An Introduction to Auditor Comfort Letters

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An Introduction to Auditor Comfort Letters

Agenda

- Comfort Letter Basics
  - What? Why? When?
- Auditing Standards No. 6101: Form and contents of a comfort letter
- Understanding the different levels of comfort
- Additional practice tips
- Refer to CLE packet for further reading and guidance

What is a Comfort Letter?

- Letter delivered by issuer's independent accountants
  to underwriters or initial purchasers
  that provides assurances with respect to certain financial information included
  in the offering document used for a securities offering.
  - Breaking it down:
    - Underwriters vs. Initial purchasers; registered vs. unregistered offerings
    - Assurances: positive vs. negative assurance; "cold" comfort
    - "Certain" financial information – not all numbers can be comforted by auditors
    - Offering document: registration statement, prospectus, offering memorandum, plus documents incorporated by reference
    - Comfort Letter = Letter itself plus its attachments

Why needed? Why does it matter?

- Obtaining comfort *matters* to underwriters
  – assists in establishing underwriter's due diligence defense against Section 11 liability and underwriter's reasonable investigation of issuer and financials
- Required by underwriting agreement or purchase agreement; closing condition
- To aid and inform drafting and preparation of disclosure document
- To ensure no material misstatements or omissions in offering document
- To enhance comfort level of parties to transaction *e.g.*, joint bookrunners, co-managers
- Part of larger due diligence process for underwriter's counsel

Why Do Underwriters Obtain Comfort Letters?

- The due diligence defense for underwriters in SEC registered offerings requires:
  - As to "expertized" information (*e.g.*, audited financial statements), the underwriter had **no reasonable ground to believe**, and did not believe, that statements were untrue or omitted to state a material fact
  - As to "non-expertized" information (*e.g*., interim financial statements, MD&A and other financial data), the underwriter, **after reasonable investigation**, had reasonable ground to believe, and did believe, that statements were true and did not omit to state a material fact.

*[**See Tab 2**: Section 11(b)(3) of Securities Act, item (C) vs. item (A); see also Section 12(a)(2)]*

- Comfort letter = evidence or record of: underwriter's "reasonable investigation" of statements re issuer's financial condition; or a basis to say "no reasonable ground to believe" statements were untrue
- To help identify and elevate problematic issues

When are Comfort Letters Delivered?

- U.S. underwritten/Rule 144A/Reg S offerings: pricing and closing
  - At pricing: the notion is that underwriters do not want to enter into contracts to sell the securities without assurances as to the financial information
  - At closing (bring-down letter): the auditors confirm that there is no material change from the initial letter delivered at pricing
- Bring-down letter is usually short
  - Reaffirms statements in initial letter; updates cut-off date of auditors' procedures
- Programs, such as MTN programs
  - Establishment of program, significant or syndicated take-downs and in some cases periodically (e.g., annually or quarterly).

What is the Role of Underwriters' Counsel?

- Identify areas of comfort at start of the transaction (prospectus, OM, incorporated documents *e.g.*, 10-K, 10-Qs, 8-Ks)
- Often prepare the "circle-up" comfort request and send to the accountants
- Review form and content of comfort letter against AS 6101 and precedents
- Negotiate form and "tickmark" levels with accountants
  - Identify items circled by counsel but not given tickmarks by auditors
  - Identify items given a lower level of comfort/tickmark by auditors
  - Review and discuss with auditors deviations from past practice
  - Ensure underwriters have no comments/further requests.
- Ensure delivery at signing and closing

How? Practice tips to review and negotiate
Know + apply

1. Review AS 6101 and relevant comfort letter precedents
2. Obtain a SAS 72 rep letter for unregistered deals
3. Plan ahead
4. Mind the 135-day rule and dates for delivery of comfort letter
5. Understand the different levels of comfort
6. Circle like a pro
7. Aim high but be realistic
8. Pay special attention to pro forma information
9. Pay attention to special considerations for FPIs
10. Have a back-up plan

*[**See Tab 5** "Top 10 Practice Tips: Comfort Letters", Lexis (2021)]*

AS 6101: Form and Contents of Comfort Letter

- The contents are principally specified in *Auditing Standards No. 6101: Letters for Underwriters and Certain Other Requesting Parties* ("AS 6101") of the Public Company Accounting Oversight Board ("PCAOB")
  - AS 6101 superseded AU Section 634 of the PCAOB, which in turn contained and codified Statement on Auditing Standards No. 72 ("SAS 72") of the American Institute of Certified Public Accountants.
  - The term "SAS 72" is however still often used (*e.g.*, "SAS 72 comfort letter").
- AS 6101 applies to both SEC-registered and non-SEC registered offerings.
  - Registered offerings: accountants provide a comfort letter to underwriters or other parties with a statutory due diligence defense under Section 11 of the Securities Act in connection with financial statements/schedules included/incorporated by reference in registration statements filed with the SEC.

AS 6101: Contents of Comfort Letter *(cont'd)*

- Non-registered offerings: accountants may provide a comfort letter to broker-dealers or other financial intermediaries in offerings/placement of securities exempt from registration requirements of Section 5 of Securities Act *e.g.*, Regulation S, Regulation D, Rule 144A offerings. Will usually ask for a "SAS 72 rep letter." Addressee must have a due diligence defense.
- In a "SAS 72 rep letter," broker-dealer or financial intermediary represents that the due diligence undertaken by it in connection with the placement of securities is "substantially consistent" with the diligence that would have been undertaken in connection with acting as an underwriter in an SEC-registered offering. *[See **Tab 6**, Form of SAS 72 rep letter under paragraph .07 of AS 6101]*

- Variations exist among different audit firms, and reflect the financial statements and reporting process of the applicable issuer. Obtain precedents.
- Qualifications, limitations and other language that are not expressly contemplated by AS 6101 are not frequent, and are proper subjects for negotiation

