➢Memo

To:	Saskia Slomp (FEE's Technical Director) Corinne Soubies (FEE's CMAG Project Manager) Jan Buisman (FEE's ECMRP Leader)
From:	Robert Gibb (FEE's CMAG member) / Iñigo Larburu (ICJCE's staff)
Date:	December 2005
Subject:	Comments and inquiries on FEE's Discussion Paper "Comfort Letters Issued in relation with financial information in a Prospectus".

Dear Sir/Mmes.,

We set out below our reaction to FEE's Discussion Paper as of April 2005. Should you need further clarification, do not hesitate to contact us and please accept our apologies for the late delivery.

General Notice

We acknowledge some participants' concerns as regards the wording recurrently used to differentiate the levels of assurance an auditor may provide dependent on the extent of procedures he applies. In our view, in the interest of consistency to avoid misleading readers the term "limited", widely identified with "negative" by these contributors, could be replaced by the exact adjective selected by IFAC, which is "moderate".

Finally, employing the expression "limited assurance" in contrast to "reasonable assurance" is rather influenced by definitions contained in ISAE 3000 "Assurance Engagements other than Audits or Reviews of Historical Financial Information", which are far beyond the scope of FEE's DP.

However, given the potential for misunderstanding in the current environment, we are reluctant to invoke any change, which could be wrongly interpreted as widening auditor risk and responsibility.

Q1

With reference to the three Comfort Letter reporting models identified by FEE, we wonder whether ruling out current practice and opting for an "agreed upon procedures" approach is the most appropriate course of action. Instead, we encourage further investigation so as to ascertain whether the set of conflicts with IFAC International Framework for Assurance Engagements that the mixture model is presumed to entail could be overcome.

Some Comfort Letters attest to prospectus elements that are not subject to mandatory scrutiny requirements, others serve the purpose of providing moderate assurance in respect of subsequent changes in financial statement items from the date of the latest financial statements contained in the prospectus up to the cut-off date. In practice, this latter case constitutes an extension of the period for which subsequent events review is conducted, but the extent of procedures performed does not allow delivering an equivalent level of comfort on the change period, compared to a full scope audit on financial statements.

ISA 560 "Subsequent Events" lays down guidance as how auditors should proceed were a public offering of their client's securities to be launched following the issuer's balance sheet closing date:

"19. In cases involving the offering of securities to the public, the auditor should consider any legal and related requirements applicable to the auditor in all jurisdictions in which the securities are being offered. For example, the auditor may be required to

carry out additional audit procedures to the date of the final offering document. These procedures would ordinarily include carrying out the audit procedures referred to in paragraphs 4 and 5 [..]".

Underwriters operating these offerings claim that removal of the moderate assurance feature from Comfort Letters would lower due diligence standards in European capital market transactions below international norms, mainly US AICPA's SAS 72 and German IDW's PS 910.

On account that tailor-made standards already exist and regardless of the fact that AICPA's standard was developed under a different legal environment and should for this reason be cautiously interpreted, we do not consider the debate on which IFAC standard should Comfort Letters be placed under to be a priority. On the contrary, we believe that coexistence of two reference frameworks, that is, IFAC ISRS 4400 "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information" with respect to the extraction of financial data in a prospectus and IFAC ISRE 2400 "Engagements to Review Financial Statements" as regards financial information for periods after the date of the last audited annual accounts, is readily possible, especially if such guidance is promptly addressed by IFAC. Meanwhile the two-tier framework presents a tentative solution.

Q2

We consider the engagement letter to be an essential step not only to formalise the client's and their auditors' understanding of the general scope of work to be performed in the context of delivering a Comfort Letter but also to specify to whom it should be addressed. In this line, both ISRE 2400 and ISRS 4400 acknowledge the need for such document.

We are also aware that underwriters are usually reluctant to sign the engagement letter alleging that they are under no obligation to the auditors as the sole contractual relationship they have entered into is with the client. Additionally, underwriters have put forward the point that engagement letters are largely repetitive of Comfort Letters themselves and that having two separate documents embodies a potential risk of inconsistent statements made therein.

