SAS 72 letters

Seeking comfort

Peter Castellon of **Proskauer Rose LLP** and **Dagmar Von Diessl** explain the purpose and content of SAS 72 comfort letters in connection with international offerings of equity securities.

Illustration: Getty Images

In connection with an international offering of securities, underwriters will generally require the issuer's independent auditors to deliver comfort letters regarding the issuer's financial condition and certain financial information contained in the offering document.

Issuers' auditors typically have tried to limit the level of comfort provided in, and the liability associated with, such letters, at times making the negotiation of the terms of the letters a contentious and time-consuming process.

This article considers the purpose and content of so-called "SAS 72" comfort letters in connection with international offerings of equity and debt securities. It also discusses briefly other forms of comfort letters that may be used in international offerings sold only outside the US (*see "Types of offering" and "Other auditors' comfort letters" below*).

SAS 72

The form and content of the most commonly used comfort letter in international offerings is governed by the US accounting profession's AU Section 634 "Letters for Underwriters and Certain Other Requesting Parties", generally referred to as SAS 72 as it was initially issued as Statement on Auditing Standards No 72.

SAS 72 was implemented by the accounting profession to standardise and provide guidance on comfort letters. There is no obligation under SAS 72 (or any law or regulation) on the issuer's auditors to issue a comfort letter in connection with a securities offering.

SAS 72 contains specific instructions that govern when and to whom a comfort letter may be issued, the scope of information that may be provided within a comfort letter, as well as examples of comfort letters that should be delivered in certain situations (*see box "Sample SAS 72 comfort letter"*).

Market practice, accounting principles and guidelines, and internal policies at the "Big Four" accounting firms are also important in respect of certain matters not clearly addressed by SAS 72. When an SAS 72 comfort letter is requested from the issuer's auditors, it is prudent to confirm that an international specialist at the auditing firm is involved early in the transaction timetable.

Sample SAS 72 comfort letter for an international Rule 144A offering

[*Date of final offering document*]

[*Underwriters, or Lead Underwriters on behalf of all Underwriters*]

[*Board of Directors of Company*]

Dear Sirs:

We have audited the consolidated balance sheets of The Blank Company, Inc. (the "company") and subsidiaries as of December 31, 20YY and 20XX, and the consolidated statements of income, retained earnings (shareholders' equity), and cash flows for each of the three years in the period ended December 31, 20YY, all included in the offering circular for [*identify number of securities*] [*identify securities*] of the company; our report with respect thereto is also included in the offering circular. The issuance and sale of the [*identify securities*] includes a public offering in [*identify jurisdiction*] and is being carried out elsewhere as a private placement of securities in accordance with Regulation S and Rule 144A under the US Securities Act of 1933, as amended (the "Act").

This letter is being furnished in reliance upon your representations to us that:

(a) You are knowledgeable with respect to the due diligence review process that would be performed if this placement of securities were being registered pursuant to the Act.

(b) In connection with the offering of [*identify securities*], the review process you have performed is substantially consistent with the due diligence review process that you would have performed if this placement of securities were being registered pursuant to the Act.

In connection with the offering circular:

1. We are independent public auditors with respect to [*identify the company*] under rule 101 of the AICPA's Code of Professional Conduct and its interpretations and rulings.

2. We have not audited any financial statements of the company as of any date or for any period subsequent to December 31, 20YY; although we have conducted an audit for the year ended December 31, 20YY, the purpose (and therefore the scope) of the audit was to enable us to express our opinion on the consolidated financial statements as of December 31, 20YY, and for the year then ended, but not on the financial statements for any interim period within that year. Therefore, we are unable to and do not express any opinion on the unaudited condensed consolidated balance sheet as of March 31, 20ZZ, and the unaudited condensed consolidated statements of income, retained earnings (shareholders' equity), and cash flows for the three-month periods ending March 31, 20ZZ and 20YY, included in the offering circular, or on the financial position, results of operations, or cash flows as of any date or for any period subsequent to December 31, 20YY.