AS 6101: Contents of Comfort Letter *(cont'd)*

Specific parts of the letter

- Date: date of pricing (or date of closing for bring-down comfort letter)
- Addressees: *e.g.*, issuer's board of directors and underwriters
- Introduction: auditors have audited financial statements included in 10-K incorporated by reference in registration statement/offering document
- If applicable, reference to SAS 72 reps (diligence review by initial purchaser)
- Statement as to the independence of the accountants
- Opinion whether audited financial statements comply as to form with Securities Act, Exchange Act and related SEC rules and regulations
- Procedures performed by accountants with respect to information other than audited financial statements:
  - Unaudited (reviewed) quarterly/interim financial statements
  - Unaudited financial statements (e.g. monthly financials)

AS 6101: Contents of Comfort Letter *(cont'd)*

Specific parts of the letter

- – Subsequent changes in key line items (e.g. change in capital stock, increase in long term debt, decrease in net income) from the date of last financials included or incorporated in the offering document through the cut-off date (often referred as the "change period" or "bring-down period")
- – Others: pro forma information, capsule financial information

- Comments/Conclusions with respect to above information
  - – Negative assurance re unaudited and any pro forma financial info
  - – Negative assurance as to changes in line items; specified procedures
- Additional procedures: "tick-and-tie comfort" (tables, other info incorporated)
  - – Purpose: identify financial information that has its source in the documents/records audited or reviewed by the auditors.
- Disclaimers, non-reliance by third parties
- Signature, Annexes

AS 6101: Contents of Comfort Letter *(cont'd)*

Examples A, B and F in AS 6101 (see tab 4)

- Date: *"June 28, 19X6" at p.1*
- Addressees: *"[Addressees]" at p.1*
- Introduction: *auditors have audited financial statements, at p.1*
- Reference to SAS 72 reps, if applicable: *not applicable*
- Statement as to the independence of the accountants – *item 1, at p.1*
- Opinion re audited financial statements – *item 2, at p.1*
- Auditor procedures performed with respect to information other than audited financial statements: - *item 3, p. 1; cut-off-date: "June 23, 19X6"*
  - Unaudited (reviewed) quarterly/interim financial statements – *item 4(a) at p. 2*
  - Unaudited financial statements (e.g. monthly financials) – *item 4(b) at p. 2*

AS 6101: Contents of Comfort Letter *(cont'd)*

Example A, B and F in AS 6101 (see tab 4)

  - Subsequent changes in key line items – *item 6, at p. 3*
  - Others: pro forma information, capsule financial information – *not applicable*
- Comments/Conclusions with respect to above information
  - Negative assurance on quarterly financials – *item 5(a), at p. 3*
  - Negative assurance on monthly financials – *item 5(b), at p. 3*
  - Negative assurance/specified procedures on key line items after monthlies to cut-off date – *item 6, p. 3*
- Additional procedures: "ticking and tying" – *items 7 to 9, at pp. 4 to 6*
- Disclaimers, non-reliance by third parties – *items 10 to 11 at p. 6*
- Signature, Annexes – *p. 6 onwards*

Sample

- See following sample comfort letter issued in MTN program quarterly update

Examining Sample Comfort Letters – Introduction to the Letter

May 15, 2018

The Board of Directors of [redacted]

and

[redacted]
New York, New York 10018

and

[redacted]
(collectively, the "Principals/Agents")

and

[redacted]
(collectively, the "Dealers")

c/o [redacted]
New York, New York 10018

Ladies and Gentlemen:

We have audited the consolidated financial statements of [redacted] (the "Company") and subsidiaries as of December 31, 2017 and 2016 and for each of the three years in the period ended December 31, 2017 included in the Company's annual report on Form 10-K for the year ended December 31, 2017 (the "Form 10-K"), and incorporated by reference in the registration statement (No. 333-[redacted]) on Form S-3 filed by the Company under the Securities Act of 1933 (the "Act"); our report with respect thereto is also incorporated by reference in that registration statement. The registration statement, including the base prospectus and prospectus supplement dated February 26, 2018, is herein referred to as the "Registration Statement."

Examining Sample Comfort Letters – Independence of Auditors

In connection with the Registration Statement:

1. We are an independent registered public accounting firm with respect to the Company within the meaning of the Act and the applicable rules and regulations thereunder adopted by the Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board (United States) ("PCAOB").

Examining Sample Comfort Letters – Audited Financial Statements and Compliance as to Form

2. In our opinion, the consolidated financial statements audited by us and incorporated by reference in the Registration Statement comply as to form in all material respects with the applicable accounting requirements of the Act and the Securities Exchange Act of 1934 and the related rules and regulations adopted by the SEC.

Examining Sample Comfort Letters – Comfort on Unaudited Quarterly Financial Statements

3. We have not audited any financial statements of the Company as of any date or for any period subsequent to December 31, 2017; although we have conducted an audit for the year ended December 31, 2017, the purpose (and therefore the scope) of the audit was to enable us to express an opinion on the consolidated financial statements as of December 31, 2017 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 consolidated balance sheet as of March 31, 2018 and the unaudited consolidated statements of income, of comprehensive income, of cash flows and of changes in equity for the three-month periods ended March 31, 2018 and March 31, 2017 included in the Company's quarterly report on Form 10-Q for the quarter ended March 31, 2018, incorporated by reference in the Registration Statement, or on the financial position, results of operations, or cash flows as of any date or for any period subsequent to December 31, 2017.