However, as a precautionary desirable measure, should all parties get their act together and reach a written agreement, this document would prevent later disagreements on the engagement scope. In practice, any preliminary arrangement of appropriate procedures is normally revised later to take new information into consideration, clarify misunderstandings resulting from oral statements etc. Consequently, despite changes in engagement scope, which may be addressed, for instance, by means of periodic amendments appended to engagement letters' initial content, we reiterate our belief that such letters prove to be useful tools. In this sense, we support the illustrative engagement letter template disclosed in Appendix 2 to FEE's DP.

Concerning the question at stake, ISRS 4400 explicitly mentions that reports on factual findings should be restricted to those parties that have agreed to the procedures, this measure opens the door to third parties involved as potential recipients provided that such agreement is stated. ISRE 2400 promotes a less stringent approach and allows for restricted use of review reports other than by the client, as it does not include any contrary assertion. Under both standards confidentiality is set forth as one of the main principles auditors should observe in performing their work, to comply with IFAC Code of Ethics. Thus, disclosure to third parties involved does not necessarily result in a breach of an auditor's professional secrecy duties. In our view, even though the client's consent has been implicitly granted in advance by way of incorporating a Comfort Letter requirement into the underwriting contract terms, an engagement letter where addressees' names are listed proves to be a useful condition. Insofar as it is fulfilled auditors will be entitled to proceed with distribution. This statement should apply irrespective of whether underwriters sign the engagement letter or not.

Q3

We fully support FEE's view that the issuance of a comfort letter does not create differences in the level of information available to banks and investors, particularly thanks to those arguments stated in points a) and c).

On paper, it is true that any material findings reported in a Comfort Letter should result in the prospectus being modified so as to provide a true and fair view of the issuer's financial situation (we refer to key feature a) of the Spanish prospectus responsibility regime in our answer to Question 5).

However, it is also true that underwriters' role (jointly with the client) is to decide which information for the period running from the latest financial statements up to the cut-off date will be disclosed to investors through the prospectus. In practice, not every Comfort Letter comment with respect to changes in financial statement items during the change period will be reflected in the prospectus, let alone non-public information that banks receive in order to perform their role. Such omission risk should not affect either of the types of subsequent events described under IAS 10 "Events after the Balance Sheet Date" provisions.

Anyway, additional measures have long been in place to mitigate information asymmetry risk. Banks are often involved in many businesses that may relate to companies for which they have managed a public offering of securities, such as, research coverage, fund management, etc. In the aim of preventing this conflict of interest from undermining their professional competence they are subject to special regulations.

Particularly, article 83 of Spanish Securities Exchange Act of 1988 requires those business segments within which investment services undertakings operate to be properly separated so as to prevent confidential information from flowing between them. Also, article 83 b) of the same Act displays conduct rules that issuers and offerors should observe, as regards analysis and discussions preceding financial transactions that are likely to cause material fluctuation of securities prices. Finally, article 84 and subsequent provisions of the said Act deal with applicable prudential supervision requirements.

Q4

As previously stated in our answer to Question 2, the underwriting agreement usually identifies delivery of a Comfort Letter among the duties to be borne by the client. However, we understand that such relief of the auditors' professional secrecy concerning submission to underwriters does not enable the former to proceed with distribution. In that event and provided that underwriters had previously refused to sign the engagement letter, we suggest that auditors obtain a representation from underwriters where the latter would acknowledge their due diligence responsibilities in the context of a public offering. In principle, this step should be completed before the Comfort Letter be disclosed to the said parties.

Q5

We have discussed this point in our answer to previous question: we support the request of a representation letter whenever the underwriters do not sign the engagement letter. Contributors which are reluctant to admit the suitability of a representation letter requirement have based their position on the assumption that regulations governing European capital markets and US legal environment diverge to a high degree. Especially, it is highlighted that auditors cannot be held directly liable towards investors, nor can they or other parties responsible allege due diligence conduct in their defence in most European jurisdictions. We hold the view that other than this the real distinctive feature of the European playing field has to do with the difference in civil liability regimes applicable across Europe, which impedes a unified approach.

Moreover, regardless of legislative environments similar to Spain's being in place (or alternatively, a converging reform under way) in the EU, let us broadly describe the cornerstones of our framework, which should to a great extent coincide with other Member States' on account of EC's FSAP goals:

Article 6 of Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading sets out which parties take responsibility for the prospectus at a minimum:

"1. Member States shall ensure that responsibility given in prospectus attaches at least to the issuer [..], the offeror, the person asking for the admission to trading on a regulated market or the guarantor, as the case may be. [..] "

"2. Member States shall ensure that their laws, regulations and administrative provisions on civil liability apply to those persons responsible for the information given in a prospectus. [..]"

