

AU Section 9634

Letters for Underwriters and Certain Other Requesting Parties: Auditing Interpretations of Section 634

1. Letters to Directors Relating to Annual Reports on Form 10-K^[*]

.01 Question—Annual reports to the Securities and Exchange Commission (SEC) on Form 10-K must be signed by at least a majority of the registrant's board of directors. In reviewing the Form 10-K, directors may seek the involvement of the registrant's independent auditors and other professionals.

.02 What types of services could the auditor perform at the request of the board of directors in connection with the Form 10-K? For example, is it permissible for the auditor to comment on compliance of the registrant's Form 10-K with the requirements of the various SEC rules and regulations?^[1]

.03 Interpretation—The auditor can express an opinion to the board of directors on whether the financial statements and financial statement schedules audited comply as to form with the applicable accounting requirements of the Securities Exchange Act of 1934 and the related rules and regulations thereunder adopted by the SEC (see section 634 paragraph .33).²

.04 The auditor may affirm to the board of directors that under generally accepted auditing standards the auditor is required to read the information in addition to audited financial statements contained in the Form 10-K, for the purpose of considering whether such information may be materially inconsistent with information appearing in the financial statements (see section 550). However, the report to the board of directors should state that the auditor has no obligation to perform any procedures to corroborate such information.

.05 In addition, the auditor could perform, at the request of the board of directors, specified procedures and report the results of those procedures concerning various information contained in the Form 10-K such as tables, statistics and other financial information. There should be a clear understanding with the board as to the nature, extent and limitations of the procedures to be performed and as to the kind of report to be issued. Although the guidance provided in section 634 is intended primarily for auditors issuing a letter to underwriters and certain other requesting parties in connection with an offering of securities, the guidance in section 634 paragraphs .54–.60 would also be applicable when the auditor is asked to furnish a letter to the board of directors in connection with the filing of Form 10-K under the Securities Exchange Act of 1934.³ The types of information on which auditors may comment are described in section 634 paragraph .55. The auditor should comment only on that information if

[*] [Footnote deleted June 1993, by the issuance of Statement on Auditing Standards No. 72.]

[1] [Footnote deleted June 1993, by the issuance of Statement on Auditing Standards No. 72.]

² The auditor should not provide any assurance on compliance with the provisions of the Securities Exchange Act of 1934 regarding controls. [Revised, January 2009, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 15.]

³ Section 634 paragraph .12 states in part: "Accountants will normally be willing to assist the underwriter but the assistance accountants can provide by way of comfort letters is subject to limitations. One limitation is that independent accountants can properly comment in their professional capacity only on matters to which his professional expertise is substantially relevant."

the criteria in section 634 paragraphs .55 and .57 have been met. The comments should be made in the form of description of procedures performed and findings obtained, ordinarily expressed in terms of agreement between items compared.

.06 Certain financial information in Form 10-K is included because of specific requirements of Regulation S-K. The auditor may comment as to whether this information is in conformity with the disclosure requirements of Regulation S-K if the conditions in section 634 paragraph .57 are met. Section 634 paragraph .57 identifies the disclosure requirements of Regulation S-K that generally meet those conditions. The auditor is limited to giving negative assurance, since this information is not given in the form of financial statements and generally has not been audited by the accountants. (See section 634 paragraph .57.)

.07 The auditor should not comment on matters that are primarily subjective or judgmental in nature such as those included in Item 7 of Form 10-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations." For example, changes between periods in gross profit ratios may be caused by factors that are not necessarily within the expertise of auditors. However, the auditor can comment on specific changes in comparative amounts that are included in management's discussion if the amounts used to compute such changes are obtained from the financial statements or accounting records as discussed in section 634 paragraph .55, but cannot comment with respect to the appropriateness of the explanations.