3. For purposes of this letter we have read the 20ZZ minutes [*should include all minutes back to the end of last audit period*] of meetings of the shareholders, the board of directors, and [*include other appropriate committees, if any*] of the company and its subsidiaries as set forth in the minute books at [*date of up to 5 days before issuance of comfort letter, referred to herein as the cut-off date*], 20ZZ, officials of the company having advised us that the minutes of all such meetings through that date were set forth therein; we have carried out other procedures to [*cut-off date*], 20ZZ, as follows (our work did not extend to the period from [*date on which the period not covered by comfort letter commences*], 20ZZ, to [*date of issuance of comfort letter*], 20ZZ, inclusive):

(a) With respect to the three-month periods ended March 31, 20ZZ and 20YY, we have:

(i) Performed the procedures specified by the American Institute of Certified Public Auditors for a review of interim financial information as described in SAS No. 71, Interim Financial Information, on the unaudited condensed consolidated balance sheet as of March 31, 20ZZ, and unaudited condensed consolidated balance sheet as of March 31, 20ZZ, on the unaudited condensed consolidated statements of income, retained earnings (shareholders' equity), and cash flows for the three-month periods ended March 31, 20ZZ and 20YY, included in the offering circular.

(ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited condensed consolidated financial statements referred to in 3(a)(i) above are stated on a basis substantially consistent with that of the audited consolidated financial statements included in the offering circular and comply as to form in all material respects with [*company's governing GAAP*].

(b) With respect to the period from April 1, 20ZZ, to May 31, 20ZZ, we have:

(i) Read the unaudited condensed consolidated financial statements of the company and subsidiaries for April and May of both 20YY and 20ZZ furnished to us by the company, officials of the company having advised us that no financial statements as of any date or for any period subsequent to May 31, 20ZZ, were available.

(ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited condensed consolidated financial statements referred to in 3(b)(i) above are stated on a basis substantially consistent with that of the audited consolidated financial statements included in the offering circular.

The foregoing procedures do not constitute an audit conducted in accordance with [*company's governing GAAP*]. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations regarding the sufficiency of the foregoing procedures for your purposes.

4. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that:

(a) Any material modifications should be made to the unaudited condensed consolidated financial statements described in 3(a)(i) included in the offering circular for them to be in conformity with accounting principles generally accepted in [*company's local jurisdiction*].

(b) At May 31, 20ZZ, there was any change in the capital stock, increase in long-term debt, or decrease in consolidated net current assets or shareholders' equity of the consolidated companies as compared with amounts shown in the March 31, 20ZZ, unaudited condensed consolidated balance sheet included in the offering circular, or (ii) for the period from April 1, 20ZZ, to May 31, 20ZZ, there were any decreases, as compared to the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income, except in all instances for changes, increases, or decreases that the offering circular discloses have occurred or may occur.

5. As mentioned in 3(b), company officials have advised us that no financial statements as of any date or for any period subsequent to May 31, 20ZZ, are available; accordingly the procedures carried out by us with respect to changes in financial statement items after May 31, 20ZZ, have, of necessity, been even more limited than those with respect to the periods referred to in 3. We have inquired of certain officials of the company who have responsibility for financial and accounting matters whether (a) at [*cut-off date*], 20ZZ, there was any change in the capital stock, increase in long-term debt or decrease in consolidated net current assets or shareholders' equity of the consolidated companies as compared with amounts shown on the March 31, 20ZZ, unaudited condensed consolidated balance sheet included in the offering circular or (b) for the period from April 1, 20ZZ, to [*cut-off date*], 20ZZ, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in paragraph 3, nothing came to our attention that caused us to believe that there was any such change, increase, or decrease, except in all instances for changes, increases, or decreases that the offering circular discloses have occurred or may occur.

6. For purposes of this letter, we have read the items that you have identified on the attached copy of pages from the offering circular, and have performed the following procedures, which were applied as indicated with respect to the symbols explained below:

Ref.	Procedures and Findings
A	Compared the amounts with the corresponding amounts appearing in the audited consolidated financial statements of the company included in the offering circular and found the amounts to be in agreement.
B	Compared the amounts with the corresponding amounts appearing in the unaudited condensed consolidated financial statements of the company included in the offering circular and found the amounts to be in agreement.
C	Compared the amounts contained in the offering circular with the corresponding amounts in the company's accounting records and found the amounts to be in agreement.
D	Recalculated the amounts or percentages from information contained in the financial statements (audited and reviewed) or accounting records of the company, compared them to the amounts or percentages in the offering circular and found the amounts or percentages to be in agreement.
E	Recomputed the amounts or percentages for arithmetical accuracy and, except for rounding, found the amounts to be in agreement.

