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Discussion Paper: Comfort letters issued in relation to financial information in a Prospectus

Introduction

We welcome the efforts of FEE, and in particular of the members of the Comfort Letter Task Force in developing this Discussion paper which proves to be most useful, not only in the European context of the new prospectus directive for which it was written, but also in an international context where there is at present no specific guidance on that subject.

These comments have been prepared by a Task Force composed of experts from 7 countries (France, Germany, Japan, Netherlands, South Africa, UK, USA) set up under the auspices of the IAASB. These comments have not been approved or even considered by the Board itself and they do not necessarily represent the views of the IAASB.

In preparing these comments we have focused particularly on whether the Discussion Paper is consistent with published IAASB documents, in particular the International Framework for Assurance Engagements and International Standard for Assurance Engagements and ISAE 3000 "Assurance Engagements Other than Audits or Review of Historical Financial Information".

Members of the Task Force are in general agreement with the FEE Paper, which they consider to be a good paper. They, however, wish to express the following comments on the specific issues for discussion, raised by FEE.

Detailed comments on specific issues for discussion

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 FEE paper presents, in its introduction, the different possible reporting models of the Comfort letter and their compatibility with the IAASB's international framework for assurance engagement.

It explains that the comfort letter engagement can be considered solely an "agreed upon procedures" engagement, as a result of which the reader has to draw their own conclusion and

no assurance is expressed. It concludes that it is possible to use that solution in the European context since the Prospectus Directive requires any assurance expressed on interim financial information to be included in the prospectus itself (and therefore that this is not necessary in the comfort letter).

A pure "agreed upon procedures" model may be acceptable in the context of the European prospectus on which the FEE paper is built. However, there is concern that even in a European context this will not necessarily meet market needs.

FEE has not explored the two other reporting models that it mentions: i.e.

- Firstly, a mixture between an "agreed upon procedures engagement" addressing the extraction of financial data in a prospectus and "assurance" engagement with respect to financial information for periods after the date of the last audited annual accounts.

- Secondly, a "non assurance" engagement, which would include as permitted by the IAASB assurance framework "professional opinions, views or wording from which a user may derive some assurance"[1]

The second approach ("non assurance engagement" containing "professional opinions, views or wording from which a user may derive some assurance") usually leads to the issuance of long form reports (such as the UK reports on working capital statements), which are not considered by the market as "comfort letters".

However, the first approach (mixture of "agreed upon procedures" and "assurance" engagements) could according to certain members of the Task Force be explored to respond to the market demand for comfort (under the form of negative assurance) in respect of assertions (explicit or implicit) that the financial and/or the trading position of the entity **has not changed significantly** since the date of the last audited accounts included in the document.

This would be in line with the present practice in the US, which allows the "auditor" to provide negative assurance as to subsequent changes as of a date of less than 135 days from the end of the most recent period for which the "auditor" has performed an audit or a review. This would also be in line with current practice in the UK, under which negative assurance is provided based on work similar to that undertaken for a review.

As mentioned above, the provision of "negative assurance" on subsequent changes as of a certain date after the date of the last audited or reviewed accounts is current practice in some countries (US and UK, for example) and it might be perceived by the investment banking community as a retrograde step if an international standard was to preclude it. At least it would create a fundamental change in what the investment banks are used to have in a comfort letter in certain countries.

If "auditors" were to report in assurance terms on significant changes, there would be a need for criteria on what is a significant change. For the moment there are no publicly available criteria on what a "significant change" is. For this reason where negative assurance is given

[1] Paragraph 14 (b) of the International framework for assurance engagements

in practice, the criteria are generally addressed in the contract with the requesting parties or in the comfort letter itself.

The Task Force recognises that if there is demand for such negative assurance comfort from market participants, there would be merit in considering whether an approach could be developed based on the assurance framework and ISAE 3000. Some members of the Task Force were not optimistic that such a model could be developed but at least one member of the Task Force believed this could be possible, particularly if publicly available criteria could be developed.

Any such consideration would of course need to include the nature of the work to be performed to provide that negative assurance. Typically, where such assurance is given today the work done involves reading Board minutes, making enquiries of Management, reviewing monthly management information/accounts (ideally at a consolidated level) and considering if there is any evidence based on those procedures of any significant change of the specific types defined.

As a general conclusion to the arguments developed above, the Task Force in its majority does not favour the possibility of providing negative assurance. If, in exceptional circumstances which need to be further defined, the auditor has to provide negative assurance, it cannot be done without having reviewed the underlying information.

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?

The FEE discussion paper states that only those parties who have signed an engagement letter with the "auditor" could be addressees of the Comfort Letter.

The Task Force discussed that issue and although it did not seem to be required in the US to always sign an engagement letter, the task force agrees with that statement especially in the context of the pure "agreed upon procedures" reporting model of the FEE paper.

There is also, however, recognition that in certain legal environments a requirement for a formal contract/engagement letter may not be the most appropriate way for the parties to agree the terms of an assignment. It is considered important that comfort letters should only be provided to parties with an appropriate interest in the due diligence process and who had participated in agreeing, and who fully understands, the specifications of the engagement. It is agreed that some flexibility in how such requirement might be worded would be appropriate so as not to preclude means other than an engagement letter.

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 has 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?