The Directive also establishes that persons responsible are clearly identified in the prospectus as well as requires them to sign and include a declaration acknowledging that having taken all reasonable care to the best of their knowledge the prospectus is free of material misstatement and relevant data omission. In this respect, Commission Regulation No 809/2004 implementing this Directive has developed schedules that take account of the given disclosure items.

The Spanish Securities Exchange Act of 1988 has been recently amended by Royal Decree-Law No. 5/2005 of 11 March and Royal Decree No. 91310/2005 of 4 November, not only for the purpose of transposing the Directive but also to modernise the Spanish IPO regime. As a result of such intention, the scope of responsibility for the prospectus has not been significantly altered. An outline of its key features follows:

a) Facts claimed by the issuer/offeror shall not be admitted as legal arguments for their defence against bona fide investors, unless such facts are incorporated in the prospectus either expressly or by reference.
b) The lead managers of the offerings are attributed responsibility to the extent that they conduct the verification procedures that have been laid down by the latter Royal Decree, which in fact do not differ greatly from the previous regulatory requirements. Particularly, managers should reasonably check, in accordance with generally accepted market practice, that all information about the transaction and the securities revealed in the Securities Note is free of material misstatement and relevant data omission. The new Royal Decree emphasises the point of data hosted in the Securities Note because lead managers are not necessarily involved in the preparation of information relating to the issuer.
c) Those persons that wholly or partially consent to the prospectus content are attributed responsibility, provided that such circumstance is properly mentioned in the prospectus. Authorisers are empowered to restrict their responsibility within the boundaries of the subject matter to which they have given their consent as long as they state such disclaimer in the prospectus.
d) Advisers on general form matters such as prospectus layout, data arrangement or drafting of narrative descriptions are exempted of any responsibility (usually attorneys in law are called in at this stage).
e) The extent of responsibility as designed for the issuer's role applies also to any guarantor ensuring that debt service obligations will be duly honoured within the boundaries of mandatory disclosures to which they are subject in the prospectus.

Additionally, persons responsible can be held unlimitedly liable for all damages caused to security holders, which derive from material misstatement or relevant data omission as regards the prospectus content, unless appropriate investor-warning measures are taken. Thus, either corrective supplements are appended to the prospectus or the applicable changes are disseminated to the market in a timely manner. The term to take legal action against the persons responsible expires after 3 years, counting from the date of awareness.

Last but not least, at first sight it may seem that a statutory due diligence defence has just been granted to all persons responsible for the prospectus content (including the lead managers of the offering), as set forth in article 37 of Royal Decree No. 91310/2005 of 4 November. However, whilst the said defence has now been consolidated within the CNMV's regulations, persons responsible have long been entitled to this protection under the Spanish code of civil liability.

With reference to the Spanish Securities Regulator (CNMV), their approval of the prospectus is an essential step for the offering/issuance to move forward. However, the fact of the prospectus being filed with the CNMV does not place any responsibility on the latter for fair presentation of the prospectus content in all material respects (including auditors' reports either attached or incorporated by reference). The CNMV's responsibility is limited to overseeing the issuer's compliance with information disclosure requirements, as determined by the applicable standards (Article 92 of Spanish Securities Exchange Act of 1988).

Q6

Concerning the importance of counting on recurring audit experience prior to issuing a Comfort Letter, whilst it is undoubtedly extremely valuable, we doubt whether such background should become a mandatory requirement. In practice, auditors often do not have prior audit experience under a wide range of circumstances such as the client's option for a larger accountants firm highly experienced in public offerings, internal policies leading to appointing different audit teams for statutory and public offering purposes, or in-process firm mergers as a result of which statutory auditors drop out. It is obvious that from an efficient allocation of resources standpoint an audit base is a key attribute, but there are not sound arguments to support that Comfort Letters could not be otherwise delivered, provided that auditors appointed possess an adequate degree of expertise. As usually done, incoming auditors would need to apply their professional judgement and overweigh testing procedures in an effort to offset their lesser knowledge of risk management and internal control systems.

