ANALYSIS OF RESPONSES TO FEE DISCUSSION PAPER COMFORT LETTERS ISSUED IN RELATION TO FINANCIAL INFORMATION IN A PROSPECTUS

May 2006

FEE

The Fédération des Experts Comptables Européens (FEE) is the representative organisation for the accountancy profession in Europe. FEE's membership consists of 44 professional institutes of accountants from 32 countries.

PURPOSE OF THIS SUMMARY REPORT

FEE published a Discussion Paper in April 2005, 'Comfort Letters Issued in relation to Financial Information in a Prospectus', with a view to inviting comment from auditors, national auditing standard setters and the International Audit and Assurance Standards Board (IAASB) on the procedures to be performed by an auditor and the reporting on these procedures with regard to comfort letters.

The paper was written against the background of the new EU Prospectus Directive. This Directive introduces major changes to prospectuses, both with regard to its contents, applicability (one regime for listed and unlisted shares) and approval. Once approved in one Member State, the prospectus may be used in all other Member States with only very limited involvement of the regulators outside of the issuers' home country. FEE was concerned about the need for this debate, as there are different practices in the Member States, relating to both the auditors' involvement[1] and the comfort letters.

The Discussion Paper considers the most common issues that may arise in practice and suggests guidance for the reporting by auditors in these situations. Illustrative examples of comfort letters and engagement letters were provided for illustration. FEE included these examples for illustration in order to focus the debate. Some countries have developed other examples and ultimately, where these documents are based on the contract between the parties, national legislation will decide form and content. FEE's Discussion Paper aims to stimulate debate, with the ultimate goal of achieving a common understanding about the procedures to be performed and the assurance to be given by auditors.

FEE has summarised the responses to the Discussion Paper in this paper and commented on these where we thought it necessary to clarify the position. The summary of the responses is presented in this report in order to provide recommendations on each of the questions and identify any new issues requiring further debate. The recommendations have been developed based on the comments received and on further reflections within FEE since the publication of the Discussion Paper. The summary of the responses is condensed and should be read in connection with the individual responses available on FEE website: http://www.fee.be/publications/default.asp?library_ref=4&content_ref=567. As a result, this summary report would be a valuable tool for the standard setters, be it at national level or the IAASB, when developing a standard for comfort letters. FEE considers such a standard (which takes into account the differences that will arise due to differences in national law), would be beneficial for all market participants, not at least for issuers and investors, as it will contribute to the transparency and the efficiency of the prospectus process.

[1] Refer to FEE Discussion Paper on the Auditor's Involvement with the New EU Prospectus Directive published in November 2004, and the Analysis of Responses to FEE Discussion Paper on the Auditor's Involvement with the New EU Prospectus Directive published in October 2005.

In alphabetical order, comments were submitted by[2]:

Credit Suisse First Boston
Deutsche Bank (Germany)
Deutsches Aktieninstitut (DAI) (Germany)
IFAC IAASB Comfort Letters Task Force
Institut der Wirtschaftsprüfer (IDW) (Germany)
Institute of Certified Public Accountants of Cyprus (ICPAC) (Cyprus)
Institute of Chartered Accountants in England and Wales (ICAEW) (UK)
Instituto de Censores Jurados de Cuentas de España (ICJCE) (Spain)
International Capital Market Association (ICMA) (UK)
Irish Financial Services Regulatory Authority (Ireland)
National Chamber of Statutory Auditors of Poland (KIBR) (Poland)
Polish Ministry of Finance (Poland)
PricewaterhouseCoopers
Slovak Chamber of Auditors (SKAU) (Slovak Republic)
Sullivan & Cromwell LLP
Treuhand Kammer (Switzerland)
White & Case London (UK)

[2] The summary in this report is made by FEE's European Capital Markets Reporting Project Group, with emphasis on the comments addressing the substantial issues in the discussion paper. Individual respondents may have emphasised other aspects than in the summary.

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EXECUTIVE SUMMARY

This FEE paper sets out the views of a number of respondents, including some banks and advisers, on the issues raised in the Discussion Paper on the 'Comfort Letters Issued in relation to Financial Information in a Prospectus' published in April 2005. It provides recommendations based on these comments and further reflections.

The responses show a diversity of views, which can be split in two groups: the accounting profession that broadly welcomes the FEE Discussion Paper as a useful guidance for the reporting by auditors in theses situations; and the banks and advisers that express some reservations in terms of FEE's understanding of the current market practice and its proposals to base the comfort letter on agreed-upon procedures.

