FREQUENTLY ASKED QUESTIONS
RELATING TO COMFORT LETTERS AND
COMFORT LETTER PRACTICE

Introduction to Comfort Letters

Why do underwriters receive comfort letters?
The underwriters of a registered securities offering will require, as a condition to their participation, the receipt of one or more comfort letters from the issuer’s accountants. As discussed below, comfort letters may also be needed in transactions that are not registered with the SEC. Comfort letters constitute an important part of the underwriters’ due diligence review of the accuracy of the financial information contained in a registration statement. Accordingly, they are a key part of the underwriters’ statutory due diligence defense against potential liability under the federal securities laws if the registration statement relating to the offering later is alleged to contain untrue statements or to omit material facts as to the issuer’s financial condition or results of operations.

Who is entitled to receive a comfort letter, and to be named as a recipient?
To be named as an addressee of a comfort letter, a recipient must be entitled to a “due diligence” defense under the Securities Act of 1933 (the “Securities Act”). Accordingly, the parties to a securities transaction that are entitled to receive a comfort letter include the underwriters and the company’s board of directors. The issuer itself, however, is not entitled to a comfort letter, as it does not have the benefit of a due diligence defense.

How does a comfort letter help an underwriter establish its “due diligence” defense?
Under Section 11(a)(5) of the Securities Act, absent a statutory defense, an underwriter may be liable for a material misstatement, or any omission to state material facts necessary to make the statements therein not misleading, in the issuer’s financial statements that are part of the registration statement. Under Sections 11(b)(3)(B) and (C) of the Securities Act, an underwriter has to satisfy two different standards of diligence to establish its defense against Section 11 liability. The lesser standard of Section 11(b)(3)(C) of the Securities Act applies to the audited annual financial statements, which are “expertized” by the auditors. In contrast, Section 11(b)(3)(B) of the Securities Act requires a higher standard of diligence for an underwriter to establish its defense with respect to the unaudited interim financial
statements and other financial information, which are not “expertized.”

With respect to its defense against liability relating to the expertized audited financial statements, an underwriter has the comparatively lighter burden of having no reasonable grounds to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a fact required to be stated therein or necessary to make the statements therein not misleading. An underwriter can rely, in part, on the comfort letter in establishing its defense, particularly the auditor’s opinion stated therein that the financial statements audited by the auditor and included in the registration statement comply as to form in all material respects with the applicable accounting requirements of the Securities Act and the SEC’s related rules and regulations.

However, with respect to an underwriter’s burden to establish a diligence defense relating to the unaudited (not expertized) interim financial statements and other financial information, the underwriter must have had, after reasonable investigation, reasonable grounds to believe and did believe, at the time that part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading. The comfort letter is helpful to an underwriter in establishing its defense under Section 11(b)(3)(B) of the Securities Act. However, an underwriter must still conduct a “reasonable investigation” of the unaudited financial information.

See the discussion below under “To what extent can underwriters rely on a comfort letter as part of their due diligence process?”

See generally SAS 72 Paragraph .12.

Are “selling agents” (named, but not called “underwriters”) entitled to receive a comfort letter in a registered offering?

Yes, if they are “underwriters” for purposes of the Securities Act, such as the “agents” in a registered medium-term note program. In practice, auditors assume that all “agents” in a medium-term note program may act as selling agents rather than underwriters and, consequently, often require the representation letter discussed below, or a legal opinion from the agents’ counsel, as a condition to delivery of a comfort letter to the agents.

Do investors in an offering receive a comfort letter?

No. Investors purchasing securities for their own accounts do not typically have liability under the Securities Act, and have no need for a due diligence defense. Accordingly, investors in a private placement or Rule 144A offering, or purchasers in a registered offering, are not entitled to receive a comfort letter.

Form and Content of Comfort Letters

What is “SAS 72” and how does it impact comfort letters?