7. The result of our described procedures follows from the attached copy of pages from the offering circular in which all items are marked with the respective symbols (A, B, C, D, and E) based on the task performed.

8. Our audit of the consolidated financial statements for the periods referred to in the introductory paragraph of this letter comprised audit tests and procedures deemed necessary for the purpose of expressing an opinion on such consolidated financial statements taken as a whole. For none of the periods referred to therein, or any other period, did we perform audit tests for the purpose of expressing an opinion on individual balances of accounts or summaries of selected transactions such as those that have been marked on the attached copy of pages from the offering circular and, accordingly, we express no opinion thereon.

9. It should be understood that we make no representations regarding questions of legal interpretation or regarding the sufficiency for your purposes of the procedures enumerated in paragraph 6 above; also, such procedures would not necessarily reveal any material misstatement of amounts or percentages so addressed. Further, we have addressed ourselves solely to the foregoing data as set forth in the offering circular and make no representations regarding the adequacy of disclosure or regarding whether any material facts have been omitted.

10. We have read the "[*summary description of differences between US GAAP and local GAAP*]" and are not aware of any significant differences between [*local GAAP*] and US GAAP that are relevant to the company's financial information included in the offering circular and that are not disclosed in such [*summary description of differences*].

11. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the offering circular, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the offering circular or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of securities covered by the offering circular.

Very truly yours,
[*Auditors' Signature*]

TYPES OF OFFERING

Under US securities laws, all offerings of securities must be registered under the US Securities Act of 1933, as amended (Securities Act) or sold under an exemption or safe harbour from registration. Some of the best known exemptions from registration under the Securities Act include the exemptions under Rule 144A for offers and sales to institutional investors and under Regulation S for offers and sales outside the US.

In connection with almost any marketed offering of securities extended into the US for which there is a prospectus or offering document, the underwriters will request an SAS 72 comfort letter. This includes a registered US offering under the Securities Act or a Rule 144A offering. The types of offering include:

- Primary offerings (including initial public offerings).
- Secondary offerings.
- Equity offerings.
- Debt offerings.

In addition, SAS 72 is frequently the form used for international equity offerings not extended into the US. Accountants will sometimes propose using the standard form comfort letter of the International Capital Markets Association (ICMA) for international equity offerings not extended into the US, but this should be resisted as the ICMA letter is the standard for non-US offerings of non-convertible debt securities.

There is no substantial difference in the content of an SAS 72 comfort letter based on the type of offering: there are not separate versions for use in debt and equity, or for use in the US and for use outside the US.

PURPOSE OF COMFORT LETTERS

Comfort letters from auditors fulfil a variety of purposes:

Defence to liability

In connection with offerings into the US under Rule 144A, comfort letters help to establish a defence against liability under Rule 10b-5 (made under section 10(b) of the US Securities Exchange Act of 1934, as amended).

Under Rule 10b-5, liability in connection with the offering document may arise if:

- There is an omission of material information, the disclosure of which is necessary to make the statements in the offering document not misleading in light of the circumstances under which they were made.
- Materially misleading information is included in the offering document.

Liability under Rule 10b-5 also requires an intent to deceive, manipulate or defraud, or reckless disregard for the truth.

Given the potential liability under Rule 10b-5 and other US securities laws, underwriters and their lawyers carry out a detailed due diligence review of the issuer to ensure that the disclosure is adequate. This review has its origins in section 11 of the Securities Act (section 11), which provides a private right of action for any security sold under a registration statement filed with the US Securities and Exchange Commission (SEC) that contained an untrue statement of a material fact or omission of a material fact that was required to be stated or was necessary to make the statements not misleading. Section 11 contains two separate, affirmative defences for underwriters:

Due diligence defence. This defence applies to portions of a registration statement that are not "expertised" (the "expertised" sections will usually be only the audited financial statements, although sometimes other expert reports are included, such as engineering reports or oil and gas reserve reports).

The due diligence defence protects an underwriter from liability for the non-expertised portions of the registration statement if it had (after reasonable investigation) reasonable grounds to believe (and did believe) at the relevant time that the contents of the registration statement were true and that there was no omission to state a material fact required to be stated or necessary to make the statements therein not misleading (*section 11(b)(3)(A), Securities Act*).