Reflecting the fact that many offerings by European companies have a US section, a number of respondents expressed a strong preference for accepting the US comfort letter standard, US Statement on Auditing Standards N° 72 (SAS 72), as the basis for any international agreement on comfort letters. This is because even where the offering is a private placement to US-based investors under Rule 144A, underwriters require the same form of comfort letter as part of their due diligence procedures as provided in a US domestic offering. Other commentators went further and stated that FEE's proposals were a backward step from standards such as SAS 72 and those elsewhere based on that standard.

In considering the issues underlying comfort letters generally, FEE took into account existing market practice and, in particular, the impact of the widespread use of SAS 72. We explain on page 8 the key elements of our proposals and contrast these with SAS 72 in order to support our contention that our proposals represent a positive step in the debate toward agreeing a common global approach to comfort letters.

Key Proposals:

- Each recipient of a comfort letter should be made fully aware of the type of engagement, and the requesting party, be it client or underwriter, should take responsibility for the adequacy of the scope of procedures performed by the auditor so as to avoid any misunderstanding regarding such matters and the extent of the auditor's responsibility.

- The differences between the FEE proposals and SAS 72 are limited. We note that the market is used to SAS 72 letters, which differ from the IAASB Framework. The lack of guidance on comfort letters should be addressed by the IAASB.

- Further debate is needed on the form of wording that can be used in an agreed-upon procedures engagement – for example, whether the form of wording highlighted above constitutes "assurance" over the entire information covered or is a form of summary of findings from agreed-upon procedures.

- FEE believes that a standard on comfort letters should codify the existing practice that this is on the basis of specified agreed upon procedures and accompanied by an explanation that the procedures applied do not constitute an audit or a review. Such procedures should be tightly defined and related back to financial information.

GENERAL COMMENTS

The Discussion Paper has certainly resulted in an exchange of views that gives us valuable insights in the way at least the accountancy profession and bankers and advisers look at the issues. We had expected more comments from the issuers and regulatory community, but they are not among the respondents.

Most of the accountancy profession welcome and support the FEE Discussion Paper on Comfort Letters issued in relation to financial information in a prospectus. They recognise the need for an international standard for providing comfort letters that will harmonise the market practice.

In general, banks and advisers responded more negatively, as they seemed to believe that the Discussion Paper's proposals are based on a misunderstanding of the current market and would result in a position that would give the underwriters a lesser degree of comfort for their due diligence defence. They consider that the Prospectus Directive[3] does not give rise to the issues presented for discussion and that it does not change the prospectus liability requirements, since securities offerings across Europe on the basis of a single prospectus were already common practice. They refer to the US Statement on Auditing Standards N° 72 (SAS 72) type letter, which is often used as a basis in current practice for multinational offerings, especially for those also directed to investors in the US. In their view, the Prospectus Directive does not necessitate the changes they believe FEE proposed.

Some agree that the Prospectus Directive and the Regulation provide an opportunity to harmonise European comfort letter practices but question how in the absence of an EU-wide regime for the determination of prospectus-based liability (and its defences) the Discussion Paper can propose to harmonise comfort letter procedures within the EU. They believe it regrettable that a harmonisation of the applicable prospectus liability rules was omitted. This leads in their view to the fact that the requirements for the underwriters' diligence and their defence position in a prospectus liability lawsuit remain the same, being governed by the prospectus liability rules of the respective jurisdiction.

The SAS 72 Issue

When preparing the Discussion Paper, FEE considered this market practice, as well as the fact that some countries have their own guidance[4]. For the development of the model in the Discussion Paper, it was considered, among other issues, that:

- SAS 72 is developed for a legal environment that differs from that in most EU Member States;
- The Prospectus Directive has specific requirements with regard to interim financial information; and
- The current market practice results in a comfort letter that may be seen as inconsistent with the IAASB Framework, which would give rise to conflicts, as the IAASB guidance is to be used as the standard for auditors in the EU.

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[3] Commission Regulation EC 809/2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements

[4] Such as the German standard AuS910 issued by the Institut der Wirtschaftsprüfer in Deutschland (IDW) and the recommendation of the Institut Österreichischer Wirtschaftsprüfer in Austria. In addition, ICMA has a standard that has been agreed with the market participants

The model suggested in the Discussion Paper was developed with the aim of avoiding possible conflict with the IAASB Framework without resulting in a lesser level of comfort than is currently common in the market.