Statement on Auditing Standards No. 72 (“SAS 72”) provides guidance to accountants in the preparation of comfort letters, including their scope and form. (SAS 72 is also referred to as “AU Section 634,” where it was subsequently codified.) SAS 72 sets forth the contents of
sample letters, which have become the basic industry text for these letters. For counsel reviewing a comfort letter, any draft received should be reviewed against SAS 72’s examples in order to help ensure that all relevant or required items are covered by the letter.

SAS 72 (as well as SAS 76, which is discussed below) may be found at the following link: http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00634.pdf.

What is a “SAS 76” comfort letter?
SAS 76 specifies the more limited type of comfort that may be provided in a non-registered offering, in which there is no statutory due diligence defense. These types of offerings include Rule 144A offerings and Regulation S offerings.

As of what date are comfort letters dated?
In most U.S. securities offerings involving a comfort letter, at least two separate letters will be delivered. These include the main comfort letter, which is delivered at the time that the underwriting agreement is signed, and dated as of the pricing date of the offering. In addition, the auditors will provide a “bring-down” comfort letter, which is delivered and dated as of the closing date. The bring-down letter may repeat the statements in the initial comfort letter, together with any updates, or may consist of a very short letter that reaffirms the statements in the initial letter.

In contrast, for comfort letters delivered in Europe, such as for Eurobond offerings, see below, “When is the comfort letter given in European capital markets transactions?”

In the case of a closing held for an over-allotment of securities (a “green shoe” closing), an additional bring-down comfort letter will also be delivered on the subsequent settlement date.

When is a dealer in a non-registered offering entitled to a SAS 72 letter instead of a SAS 76 comfort letter?
In unregistered offerings, where there is no due diligence defense, the issuer’s auditors may issue comfort letters to broker-dealers or other financial intermediaries that are participating in the offering, and to the issuer’s board of directors. For example, the initial purchaser in a Rule 144A offering or the lead dealer for a Section 3(a)(2) bank note offering, will request and receive comfort letters. A sample comfort letter delivered to a non-underwriter can be found at Example P of SAS 72. However, as a condition to receiving such a letter, these parties must first deliver a representation letter to the auditors stating that they are conducting a review process or due diligence investigation substantially consistent with the inquiry that they would make in an SEC-registered offering of securities. Paragraphs .06 and .07 of SAS 72 set out the required content of these letters.

What are the key sections of a comfort letter?
A comfort letter will typically include the following principal substantive sections:

- A statement as to the accountants’ independence from the issuer.
- The compliance of the issuer’s audited financial statements with applicable SEC requirements.
- Statements regarding the accountants’ review of interim unaudited financial statements.
- Negative assurance statements relating to the unaudited comparative stub period financial
statements included in the registration statement.

- Recital of any changes in selected key line items during the period after the date of the latest financial statements in the registration statement.
- Comments on the results of additional procedures performed on the miscellaneous financial information in the registration statement (“ticking and tying”).

What are the dates after the end of a fiscal quarter/fiscal year end beyond which a comfort letter cannot be delivered (the 135-day rule)?

In a comfort letter, the auditors can only provide limited comfort as to the period between the last quarterly or monthly financial statements and an agreed cut-off date. The auditors’ procedures for this period are typically limited to asking officials of the issuer who have responsibility for financial and accounting matters whether any changes have occurred in certain key financial statement line items, such as outstanding debt and outstanding equity. If 135 days or more have passed between the date of the most recent financial statements that have been audited or reviewed, on the one hand, and the cut-off date of the comfort letter, on the other hand, the auditors cannot give negative assurance on the change period. This limitation stems from SAS 72, which states that “if the underwriter requests negative assurance as to subsequent changes in specified financial statement items as of a date 135 days or more subsequent to the end of the most recent period for which the accountants have performed an audit or a review, the accountants may not provide negative assurance but are limited to reporting procedures performed and findings obtained.”

In addition, for a registered offering, Rule 3-12(a) of Regulation S-X requires that the latest balance sheet included in a registration statement be dated no more than 134 days for non-accelerated filers (or 129 days for accelerated and large accelerated filers) before the effective date of the registration statement.

