

# Client Alert

Latham & Watkins Corporate Department

## New SAS 100 Replaces SAS 71 – Reviews of Interim Financials Are Limited to Public or Nearly Public Companies

In October 2002, the Auditing Standards Board of the American Institute of Certified Public Accountants approved Statement on Auditing Standards No. 100, *Interim Financial Information*. The new SAS 100 supersedes Statement on Auditing Standards No. 71, *Interim Financial Information*. SAS 100 limits the situations in which accounting firms are permitted to perform reviews of interim financial statements and provides additional requirements for reviews of interim financial statements. SAS 100 is effective for interim periods within fiscal years beginning after December 15, 2002.

### Impact on Comfort Letters

The form and content of comfort letters used in securities offerings must comply with the standards set out in Statement on Auditing Standards No. 72, *Letters for Underwriters and Certain Other Requesting Parties*.

Under SAS 72, accountants may provide comfort letters to (1) underwriters in connection with registered public offerings of securities and (2) initial purchasers in private offerings of securities (including those taking advantage of Rule 144A and Regulation S). However, in the case of private offerings, accountants are only permitted

to give comfort to addressees who provide the accountant with a letter of representation to the effect that the addressee is conducting a review process, or due diligence investigation, substantially consistent with the inquiry it would conduct in an SEC registered offering. SAS 72 also provides that comfort letters should only be issued when the accountant has appropriate knowledge of an issuer's internal controls in relation to both annual and interim financial information. None of the provisions of SAS 72 is affected by the promulgation of new SAS 100. However, the limitations in SAS 100 are likely to have a dramatic impact on the content of comfort letters for first-time issuers and for public companies that have recently acquired, or agreed to acquire, other private companies.

### What Does a Standard Comfort Letter Contain?

In a standard comfort letter, an accounting firm provides a level of comfort on financial and accounting data that varies with the nature and source of the financial data appearing in the offering document. Set forth on the following page is a brief summary of the salient features of a standard comfort letter.

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- *Annual Financial Statements.* Annual financial statements in an offering document are generally audited and form part of the document that is considered to have been “expertised” within the meaning of the Securities Act of 1933, as amended. The accounting firm indicates in the comfort letter that it has audited the annual financial statements included in the offering document. Non-experts, such as underwriters and initial purchasers, are not liable with respect to audited financial information if they had no reasonable grounds to believe and did not believe that such information was misleading.
- *Interim Financial Statements.* Interim financial statements included in offering documents are typically unaudited and are, therefore, not considered “expertised.” As a result, underwriters and initial purchasers undertake a “reasonable investigation” in order to establish the accuracy of those financial statements and to satisfy their “due diligence” obligations. Under SAS 71, the practice developed for investment banks to request that the accountants perform a review of interim financial statements. When accountants performed a SAS 71 review, they would include in the comfort letter a statement to the effect that they had conducted such a review and a further statement to the effect that nothing came to their attention during that review process that caused them to believe that any material modifications should be made to the interim financial statements in order for them to be in conformity with GAAP. This practice, all agreed, constituted a “reasonable investigation” sufficient to establish a valid “due diligence” defense.
- *Negative Assurances.* Negative assurances are another critical element of a standard comfort letter. SAS 72 includes industry standard wording for customary negative assurances from an accounting firm. These assurances address whether, in the course of performing certain specified procedures, the accounting firm has become aware of (1) any changes in specified balance sheet items (long-term debt, stockholders’ equity, net current assets) since the most recent balance sheet included in the offering document or (2) any changes in specified income statement items (revenues, operating profit, net income, income per share) during the period between the end of the most recent income statement included in the offering document and the date of the comfort letter compared to the corresponding period of the prior year (sometimes called the “change period”). These negative assurances are thought to be an important element of a typical due diligence investigation.
- *Tick Mark Procedures.* Finally, a standard comfort letter will include a section reciting the handful of agreed upon procedures that have been performed by the accounting firm to verify individual financial numbers that appear in the text of the disclosure document, most notably in the “MD&A” section of the document. These agreed upon procedures are usually indicated by a series of “tick marks” noted on the pages of the disclosure document that are attached to the comfort letter as exhibits. They constitute evidence that the underwriters or initial purchasers conducted a reasonable investigation as to each of the numbers covered by the agreed procedures.