The responses outline an expectation gap that FEE believes does not exist to the extent that is expressed in some of the response letters. In order to demonstrate this, we contrast below the procedures performed under SAS 72 with those in the suggested model.

	SAS 72	**FEE proposals**
Unaudited condensed information (disclosed in the prospectus)	Requires US GAAS review under SAS 100 in order to provide a negative assurance opinion	Requires interim review under ISRE 2410[5] to perform a limited assurance engagement providing a negative assurance opinion[6]
Capsule financial information for periods subsequent to the last audited year end	Requires US GAAS review under SAS 100 in order to provide a negative assurance opinion	Requires interim review under ISRE 2410 in providing a negative assurance opinion
Pro forma financial information	Negative assurance under certain conditions	Not applicable, as covered by auditor's public reporting obligation under the EU Prospectus Regulation principally to report on proper compilation
Forecasts	Agreed upon procedures for reporting on compilation of a forecast	Not applicable, as covered by auditor's public reporting obligation under the EU Prospectus Regulation principally to report on proper compilation
Subsequent change in specific line items (through date of latest management accounts)	Limited assurance engagement based on defined procedures	Limited assurance engagement based on performing interim review under ISRE 2410 or report on factual findings based on defined agreed upon procedures
Subsequent change in specific line items (from date of latest management accounts to date of prospectus)	Limited assurance engagement based on defined procedures	Reporting on factual findings based on defined agreed upon procedures
Tables, statistics and other financial information	Agreed upon procedures where information has been obtained from accounting records subject to the same controls over financial reporting as the financial statements	Agreed upon procedures where information has been obtained from accounting records subject to the same controls over financial reporting as the financial statements.

5 International Standard on Review Engagements 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity.

6 *Limited assurance engagement* - The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

As shown in the table above, the differences between the FEE proposals and SAS 72 are limited. We note that the market is used to SAS 72 letters, which differ from the IAASB Framework. The IAASB should address the lack of guidance on comfort letters.

Other general comments

Some of the respondents do not advocate change; others recognise that it would be desirable to have a common, internationally recognised framework for providing comfort letters. FEE's starting point that currently there are different practices in each country is confirmed by the comment letters. It is thought beneficial for the market to have, as far as possible, a common approach. Respondents also note that the term "comfort letter" is ill-defined and may be used in different countries for a range of reporting situations.

FEE Recommendation

Although work performed in relation to the change period is generally considered to be of the agreed-upon-procedures type, there are some inconsistencies between current practice and the assurance and related service standards issued by IAASB, as indicated in the responses to Issue 1. These areas of difference should be further debated. The example comfort letter proposed in Appendix 1 of the Discussion Paper illustrates these differences and provides a good basis for further consideration if a standard or common approach is to be developed for use at international level.

Given the different views on the liability issues and the different requirements for responsibility, liability and reporting in different countries, it is unlikely that an international standard can address all issues.

Some countries have well established securities laws and auditing standards that together provide a framework for issuing comfort letters in their domestic markets. In circumstances where market practices are less well developed, and in the case of cross-border securities offerings, there is a greater need to establish common principles around the use of comfort letters.

These principles and objectives might include, for example:

- Reinforcing the fact that the comfort letter is issued in the context of the underwriters' responsibility to undertake enquiries and procedures;
- Making clear the respective responsibilities of management and the auditors for any financial statements referred to, and indicating the type of assurance work previously performed by the auditors on those statements;
- Indicating the auditors' independence;
- Making clear that the underwriters are responsible for setting the scope of the additional procedures the auditors agree to perform;
- Ensuring the limitations of the procedures the auditors perform are understood;
- Indicating clearly the dates of any "change period" and "cut-off" date in relation to procedures applied; and
- Making clear what law and/or legal jurisdiction will apply to the relationship with the recipients of the comfort letter.

1. INTRODUCTION

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?

Position as per the FEE Discussion Paper

In considering the comfort letter, the following possible reporting models were identified:

Firstly, the current practice where the comfort letter engagement is a mixture between an "agreed upon procedures" engagement addressing the extraction of financial data in a prospectus from specified sources, and "assurance" engagement with respect to financial information for periods after the date of the last audited annual accounts. This current practice, however, can cause difficulties in reconciling the comfort letter model with the IAASB International Framework for Assurance Engagements.