4. For purposes of this letter, we have read the minutes of the 2018 meetings of the Board of Directors, the Risk Committee, and the Audit Committee of the Company and its subsidiaries as set forth in the minute books at May 14, 2018, officials of the Company having advised us that the minutes of all such meetings through that date were set forth therein, except for the minutes of the April 25, 2018 Audit Committee, the April 25, 2018 Risk Committee and the April 26, 2018 Board of Directors meetings which were not approved in final form, for which agendas were provided to us; officials of the Company have represented that such agendas include all substantive actions taken at such meetings, and have carried out other procedures to May 14, 2018 (our work did not extend to May 15, 2018, inclusive) as follows:

   a. With respect to the three-month periods ended March 31, 2018 and 2017, we have:

      (i) performed the procedures (completed on May 4, 2018) specified by the PCAOB for a review of interim financial information as described in AS 4105 , *Reviews of Interim Financial Information*, on the unaudited consolidated balance sheet as of March 31, 2018, and unaudited consolidated statements of income, of comprehensive income, of cash flows and changes in equity for the three-month periods ended March 31, 2018 and 2017, included in the Company's quarterly report on Form 10-Q for the quarter ended March 31, 2018, incorporated by reference in the Registration Statement; and

      (ii) inquired of certain officials of the Company who have responsibility for financial and accounting matters whether the unaudited consolidated financial statements referred to in 4.a.(i) above comply as to form in all material respects with the applicable accounting requirements of the Securities Exchange Act of 1934 as it applies to Form 10-Q and the related rules and regulations adopted by the SEC.

Examining Sample Comfort Letters – Comfort on Unaudited Quarterly Financial Statements

5. It should be noted effective January 1, 2018, the Company adopted Accounting Standards Codification 606, *Revenue from Contracts with Customers*, Accounting Standards Update 2016-01, *Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*, and Accounting Standards Update 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that:

   a. (i) Any material modifications should be made to the unaudited consolidated financial statements described in 4.a.(i), incorporated by reference in the Registration Statement, for them to be in conformity with generally accepted accounting principles;

   (ii) The unaudited consolidated financial statements described in 4.a.(i) do not comply as to form in all material respects with the applicable accounting requirements of the Securities Exchange Act of 1934 as it applies to Form 10-Q and the related rules and regulations adopted by the SEC; or

Examining Sample Comfort Letters – Comfort on Unaudited Monthly Financial Statements

4. For purposes of this letter, we have read the minutes of the 2018 meetings of the Board of Directors, the Risk Committee, and the Audit Committee of the Company and its subsidiaries as set forth in the minute books at May 14, 2018, officials of the Company having advised us that the minutes of all such meetings through that date were set forth therein, except for the minutes of the April 25, 2018 Audit Committee, the April 25, 2018 Risk Committee and the April 26, 2018 Board of Directors meetings which were not approved in final form, for which agendas were provided to us; officials of the Company have represented that such agendas include all substantive actions taken at such meetings, and have carried out other procedures to May 14, 2018 (our work did not extend to May 15, 2018, inclusive) as follows:

   b. With respect to the period from April 1, 2018 to April 30, 2018, we have:

      (i) read the unaudited consolidated financial data of the Company and subsidiaries for April of both 2018 and 2017 furnished us by the Company, officials of the Company having advised us that no such financial data as of any date or for any period subsequent to April 30, 2018 were available. The financial data for April of both 2018 and 2017 is incomplete in that it omits the statement of cash flows, the statement of changes in equity, the statement of comprehensive income and other disclosures.

      (ii) inquired of certain officials of the Company who have responsibility for financial and accounting matters whether the unaudited consolidated financial data referred to in 4.b.(i) above is stated on a basis substantially consistent with that of the audited consolidated financial statements incorporated by reference in the Registration Statement.

   The foregoing procedures do not constitute an audit conducted in accordance with standards of the PCAOB. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations as to the sufficiency of the foregoing procedures for your purposes.

Examining Sample Comfort Letters – Comfort on Unaudited Monthly Financial Statements

5. It should be noted effective January 1, 2018, the Company adopted Accounting Standards Codification 606, *Revenue from Contracts with Customers*, Accounting Standards Update 2016-01, *Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*, and Accounting Standards Update 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that:

b. (i) At April 30, 2018 there was any change in common or preferred stock, increase in long-term debt, or decrease in consolidated total assets or total equity of the Company and subsidiaries consolidated as compared with amounts shown on the March 31, 2018 unaudited consolidated balance sheet incorporated by reference in the Registration Statement, or (ii) for the period from April 1, 2018 to April 30, 2018, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net income, except in all instances for changes, increases or decreases which the Registration Statement discloses have occurred or may occur, and except that the unaudited consolidated financial data, which we were furnished by the Company, showed a decrease from March 31, 2018 in consolidated total assets and total equity as follows (in millions of dollars):

	Consolidated Total Assets	*Total Equity*
April 30, 2018	177,193	19,585
March 31, 2018	182,035	19,683

Examining Sample Comfort Letters – Comfort on Change Period

6. As mentioned in 4.b.(i), Company officials have advised us that no consolidated financial data as of any date or for any period subsequent to April 30, 2018 are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after April 30, 2018 have, of necessity, been even more limited than those with respect to the periods referred to in 4. We have inquired of certain officials of the Company who have responsibility for financial and accounting matters whether at May 14, 2018 there was any change in the common or preferred stock, increase in long-term debt or decrease in consolidated total assets or total equity of the Company and subsidiaries consolidated as compared with amounts shown in the March 31, 2018 unaudited consolidated balance sheet incorporated by reference in the Registration Statement.

   Those officials referred to above stated that they cannot comment on any such changes, increases or decreases in consolidated long-term debt, consolidated total assets or total equity of the Company for the periods referred to above.

   On the basis of these inquiries and our reading of the minutes and agendas as described in 4, nothing came to our attention that caused us to believe that there was any such change in common or preferred stock, except in all instances for changes, increases or decreases, that the Registration Statement discloses have occurred or may occur.