These timing limitations will also limit the underwriters’ appetite for effecting an offering during periods in the issuer’s financial reporting cycle, and need to be considered at the time that the offering’s calendar is determined, such as at an “organizational meeting.”

Scope of Comfort Provided

What kind of comfort is provided for audited financial statements?

The comfort letter will affirm that the audited financial statements comply as to form in all material respects with the applicable accounting requirements of the Securities Act, and the related rules and regulations of the SEC thereunder.

What kind of comfort is provided for unaudited quarterly financial statements?

For unaudited quarterly financial statements, the highest level of comfort that may be provided is a review conducted in accordance with the PCAOB interim review standards for a public company (Statement on Auditing Standards No. 100 (“SAS 100”) or, for private companies, Statement on Auditing Standards No. 116 (“SAS 116”)). A review conducted in accordance with these standards permits the
accountants to provide the underwriters negative assurance as to whether (i) any material modifications should be made to the quarterly financial statements for them to be in conformity with generally accepted accounting principles ("GAAP") and (ii) such financial statements comply as to form with the accounting requirements of the Securities Act.

**What kind of comfort is provided for unaudited monthly financial statements?**

The procedures the accountants can perform on any available monthly financial statements (which cover the period since the end of the last fiscal quarter for which quarterly financial statements are available) are even more limited than those performed in a SAS 100 review. The accountants will read the monthly financial statements and make inquiries of management as to those financial statements. Based on these procedures, the accountants will generally compare (i) certain balance sheet items set forth in the most recent monthly balance sheet to the corresponding items set forth in the most recent balance sheet included or incorporated by reference in the registration statement and (ii) certain income statement items set forth in the most recent monthly income statement to the corresponding items set forth in the income statement covering the comparable period of the prior year and, in each case, comment on changes in these items. The line items typically covered include capital stock, long-term debt, consolidated net current assets, stockholders' equity, net sales, total or per-share amounts of income before extraordinary items, and total or per-share amounts of net income. The precise line items to be covered are often subject to negotiation. The accountants will give negative assurance that, as of the end of the most recent full month, there were no changes in the balance sheet line items since the end of the last fiscal quarter, and that there were no decreases in the income statement items that have not been disclosed in the registration statement. To the extent that there are material changes, the underwriters and their counsel will need to consider whether additional disclosures should be made in the registration statement, or if additional due diligence procedures are appropriate.

**What kind of comfort can be provided for financial information between the last completed month, and the date of the comfort letter?**

The comfort on any financial information available for the remaining stub period — that is, from the date of the latest available quarterly or monthly financial statements through to the "cut-off" date — is very limited. At best, the accountants will cover those line items addressed in their comfort provided on the monthly financial statements, and based on management’s representations, will describe any material changes to these line items. If there are no such changes, the accountants, based on management’s representations and their reading of the issuer’s board minutes, will provide negative assurance that no changes have occurred, other than those disclosed in the registration statement. As with the monthly financial statement line item comparisons, material changes may require additional investigation as a due diligence matter.

**What is a “negative assurance” statement?**

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, that nothing came to
their attention that caused them 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 generally accepted accounting principles).

*SAS 72, Paragraph .12, note 10.*

**What is the proper timing for the “cutoff date” set forth in the comfort letter?**

SAS 72 states that the cutoff date, which is the date that the underwriting agreement states as the date through which certain procedures will be performed by the accountants, may be five days prior to the date of the comfort letter. In practice, the cutoff date is often the second or third business day prior to the date of the comfort letter, as the underwriters prefer to have a shorter “dark period.”

*SAS 72, Paragraph .23.*

**What documents incorporated by reference in the registration statement should be covered by the comfort letter?**

Typically, any report under the Exchange Act that contains company financial information can be covered by the comfort letter. This will typically include the issuer’s annual report on Form 10-K (or Form 20-F), quarterly reports on Form 10-Q, and any reports on Form 8-K or Form 6-K that are filed, rather than “furnished,” and include audited or unaudited financial information. A Form 6-K must specifically state that it is incorporated by reference into a particular registration statement to be covered by the comfort letter, or the registration statement must list that Form 6-K as being incorporated into the registration statement.