Secondly, 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. This is consistent with the IAASB International Framework for Assurance Engagements and would now be possible because the Prospectus Directive requires any assurance expressed on interim financial information to be included in the prospectus itself.

Thirdly, the comfort letter engagement could be said to be a "non-assurance" engagement, although the comfort letter, as permitted by the IAASB International Framework for Assurance Engagements, "includes professional opinions, views or wording from which a user may derive some assurance" if the conditions outlined in the assurance framework concerning such reporting and its use are followed.

This discussion paper is prepared on the second alternative and does not explore the other alternatives.

Summary of Responses[7]

Bankers and advisers generally prefer the continuation of the current reporting model and are less concerned about a conflict with the IAASB Framework that brought FEE to the model developed in the Discussion Paper. These respondents even consider that a reporting model that is based on agreed-upon procedures would weaken the contribution that the auditing profession can bring to a securities offering. These respondents refer to the international standard or reference point for comfort letters SAS 72. FEE notes that this standard, although it has international acceptance, is still a national standard that is based on the specific US situation. The legal systems in which the EU prospectus is to operate are significantly different from the US to warrant consideration.

[7] The responses have been summarised by the European Capital Markets Reporting Project Group. Individual respondents may have emphasised other aspects than those presented in the summary.

Respondents from Germany point out that the IDW AuS910 refers to the so-called "post audit review procedures", as a result of which auditors can either issue a negative assurance opinion to the effect that they are not aware of any adjusting events with respect to the latest financial statements occurring at the date of the respective auditors' report or report on the respective findings.

A number of respondents state that they do not agree with FEE's position that any assurance expressed on interim financial information is to be included in the prospectus itself. They hold that the Prospectus Regulation (EC) no. 809/2004 (the "Prospectus Regulation") only requires those audits reports that have already been published to be included.

Respondents note that accountants have often followed approaches that are based on or derived from SAS 72, and in particular the reporting approach to material changes, which includes a conclusion "whether the accountant has on the basis of work performed become aware of any increase or decrease in an agreed financial measure". This seems to combine the procedures for an agreed-upon engagement and the reporting for a review engagement. One of the respondents notes that they would welcome further debate on the form of wording that can be used in an agreed-upon procedures engagement – for example, on whether the form of wording highlighted above constitutes "assurance" over the entire information covered or is a form of summary of findings from agreed-upon procedures.

Another issue addressed is that ISRE 2410 is clearly relevant to consideration of obtaining assurance on accounts taken as a whole but is less clear on whether it applies to information that is restricted to the limited period and does not constitute full accounts. This also points to the need for standard setters to develop a specific standard on comfort letter engagements.

Respondents point out that an international approach or standard on comfort letters would most logically be developed by the IAASB. The IAASB already has in place a structure for its pronouncements, covering both assurance engagements and related services. The current practice and professional standards, such as the widely-used SAS 72, should be given consideration in the development of an international approach to ensure that an adequate degree of market acceptance can be attained.

FEE Recommendation

There is a general view that a comfort letter is a well accepted, but not well defined, instrument in the marketplace. Underwriters place much reliance on the comfort they derive from it, with SAS 72 as the common example. However, it should be noted that there are some potential inconsistencies between those current practices and the IAASB Framework. Users of comfort letters are less concerned with this difference than auditors. There is also support for a standardised comfort letter, including one that recognises that due regard should be given to the differences in legislation that will result in comfort letters that cannot be harmonised to the full extent.

FEE continues to believe that the suggested model (agreed upon procedures engagement) is a form of reporting that fits in the overarching framework for the auditor's engagements. We do not agree that the proposed model results in underwriters deriving less comfort. However, the current market practice agreed/upon procedures performed are combined with wording relating to the change period from a negative assurance opinion or conclusion '…nothing came to our attention as a result of the foregoing procedures that caused us to believe that...'

To be consistent with the IAASB's structure, any comfort letter standard would have to be more clearly presented as a limited assurance engagement or an agreed upon procedures engagement.

We have outlined in the illustrative comfort letter included in Appendix 1 of the FEE paper the procedures performed and factual findings, but without the accompanying negative assurance conclusion of the type mentioned above. We suggest that it needs to be considered whether this illustrative letter could be compatible with the IAASB's Framework, since each of the elements of work referred to in the letter is related to the respective assurance or related service standard. Further discussion is needed with interested parties as to whether the level of comfort is seen to be meeting the user requirements.