## How Will SAS 100 Change Comfort Letters?

SAS 100 supercedes SAS 71 and establishes new standards for accountants reviewing interim financial statements included in offering documents. It does not have any direct impact on SAS 72, and SAS 72 continues to be the accepted guideline for comfort letters in all securities offerings. However, SAS 100 will significantly impact the content of comfort letters in some cases because it

significantly restricts the ability of accounting firms to perform reviews of interim financial statements. The text of SAS 100 states that an accountant **may** conduct a review of the interim financial information of (1) an SEC registrant or (2) a non-SEC registrant that makes a filing with a regulatory agency in preparation for a public offering or listing, if the entity's latest annual financial statements have been or are being audited. Some accounting firms are interpreting this to mean that they **may not** review interim financial statements of issuers that do not meet these requirements. Even worse, since no review of the interim financial statements has occurred, those same firms are taking the position that they cannot provide the customary level of negative assurances with respect to the change period in situations where 135 days or more have passed since the most recent audit of the issuer's financial statements. Taken together, these positions represent a significant change in comfort letter practice for some Rule 144A/Regulation S financings.

Until today, the market practice has been for underwriters and initial purchasers to require that a SAS 71 review be performed on the interim financial statements of all securities issuers, including first-time issuers, as well as upon the interim financial statements of all recently acquired or soon-to-be acquired private companies if the interim financial statements of those companies appear in the offering documents. The comfort letter in those cases would include customary negative assurances and would be in the form prescribed in SAS 72 as "Example A."

However, under SAS 100, investment banks may not receive the same level of comfort on interim financial statements for issuers who do not meet the "public company" standards of SAS 100. Instead, investment banks may receive a comfort letter that follows the directions set forth in SAS 72 for interim financial statements

that were not subject to an interim review. The format for this lower level of comfort is set forth in "Example O" of SAS 72. Example O-level comfort on interim financial statements is weaker than Example A-level comfort in two important respects:

- no review of interim financials is conducted; and
- no comment is made as to whether the accounting firm is aware of any need to amend the interim financials in order to bring them into conformity with GAAP.

In addition, if 135 days or more have passed since the date of the most recent audit or review, SAS 72 permits the accounting firms to provide a weaker level of comfort on balance sheet and income statement changes since the date of the most recent interim financial statements included in the offering document.

The language in the box labeled "Example A" on the following page sets forth the language called for by SAS 72 for situations where a SAS 71 (now SAS 100) review has been performed. The language in the box labeled "Example O" on the following page sets forth the language called for by SAS 72 for situations where no review of interim financials has been performed. It is important to note that the Example O language does not contain any comfort from the accountants as to the interim financial statements' compliance with GAAP. In addition, Example O includes the weaker level of comfort called for by SAS 72 on the change period where more than 135 days have passed since the last audit or review. Rather than providing for customary negative assurances as to the change period, Example O-level comfort merely recites the procedures performed and the findings obtained. In other words, it simply "passes through" to the addressee whatever management has told the accounting firm about the change period.

### Example A

4. For purposes of this letter we have read the 200Z minutes of meetings of the shareholders, the board of directors, and [*include other appropriate committees, if any*] of the company and its subsidiaries as set forth in the minute books at June 23, 200Z, officials of the company having advised us that the minutes of all such meetings through that date were set forth therein; we have carried out other procedures to June 23, 200Z, as follows (our work did not extend to the period from \_\_\_\_\_, 200Z, to \_\_\_\_\_, 200Z, inclusive):

- a) With respect to the three-month periods ended March 31, 200Z and 200Y, we have:
  - i) Performed the procedures specified by the American Institute of Certified Public Accountants for a review of interim financial information as described in SAS No. 71, *Interim Financial Information*, on the unaudited condensed consolidated balance sheet as of March 31, 200Z, and unaudited condensed consolidated statements of income, retained earnings (shareholders' equity) and cash flows for the three-month periods ended March 31, 200Z and 200Y, included in the [*offering document*].
  - ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited condensed consolidated financial statements referred to in 4(a)(i) above are stated on a basis substantially consistent with that of the audited consolidated financial statements included in the [*offering document*] and comply as to form in all material respects with United States generally accepted accounting principles.
- b) With respect to the period from April 1, 200Z, to May 31, 200Z, we have:
  - i) Read the unaudited condensed consolidated financial statements of the company and subsidiaries for April and May of both 200Y and 200Z furnished to us by the company, officials of the company having advised us that no financial statements as of any date or for any period subsequent to May 31, 200Z, were available.