Such cases resemble that of prior period financial statements audited by another auditor (para 17 of ISA 710 "Comparatives"). Under Spanish professional standards, the permission to refer to the predecessor auditor's report on the corresponding figures in the incoming auditor's report for the current period becomes a binding requirement. In this line, we welcome FEE's treatment insofar as the Comfort Letter template disclosed in Appendix 1 to FEE's DP also quotes reference to statutory auditors for the three precedent fiscal years.

With regard to identification of standards in accordance with which the Comfort Letter engagement is conducted, the illustrative wording suggested on page 10 only makes reference to the audit framework followed for statutory purposes. At this point we miss quotation of standards such as US AICPA's SAS 72 or German IDW's PS 910.

Q7

We fully support FEE's view that auditors should remain independent of their Comfort Letter clients. Moreover, should external accountants involved be different from statutory auditors, the former may have rendered incompatible services in the past. IFAC regards *independence* among the set of ethical principles governing the auditor's professional responsibilities when an engagement to review financial statements is undertaken (ISRE 2400). We take such approach as a reinforcement of our position.

Q8

As remarked by FEE, according to Annex I - 20.6.1 to the Regulation, if the issuer has published quarterly or half-yearly financial information since the date of its last audited

financial statements, these must be included in the Registration Document. Article 5 of Directive 2004/109/EC on the harmonisation of transparency requirements expressly establishes that half-yearly financial reports covering the first six months of the financial year shall be made public at the latest two months after the end of the relevant period. Therefore, if the Registration Document is dated more than eight months after the end of the last audited financial year, the half-year financial report for the succeeding period must be incorporated in the prospectus. Except for the case where the Registration Document is dated sometime in the two-month term following the closing date for the given half-yearly period without the report for such period being yet published, the issuer cannot avoid including half-year financial report. However, the issuer is not expected to proceed imprudently and pursue this exceptional set of circumstances on account of his role as regards the responsibility burden (please refer to key feature a) of the Spanish prospectus responsibility regime in our answer to Question 5).

Quarterly financial reporting is also mandatory in compliance with Spanish Securities Regulator's By-law of 18 January 1991 as regards interim information requirements affecting issuers whose securities are admitted to trading on a regulated market. Deadlines for filing are set out for the first and third quarters as 16 May and 16 November respectively. We stick to the same pattern of thinking showed in the above paragraph.

As far as attestation of the said interim financial information is concerned, we share FEE's view that Annex I - 20.6.1 to the Regulation rules out any alternative approach: if the quarterly or half-yearly financial information has been reviewed or audited, the audit or review report must also be included. Although CESR's Recommendation for the Consistent Implementation of the Regulation (05-054b) does not explicitly comment on the nature of review reports under section "8 Interim Financial Information", it clearly states under para 98 of the same section that the prospectus shall present all the up-to-date financial information that has already been published by the issuer.

Q9

Immediately before "Issue for discussion 8" FEE affirms that the auditor does not provide assurance in the Comfort Letter on (audited or reviewed) interim financial statements, as the audit or review report is included in the offering document. Regarding this point, in conformity with the mixture model we wonder whether an assurance conclusion on (audited or reviewed) interim financial statements may not be provided to the extent that the period for which subsequent events review is conducted has now been extended. Such approach resembles updating the review report to the prospectus cut-off date. It should be noted that the date of the Comfort Letter should not be mistaken for the date of the interim information subjected to review, which remains unchanged.

The above argument does not conflict, however, with the US legal picture as drawn by some contributors to FEE's DP, whereby Comfort Letters are relieved of moderate assurance provision requirement on the 135-day rule basis. In a simplified manner it implies that as long as listed companies have filed reviewed[1] quarterly reports (Form 10-Q) with the SEC, a report on factual findings thereafter provides sufficient comfort.

Additionally, some contributing parties -mainly potential underwriters- have questioned FEE's assertion that moderate (negative) assurance may only be given on interim financial statements subjected to the procedures of an ISRE 2400 review. We have carefully read through EC DG Internal Market services' working document ESC/34/2005 Rev.2 of November 2005, insofar as it presents a draft binding legal text containing possible

[1] "Prior to filing, interim financial statements included in quarterly reports on Form Q-10 must be reviewed by an independent public accountant [..]. If, in any filing, the company states that interim financial statements have been reviewed by an independent public accountant, a report of the accountant on the review must be filed with the interim financial statements". SEC Reg. S-X Accounting Rules, Reg§210.10-01(c).

implementing measures to the Transparency Directive. The text includes possible draft recitals in relation to issues that are not specifically addressed in the draft articles:

"Possible Recital on Auditor's review of half-yearly report: It is important to ensure a common understanding on the level of assurance that investors can expect from the auditors' review of half yearly reports referred to in Article 5(5) of the Transparency Directive. Without prejudice to the international standards on auditing under development, the nature of the auditors' review of half-yearly report should be understood as requiring at least a limited review containing conclusions in the form of negative assurance and providing a moderate level of assurance, which is less than a full scope audit."