2. COMFORT LETTER

2.1 Addressee

Issues for Discussion 2, 3, 4, 5

Position as per the FEE Discussion Paper

In many places, underwriters can be held liable for material omissions and/or misstatements in a prospectus. The underwriters' defence against this liability is that they exercised due diligence, i.e., after a reasonable investigation, the underwriter had grounds to believe that there were no material omissions or misstatements. Consequently, underwriters perform a reasonable investigation of financial and accounting data that has not been "expertised." Expertised means that the information is covered by a report of independent auditors. One of the investigation procedures that an underwriter uses is to request the independent auditors to provide them with a "comfort letter" in relation to unexpertised financial information.

One of the components of such letters is the addressee.

The following parties can be recipients and addressees of the comfort letter, only if they have signed an engagement letter with the auditor, or the auditor by other means has ensured that the recipients have a clear understanding of the agreed procedures and the conditions of the engagement:

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.*

The auditor should ask to be provided with a draft of the underwriting agreement to understand the context in which a comfort letter will be issued.

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 the responsibility of the definition of the scope of work is with the underwriter, by the nature of the engagement (agreed-upon procedures), it is preferable to formalise the agreement of the scope of work in writing, especially from a liability standpoint.

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

Summary of Responses

Bankers and advisers state that it is uncommon in an international offering and unnecessary for the underwriter to sign an engagement letter because the underwriter has no contractual relationship with the auditor; it is the issuer that engages the auditor. The accounting profession is, however, generally of the opinion that an engagement letter is needed in order to clarify the respective positions of the parties. An exception may exist where a professional standard clearly defines this, as is the case with, for example, IDW AuS910.

Some respondents_view that national law determines the parties constituting parties to the contract, i.e. parties signing the engagement letter, and those constituting beneficiary third parties.

Others generally are of the opinion that it is best practice for accountants to issue a comfort letter only to those who have signed the engagement letter.

Although the bankers and advisers in general do not explain why an engagement letter is not needed at all or why there is no need for the underwriters to make a draft underwriting agreement available, it is also noted that other features address the situation. They mention that signing the engagement letter is unnecessary, as underwriting agreements for securities transactions in Europe commonly include the agreed form of comfort letter as an annex. FEE notes, however, that at the same time some respondents deny the auditor access to the underwriting agreement, which seems to be contradictory.

FEE Recommendation

Whether or not the underwriter has to sign an engagement letter depends on the applicable legal requirements. The law and regulations in different countries may have different stipulations as to the respective roles of the addressees and the need for written terms of engagement between the auditor and the recipients of the comfort letter.

FEE therefore proposes that a standard on comfort letters should not be too specific with respect to the contractual relationship, but could be limited to addressing the objectives of the report and the main issues an auditor should consider before issuing a comfort letter.

The most important issue is that each recipient of a comfort letter should be made fully aware of the type of engagement, and the requesting party, be they client or underwriter, should take responsibility for the adequacy of the scope of procedures performed by the auditor so as to avoid any misunderstanding regarding such matters and the extent of the auditor's responsibility.

Depending on the underlying legal framework, such awareness might be achieved either through an engagement letter signed by all recipients of a comfort letter or through the underlying professional standard or the comfort letter itself.

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 its capacity as underwriter, not in its capacity as an investor, (b) the comfort letter is part of the due diligence process that the bank has to perform in accepting its responsibility towards the investing public, and (c) it does not include other information than that in the prospectus.

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

Summary of Responses

Responses vary from the issue that the comfort letter does not provide additional information, to that it is the extra information in the comfort letter that is important to the underwriter.

Respondents note that banks, in order to perform their role in an offering, will of necessity receive non-public information that will not be made public to investors, including confidential contract information, detailed budgets, plans, forecasts and projections.

They do not believe that the issuance of a comfort letter creates a problem with regard to different levels of information. If the auditors, in preparing their comfort letter, or the underwriters, in their due diligence, discover anything that is material to investors, that information must be disclosed in the prospectus. If information is discovered that is not material to investors, it need not be disclosed.

One respondent mentions that the different roles of the bankers and underwriters (due diligence and marketing) may lead to conflicts. Although FEE agrees with this point, it is considered beyond the scope of the comfort letter that only fulfils due diligence.