Requiring the issuer's independent auditors to issue comfort letters is one of a number of market practice procedures used by underwriters to establish that they have conducted such a "reasonable investigation" when preparing the offering document. Other procedures include:

- Having discussions with senior officers and the independent auditors of the issuer.
- Participating in meetings where the offering document is drafted.
- Reviewing board minutes and material contracts.
- Requesting certain letters and opinions from lawyers.

Reliance defence. This defence applies only to portions of an offering document that are "expertised". It provides that an underwriter will not be liable with respect to the audited financial statements if it reasonably did not believe that the contents of those financial statements were untrue or omitted a material fact required to be stated or necessary to make the contents not misleading (*section 11(b)(3)(B), Securities Act*).

Unlike the due diligence defence, the reliance defence allows the underwriter to rely on expertised portions of a registration statement without performing its own independent investigation. However, underwriters may not blindly rely on such expertised portions where there are red flags regarding the reliability of such expertised portions. In these cases, the underwriters must undertake a further, independent investigation.

Sample underwriter representation letter

[*Date, on or prior to the date of the first comfort letter*]

Dear [*Auditors*]:
[*Name of underwriter*], as principal or agent, in the placement of [*identify securities*] to be issued by [*name of issuer*], will be reviewing certain information relating to [*name of issuer*] that will be included in the document [*if appropriate, document should be further identified*], which may be delivered to investors and used by them as a basis for their investment decision. This review process, applied to the information relating to [*name of issuer*], is substantially consistent with the due diligence review process that we would perform if this placement of securities were being registered pursuant to the US Securities Act of 1933, as amended (the "Act"). We are knowledgeable with respect to the due diligence review process that would be performed if this placement of securities were being registered pursuant to the Act.

It is recognised that what is "substantially consistent" may vary from situation to situation and may not be the same as that done in a registered offering of the same securities for the same issuer; whether the procedures being, or to be, followed will be "substantially consistent" will be determined by us on a case-by-case basis.

We hereby request that you deliver to us a "comfort" letter concerning the financial statements of the issuer and certain statistical and other data included in the offering document. We will contact you to identify the procedures we wish you to follow and the form we wish the comfort letter to take.

Yours faithfully,

[*Name of Global Co-ordinator*],
as Representative and on behalf of the Underwriters

Although Rule 144A transactions do not subject an underwriter to liability under section 11, and technically the concept of "expertised" and "non-expertised" portions of an offering document only apply to registration statements filed with the SEC, market practice has developed so that the same level of investigation is given to an offering document used in a Rule 144A transaction.

Underwriters will have to represent to the auditors giving the comfort letter that the due diligence performed on the transaction was "substantially consistent" with the due diligence review process that the underwriters would perform if the transaction were a registered offering under the Securities Act (*see "Addressees" below and box "Sample underwriter representation letter"*).

Due diligence

In addition to protecting against specific legal liability under US (and potentially other) securities laws, the receipt of comfort letters also helps the underwriters to perform their traditional role as gatekeepers. Comfort letters help to mitigate the reputational risks associated with international securities offerings if incorrect financial information were to be included in the offering document.

COMFORT LETTER REQUIREMENTS

There are a number of requirements around how, to whom and under what terms, SAS 72 comfort letters are issued.

Addressees

Under SAS 72, auditors may issue comfort letters to broker-dealers or other financial intermediaries, acting as principal or agent, in connection with the offering. However, in the context of offerings exempt from registration, including Rule 144A and Regulation S offerings, comfort letters may be issued to such addressees only if they have provided a representation letter to the auditors regarding their review process (*see box "Sample underwriter representation letter"*).

Comfort letters also may be addressed to the issuer and its board of directors. Similar to underwriters, comfort letters may assist directors (especially independent directors) to assert their own due diligence defence.

In circumstances where broker-dealers or other financial intermediaries are not able, or are unwilling, to provide a representation letter, auditors are unlikely to be willing to issue an SAS 72 comfort letter containing negative assurance. In these instances, the accountants might provide a form of letter known as a "SAS 76" comfort letter.

Engaging parties

Although the comfort letter is required principally by the underwriters, it is

the issuer that should formally engage the auditors to deliver and perform the work underlying the letter. SAS 72 prescribes the scope and content of the comfort letter, so in the US there is no need for an engagement letter. Nevertheless, auditors of European issuers will sometimes ask the underwriters to sign an engagement letter or arrangement letter between the auditors and the issuer. In the US, such engagement letters are unheard of (*see "Number of comfort letters" below*).