Examining Sample Comfort Letters – "Tick-and-Tie" Comfort

7. For purposes of this letter, we have also read the items identified by you on the attached copy of the Form 10-K and the Company's quarterly report on Form 10-Q for the quarter ended March 31, 2018, incorporated by reference in the Registration Statement, and have performed the following procedures, which were applied as indicated with respect to the letters explained below. We make no comment as to whether the SEC would view any non-GAAP financial information included or incorporated by reference in the Registration Statement as being compliant with the requirements of Regulation G or Item 10 of Regulation S-K.

A	Compared to or recalculated from amounts included in the Company's audited consolidated financial statements included in the Form 10-K, incorporated by reference in the Registration Statement, and found such amounts to be in agreement, after giving effect to rounding, if applicable. However, we make no comment with respect to classification or reasons given for changes between periods, where applicable.
B	Compared to or recomputed from a corresponding amount included in the Company's accounting records and found such amounts to be in agreement, after giving effect to rounding, if applicable.
C	Compared to or recomputed from a schedule prepared by the Company from its accounting records and found such amounts to be in agreement, after giving effect to rounding. We (a) compared the amounts on the schedule to corresponding amounts appearing in the accounting records and found such amounts to be in agreement and (b) determined that the schedule was mathematically correct. We make no comment with respect to the Company's: • classification or reasons given for changes between periods, where applicable; • calculation of yield on total interest earning assets; • methodology, determination and classification of nonaccrual loans, accruing loans contractually past due 90 days, or total nonperforming loans and assets; • methodology for calculating average balances, regulatory measures, or ratios; • classification of deposit balances by type of deposit or major depositor categories, other fees and commissions by type, and other expenses by expense type; • classification of loans two-months-and-over contractual delinquency;

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Examining Sample Comfort Letters – "Tick and Tie" Comfort

	• classification of loan types, types of other fees and commissions, and other expenses; • determination of delinquency status of loans; and • the definition, calculation and presentation of selected regulatory capital balances and ratios (e.g. tangible common equity, Tier 1 Capital, Risk Weighted Assets, Tier 2 capital, etc.), made by the Company to comply with regulatory reporting requirements of the Federal Financial Institutions Examination Council or their usefulness for any purposes.
D	Recalculated a specific dollar amount or percentage included under the heading "Ratio of Earnings to Fixed Charges" by reference to unaudited schedules or analyses prepared and provided to us by the Company from its accounting records and performed the following procedures: (a) compared the amounts or percentages on the schedules or analyses to corresponding amounts appearing in the accounting records and found such amounts to be in agreement, after giving effect to aggregation or rounding, if applicable; and (b) determined that the schedules were mathematically correct. We make no comment with respect to reasons given for changes between periods. We make no comment as to the appropriateness of the Company's definition of earnings, fixed charges, rents and the interest factor thereof, and coverage category.
E	Compared to a schedule prepared by the Company from its accounting records and found such amounts to be in agreement. We (a) compared the amounts on the schedule to corresponding amounts appearing in the accounting records and found such amounts to be in agreement and (b) determined that the schedule was mathematically correct. It should be noted that the following are not measures of operating performance or liquidity defined by generally accepted accounting principles and may not be comparable to similarly titled measures presented by other companies. We make no comment about the Company's definition, calculation or presentation of these measures or their usefulness for any purposes. • adjusted performance; • taxable equivalent; • total tangible assets; • tangible common equity; • tangible common equity to total tangible assets; • efficiency ratios; • rate of return on average balances; and • net charge-off and net charge-off coverage ratios.

Examining Sample Comfort Letters – "Tick and Tie" Comfort

F	Recalculated the amount, percentage, ratio or subtotal from amounts included in the Company's audited consolidated financial statements as of and for the year ended December 31, 2017 incorporated by reference in the Registration Statement and the comparative period presented for the year ended December 31, 2016, as applicable (included in the Company's audited consolidated financial statements as of December 31, 2017 and 2016 and for the three years ended December 31, 2017), and found it to be in agreement after giving effect to rounding, if applicable. However, where applicable, we make no comment as to the appropriateness or manner in which such classifications have been made, and we make no representation as to these amounts, percentages, ratios or subtotals or the appropriateness of these measures for your purposes.
G	Compared to or recomputed from amounts included in the Company's unaudited financial statements as of March 31, 2018 and for the three-month period ended March 31, 2017, incorporated by reference in the Registration Statement, and found such amounts to be in agreement, after giving effect to rounding, if applicable. However, we make no comment with respect to classification or reasons given for changes between periods, where applicable.

Understand different levels of comfort from auditors

procedures performed + period covered = comfort level

- Year-end Audit of Financial Statements
  - *e.g.*, years ended December 31, 2017, 2016 and 2015
- Interim Review of Quarterly Financial Statements
  - *e.g., quarterly periods ended March 31, 2018 and 2017*
- Specified Procedures on Internal monthlies
  - *e.g., specified items as of May 31, 2018 (vs. March 31, 2018), and for two-month period from April 1, 2018 to May 31, 2018 (vs. corresponding period in 2017)*
- Specified Procedures on remaining change period
  - *e.g., specified items as of June 23, 2018 (vs. March 31, 2018), and for period from April 1, 2018 to June 23, 2018 (vs. corresponding period in 2017)*

Audited Annual Financial Statements

- Top level: financial statements audited by accountants in accordance with PCAOB standards and covered by auditor's unqualified opinion
- Have been "expertized" (they have been audited).
- Independent accountants consent to inclusion of financial statements and their report, and being named an expert in registration statement
- Main objective of audit: provide accountants with a reasonable basis (and not an absolute basis) for expressing an unqualified opinion regarding financial statements of issuer taken as a whole (auditors call this the "attest function").
- An audit opinion consists of two basic elements:
  - First, that the financial statements audited present fairly, in all material respects, the financial condition and results of operations for the issuer and its consolidated subsidiaries as of and for the periods covered; and
  - Second, that the financial statements have been prepared in accordance with applicable GAAP or IFRS.