FEE Recommendation

The obligation of those involved in preparing a prospectus to perform due diligence procedures inherently results in their receiving more information than an investor. It therefore seems neither unacceptable nor avoidable that comfort letters include information that is not included in the prospectus.

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?

Summary of Responses

All respondents agree that the auditor's client should relieve the auditor of his professional secrecy in all cases and that this should be a precondition for the issuance of a comfort letter. However, some mention that this release is subject to the applicable underlying national law.

FEE Recommendation

The release from confidentiality obligations is subject to the applicable national law. A standard for comfort letters should include such a release as a precondition for engagement; further details as to how this is achieved should not be part of the standard.

<u>Issue for Discussion 5</u>

It is practice for the auditor only to issue 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, 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) who 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?

Summary of Responses

Respondents that favour the approach of SAS 72 do not consider it necessary for those who receive the comfort letter without having a due diligence obligation to sign a representation letter. This conflicts both with current practice, as it refers to SAS 72 and with the concept of restricted circulation of an agreed-upon procedures report in accordance with ISRE 2410.

Some state that anyone who might be held responsible for the contents of a prospectus should be a possible addressee of a comfort letter to be able to use it for its legal defence. In contrast, other respondents note that a comfort letter should only be addressed to those persons who bear a legal responsibility for the prospectus (including a corresponding due diligence defence).

An interesting view is expressed with regard to management. Directors, as the persons responsible for the offering document, have a due diligence defence. However, FEE believes that the comfort letter should not be used by them for due diligence purposes, as it is deemed inappropriate for them to avoid their prospectus liability by referring to a comfort letter relating to information for which they are the owner/responsible originator. They should therefore only be copied under this view.

The responses show that there still appears to be some doubt as to whether the text proposed is sufficiently clear in stating the fact that a comfort letter does not diminish the obligation of the addressee to do their own due diligence. 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.

FEE Recommendation

The question of who is entitled to receive a comfort letter depends on the underlying legal requirements regarding responsibility for the content of a prospectus. FEE continues to believe a comfort letter should be addressed only to those persons who have a legal responsibility for the prospectus (including a corresponding due diligence defence). The letter is issued in order to support those persons in fulfilling their due diligence obligations. The respective statutory due diligence defence obligation is therefore the essential pre-condition for receiving a comfort letter.

FEE recommends that a standard for comfort letters should therefore include:

a) A presumption that the statutory due diligence obligation of the addressees is clearly determined by law;
b) If such responsibility is not clearly determined, a representation letter should be required to clarify the respective roles; and
c) In all cases, to state in a comfort letter that the comfort letter does not diminish the responsibility of its addressees to carry out their own independent due diligence procedures.

2.2 Reference to Auditing Standards

Issue for Discussion 6

Even if an audit base[8] 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 who has an audit base.

This situation can exist in several circumstances:

- **First year 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?

Position as per the FEE Discussion Paper

A comfort letter should only be issued when the auditor has an audit base. To have an audit base, the auditor must have audited at least one year's financial statements or, alternatively, 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. Typically, the latter alternative will require the auditor to have performed substantial audit work in connection with a first-time audit engagement for which he has not yet issued an audit report.

When the work is to cover periods prior to the period in which the auditor was initially engaged to audit, he also must have an in-depth knowledge of the accounting and financial reporting practices and system of internal accounting control that was utilised in those periods. The extent of the work needed to obtain this knowledge is a judgmental decision, to be made based on the circumstances encountered in the first-time-through work on the initial audit engagement.

[8] Audit base is meant to refer to the knowledge about the issuer and its business that normally is derived from performing an audit of the issuer's financial statements.

Summary of Responses

Most respondents agree that an audit base should not be required. There seems to be general acceptance for the situations where it is necessary for an auditor who has not previously audited the issuer’s financial statements to issue a comfort letter. Respondents acknowledge that it is unlikely that the auditors who have been replaced will be willing to issue a comfort letter.

The principle is, as with any other engagement, that an auditor issuing a comfort letter should have sufficient knowledge of the subject under consideration. In particular, for an assessment of financial information, as a minimum, the auditor will have to possess or obtain an understanding of the issuer’s internal control system relevant to its accounting function to facilitate an assessment of its appropriateness and effectiveness relevant to the engagement. This applies irrespective of whether the previous annual financial statements have been audited by the auditor issuing the comfort letter or by another auditor.