When can a Form 8-K that includes earnings release information be covered in a comfort letter?

Prospectuses that are filed after the end of a fiscal year or quarter, but before the audited or unaudited financial statements are issued, often include or incorporate by reference “capsule financial information” for the relevant completed quarter. This information consists of summary financial information for the period. The underwriters will typically request that the comfort letter cover this information.

Prior to the adoption of the 2005 “white paper” issued by the American Institute of Certified Public Accountants (the “AICPA”), it was common for comfort letters to cover Form 8-K filings (or Form 6-K filings) that included the issuer’s most recent unaudited financial information set forth in an earnings release. However, under the white paper, the AICPA discouraged auditors from providing comfort on capsule information for a completed fiscal year before the auditors had completed their review procedures with respect to the relevant Form 10-K (or Form 20-F) filing. The limitations on comfort described in the white paper only explicitly apply to fourth-quarter and full-year capsule financial information. However, in practice, many auditors have declined to provide comfort as to capsule financial information for all quarterly periods, due to the principles articulated in the white paper.

In these cases, it is possible, depending upon the circumstances, for (a) the offering to be postponed until new financials are available or (b) the relevant financial information to be covered by additional officer certifications.
The “white paper” may be found at the following link:

What information should be subject to the auditor’s ticks and ties?
The auditors can typically cover information that is taken from, or based on, the issuer’s financial statements or internal financial records. SAS 72 limits the information that the auditors can give tick-mark comfort as to information that:

- Is expressed in dollars or percentages based on dollar amounts and has been obtained from the issuer’s accounting records that are subject to its controls over financial reporting.
- Has been derived by analysis or computation directly from the issuer’s accounting records that are subject to controls over financial reporting.
- Is quantitative and has been obtained from an accounting record if the information is subject to the same controls over financial reporting as dollar amounts.

SAS 72 also lists examples of the types of quantitative information that can only be comforted if it is derived from accounting records subject to controls. These include number of employees, square footage of facilities and backlog information. SAS 72 notes that usually, this type of information is not subject to controls.

In practice, only numbers in the narrative sections of the registration statement (management’s discussion and analysis, for example, and summary financial data) are tick-marked. The numbers in the audited financial statements, and the quarterly financial statements covered by an AU 100 review, and the related footnotes, are not tick-marked.

In addition, SAS 72 prohibits auditors from giving comfort on information that is subject to legal interpretation. This includes, for example, the number of shares that are “beneficially owned” by the issuer.

Needless to say, the identification of the information to be ticked and tied will typically require careful analysis, and discussions between underwriters’ counsel and the auditors. Accordingly, particularly in the context of new disclosures (and in an IPO, virtually all information is new), underwriters’ counsel is encouraged to begin this process as early as possible, and in all cases, before a red herring is circulated to investors.

What other disclosures that are not part of the issuer’s financial statements may be comforted by the accountants?
The accountants may be requested to comfort financial information included in the registration statement under SEC Regulation S-K. The accountants may comment as to whether this information is in conformity with Regulation S-K requirements if the information is (i) derived from accounting records subject to the issuer’s control over financial reporting, or has been derived directly from such accounting records by analysis or computation, and (ii) capable of evaluation against reasonable criteria that have been established by the SEC.

Consequently, the accountants may provide comfort on information responsive to Item 301 of Regulation S-K (Selected Financial Data), Item 302 (Supplementary Financial Information), Item 402 (Executive Compensation), and Item 503(d) (Ratio of Earnings to
Fixed Charges) and the related Exhibit 12 to the registration statement.

The auditors may not give positive assurance on conformity of these sections with the disclosure requirements of Regulation S-K of the type contemplated by a law firm’s “compliance as to form” legal opinion. Instead, they are limited to giving negative assurance, since this information is not given in the form of financial statements and generally has not been audited.

