

Comfort Letter Procedures Relating to Capsule Financial Information Presented In a Registration Statement Prior to the Issuance of the Year-End Financial Statements

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Notice to Readers

Issuers sometimes undertake securities offerings after their year-ends, but before the issuance of their annual audited financial statements. This paper provides a framework for evaluating the types of comfort letter procedures that an independent accountant could perform in connection with information included or incorporated by reference in securities offerings related materials relating to an issuer's fourth quarter when the annual audited financial statements have not been issued.

This paper was developed by, and reflects the views of, a task force of the Center for Public Company Audit Firms' SEC Regulations Committee. It provides knowledgeable individuals with a framework to assess the types of procedures that could be performed, however caution and individual judgment, based on facts and circumstances should be exercised when considering performing procedures on information which is the subject of ongoing audit procedures and/or which is subject to change until the issuance of the annual audited financial statements.

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Executive Summary

Issuers frequently prepare registration statements after year-end but before issuing their year-end financial statements. Those registration statements oftentimes include capsule financial information for the recently completed 4th quarter and fiscal year (e.g., information that is included in an earnings release).

As part of their due diligence procedures, underwriters frequently request accountants to perform procedures with respect to the capsule financial information.

Accountants must exercise caution when considering performing procedures and reporting results that relate to information which is the subject of ongoing audit procedures and/or which is subject to change once the issuer finalizes and issues its year-end financial statements.

Issue

Underwriters frequently ask accountants to provide a comfort letter in connection with securities offerings that take place after the issuer's fiscal year-end but prior to the date that the issuer has "issued" its year-end financial statements¹.

Registration statements prepared during this timeframe oftentimes include² capsule financial information for the fourth quarter and/or full year notwithstanding the fact that the year-end financial statements have not been "issued".

A number of questions arise as to what level of comfort the accountant should consider providing (at the request of the underwriter) on the fourth quarter or full year capsule financial data in connection with a registration statement that is declared effective prior to the issuance of the year-end financial statements.

Underwriter requests for comfort on this type of capsule data generally include one or more of the following:

1. Positive assurance that the year-end capsule financial information has been audited (or the year-end financial statements have been audited);
2. Negative assurance that the capsule information for full year or the 4th quarter have been reviewed pursuant to Statement on Auditing Standards No. 100 "Interim Financial Information" (or that the underlying 4th quarter or full year financial statements have been reviewed under SAS 100);
3. Reading unaudited financial information for the 4th quarter and reporting certain changes in specified financial statement elements;

¹The term "issued" in this paper is used in the context as it was interpreted by the SEC staff in EITF Topic No. D-86. Financial statements are considered issued "as of the date they are distributed for general use and reliance in a form and format that complies with generally accepted accounting principles (GAAP) and, in the case of annual financial statements, that contain an audit report that indicates that the auditors have complied with generally accepted auditing standards (GAAS) in completing their audit. Issuance of financial statements then would generally be the earlier of when the annual or quarterly financial statements are widely distributed to all shareholders and other financial statement users or filed with the Commission." Financial statements would not be considered issued as of the date of either an earnings release or posting of financial statements to the registrant's web site.

²Throughout this paper references to "included" are intended to mean "included or incorporated by reference".

4. Inquiring of company officials as to changes in specified financial statement elements;
5. Agreeing the 4th quarter or full year capsule financial information to the company's accounting records (commonly referred to as "tickmark" comfort).

The purpose of this paper is to explain what types of procedures accountants are generally willing to perform on behalf of and report to underwriters relating to 4th quarter and full year capsule financial information included in a registration statement prior to the time that the year-end financial statements have been issued.

Background

Section 11 of the Securities Act of 1933 (the "Act") provides that underwriters could be liable if any part of a registration statement contains material omissions or misstatements. Specifically, Section 11(a) of the Act provides (in part) that every underwriter with respect to a security may be sued by any person acquiring that security if any part of the registration statement contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

Section 11(b)(3) of the Act, however, provides that the underwriter would not be liable if he sustains "the burden of proof that (among other things)...:

as regards any part of the registration statement not purporting to be made on the authority of an expert [e.g., the capsule financial information]...he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading;..."