Respondents also noted that, where the comfort letter is restricted to agreed-upon procedures, it is an open question whether the factual findings of an accountant with an audit base would differ from the findings of an accountant without an audit base. At the same time, it is questionable whether a responsible and prudent accountant would agree to perform procedures in relation to information if the accountant had actual doubts as to its validity to be able to give the same comfort.

There is some disagreement with the illustrative wording set out in the paper (page 9). The suggested wording describes the standards adopted in connection with the audit of historical financial statements rather than the comfort letter. It is therefore inappropriate in the context of recording the basis for the comfort letter. The information that is contained in the illustrative wording will be available to banks/underwriters as a consequence of the published audit reports, and therefore even if it were thought to be information of interest to readers of the comfort letter, it is unnecessary for it to be repeated.

FEE Recommendation

FEE supports the principle that an auditor issuing a comfort letter should have sufficient knowledge of the subject matter under consideration – the financial information and records and the control systems around the financial reporting function. The auditor therefore has to exercise his or her professional judgement to decide the extent of knowledge or understanding of the issuer needed for the individual engagement. For an assessment of financial information, as a minimum, the auditor will have to possess or obtain a good understanding of the client and its business and financial reporting system in order to evaluate its appropriateness and effectiveness relevant to the engagement. This applies irrespective of whether the previous annual financial statements have been audited by the auditor issuing the comfort letter or by another auditor.

2.3 Independence

<u>**Issue for Discussion 7**</u>

The Independence Section of the IFAC Code of Ethics 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?

Position as per the FEE Discussion Paper

The auditor should be prepared to assert independence under those standards of independence specified by the auditing standards to which he refers.

Accordingly, a representation regarding the auditor's independence should be worded along the following lines:

> *"We are independent public auditors with respect to Issuer as required by the laws of [issuers country of incorporation] and under the applicable professional rules relating to independence of [NAME OF GOVERNMENTAL BODY OR PROFESSIONAL ORGANISATION PROMULGATING THOSE RULES]."*

If no published rules of independence exist in a particular country, the addressee of the letter should specify what rules were to be applied; for example, the Independence Section of the IFAC Code of Ethics for Professional Accountants issued by the International Federation of Accountants or the EC Recommendation on Statutory Auditor's Independence in the EU.

Summary of Responses

Many respondents supported that a section on independence should be part of the comfort letter. One respondent notes that if the scope of comfort letters is limited to agreed-upon procedures and if a comfort letter is the only professional service the accountants provide, the independence section of the IFAC Code of Ethics does not apply.

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.

Normally, a comfort letter is requested from the auditor that audited the latest financial statements included in the prospectus. The auditor is required to be independent with respect to the audit engagement so would be independent with regard to the issuance of the comfort letter. It is also mentioned that in situations where a comfort letter is requested from a predecessor auditor, independence should not be required to be maintained for the issuance of the comfort letter.

FEE Recommendation

It is common practice for the auditor to issue the comfort letter in his or her specific role as an independent accountant. A comfort letter is normally requested from the auditor that audited the latest financial statements included in the prospectus, and would therefore be independent with regard to the issuance of the comfort letter.

A special situation arises where a comfort letter is requested from a predecessor auditor. The standard comfort letter should include a reference to independence that should be modified accordingly in predecessor auditor situations, to indicate independence as of the date of the prior audit report included in the document.

2.4 Interim Information

Issue for Discussion 8

The discussion paper takes the position that any interim financial information that has been 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?

Position as per the FEE Discussion Paper

Under the current market practice, if the issuer has published interim financial information since the date of the last audited financial statements, these must be included in the registration document (Annex I - 20.6.1). If the registration document is dated more than nine months after the end of the last audited financial year, it should include interim financial information covering at least the first six months (Annex I - 20.6.2). These interim financial statements are not required to be audited (nor reviewed). However, if interim information is audited or reviewed, the auditor's report must be included in the prospectus. The issuer should not therefore require the auditor to perform an audit or a review of these interim financial statements for the unique purpose of providing private assurance to the underwriter.

If interim financial information is not audited or reviewed, the auditor will not be in a position to issue assurance on subsequent changes occurring from the date of the last audited historical financial statements to the date of the interim financial statements.

In order to ensure a certain level of assurance on these interim financial statements, the issuer could ask the auditor to review (or audit) these financial statements and should include the respective review (or audit) report in the prospectus.