Although it is the issuer that engages the auditors to deliver the comfort letter, lawyers to the underwriters lead on negotiating it, even if the issuer or its board of directors are included as addressees, because the underwriters are the main recipients.

Number of comfort letters

As a result of the mixed custom of having engagement letters outside the US but not in the US, a practice has developed in recent years for there sometimes to be two comfort letters (one for use in the US, one for outside the US).

The comfort letter for use outside the US is sometimes referred to as the SAS 72 "look-alike" letter. The engagement letter that governs the use of the non-US letter confirms the due diligence procedures to be performed by the underwriters. It also gives greater detail on the use of the non-US comfort letter, the ability of third parties to rely on it, and the work and procedures to be performed in connection with its delivery, together with certain representations given by the issuer and certain standard terms of business.

The two comfort letters should be identical, although each comfort letter may have a paragraph limiting its geographic use (within or outside the US, as appropriate).

There will still be some deals that use a single SAS 72 comfort letter for all jurisdictions. In such cases, there may or may not be an engagement letter. On occasion, there will be an engagement letter that by its terms does not govern the use of the comfort letter in the US. In certain jurisdictions, auditors will sometimes attempt to limit their liability in the engagement letter in connection with the use of the non-US comfort letter, either by a choice of local law clause or an express limitation on liability. Generally, these provisions should be strongly resisted in accordance with the underwriter's policies.

Multiple auditors

SAS 72 specifically contemplates the receipt of comfort letters from more than one auditor. For example, the offering document may contain financial statements of an acquired business or of a separate subdivision whose financial statements were audited by a different auditor. The issuer may also have changed its independent auditors during the financial period covered by the offering document and, therefore, need comfort letters from both its current and previous auditors in order for the underwriters to receive complete comfort.

Auditors may not comment in a comfort letter on interim financial information, capsule financial information, or changes in key line items unless they have obtained knowledge of the issuer's relevant internal controls. Such knowledge is generally gained on conducting the audit process.

If the issuer has changed auditors since its most recently audited financial statements and the new auditors are asked to give any form of negative assurance, they must acquire sufficient knowledge of the issuer's internal controls before doing so. If the new auditors are unable to acquire such knowledge without performing an audit, the issuer may have to rely on its previous auditors to provide the negative assurance. This may be difficult as the auditors may not be adequately incentivised if their auditing relationship with the issuer has terminated.

Dates of comfort letters

The principal SAS 72 comfort letter is ordinarily dated as at the date of pricing. The comfort letter states that the inquiries and procedures do not cover the period from the cut-off date to the date of the letter.

An additional comfort letter, referred to as a bring-down letter because it updates or brings down to a later date the contents of the original comfort letter, is ordinarily dated on the date on which the issuer delivers the securities to the underwriter (the closing date).

The comfort letter delivered at the closing date may be a full comfort letter with a new date or it may be an abbreviated version (*see box "Sample SAS 72 bring-down comfort letter for an international Rule 144A offering"*). An additional bring-down comfort letter is usually requested for an over-allotment option closing, although some underwriters may choose to forgo the over-allotment comfort letter on the theory that potential liability in connection with an offer and sale of securities attaches at the time of sale of the securities (including any over-allotment sales) (*see box "Over-allotment option"*).

LEVEL OF COMFORT

The level of comfort that the issuer's independent auditors may provide to the addressees of the SAS 72 letter will depend on the type of review that the auditors have conducted on the financial information. While the auditors give the highest level of assurance on the audited financial statements as part of their audit report, the comfort that they are prepared to give on unaudited financial information is typically limited to "negative assurance" (*see box "Accountants' levels of comfort"*).

Negative assurance is a statement by the auditors to the effect that, as a result of performing specified procedures, nothing came to their attention that caused them to believe that specified financial information did not meet a specified standard (for example, no changes in capital stock or increases in long-term debt). If the auditors do identify a change in a financial statement item, they should be asked to quantify it and consideration should be given to appropriate disclosure in the offering document.

Sample SAS 72 bring-down comfort letter for an international Rule 144A offering

[*Date of closing*]
[*Underwriters, or Lead Underwriters on behalf of all Underwriters*]
[*Board of Directors of Company*]

Dear Sirs:

We refer to our letter of [*date of comfort letter*], relating to the issue and sale of [*identify securities*] of [*identify the company*] through a public offering in [*identify jurisdiction*] and elsewhere through a private placement of securities in accordance with Regulation S and the Rule 144A under the US Securities Act of 1933, as amended (the "Act"). A copy of pages from the offering circular [*define offering circular*] relating to such issue and sale was attached to that letter.