SAS 72, Paragraph .57.

**What types of information are not covered by comfort letters?**

Several types of information will typically not be subject to a comfort letter:

- Information that is deemed “furnished,” but not “filed,” with the SEC. This may include, for example, (a) certain information that is included as an exhibit to a Form 8-K that contains earnings information or (b) certain information furnished (but not filed) by a foreign private issuer on a Form 6-K.

- The “dark period”—several days between the cut-off date and the date of the letter, as discussed above.

- Non-GAAP financial information, if applicable.

Some financial ratios of banks and bank holding companies are not comforted; alternatively, they may receive a low level of comfort, such as confirming that the ratio conforms to the number in the bank’s accounting records and/or that the calculation of the ratio, as performed by the bank, was correct. If a financial ratio or other financial data in the disclosure document is derived from a bank’s Call Report, the auditors will expressly state that they are not commenting on the bank’s application of the regulatory requirements related to the Call Report. That is because a bank’s Call Report contains financial data prepared in accordance with the guidelines of the Federal Financial Institutions Examination Council, rather than GAAP. Thus, they are non-GAAP numbers with respect to which the accountants will only perform agreed-upon procedures set forth in the comfort letter.

In contrast, the ratio of earnings to fixed charges, and the related exhibit filed with the registration statement, are comforted.

**How does an underwriter conduct due diligence on financial information that is not comforted by the auditors?**

Underwriters may request an officer’s certificate of the chief financial officer of the issuer attesting to the accuracy of financial information not covered by the comfort letter. The officer’s certificate may include tick-marked pages covering that financial information. Although not as helpful as a comfort letter provided by the issuer’s auditors, this certificate would be part of the underwriter’s due diligence investigation of the issuer and its financial disclosure.

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**Comfort Letters and Different Types of Transactions**

**When should pro forma financial information relating to mergers and similar transactions be covered by a comfort letter?**

Pro forma financial statements are hypothetical historical financial statements that are designed to demonstrate the impact of a particular transaction.
They show how an issuer’s financial statements for a specific historical period, or as of a specific date, would have appeared if the transaction had occurred at an earlier time.

Under SAS 72, auditors may ask management for the basis of its determination of the pro forma adjustments to the historical financial statements, and may confirm that the pro forma financial information complies with applicable accounting requirements (such as Rule 11-02 of Regulation S-X), and check the arithmetical accuracy of those adjustments, provided that:

- the auditors 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 financial statements for one or more periods); and
- the auditors 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.

See SAS 72, Paragraph .42 and Example D.

Who provides the comfort letter when securities are issued in a merger?

In a merger where shareholders of the target company are receiving shares of the acquiror, the proxy statement is also a prospectus of the acquiror because it includes an offer of the acquiror’s shares. The dealer-manager for the merger will request a comfort letter because it is in a position similar to that of an underwriter as to the offering of the acquiror’s shares.

Because the proxy/prospectus will include or incorporate by reference historical financial statements of both the acquiror and the target, and also include pro forma combined financial data, the dealer-manager will want to receive separate comfort letters from the auditors of both the acquiror and the target company. The dealer-manager will have to provide the representation letter described in SAS 72 paragraphs .06 and .07. The auditors of the acquiror will typically cover the pro forma combined financial data in their comfort letter. Example D of SAS 72 sets forth typical comfort letter language with respect to pro forma financial statements.

If the business to be acquired is a non-public company whose financial statements are not subject to the PCAOB’s audit standards, the comfort letter for the acquired company may be governed by AU 920 rather than SAS 72. AU 920 may be found at: http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-C-00920.pdf.

How often should comfort letters be delivered under an MTN or similar program?