The standard of reasonableness for purposes of determining what constitutes a reasonable investigation and a reasonable ground for belief under Section 11(b)(3) "...shall be that required of a prudent man in the management of his own property".³ This is commonly referred to as the "due diligence" defense.

³See Section 11(c) of the Act.

Underwriters generally request that accountants issue a comfort letter with respect to certain information included in the registration statement as one of a number of procedures that may be used to establish that an underwriter has conducted a reasonable investigation⁴.

Statement on Auditing Standards No. 72 “Letters for Underwriters and Certain Other Requesting Parties” (SAS 72/AU 634) provides guidance to accountants for performing and reporting on the results of engagements to issue comfort letters to underwriters. SAS 72 provides for several different types of procedures which an accountant may, at the request of the underwriter, consider⁵ performing.

The Parties Involved

There are three key parties involved with a comfort letter to be issued in connection with an underwritten registered offering: the issuer, the underwriter and the accountant.

The issuer is responsible for preparing the registration statement and determining its contents. By including the capsule financial information in the document, the issuer is likely attempting to ensure that investors have the most current information available for purposes of making an investment decision. The information that the issuer determines to present in the registration statement is a key factor in establishing the population of information that the underwriter must consider in designing his “due diligence” procedures.

The underwriter is also striving to ensure that the offering materials contain the appropriate information. However, unlike issuers which are always directly liable for material misstatements or omissions in the registration statement (including the capsule financial information), the underwriter may have the ability to “avoid” liability for a material misstatement or omission in the registration statement (including the capsule financial data) if the underwriter can show that after reasonable investigation, the underwriter had reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

⁴AU 634.12 states: “What constitutes a reasonable investigation of unaudited financial information sufficient to satisfy an underwriter’s purposes has never been authoritatively established. Consequently, only the underwriter can determine what is sufficient for his or her purposes.”

⁵It is important to note that neither the Act nor SAS 72 obligates the accountant to issue a comfort letter and there is nothing which would preclude the underwriter from performing (for himself) all of the “due diligence” procedures he believes are necessary in order to demonstrate that a reasonable investigation was performed.

The accountant's primary role is to audit the annual financial statements included in the registration statement. However, as a service, an accountant may also issue a comfort letter reporting the results of certain procedures (selected by the underwriter as considered necessary in connection with performing his "due diligence").

Performing Procedures on Information that Is Subject to Change

There is a natural tension that exists when an underwriter asks the accountant to perform procedures on capsule financial information for a period more current than the financial statements included in the registration statement.

The issuer, by not including the year-end financial statements in the registration statement, is acknowledging that the audited financial statements are, in fact, not available.⁶

The underwriter, however, wants to ensure that the registration statement has the appropriate level of current information while protecting himself from liability.

Accountants want to facilitate, to the extent practical and appropriate, the capital formation process, but are reluctant to perform procedures on capsule financial information and report findings in the context of a comfort letter when the financial statements underlying that data are not yet complete and have not been issued. In fact, oftentimes, the accountant is in the process of performing an audit of the underlying financial statements at the time that the comfort letter is issued, thus putting the accountant in the position of being asked to comment on balances and amounts which are subject to change⁷ and which are currently being subjected to a higher level⁸ of professional service.

⁶Rule 3-12(c) of Regulation S-X states that: "Where a filing is made near the end of a fiscal year and audited financial statements for that fiscal year are not included in the filing, **the filing shall be updated with such audited financial statements if they become available** prior to the anticipated effective date, or proposed mailing date in the case of a proxy statement." [emphasis added]

⁷Even if audit fieldwork is substantially complete or the date of the audit report has passed, both the issuer and the auditor are responsible for evaluating post-balance sheet (pre-issuance) subsequent events for their impact on the financial statements and disclosures **up to the issuance date.**

⁸An audit (the expression of an opinion, or positive assurance, as to whether a particular set of financial statements presents fairly, in all material respects, the financial position, and results of operations and cash flows in conformity with generally accepted accounting principles) is a higher level of professional service as compared to reporting in a comfort letter either negative assurance or findings as a result of applying agreed upon procedures specified by the underwriter.