Audited Annual Financial Statements

- Comfort level: positive assurance
  - Opinion in auditor's report found in audited financial statements included in Form 10-K
  - Comfort letter: "*In our opinion, the consolidated financial statements audited by us and incorporated by reference in the registration statement comply as to form in all material respects with the applicable accounting requirements of the Securities Act and the Securities Exchange Act of 1934 and the related rules and regulations adopted by the SEC.*"
- Compare this positive assurance with "negative" assurance
  - Per AS 6101, procedures short of an audit, provide accountants with a basis for expressing, at most, negative assurance
  - Negative assurance consists of a statement by accountants that, as a result of performing specified procedures, nothing came to their attention that caused them to believe that specified matters do not meet a specified standard
    (for example, nothing came to our attention that caused us to believe that any material modifications should be made to the unaudited financial statements or unaudited condensed financial statements for them to be in conformity with GAAP. *[See footnote 10, AS 6101]*

Unaudited Quarterly Financial Statements

- Have not been "expertized" (they have not been audited).
- An opinion is not given (AS No. SAS 100 (now *AS 4105, Reviews of Interim Financial Information*) establishes the standards for engagements by independent accountants concerning the review of interim financial information issued by public companies).
  - The purpose of a review is to provide the accountant with a basis for reporting whether material modifications are necessary for the interim financial information to be in accordance with GAAP or IFRS. A review of interim financial information differs significantly from an audit of financial information because a review does not include the collection of corroborative evidence through the performance of typical substantive audit tests.
  - In performing a "SAS 100" review, the accountants will, among other things, (i) review minutes of shareholder and board meetings, (ii) make inquiries of management as to whether the interim financial statements are prepared in accordance with GAAP and whether there have been any changes in accounting principles or practices or in business activities, (iii) compare current interim period financial statements to the comparable previous interim period financial statements and (iv) compare recorded amounts to expectations.

Unaudited Quarterly Financial Statements

- Comfort level: Negative assurance
  - *"Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that —*

    i. Any material modifications should be made to the unaudited condensed consolidated financial statements, incorporated by reference in the registration statement, for them to be in conformity with generally accepted accounting principles

    ii. The unaudited condensed consolidated financial statements do not comply as to form in all material respects with the applicable accounting requirements of the Securities Exchange Act of 1934 as it applies to Form 10-Q and the related rules and regulations adopted by the SEC."

Numbers in Change or Bring-Down Period

- The period between the last day of the stub period (period covered by interim financial statements) and the cut-off date (date up to which auditors have performed their specified procedures) for the comfort letter.
- The change or bring-down period can be broken down into two parts:
  - Any time period for which the company has prepared internal financial statements
  - The remaining time, for which the company has no internal financial statements
- Procedures accountants perform are more limited than a SAS 100 review
  - *e.g.*, reading monthly financial statements; inquiries of issuer's officials whether monthly statements are prepared on a basis substantially consistent with audited financial statements incorporated in the offering document

Change or Bring-Down Period *(cont'd)*

- Accountants will compare (i) key balance sheet items found in the most recent monthly statements vs. corresponding items found in most recent balance sheet incorporated in offering document, and (ii) key income statement line items found in most recent monthly statements vs. corresponding items found in income statements for comparable period in prior year
- Relevant line item changes listed in AS 6101 include:
  - Changes in capital stock.
  - Increases in long-term debt.
  - Decreases in consolidated net current assets or shareholders' equity.
  - Decreases in net sales.
  - Total or per-share amounts of income before extraordinary items.
  - Total or per-share amounts of net income.
    - Line items can vary e.g., depending on issuer, industry, peer practice

Changes in Line Items *(cont'd)*

- The best comfort accountants can give on change period is limited to assuring underwriters there have been no changes in key financial statement line items during period compared to comparable past periods covered by financials
  - *"Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that— (a) at May 31, 2018, there was any change in the capital stock, increase in long-term debt, or any decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown in the March 31, 2018 unaudited condensed consolidated balance sheet incorporated by reference in the registration statement or (b) for the period from April 1, 2018, to May 31, 2018, 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, except in all instances for changes, increases, or decreases that the registration statement discloses have occurred or may occur."*

Changes in Line Items *(cont'd)*

- *"We have inquired of certain officials of the company who have responsibility for financial and accounting matters whether (a) at June 23, 2018, there was any change in capital stock, increase in long-term debt or any decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown on the March 31, 2018, unaudited condensed consolidated balance sheet included in the registration statement or (b) for the period from April 1, 2018, to June 23, 2018, 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, 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 registration statement discloses have occurred or may occur."*

- Confirm that no changes in key financial statement line items have occurred during change period that would need to be disclosed in offering document.
  - If material changes in key financial statement line items have indeed occurred during the change period, to craft disclosure to include in the offering document describing those changes.

The "135 Day" Rule under AS 6101

- If 135 days or more have elapsed since the date of the issuer's most recent audited annual financial statements or reviewed interim financial statements, on the one hand, and the cut-off date of the comfort letter, on the other hand, then auditors will not be able to give any negative assurance as to subsequent changes in specified financial statement items.
  - Rather, they will be limited to reporting procedures performed and findings obtained.
- Likely to be an issue during Q1 of a year, when audited financials are being prepared.
  - There are 92 days in the fourth quarter, thus the Form 10-K must be filed in February (or the other applicable 2nd month of the quarter) for there to be no gap in coverage.
- To illustrate, if accountants reviewed issuer's interim financial statements for Q3 ended September 30, 2022, then they may provide negative assurance on increases or decreases in specified financial statement items as of any date up to February 11, 2023 (134 days subsequent to September 30, 2022).