We reaffirm as of the date hereof (and as though made on the date hereof) all statements made in that letter except that:

(a) The reading of the minutes described in paragraph 3 of that letter has been carried out up to and including [*date of up to 5 days before issuance of comfort letter*], 20ZZ.

(b) The procedures and inquiries covered in paragraph 3 of that letter were carried out to [*date of final offering document, or later*] (our work did not extend to the period from [*date on which the period not covered by bring-down comfort letter commences*], 20ZZ, to [*date of issuance of bring-down comfort letter*], 20ZZ, inclusive).

(c) The references to [*original comfort letter cut-off date*] in paragraph 5 of that letter are changed to [*bring-down comfort letter cut-off date, set forth in (b) above*]. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the offering circular, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the offering circular or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of securities covered by the offering circular.

Very truly yours,

[*Auditors' Signature*]

Auditors' review

The periods addressed in a comfort letter can be grouped into four categories for the purposes of understanding the level of comfort that auditors typically provide:

Audited period. Annual audited financial statements provide the highest level of protection from the auditors. Underwriters are typically not liable for such expertised information if they had no reasonable grounds to believe and did not believe that it was misleading (*see "Defence to liability" above*). US courts have interpreted this to mean that underwriters may reasonably rely on the contents of audited financial statements, unless they are presented with a red flag that calls for further investigation. The SAS 72 letter will not repeat the audit opinion in its text, but will make reference to the fact that the auditor has audited the issuer's financial statements and delivered an audit opinion.

Interim period. Interim financial statements, whether quarterly or half-yearly, are frequently included in offering documents, but are typically unaudited and subject to more limited procedures by auditors. The underwriter may request that the auditors perform a limited review of interim financial statements in accordance with the relevant accounting standard.

An interim review allows the auditors to state that nothing came to their attention that caused them to believe that any material modifications should be made in order for the interim financial

statements to conform to relevant accounting principles. By contrast, the objective of an audit is to provide a reasonable basis for expressing an opinion regarding the financial statements as a whole.

Monthly accounts. If the issuer has prepared internal, monthly financial statements covering the period from the most recent audited or reviewed period, the auditors will perform even more limited procedures than an interim review.

These procedures include the auditors reading the issuer's monthly financials and making certain inquiries of the issuer's officials who have responsibility for financial and accounting matters.

Under SAS 72, once the auditors have performed these procedures, they can make a statement that nothing came to their attention that caused them to believe that any material modifications should be made in order for the internal statements to conform to relevant accounting principles, and that nothing came to their attention that caused them to believe that there had been any material change to certain key financial statement line items compared to:

- The most recent balance sheet included or incorporated by reference in the offering document (for balance sheet line items).
- The corresponding period in the previous year (for income statement line items).

If the issuer is a high-growth company, it may be appropriate for the income statement items to be compared to the prior quarter or half-year period.

Stub period. The date from the most recently prepared financial statements (including monthly accounts if so prepared) to the cut-off date, which is a date no more than five days before the desired date of the comfort letter is referred to as the stub period. The stub period review procedures are typically limited to:

- Making inquiries of the relevant issuer's officials regarding any subsequent changes in the company's financial condition and results of operations.
- Reading the issuer's minutes.

Under SAS 72, once the auditors have performed these procedures, they can make a similar statement as they do for monthly accounts.

Time limits on comfort

If 135 days or more have passed between the date of the most recent financial statements that have been audited or reviewed and the date of the comfort letter (*see "Dates of comfort letters" above*), auditors might not give negative assurance as to subsequent changes since the audit or review date. This limitation stems from a particular section in SAS 72, which provides that, in such circumstances, the accountants may not provide negative assurance but are limited to reporting the procedures performed and findings obtained.

If a comfort letter is requested more than 135 days after the date of the issuer's last audit or review, the auditors should conduct a review of the monthly financial statements to reset the 135-day clock. If the issuer's structure (for example, multiple subsidiaries reporting in different GAAPs) or the transaction structure makes such a review impractical, the auditors are limited to delivering a lesser form of comfort.