Reporting the results of procedures on balances and amounts, which are the subject of ongoing, soon to be undertaken or completed auditing procedures, and which are still subject to change, is a risky proposition that the accountant must approach with caution to avoid assuming undue and disproportionate risk.

There are, however, a number of procedures which accountants are generally willing to perform on capsule financial information prior to the date that the year-end financial statements are issued. However, prior to considering any level of comfort on 4th quarter or full fiscal year capsule financial information, the accountant must first consider the issuer's circumstances such as the internal control environment, past history of audit adjustments, open contingencies (including the likelihood of resolution prior to "issuance" of the financial statements) and the nature of the business.

A discussion of the various types of comfort letter procedures on capsule financial information that underwriters may request accountants to perform prior to the date that the year-end financial statements are issued (together with any relevant milestones that must be achieved prior to the accountant being in a position to give the indicated comfort) is presented below:

Negative assurance that the capsule information for the full year has been reviewed pursuant to Statement on Auditing Standards No. 100 "Interim Financial Information" (or that the underlying full year financial statements have been reviewed under SAS 100)

An accountant cannot give SAS 100 negative assurance on financial information for a company's full fiscal year because SAS 100 only applies to interim financial information as that term is defined in AU 722.02.

Negative assurance that the capsule information for the 4th quarter has been reviewed pursuant to SAS 100 (or that the underlying 4th quarter financial statements have been reviewed under SAS 100)

Paragraphs 37 and 38 of AU 634 state that accountants can comment, in the form of negative assurance, on unaudited condensed interim information when they have conducted a SAS 100 review, in which case the accountants must (i) state in the comfort letter that the information has not been audited and (ii) disclaim an opinion thereon. Paragraph 39 of AU 634 states that accountants can comment, in the form of negative assurance, on capsule financial information only when they have conducted a SAS 100 review of the financial statements underlying the capsule financial information.⁹

⁹AU 634.39 provides that negative assurance as to conformity with GAAP is limited to capsule information that complies with the minimum disclosure requirements of Accounting Principles Board (APB) Opinion No. 28. Otherwise, negative assurance is limited to consistency with the audited financial statements.

However, as noted above, management is responsible for evaluating subsequent events until the time that year-end financial statements are issued. Therefore, until the financial statement issuance date, management is not in a position to assert that the financial statements are final. Additionally, until the audit is complete and the financial statements are issued, there may well be adjustments to the balances and amounts included in the capsule financial information and those adjustments may be material.

Even though SAS 72 does not otherwise place specific conditions on giving SAS 100 negative assurance on 4th quarter financial statements or capsule information, the facts that i) financial statement balances and amounts are subject to change and ii) are subject to on-going audit procedures should result in the exercise of extreme caution by the accountant.

Recognizing this, the accountant should wait until audit fieldwork is substantially complete¹⁰ and the year-end financial statements are in substantially final form¹¹ before considering providing SAS 100 negative assurance on the 4th quarter financial statements or capsule information. If the accountant is in a position to give this level of comfort, 4th quarter financial statements must be prepared (at an S-X Article 10 level of detail, with all required financial statements and disclosures) and must be attached to the comfort letter if not included in the registration statement (see AU 634.41).

Reading unaudited financial information for the 4th quarter and reporting certain changes in specified financial statement elements

SAS 72 permits an accountant to give negative assurance that he has read the issuer's financial information for October, November and December (for a calendar year end company) and that he is unaware of certain specified changes in financial statement amounts (see paragraphs 4b and 5b of Example A to SAS 72).