The "135 Day" Rule under AS 6101

- From February 12, 2023, which is the 135th day, the auditors will refuse to give negative assurance on the change period, since the September 30, 2022 interim financial statements then would not be less than 135 days old
- Implications:
  - Underwriters will often be unwilling to proceed with the deal if they do not receive negative assurance on the change period. In the above illustration, the underwriters may decide to postpone the deal until after the issuer files its 2022 Form 10-K (that contains the year-end audited financial statements) in March 2023.
- The 135 day rule under AS 6101 is different from and in addition to, the financial staleness rules of the SEC.

*[**See Tab 7b** for 2023 financial statement staleness calendar]*

Circle like a pro

What should be included in the "Circle-Up" request?

- All financial information included or incorporated by reference in the offering document that can be tied to the financial statements (audited or unaudited), accounting books/records and company schedules.
  - This would include selected financial data tables, capitalization tables and dilution tables included in the body of the offering document, as well as those financials included in the SEC filings incorporated by reference in the offering document.
  - This would exclude SEC filings that are "furnished" rather than filed.
- Figures that can be tied to contracts or agreements (e.g., principal amount of notes outstanding reflected in a global note or indenture) generally will not be circled and tickmarked.
- The actual financial statements and notes thereto, included in issuer's Form 10-K or Form 10-Q that are incorporated into the offering document do not need to be circled. But circle the numbers appearing in the MD&A and OM.

What should be included in the "Circle-Up"? *(cont'd)*

- Figures pertaining to the company's market/industry that are not financial in nature (e.g., market data) do not need to be circled or tickmarked.
- The number of employees, the square footage of facilities and backlog information are typically not circled or tickmarked.
- AS 6101 lists examples of the types of quantitative information that can only be comforted if it is derived from accounting records subject to controls.

Tick-and-tie comfort

- After you send the circle-up request to the accountants, they will deliver their circle-up and will provide “tickmarks” next to circled numbers in the offering document and/or documents incorporated by reference and trace these numbers to the company’s financial statements, trial balance/general ledger or books and records.
- The purpose is to identify financial information that has its source in the documents audited or reviewed by the auditors.
- Accountants frequently will not cover certain numbers in the offering document (that they cannot trace to the company’s financial statements) such as share numbers, square feet, sales per square feet, backlog, employee counts and projected/estimated capital expenditures.

Tickmarks *(cont'd)*

- The tickmark letters or numbers represent varying levels of comfort depending on whether information is derived from audited financials, interim financials or other accounting books or records.
- The applicable tickmark is placed next to each number in the offering document and/or documents incorporated by reference that the accountants will give comfort on.
- The meaning of each tickmark is provided in the comfort letter with its purpose being to tie that number back to another source (principally the issuer's audited or unaudited financial statements).
- The accountants may sometimes have to trace numbers back directly to the books and records of the issuer or may even rely on a schedule prepared by company management.

Tickmarks *(cont'd)*

- When a number is tied back to anything other than financial statements or the issuer's books and records, the value of such comfort decreases.
- AS 6101 states that the comfort letter can only cover numbers that are derived from the company's accounting records that are subject to the company's system of internal accounting controls (some accountants define "accounting records" more broadly than others).
- One of the most negotiated items on tickmarks is which numbers are tied to a "company-prepared schedule," where neither the accountants nor the company have tied the data on the schedule to the underlying records.

Levels of tickmark comfort

Aim high but be realistic

- In general, there are several possible levels of tickmark comfort, including that (a) the auditors have compared or recalculated the number or percentage:
  - To or from amounts in the audited financial statements and found them to be in agreement.
  - To or from amounts in the reviewed interim financial statements and found them to be in agreement.
  - To or from amounts in the company's accounting records and found them to be in agreement.
  - To or from amounts in a schedule prepared by the company based on its accounting records and found them to be in agreement; and
- (b) the auditors have verified the arithmetic accuracy of certain calculations.

❖ Read and review the tickmark legend in the comfort letter when reviewing tick-and-tie comfort on the circle-up request

Sample tick-and-tie comfort

- "7. At your request, we have also read the items identified by you on the attached pages from the Prospectus, the Preliminary Prospectus Supplement, the Company's Form 10-K for the year ended December 31, 2017, the Company's Quarterly Reports on Form 10-Q for the quarters ended March 31, June 30, and September 30, 2018, and the Company's Current Report on Form 8-K dated January 22, 2019 and have performed the following procedures, which were applied as indicated with respect to the letters explained below:
  - A. **Compared** the dollar and other amounts either **to the amounts in the audited consolidated financial statements** described in the introductory paragraph of this letter or, for prior years, included in the Company's annual reports to shareholders for the years 2016, 2015, 2014, or 2013 to the extent such amounts are included in or can be derived from such statements and found them to be in agreement.
  - B. **Compared** the dollar and other amounts **to the amounts in the unaudited consolidated financial statements included in** the Company's Quarterly Reports on **Form 10-Q** described in paragraph 3. to the extent such amounts are included in or can be derived from such statements and found them to be in agreement.
  - C. **Compared** the dollar and other amounts not derived directly from the audited consolidated financial statements or the unaudited consolidated financial statements included in the Company's Quarterly Reports on Form 10-Q **to amounts in the Company's accounting records** to the extent such amounts could be so compared directly and found them to be in agreement.
  - D. **Compared** the dollar and other amounts not derived directly from audited consolidated financial statements, not derived from the unaudited consolidated financial statements included in the Company's Quarterly Reports on Form 10-Q or that could not be compared directly to the Company's accounting records, **to amounts in analyses prepared by the Company from its accounting records** and found them to be in agreement.