In these instances, the auditors perform procedures similar to those they would perform if they were delivering negative assurance. However, their conclusion is limited to stating that certain officials have confirmed that specified matters met a specified standard. Such a letter is known as a "SAS 76" comfort letter.

OTHER FORMS OF COMFORT

The SAS 72 letter may provide other forms of comfort.

Pro forma

Pro forma financial statements are intended to show the effect of a particular transaction by illustrating how the financial statements of an issuer for a specific historical period, or as of a specific date, would have looked if that transaction had occurred at an earlier time.

Under SAS 72, auditors may provide limited pro forma comfort comprising: reviewing the pro forma financial information in the offering document; asking management for the basis of its calculations of the pro forma adjustments; and proving the arithmetical accuracy of those adjustments.

However, auditors are only able to give such pro forma comfort if:

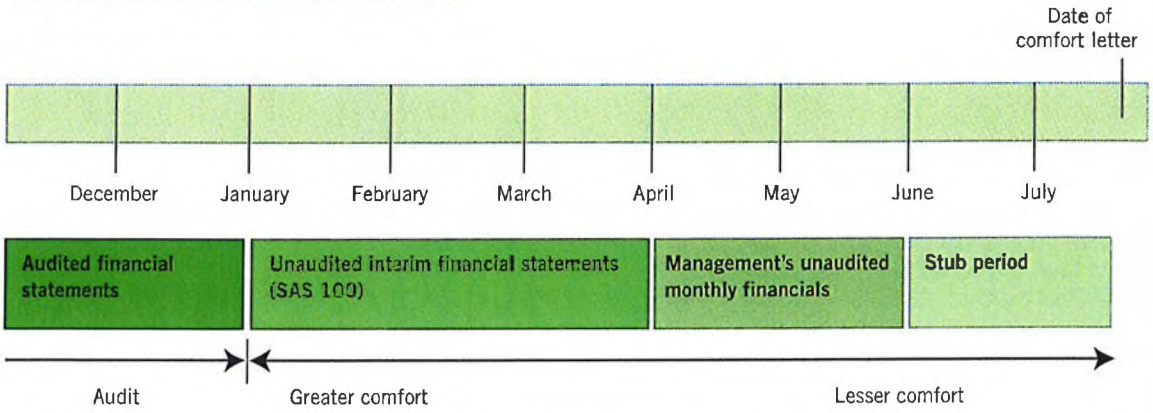
- They have an appropriate level of knowledge of the accounting and financial reporting practices of the entity (ordinarily obtained if the auditors have audited the issuer's fi-

Over-allotment option

When allocating shares following the pricing of an offering, a lead underwriter may allocate more shares than the company is actually offering and may buy shares on market during the immediate post-offer period in order to stabilise the share price during this period.

The over-allotment option allows it to cover the short position that can arise if the share price rises above the offering price by giving it the option to buy additional shares from the issuer at the offering price. Stabilisation is therefore intended to give some protection against volatility in the share price in the immediate post-offer period. An over-allotment option is also known as a "greenshoe" option, because the first company to grant such an option was the Green Shoe Corporation of New York.

Accountants' levels of comfort



Note: This illustration assumes that the issuer's most recent audited financial statements cover the year ended 31 December.

nancial statements for one or more periods).

- They have performed an audit of the annual financial statements or an interim review of the interim financial statements of the entity to which the pro forma adjustments have been applied.

The type of pro forma comfort given under SAS 72 is different from other pro forma reports given in securities offerings. For example, when a prospectus is required under the Prospectus Directive (*2003/71/EC*) and pro-forma financial information is required to be included by the Prospectus Regulations (*809/2004/EC*), an accompanying accountant's report will also be required. The report is required to state that in the opinion of the independent accountants or auditors:

- The pro forma financial information has been properly compiled on the basis stated.
- Such basis is consistent with the accounting policies of the issuer.

Although conceptually similar, this is different from the pro forma comfort given under SAS 72.

Tick and tie

If requested by the underwriters, the auditors will perform certain procedures on the text of the offering document. Usually, the underwriter or its lawyers will go through the offering document and circle in manuscript the financial information in the offering document (and any documents incorporated by reference) on which they would like comfort. This is generally referred to as the "circle-up". At a minimum, the request should cover numbers and quantitative statements in the text that can be traced back to, or easily derived from, the issuer's audited and unaudited financial statements or internal accounting records.