¹⁰ The independent accountant must exercise professional judgment in determining what constitutes "substantially complete". Some accountants may view "substantially complete" as fieldwork being complete (having reached the audit report date). Other accountants may view "substantially complete" as audit procedures having sufficiently advanced to a point that the accountant is satisfied that there are no significant matters that would likely cause a change in the numbers on which comfort is being considered.

¹¹ The independent accountant must exercise professional judgment in determining what constitutes "substantially final form". Some accountants may view "substantially final form" as being the same as "issued". Other accountants may view "substantially final form" as having been through the full measure of a company's internal quality control procedures (including any planned involvement/review by senior management, company counsel, the disclosure committee, the audit committee and the board of directors) but not requiring that the financial statements be issued. Still others may view "substantially final form" as being primary financial statements with key footnote disclosures (but not necessarily through the full measure of internal quality control procedures and senior management/audit committee/board/counsel/disclosure committee review).

Even though SAS 72 does not otherwise place specific conditions on giving negative assurance as to specified changes in financial statement amounts based on reading subsequent financial statements through the end of a fiscal year, the facts that i) the 4th quarter/year-end financial information cannot be finally determined until the year-end financial statements are “issued” and ii) the accountant either has been engaged to perform or is performing an audit on the annual period, indicate that the accountant should exercise extreme caution in providing this level of comfort prior to the completion of the audit.

Recognizing this, the accountant should consider providing negative assurance as to specified changes in financial statement amounts based on reading subsequent financial statements through the end of a fiscal year only after audit fieldwork is substantially complete¹²(even if the annual financial statements are not in substantially final form)¹³. The accountant could however provide negative assurance that he has read financial information for a shorter period within the fourth quarter (e.g., one or two months) even if the audit fieldwork is not substantially complete.

Inquiring of company officials as to changes in specified financial statement elements

SAS 72 permits an accountant to give negative assurance that he has inquired of company officials and that he is unaware of certain specified changes in financial statement amounts up to a date that is less than 135 days from the end of the most recent period for which the accountant has performed an audit or review (see paragraph 6 of Example A to SAS 72).

Even though SAS 72 does not otherwise place specific conditions on giving negative assurance as to specified changes in financial statement amounts based on inquiries as of or subsequent to the end of a fiscal year, the facts that i) the 4th quarter/year-end financial information cannot be finally determined until the year-end financial statements are “issued” and ii) the accountant either has been engaged to perform or is performing an audit on the annual period, indicate that the accountant should exercise extreme caution in providing this level of comfort prior to the completion of the audit.

¹²See footnote 10.

¹³ The independent accountant should apply judgment and may determine that prior to agreeing to provide this level of comfort that the company must publicly disseminate 4th quarter information (e.g., an 8-K with primary financial statements but no footnotes) as evidence supporting management’s assertion that the information has been prepared on a basis consistent with the audited financial statements and has been subjected to the appropriate internal quality control processes. Additionally, the accountant may decide to comment in the comfort letter that the accountant has not completed the audit of the full year financial statements and that the 4th quarter information is still subject to change.

Recognizing this, if the cut-off date is year-end, the accountant should make these inquiries only after substantially completing the year-end audit field work (even if financial statements are not in substantially final form)¹⁴.

The accountant can consider making these inquiries and reporting the results even if he has not substantially completed the audit or fourth quarter SAS 100 review procedures as long as the cutoff date is not the year-end¹⁵ (mindful of the 135 day rule discussed above).

Agreeing the 4th quarter or full year capsule financial information to the company's accounting records (commonly referred to as "tickmark" comfort)

Paragraph 55 of AU 634 permits an accountant to agree certain information relating to an unaudited period to an issuer's accounting records if the accountant has performed an audit of the financial statements for a period including or immediately prior to the unaudited period or if they have otherwise obtained knowledge of the issuer's internal control (as described in AU 634).

Even though SAS 72 does not otherwise place specific conditions on commenting on financial amounts related to the recently completed fiscal year or fourth quarter thereof, the facts that i) the 4th quarter/year-end financial information cannot be finally determined until the year-end financial statements are issued and ii) the accountant either has been engaged to perform or is performing an audit on the annual period, indicates that the accountant should exercise caution in providing this level of comfort prior to the completion of the audit.