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

The foregoing procedures do not constitute an audit conducted in accordance with United States generally accepted accounting principles. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations regarding the sufficiency of the foregoing procedures for your purposes.

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

- a) Any material modifications should be made to the unaudited condensed consolidated financial statements described in 4(a)(i), included in the [*offering document*], for them to be in conformity with accounting principles generally accepted in United States generally accepted accounting principles.
- b) (i) At May 31, 200Z, there was any change in the capital stock, increase in long-term debt, or decrease in consolidated net current assets or shareholders' equity of the consolidated companies as compared with amounts shown in the March 31, 200Z, unaudited condensed consolidated balance sheet included in the [*offering document*], or (ii) for the period from April 1, 200Z, to May 31, 200Z, there were any decreases, as compared to the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income, except in all instances for changes, increases or decreases that the [*offering document*] discloses have occurred or may occur.

6. As mentioned in 4(b), company officials have advised us that no financial statements as of any date or for any period subsequent to May 31, 200Z, are available; accordingly the

### Example A (continued)

procedures carried out by us with respect to changes in financial statement items after May 31, 200Z, have, of necessity, been even more limited than those with respect to the periods referred to in paragraph 4. We have inquired of certain officials of the company who have responsibility for financial and accounting matters whether (a) at June 23, 200Z, there was any change in the capital stock, increase in long-term debt or decrease in consolidated net current assets or shareholders' equity of the consolidated companies as compared with amounts shown on the March 31, 200Z, unaudited condensed consolidated balance sheet included in the [offering document], or (b) for the period from April 1, 200Z, to June 23, 200Z, there were any decreases, as compared with the

corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in paragraph 4, nothing came to our attention that caused us to believe that there was any such change, increase, or decrease, except in all instances for changes, increases, or decreases that the [offering document] discloses have occurred or may occur.

(Based on Example A of SAS No. 72 with amendments to delete references to registration statements and compliance with SEC accounting rules.)

### Example O

4. For purposes of this letter we have read the 200X minutes of meetings of the stockholders, the board of directors, and [include other appropriate committees, if any] of the company as set forth in the minute books at June 23, 200X, officials of the Company having advised us that the minutes of all such meetings through that date were set forth therein; we have carried out other procedures to June 23, 200X, as follows (this work did not extend to the period from \_\_\_\_\_, 200X to \_\_\_\_\_, 200X, inclusive):

- a) With respect to the three-month periods ended March 31, 200X and 200W, we have:
  - i) Read the unaudited condensed consolidated balance sheet as of March 31, 200X, and unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month period ended March 31, 200X and 200W, included in the [offering document] and agreed the amounts contained therein with the company's accounting records as of March 31, 200X and 200W, and for the three-month period then ended.
  - ii) Inquired of certain officials of the company who have responsibility for

financial and accounting matters whether the unaudited condensed consolidated financial statements referred to in (a)(i): (1) are in conformity with accounting principles generally accepted in the United States applied on a basis substantially consistent with that of the audited consolidated financial statements included in the [offering document]. Those officials stated that the unaudited condensed consolidated financial statements are in conformity with accounting principles generally accepted in the United States applied on a basis substantially consistent with that of the audited consolidated financial statements.

- b) With respect to the period from April 1, 200X to May 31, 200X, we have:
  - i) Read the unaudited condensed consolidated financial statements of the company for April and May of both 200X and 200W furnished to us by the company and agreed the amounts contained therein with the company's accounting records. Officials of the company have advised us that no such financial statements as of any date or for any period subsequent to May 31 200X were available.