Where the auditor has been requested to provide assurance on interim financial information, he must have conducted at least a review of the interim financial information in accordance with ISRE 2410 or other GAAS on reviews based on the ISRE.

The auditor does not provide assurance in the comfort letter on interim financial statements, as the review report is included in the offering document.

Summary of Responses

The Regulation seems to be very specific and clear with respect to the inclusion of interim financial information in a prospectus. However, the same does not apply to the inclusion of review reports in a prospectus.

National authorities responsible for the approval of prospectuses seem to adopt different views regarding the inclusion of review reports in prospectuses.

The Prospectus Directive requires as a principle that all previously *published* information should be presented to investors in a prospectus. In respect of reviews of interim financial information by auditors, this may imply that review reports should be included in prospectuses where such reports have previously been published (with the interim financial information) prior to the preparation of the prospectus. Where reviews were performed solely for the issuer's internal use – or in the case of a comfort letter, the issuer's and underwriters' internal purposes – but not to be provided to the public, such reports would seem to be outside the scope of the Regulation and may simply be referred to in a comfort letter.

With respect to the question of different levels of information being provided to the underwriters and the investors, see the responses to Issue 3 above.

FEE Recommendation

FEE recommends that the auditor does not provide assurance in the comfort letter on interim financial statements where the review report is already included in the offering document.

2.5 Subsequent Changes

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 engagement. Where the latter is required, the auditor needs to apply the procedures of a review (ISRE 2410), which requires interim information to be available at a date as close as possible to the cut-off date. No negative assurance opinion 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?

Summary of Responses

Most respondents agree that assurance through the date of a prospectus is not possible. Respondents from the banking and underwriting community do not consider a review of the underlying information as a necessity to give a negative assurance opinion. They refer to a negative assurance opinion on specific line items that SAS 72 foresees up to the cut-off date on agreed-upon procedures and not on the basis of a review in accordance with ISRE 2410. Therefore, they do not consider that ISRE 2410 provides a standard for providing a negative assurance opinion in respect of subsequent changes.

Respondents from the accountancy profession refer to the IAASB Framework and note that within this structure, a negative assurance opinion can only be given when the auditor has performed procedures in accordance with ISRE 2410. In all other cases, the report will be limited to reporting factual findings.

In current international market practice, accountants do not perform an ISRE 2410 review for subsequent changes, but it is customary to provide comfort on the basis of specified agreed-upon procedures.

FEE Recommendation

With regard to the IAASB assurance standards, FEE believes that *assurance* can only be provided through performing an audit or review-type engagement. Therefore, assurance through the cut-off date of a comfort letter may only be provided in accordance with the respective requirements of the IAASB standards. .

There is a practice (and a legitimate need) to provide underwriters that certain line items are not changed through a cut-off date compared with the position reported in the previous financial statements.

FEE believes that a standard on comfort letters should codify the existing practice that this is on the basis of specified agreed-upon procedures and accompanied by an explanation that the procedures applied do not constitute an audit or a review. Such procedures should be tightly defined and related back to financial information.

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?

Summary of Responses

The respondents from the banking and underwriting community generally have not answered this question, as they believe (see issue for discussion 9 above) that a review is not a condition for a limited assurance engagement on subsequent changes.

The other respondents agree with the criteria proposed in the FEE Discussion Paper. Where comfort is provided on the basis of internal monthly reports, such reports should consist at least of a condensed balance sheet and a condensed income statement, each prepared on a basis substantially consistent with that of the last financial statements.

FEE Recommendation

Where comfort is provided on the basis of internal monthly financial reports, such reports should consist of at least a condensed balance sheet and a condensed income statement, each prepared on a basis substantially consistent with that of the last annual or interim financial statements. The auditor should have sufficient knowledge and understanding of the internal control system that safeguards the quality of such internal reports.

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?

Summary of Responses

Respondents 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. They mention that auditors are not normally asked to provide comfort to such general assertions.

FEE Recommendation

General assertions such as "material adverse changes" should not be referred to in a comfort letter. FEE accepts that an essential element of a comfort letter is to provide comfort with respect to changes in financial statement items during the change period. This financial information should be prepared on a basis consistent with the accounting standards applied in the issuer's financial reporting. In order to avoid any misunderstanding, a comfort letter should only refer to such financial statement items, but not to any other terms that are not defined in the relevant accounting standards.