Recognizing this, an accountant should agree fourth quarter and full year information to the issuer's accounting records (so-called "tick mark comfort") only after audit fieldwork is substantially complete (even if financial statements are not substantially in substantially final form)¹⁶.

¹⁴Ibid.

¹⁵ If the cut-off date extends beyond year-end, the accountant may wish to wait until audit fieldwork is substantially complete and apply the guidance in footnote 13 above. Alternatively, the accountant may decide to restrict his comments to reporting the results of the inquiries (rather than expressing negative assurance) similar to paragraph 4c of Example O of SAS 72.

¹⁶See footnote 13.

Positive assurance that the year-end capsule financial information has been audited (or the year-end financial statements have been audited);

Underwriters sometimes request that accountants make a statement in the comfort letter indicating that an audit of the recently ended fiscal year is complete prior to the date that the client has issued the underlying annual financial statements.

The accountants should not comment on the completion (or the status, other than the fact that the audit is pending completion) of the audit prior to the issuance of the underlying financial statements. Even though audit fieldwork may be substantially complete or the date of the audit report has passed, both the company and the auditor are responsible for evaluating post-balance sheet (pre-issuance) subsequent events for their impact on the financial statements and disclosures **up to the issuance date.** Therefore management cannot assert that the financial statements are complete until the date that the financial statements are issued. Since management is not in a position to represent that the financial statements are complete, the auditor cannot indicate that the audit is complete. Additionally, as noted above, if the audited financial statements were complete (and therefore, by definition, “available”), S-X 3-12(c) would require that they be included in the registration statement.

Summary of Procedures and Milestones

	<u>Y e a r e n d</u>		Fourth	Fourth
	F/S Issued	F/S In Substantially(1) Final Form	Audit Fieldwork Substantially(2) Review Complete	Quarter SAS 100 Review Complete
SAS 100-level assurance on full-year f/s or capsule information	Precluded by SAS 100			
Audit-level assurance on full-year f/s	Yes			
SAS 100-level assurance on 4 th quarter f/s or capsule information	*** ⁽⁴⁾	Yes ⁽³⁾		Yes ⁽³⁾
Read 4 th quarter info and report changes	***	Yes		***
Read info for 1 st two months of 4 th quarter and report changes	***	***	***	Yes ⁽⁵⁾
Inquire of mgt. with respect to changes—cut-off date <u>after</u> year-end	***	***	***	*** ⁽⁶⁾
Inquire of mgt. with respect to changes—cut-off date is year-end		***	*** ⁽⁷⁾	*** ⁽⁷⁾
Inquire of mgt. with respect to changes—cut-off date <u>before</u> year-end	***	***	Yes ⁽⁶⁾	*** ⁽⁶⁾
Agree 4 th quarter or full year information to the books and records (tickmark comfort)	***	***	***	***
			Yes ⁽⁶⁾	*** ⁽⁶⁾

Yes = Must be completed prior to giving the indicated level of comfort.

*** = Subject to the accountant's judgment, need not be completed prior to giving the indicated level of comfort.

- (1) Refer to footnote 11 on page 7.
- (2) Refer to footnote 10 on page 7.
- (3) Given that issuance of audited financial statements is a pre-requisite to giving this level of comfort, financial statements must be in final form and the audit and 4th quarter SAS 100 reviews must also be complete.
- (4) Given that there is likely an audit of the fiscal year that is ongoing or to begin shortly, the independent accountant should exercise judgment and may conclude that prior to giving SAS 100 negative assurance on the 4th quarter capsule financial information (or 4th quarter financial statements) that the audited financial statements must be issued.



- (5) The 4th quarter financial statements must be prepared using an S-X Article 10 level of detail, including all required financial statements and disclosures, and must be attached to the comfort letter (if not included in the document).
- (6) See footnote 13 on page 8.
- (7) See note 15 on page 9.