Sample tick-and-tie comfort (cont'd)

- E. **Proved the arithmetic accuracy** of the percentages or amounts based on the data in the above-mentioned audited consolidated financial statements, unaudited consolidated financial statements included in the Company's Quarterly Reports on Form 10-Q, accounting records or analyses, as applicable. With respect to any non-GAAP financial measures, we proved the arithmetic accuracy based on definitions contained within the Registration Statement, Form 10-K or the Company's Quarterly Reports on Form 10-Q; we make no representation as to the appropriateness or completeness of such definitions.
- F. **Compared the non-GAAP financial measure to the reconciliation of that non-GAAP financial measure to the corresponding GAAP measure** included, or incorporated by reference, in the Registration Statement and found them to be in agreement.
- NC. No procedures performed"

Sample tick-and-tie comfort (cont'd)

- **10-K circle-up**

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A")

Financial Highlights

We reported net income of $2.0 billion ($3.49 per diluted common share) on total net revenue of $27.2 billion for 2017. In comparison, we reported net income of $3.8 billion ($6.89 per diluted common share) on total net revenue of $25.5 billion for 2016, and $4.1 billion ($7.07 per diluted common share) on total net revenue of $23.4 billion for 2015.

Total Company Performance

- *Earnings*: Our net income decreased by $1.8 billion to $2.0 billion in 2017 compared to 2016.

On June 28, 2017, we announced that our Board of Directors authorized the repurchase of up to $1.85 billion of shares of our common stock from the third quarter of 2017 through the end of the second quarter of 2018. In December 2017, the Board of Directors reduced the authorized repurchases of our common stock to up to $1.0 billion for the remaining 2017 Comprehensive Capital Analysis and Review ("CCAR") period, which ends June 30, 2018 ("2017 Stock Repurchase Program"). In the first quarter of 2018, we repurchased approximately $200 million of our common stock. See "MD&A—Capital Management—Dividend Policy and Stock Purchases" for additional information.

Sample tick-and-tie comfort (cont'd)

- **10-Q circle-up**

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A")

Financial Highlights

We reported net income of $1.3 billion ($2.62 per diluted common share) on total net revenue of $6.9 billion for the first quarter of 2018. In comparison, we reported net income of $810 million ($1.54 per diluted common share) on total net revenue of $6.5 billion for the first quarter of 2017.

B B B B

- **8-K exhibit circle-up**

Exhibit 99.2, Financial Supplement, Fourth Quarter 2018

Table 15: Calculation of Regulatory Capital Measures and Reconciliation of Non-GAAP Measures[1]

	Basel III Standardized Approach				
(Dollars in millions, except as noted)	December 31, 2018	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017
Tangible common equity ("TCE")[9]	F 9.1	9.0	8.8	8.6	8.3

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Limitations on Comfort

- Pay attention to different levels of comfort, as some comfort is minimal
- No comfort may be available in certain circumstances:
  - 135 day rule
  - White Paper I (accounting industry guidance): cautions auditors against giving comfort on year-end financial information that is subject to change pending completion of an audit
- Information "furnished" with the SEC, but not "filed."
  - This information is not part of the prospectus for liability purposes in an offering
- The "dark period": several days between the cut-off date and the date of letter.

Limitations on Comfort

- Key data not comforted (or subject to limited comfort) typically include:
  - Mixed financial/operating data
  - Estimates
  - Projections
  - EBITDA, Adjusted EBITDA and other non-GAAP financial measures
- Information proposed to be released to public before completion of auditor's review procedures.
  - For example, financial projections or forecasts and earnings releases.
  - However, in some cases auditors will provide comfort on earnings releases (this happens when the offering prices after earnings are released but before the Form 10-K/10-Q is filed). *e.g.*, ask for comfort on 8-K earnings release exhibits
- Non-financial/business/market information

Have a back-up plan and look at the big picture

- Comfort letters are a *part of* the process of establishing a due diligence defense under federal securities laws. They do not:
  - Substitute for independent review and due diligence discussions with management and accountants about business and financial results
  - Protect underwriters in the face of "red flags" (*WorldCom* litigation)
- "Financial" due diligence typically includes:
  - Reading financial statements and notes
  - Review of accounting presentation, historical results, financial policies, debt covenants and industry hot button issues with the CFO and other principal financial executives
  - Review of financial projections and underlying assumptions with CFO and other principal financial executives
  - Drafting sessions on financial disclosure (*e.g.*, MD&A, EBITDA presentation, pro formas, recent developments)
  - Auditor due diligence session
  - Comfort letter
    - Note that counsel 10b-5 negative assurance letters exclude financial statements and financial and accounting data

Have a back-up plan (cont'd)

Heightened due diligence procedures

- In the event of limited comfort or red flags, heightened due diligence procedures may include:
  - Specific calls with management and auditors on recent financial results or other significant developments
  - Review of the issuer's internal monthly financial statements
  - CFO certificate/management comfort letter
  - Additional back-up
  - Conversations with Audit Committee
  - Further review of offering documents to add protective disclosure, such as:
    - Risk factors
    - MD&A overview or trend disclosure
  - Further internal review with the underwriter's in-house counsel and committee

❖ The back-up is back-up

Additional practice tips

- Discuss financial disclosure issues with the auditors as early in the offering process as practicable.
- While drafting the offering document, solicit input from the auditors and draft the offering document with the comfort letter in mind.
- Request a draft of the comfort letter from the auditors, provide any comments on the draft and send to the auditors the draft circle-up early in be offering process.
- Agree on the final form of the comfort letter as soon as practicable before pricing of offering.
  – Ideally the final draft of the comfort letter should be agreed before filing of the registration statement in an SEC-registered offering or before finalizing the preliminary offering document in an unregistered offering.

Additional practice tips (cont'd)

- Discuss timing and logistics of comfort letter delivery with the auditors well in advance of pricing.
  - Make sure the auditors are aware of the expected date and time of pricing and that the underwriters expect the comfort letter to be delivered shortly thereafter.
  - Especially if the pricing comfort letter will cover the final offering document, make sure a representative of the auditors will be available to deliver the circle-up as the final offering document is being completed the night of pricing.
- Send drafts to underwriters for their review and comment.