The need for issuing a comfort letter is dependent on the different responsibilities of the various parties acting on the financial market (banks/ underwriters, regulators, issuers, auditors …). In countries/jurisdictions where the banks/underwriters are responsible for the information included in the prospectus for example and have to perform due diligences to discharge their responsibility towards the investing public, it is clear that they may need, as part of their due diligences, to obtain a comfort letter from the "auditor". As explained in the FEE paper, the banks do not receive the comfort letter as investors but in respect of their capacity as underwriters. We consider therefore the issuance of a comfort letter on market organised as such does not create a different level of information.

Issue for Discussion 4:
Certain jurisdictions have professional secrecy 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?

The question of professional secrecy is a difficult one, very much linked to the local legislation in place in the various countries/jurisdictions. It is true that in certain countries/ jurisdictions there are rules of professional secrecy from which the auditor cannot be relieved, even by the audit client.

However, even in those countries/jurisdictions where the audit client cannot relieve the auditor from its obligations in terms of professional secrecy, it is always possible that the audit client provides the bank with a copy of the comfort letter issued by the auditor.

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?

The FEE discussion paper list as potential recipients or addressees of the Comfort letter:

1. Issuer,
2. Named underwriters acting in that capacity, and
3. Other parties **with a statutory due diligence defence**, only when a law firm or attorney for the requesting party issues a written opinion to the auditors that states that such a party has a due diligence defence under applicable laws and regulations.

At least one member of the Task Force expresses a number of concerns about the wording of these limitations, explaining that the specific reference to "underwriters" may not be appropriate outside a US context (in the US there is strict liability for underwriters in statute but this is not the case in other environments) and accordingly a principle based approach would be more appropriate, following the principle that the engagement should only be in the context of actual due diligence enquiries of the requesting parties based on a reasonable expectation of potential liability for the document content on the part of the requesting party and the provision of the services only in that context. This same member of the Task force also has concerns about the overly restrictive nature of paragraph (3) in that it is more restrictive than this principle (for example, in the UK a Sponsor may have responsibilities for a document and a reasonable need to undertake due diligence but may not be an underwriter and would not have a "statutory" due diligence defence).

The Task Force is in general agreement that the "auditor" should always be satisfied before accepting the assignment that the comfort letter is being requested for appropriate purposes as part of a wider due diligence process in which the requesting party is an active participant. However, criteria should be defined as to what is meant by "wider due diligence process" so as to define more precisely, even in terms of principles, who can ask for a comfort letter.

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 year of operations,*
- *Change in statutory auditor, and*
- *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?

The FEE discussion paper questions whether it should always be required to have an audit base before issuing a comfort Letter and whether it is always possible to have that audit base.

The task force agrees with that statement that an audit base should be required before issuing a comfort Letter under the condition that having an audit base either comes from having audited at least one year's financial statements or alternatively, having done sufficient work to gain an in-depth knowledge of the client's accounting and financial reporting practices and

system of internal accounting control for the periods for which the procedures are to be applied (which is, in our understanding, the position in the FEE paper).

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?

The FEE discussion paper, as explained above, recommends that auditor should be required to respect the independence requirements (i.e. at least the Independence Section of the IFAC code of Ethics) for comfort letter types of engagement, even though it classifies them as "agreed upon procedures".

The Task Force agrees with that position.

Issue for discussion 8:

The 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?

The FEE discussion paper, as explained above, takes the position that any interim financial information that has been reviewed should be put in the prospectus, together with the review report.

The Task Force agrees with the position taken in the FEE paper, however, it considers that it is not the role of professional standards to impose on the issuer obligations which have not been required by the regulator.

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?

The FEE paper relies solely on ISRE based engagements to provide any negative assurance in connection with the financial position of an entity after the date to which financial information included in the prospectus has been audited or reviewed. However, ISRE 2400 is primarily directed towards the review if financial statements, therefore, unless the "auditor" could undertake an engagement to review very recent financial information (ie as at a date close to the date of the document) and could express that assurance not only for the benefit of the company but also for that of requesting parties, there would be no available basis for an "auditor" to provide assurance in connection with recent changes in the financial performance and position of the entity.

For the second question of this issue for discussion, see above comments on the previous issue for discussion n° 9 on the fact that it is not the role of professional standards to impose on the issuer obligations which have not been required by the regulator.

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?

The Task Force agrees with the criteria developed in the FEE paper ie providing comfort on the basis of monthly management reporting should only be possible if:

- Management reporting includes at least an income statement and a balance sheet;
- The auditor obtained an understanding of the internal control system for monthly management reporting; and
- The figures included in the management reporting are derived from and in agreement with the underlying accounting records.

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 from accounting figures (differences, percentages,…)

Do you agree with this statement? If not, why not?

The Task Force agrees with this statement (see comments above on significant changes –issue for discussion n° 1).

Other comments on the FEE paper

The paragraphs relating to the narrative description of GAAP differences is not allowed anymore in the US. It was agreed that this area would need careful additional consideration in drawing up any international guidance and should also consider the implications of the equivalence proposals recently published by CESR for application in Europe.

Differences remain in practice between countries as to the kind of work/assurance which can be performed/provided on certain item such as the capitalisation and indebtedness table and that the various models should be carefully considered in drawing up any international guidance.

We hope that those comments will be useful to FEE. Should you need any other information or precision on those comments, please do not hesitate to contact Gérard Trémolière, chairman of the IAASB Comfort letter Task Force.

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