The comfort letter will include a list of procedures and findings, each of which is assigned a symbol (*see box "Sample SAS 72 comfort letter for an international Rule 144A offering"*). The circled-up pages of the offering document are attached to the comfort letter. Each relevant item or statement that has been circled by the underwriter's lawyers is assigned the relevant symbol to indicate which procedure was carried out and which finding was made regarding that item. The annotated pages from the offering document are known as the "ticks and ties", because the auditors are tying back the numbers that are circled or ticked to the appropriate procedures and the conclusions reached about the numbers based on such procedures.

It is important to use a substantially final draft of the offering document so that the work will not have to be repeated when changes are made.

The level of comfort that can be provided depends on the source of the number. Generally, the auditors will have compared the circled number or percentage and found it to be in agreement with the amounts in one of the audited financial statements, the reviewed financial statements, or the company's accounting records.

Where it is not possible to tie an item of information to the issuer's financial statements or accounting records, the auditors may be able to compare the information to a schedule prepared by the company based on its accounting records, whereby the auditors trace the numbers on the schedule back to the company's accounting records and recompute the schedule for mathematic accuracy. However, this process may be of limited value unless the underwriter understands and is comfortable with how the information in the schedule was derived.

Flash comfort

Securities offerings sometimes occur shortly before or after the end of a fiscal year or quarter. Close to the end of a year or quarter, a company is likely to have some sense of its financial results for the period just ended, despite not having audited or reviewed financial statements prepared. In these cases, the

deal team may decide to include unaudited financial information about the period in the offering document. It may be important to include this information in order to warn investors about negative performance.

Typically, this information is in the form of narrative text and is often referred to as capsule or flash financial information. The expected results may be stated in the form of a range or used to confirm previous earnings guidance. When capsule or flash information is included in an offering document, the underwriters often would like to get some form of comfort on it from the auditors, which will typically be a form of "tick mark" comfort (*see "Tick and tie" above*).

Whether the auditors can provide any comfort is a case-by-case discussion among senior deal team members. If the auditors cannot provide comfort and the capsule financial information must be included in the offering document, the underwriters and their lawyers must conduct their own detailed due diligence on the capsule financial information to ensure that it is accurate and not misleading.

There are particular limitations on the comfort that can be given on fourth quarter and full year capsule financial information. These limitations are described in a white paper issued by the American Institute of CPAs (AICPA) (*www.thecaq.org/resources/secregs/pdfs/otherguidance/Comfort_Letter_Procedures.pdf*). Although not authoritative, the white paper is meant to give guidance to auditors on their ability to give comfort on capsule financial information under SAS 72.

Practitioners have reported that some auditors have increasingly been declining to give comfort on capsule financial information in all periods using the principles in the white paper (not just on fourth quarter and full year capsule information to which it applies). Nevertheless, it is customary for the underwriters' lawyers to go through the exercise of requesting such comfort from the auditors as it is helpful to document that the request was made and declined by the auditors.

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Auditors' independence

Although the underwriters should establish the auditors' independence as part of the due diligence process, comfort may be given regarding the auditors' independence in reference to local accounting rules (*see box "Sample SAS 72 comfort letter for an international Rule 144A offering"*).

Other auditors' comfort letters

In some countries, there is a local practice of delivering auditor's comfort letters and other similar reports. For example, in connection with offerings of securities of English issuers, auditors will sometimes provide a comfort letter known as "the no significant change letter", and in connection with offerings of securities of German issuers, auditors will sometimes provide comfort in accordance with German accounting standard IDW 910. In the case of a local offering, these letters may be the sole comfort letter provided. In the case of an international offering, these letters may be provided for use in the issuers' home jurisdiction, and an SAS 72 comfort letter provided for use in the rest of the world.

Depending on the jurisdiction and stock market listing, the auditor's comfort letter may be part of a suite of reports that provide comfort to the underwriters, the issuer or both. For example, for a listing on the premium segment of the Official List, the reporting accountants are instructed to prepare several reports in order to help the financial institution that is serving as sponsor fulfil its gatekeeper responsibilities, including a financial reporting procedures report, a working capital report and a long-form due diligence report. These reports, together with the comfort letter, are often referred to as the "comfort package".

Peter Castellon is a partner at Proskauer Rose LLP and Dagmar Von Diessl is a New York qualified lawyer. *The authors wish to thank Jesse Zigmund, at the time an associate at Weil, Gotshal & Manges LLP.*