The EC DG Internal Market services tentative wording acknowledges that applicable international standards on auditing are being developed, which we interpret as an indirect reference to ISRE 2410 "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" even though such standard was issued in July 2005. It will be effective for reviews beginning on or after December 15, 2006, irrespective of the timeline for the Commission's ISAs endorsement process as stated in article 26 of the upcoming 8th Directive.

However, the scope of ISRE 2410 is limited to a review of interim financial information performed by the independent auditor of the financial statements of the entity. Para 3 of the Introduction to such standards expressly reads:

"A practitioner who is engaged to perform a review of interim financial information, and who is not the auditor of the entity, performs the review in accordance with ISRE 2400 "Engagements to Review Financial Statements". As the practitioner does not ordinarily have the same understanding of the entity and its environment, including its internal control, as the auditor of the entity, the practitioner needs to carry out different inquiries and procedures to meet the objective of the review."

The EC DG Internal Market services working document builds on CESR's Final Technical Advice on Possible Implementing Measures of the Transparency Directive (05-407), sent to the Commission on 30 June 2005. Concerning current market practice, CESR's survey conclusion as regards the use of generally accepted auditing standards at national levels when conducting a review of the half-yearly report, was collected in para 447:

"The large majority of Member States use the standard issued by IFAC (say ISRE 2400) or an adaptation of it at national level. However, it is not for CESR to determine whether or not this standard is adequate for the purposes of investor protection".

Having regard to the above background, we fully agree with FEE's view that ISRE 2400 is the suitable review framework, as a general rule.

Lastly, the same parties claim that ISRE 2400 does not provide a standard for providing negative (moderate) assurance in respect of subsequent changes, a critical element in a Comfort Letter delivered pursuant to current international practice, according to their view (a list of procedures accounting for current international practice accompanies such statement). We challenge this argument because in spite of the fact that ISRE 2400 is not intended to provide an exhaustive working program comprising detailed procedures applicable to every review engagement, it does indeed disclose some illustrative suggestions relating to subsequent events. These are points 81, 82 and 83 of Appendix 2, which happen to exactly match those included in the dissenting parties' list.

<u>Q10</u>

ISA 560 "Subsequent events" includes reading the entity's latest available interim financial statements and other related management reports if appropriate, among the audit procedures ordinarily needed to identify events that may require adjustment of or disclosure in the financial statements. In this respect, we would like to stress ISA 560's prior condition that such audit procedures should take into account the auditor's risk assessment.

In our view, the above guidance is equally eligible for Comfort Letter engagements (assuming that such is the purpose underlying FEE's words "for giving (limited) comfort provided it is performed in line with the IAASB Assurance Framework").

At a minimum, we believe that an auditor's risk assessment should comprise his evaluation of internal control over financial reporting and ensure that internal management monthly financial statement balances are in agreement with the underlying records from which they are derived.

Q11

FEE takes the position that auditors should not comment on "material adverse changes" as these general assertions are not defined from an accounting standpoint, we firmly align with this thinking. Rather, this component forms part of the scope of due diligence responsibilities attributed to underwriters. It is only in light of their own professional judgement that reported changes in balance sheet line items may be classed as materially adverse.

In connection with this point, FEE continues:

"If the underwriters require (comfort on subsequent changes to) non-GAAP line items, such as "net indebtedness", "working capital" and "EBITDA", the prospectus should include a proper definition of these aggregates, linked to specific line items of the financial statements. The comfort letter should refer to these definitions (2.2 The Comfort Letter, Subsequent Changes, page 15)."

It is worth noting here CESR's Recommendation on Alternative Performance Measures, of October 2005 (05-178b) whereby CESR partially handles this issue by providing guidance on the definition, presentation and audit of such non-GAAP indicators to the extent that they derive from income statement line items.

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