Annex A: Special Issues / Additional items (for further reading)

- Pro forma financial information
- Capsule or flash financial information
- Going concern issue
- Special considerations for foreign private issuers
- Worldcom case
- AICPA white paper

What About Pro Forma Financial Information?

- If the offering document includes pro forma financial statements (acquisition or merger related), the accountants provide negative assurance that the pro formas comply with Rule 11-02 of Regulation S-X.
- The accountants also prove the arithmetic accuracy of the pro forma adjustments to confirm whether the pro forma adjustments have been properly applied to the historical amounts in the compilation of those statements.
- In connection with the negative assurance, the accountants will first:
  - Read the pro forma statements, and
  - Make inquiries of management of the issuer.

What About Pro Forma Financial Information? *(cont'd)*

- Pursuant to AS 6101, an accounting firm can only provide negative assurance on pro forma financial statements if that firm has audited or reviewed a substantial portion of the overall company.
  - This can be problematic where the pro formas include large acquisitions of companies that the accounting firm did not audit or review.
- It is also important to obtain comfort on all of the historical information included in the pro forma financials.
  - Underwriters often want comfort on historical data in the pro formas even when there is no corresponding F-page financial statement disclosure.
  - This may require multiple comfort letters from various acquired entities' accounting firms.

What About Capsule or Flash Financial Information?

- Financial information more recent than the most recent financial statements included in an offering document is referred to as capsule or flash financial information.
  - *e.g.*, potential offering in January or February of 2019, where auditors are in the process of completing the 2018 year end audit. Deal question: should we include in the OM preliminary estimates/ranges of Q4 and 2018 year-end numbers, before filing of the 10-K?
- Typically, this information is in the form of narrative disclosure and the expected results may be stated in the form of a range.
- The issuer may choose to include such information in the offering document because:
  - The information the company has about the period is materially negative, and therefore must be included for antifraud reasons or to satisfy SEC line-item disclosure requirements, such as the requirement to disclose known trends and uncertainties.
  - The information the company has about the period is positive, and therefore it would assist the marketing of the offering.
- When capsule or flash information is included in an offering document, the underwriters often ideally would like to get some form of comfort on it from the auditors.

What About Capsule or Flash Financial Information? *(cont'd)*

- Type of comfort auditors provide is usually limited to "agreed upon procedures". Ask for a CFO certificate to cover capsule information.
- Counsel should be aware that 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 2005 AICPA White Paper regarding capsule financial information presented in a registration statement prior to the issuance of the year-end financial statements. Affect January and February offerings.
  - While the limitations on comfort described in the white paper technically only apply to fourth quarter and full-year capsule financial information, practitioners have reported that many auditors have increasingly been declining to give comfort on capsule financial information in all periods using the principles articulated in the white paper

Going-Concern Issue

- As part of the audit, an auditor must evaluate conditions or events discovered that raise questions about whether the issuer will be able to continue as a "going concern."
- Information that raises going concern questions generally relates to the issuer's ability to meet its maturing obligations without selling operating assets, restructuring debt or revising operations based on outside pressures or similar strategies.
- SAS 59 (now AS 2415) concludes that the projection of the going-concern concept is limited to a reasonable period of time, which is defined as not exceeding one year beyond the date of the audited financial statements.
- Auditors are required to evaluate information obtained during the course of the audit engagement to determine whether substantial doubt has been raised about the issuer's continued existence as a going concern.

Going-Concern Issue *(cont'd)*

- Some conditions and events which may raise substantial doubt include: (i) recurring operating losses/negative cash flows from operations, (ii) defaults on indebtedness, (iii) the need to sell substantial assets, (iv) labor difficulties, (v) uneconomic long-term commitments, (vi) legal proceedings or pending legislation that may affect the issuer's ability to continue operations and (vii) the loss of a principal customer.
- When substantial doubt has been raised, the auditor is required to identify and evaluate management's plans (which may also include an evaluation of management's financial projections) for dealing with the conditions and events that prompted the substantial doubt conclusions.
- If there is substantial doubt as to whether the issuer can continue as a going concern, the audited financial statements must adequately disclose the conditions/events that raised the going-concern issue and the auditor's report must include language to the effect that "substantial doubt exists as to the issuer's ability to continue as a going concern."

Special considerations for foreign private issuers

- Comfort letter should state that accountants are also independent under *local* standards
- Comfort letter should state that audited financial statements comply as to form with local accounting standards *and* the ’33 Act/’34 Act
- Currency translations can add a layer of complexity to “tick-and-tie” comfort
- Accounting firms in many non-U.S. jurisdictions request written “arrangement” or “engagement” letters (particularly if the securities are anticipated to be sold outside of the U.S.) that are commonly used outside of the U.S. and may, among other things, limit the liability of, and provide indemnification for, the accountants
  - These letters should be reviewed carefully with counsel and possibly appropriate members of in-house counsel
  - Care should be taken to ensure that any exculpation or indemnification provisions do not limit the value of the comfort letter in litigation

WorldCom and Comfort Letters

- WorldCom's underwriters claimed a due diligence defense in a securities action based upon the comfort letters received in an offering.
- The court determined that the underwriters' reliance on the statements in the comfort letter may have been unreasonable, in light of "warning signs" in the company's financial statements.
  - Key financial ratios were out of line with those of competitors.
- Impact: comfort letters may not provide as much protection as hoped, in the absence of other due diligence procedures by the underwriters on the financial statements.
  - Underwriters must consider the totality of the information.

AICPA White Paper

- AICPA White Paper I (2004): Auditors encouraged not to cover earnings releases until the related quarterly or annual reports are complete.
- AICPA White Paper II (2005) draft relating to the auditor's role in due diligence: purported to prohibit auditors from commenting on financial statements beyond what the comfort letter states.
  - The draft was withdrawn in light of protests from the financial industry.

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