### Example O (continued)

ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether (1) the unaudited condensed consolidated financial statements referred to in b(i) are stated on a basis substantially consistent with that of the audited consolidated financial statements included in the [offering document], (2) at May 31, 200X, there was any change in the capital stock, increase in long-term debt or any decrease in consolidated net current assets or stockholder's equity of the consolidated companies as compared with amounts shown in the March 31, 200X unaudited condensed consolidated balance sheet included in the [offering document], and (3) there were any decreases for the period from April 1, 200X, to May 31 200X, 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. Those officials stated that (1) the unaudited condensed consolidated financial statements referred to in b(i) are stated on a basis substantially consistent with that of the audited consolidated financial statements included in the [offering document], (2) at May 31, 200X, there was no change in the capital stock, no increase in long-term debt and no decrease in consolidated net current assets or stockholder's equity of the consolidated companies as compared with amounts shown in the March 31, 200X unaudited condensed consolidated balance sheet included in the [offering document], and (3) there were no decreases for the period from April 1, 200X, to May 31 200X, 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.

c) As mentioned in 4(b)(i), company officials have advised us that no financial statements as of any date or for any period subsequent to May 31, 200X, are available; accordingly the procedures carried out by us with respect to changes in financial statement items after

May 31, 200X, have, of necessity, been even more limited than those with respect to the periods referred to in 4(a) and 4(b). We have inquired of certain officials of the company who have responsibility for financial and accounting matters whether (a) at June 23, 200X, there was any change in the capital stock, increase in long-term debt or decrease in consolidated net current assets or shareholders' equity of the consolidated companies as compared with amounts shown on the March 31, 200X, unaudited condensed consolidated balance sheet included in the [offering document], or (b) for the period from April 1, 200X, to June 23, 200X, 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. Those officials stated that (1) at June 23, 200X, there was no change in the capital stock, no increase in long-term debt and no decrease in consolidated net current assets or shareholders' equity of the consolidated companies as compared with amounts shown on the March 31, 200X, unaudited condensed consolidated balance sheet included in the [offering document], and (2) for the period from April 1, 200X, to June 23, 200X, there were no 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.

The foregoing procedures do not constitute an audit conducted in accordance with United States generally accepted accounting principles. We make no representations regarding the sufficiency of the foregoing procedures for your purposes. Had we performed additional procedures or had we conducted an audit or a review, other matters might have come to our attention that would have been reported to you.

(Based on Example O of SAS No. 72 with amendments to delete references to registration statements and compliance with SEC accounting rules.)

## How Does SAS 100 Affect the Process of Conducting a Review of Interim Financials?

SAS 100 adopts the review procedures provided for in SAS 71 and adds certain new analytical procedures, inquiries and other review procedures, including providing for the accountants to:

- compare disaggregated revenue data (e.g. revenue reported by month and by product line or business segment for the current interim period with that of comparable prior periods);
- obtain evidence that the interim financial information agrees or reconciles with the accounting records; and
- inquire of members of management who have responsibility for financial and accounting matters about their knowledge of any fraud or suspected fraud affecting the entity and inquire whether they are aware of allegations of fraud or suspected fraud, affecting the entity, received in communications from employees, former employees, analysts, regulators, short sellers or others.

As a result, although the review of interim financial statements called for by SAS 100 is similar to the review contemplated by SAS 71, the SAS 100 standards are somewhat more rigorous.

### Conclusion

The primary impact of SAS 100 will be to reduce the level of comfort available from accounting firms on interim financial statements contained in offering documents for first-time issuers. Many high yield bond issuers are not

yet public companies, and almost all high yield bonds are issued in private offerings under Rule 144A and Regulation S. It is possible that all first-time high yield offerings will be affected by these new guidelines. Securities offerings by non-U.S. issuers that are not SEC registrants may similarly be affected, unless accounting firms interpret SAS 100 differently for non-U.S. issuers. A secondary impact of SAS 100 will be to limit the level of comfort available with respect to probable or recently completed acquisitions of entities that were not themselves public companies, even where the issuer of the securities is itself a public company. Finally, in situations where no review of interim financials has been performed, the level of negative assurances available to underwriters and initial purchasers on the period since the end of the most recent interim financials appearing in the offering documents will be limited if 135 days or more have passed since the date of the last audit.

It remains to be seen whether accounting firms will agree to provide SAS 100 reviews of interim financials of private issuers who sign a customary A/B registration rights agreement. We believe that the answer to this question should be yes since they will become public companies in a matter of weeks or months following the closing of the high yield offering. However, the most that can be said definitively at this point is that the interpretation of these new guidelines by the accounting profession will evolve in practice over time. We have no doubt that we will all be discussing SAS 100 and its implications with some frequency over the next few months.

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