ("review" versus "agreed upon procedure") or form of report ("negative assurance" versus "report on factual findings") monthly reports forming the basis for a statement in a comfort letter should at least consist of a condensed balance sheet or a condensed income statement. Moreover, these monthly reports should be prepared on a basis substantially consistent to that applied to the last annual or interim financial statements.

Issue for Discussion 11:

> *General practice prohibits comfort from being issued on general assertions such as "material adverse changes", as these assertions are not defined from an accounting standpoint. The role of the auditor should be limited to reporting on accounting figures or figures derived form accounting figures (differences, percentages, …)*
>
> *Do you agree with this statement? if not, why not?*

We agree that phrases such as "negative" or "adverse changes", "changes in the financial position" or "changes in the economic position of the issuer" should be avoided in a comfort letter because their meaning can be ambiguous and is not defined in accounting standards.

Likewise, no reference to the materiality of any change should be made in a comfort letter since there aren't any (professional) standards determining a level of materiality in the context of capital market transactions.

Yours faithfully,

Heinrich Harms