Most programs provide for comfort letters to be delivered at the time of the establishment of the program, and following the issuance of audited financial statements. Many programs also provide for the delivery of comfort letters when the issuer’s unaudited quarterly financial information is released. Whether or not required by the applicable program agreement or similar agreement, the underwriters will also typically require the delivery of an updated comfort letter in connection with a syndicated or other significant takedown of securities under the program.
Are comfort letters provided to the dealer-manager in an exchange offer?

Yes. An exchange offer is an offering of securities and must either be registered under the Securities Act or qualify for an exemption from the requirements. The offering documentation will often include disclosure that is similar to that of a securities offering. Dealer-managers will generally conduct a due diligence process and obtain comfort letters (and legal opinions and other deliverables) in a manner that is comparable to that of the underwriters in a securities offering for cash.

Are comfort letters also given in European capital markets transactions?

In the European capital markets, it is typical for the underwriters to require a comfort letter from the issuer’s/guarantor’s accountants. This letter has traditionally confirmed, in essence, two main items:

(i) that the financial information contained in the offering document is accurate and fairly presented; and

(ii) that there has been no material adverse change to the financial condition of the issuer/guarantor between the date of its last audited accounts and the date on which the comfort letter is provided.

The major accounting firms in the United Kingdom and elsewhere in Europe expect to provide comfort letters that follow the form published by the International Capital Markets Association (“ICMA”). The comfort provided in this form is limited to information about changes in specific financial measures; the accountants are not required either to state expressly that there has been no adverse change in the financial condition of an issuer/guarantor or to offer an opinion as to whether or not any change in the issuer’s/guarantor’s financial condition is material.

However, practices in relation to accountants’ comfort letters differ between the United States and the European Markets. In this regard, it should be noted that there is no uniform liability regime in Europe. In particular, there is no statutory liability in the U.K. regime regarding financial statements equivalent to that in the Securities Act in the United States.

When is the comfort letter given in European capital markets transactions?

Underwriters typically receive a comfort letter from the auditors at the date on which the offering circular/prospectus is published (i.e., the signing date, in the case of a standalone issue, or the establishment/update of the program, in the case of an EMTN program).

Where a comfort letter is required as a condition precedent to closing, it is, therefore, often no more than a confirmation that the statements made in the earlier comfort letter remain true.

What are “engagement letters” and how are they used in comfort letter practice?

In U.S. practice, there is no engagement letter between the auditing firm and the underwriters, because the auditors are hired and paid by the issuer. However, in Europe and other jurisdictions, the auditing firm will often have a separate agreement with the underwriters. This agreement may be referred to as an “engagement letter” or an “arrangement letter.” In this agreement, the auditing firm will seek to include provisions that may limit its liability, for example, up to a specified amount, or to limit liability to the office of the firm that
is issuing the comfort letter. Other provisions in the document may include, for example:

- restrictions on the use of the comfort letter, and the (lack of) ability of third parties to rely on it; and
- the procedures that the auditors will perform to deliver the letter.

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Limitations of Comfort Letters
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To what extent can underwriters rely on a comfort letter as part of their due diligence process?

Comfort letters are regarded as an important part of the underwriters’ due diligence process. However, without appropriate due diligence procedures by the relevant underwriters, the comfort letter itself may not be particularly useful to establish a due diligence defense.

In the case In re WorldCom, Inc. Securities Litigation, 346 F. Supp. 2d 628 (S.D.N.Y. 2004), the District Court for the Southern District of New York held that the underwriter defendants’ reliance on comfort letters and unaudited financial statements, absent reasonable investigation of the statements’ accuracy, would not establish a due diligence defense. The court held that the underwriters’ mere reliance on audited financial statements, where the underwriter faces facts suggesting a red flag concerning the accuracy of those statements, would not establish a reliance defense and that the red flag triggered a duty to investigate.

Accordingly, the receipt of comfort letters should be accompanied by appropriate due diligence, and follow-up with respect to any issues that raise concerns.

Or, put another way, comfort letters are a significant part of an underwriter’s due diligence process, and care should be applied to their review and negotiation. However, comfort letters are certainly not a substitute for robust due diligence of the issuer’s financial statements and other financial information.

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