.08 There are no criteria by which to measure the sufficiency of the procedures performed by the accountants for the directors' purposes. Ordinarily the auditor should discuss with the directors or the audit committee the procedures to be performed and may suggest procedures that might be meaningful in the circumstances. However, the auditor should clearly indicate to the board of directors that the auditor cannot make any representations as to whether the agreed-upon procedures are sufficient for the directors' purposes.

.09 It should not ordinarily be necessary for the auditor to reaffirm the auditor's independence to the board of directors. If such a representation is requested, however, the auditor may include in the letter a statement similar to that described in section 634 paragraph .31.

[Issue Date: April, 1981; Modified: May, 1981;
Revised: June, 1993; Revised: January, 2001.]

[2.] Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters

[.10-.12] [Deleted April 1993 by Statement on Auditing Standards No. 72.]

3. Commenting in a Comfort Letter on Quantitative Disclosures About Market Risk Made in Accordance With Item 305 of Regulation S-K

.13 *Introduction*—Regulation S-K Item 305, *Quantitative and Qualitative Disclosures About Market Risk*, requires certain quantitative and qualitative disclosures with respect to derivative financial instruments, generally as defined in Financial Accounting Standards Board *Accounting Standards Codification* glossary.

.14 In addition to qualitative (i.e., descriptive) disclosures, Item 305 requires quantitative disclosures that may be presented in the form of a tabular presentation, sensitivity analysis, or value-at-risk disclosures. Disclosures

generally include a combination of historical and fair value data and the hypothetical effects on such data of assumed changes in interest rates, foreign currency exchange rates, commodity prices and other relevant market rates. The quantitative and qualitative information required by Item 305 should be disclosed outside the financial statements and related notes thereto.

.15 Question—May an accountant provide positive or negative assurance on conformity with Item 305 of Regulation S-K?

.16 Interpretation—Section 634, *Letters for Underwriters and Certain Other Requesting Parties*, paragraph .57, states that accountants may not give positive assurance on conformity of information with the disclosure requirements of Regulation S-K since this information is not in the form of financial statements and generally has not been audited by the accountants. Accountants may provide negative assurance on conformity with Regulation S-K only if the following conditions are met:

- a. The information is derived from the accounting records subject to the entity's controls over financial reporting, or has been derived directly from such accounting records by analysis or computation.
- b. This information is capable of evaluation against reasonable criteria that have been established by the SEC.

Although some information needed to comply with Item 305 is derived from the accounting records, registrants must also provide a substantial amount of information that is not derived from accounting records subject to the entity's controls over financial reporting. As a result, accountants should not provide negative assurance on conformity with Item 305 of Regulation S-K.

.17 Question—May an accountant otherwise provide comments in a comfort letter on items disclosed by registrants in accordance with Item 305 of Regulation S-K?

.18 Interpretation—Section 634 paragraph .55 states that accountants should comment only with respect to information—

- a. That is expressed in dollars (or percentages derived from such dollar amounts) and that has been obtained from accounting records that are subject to the entity's controls over financial reporting or
- b. That has been derived directly from such accounting records by analysis or computation.

As a result, accountants should not comment on the Item 305 qualitative disclosures.

.19 The three alternative forms of quantitative disclosures under Item 305 reflect hypothetical effects on market-risk-sensitive instruments and result in differing presentations. The forward-looking information used to prepare these presentations may be substantially removed from the accounting records that are subject to the entity's controls over financial reporting. Further, section 634 paragraph .55 also states that "the accountants should not comment on matters merely because they happen to be present and are capable of reading, counting, measuring, or performing other functions that might be applicable." Accordingly, an accountant's ability to comment on these disclosures is largely dependent upon the degree to which the forward-looking information used to prepare these disclosures is linked to such accounting records.

.20 The tabular presentation includes the fair values of market-risk-sensitive instruments and contract terms to determine the future cash flows

from those instruments that are categorized by expected maturity dates. This approach may require the use of yield curves and implied forward rates to determine expected maturity dates, as well as assumptions regarding prepayments and weighted average interest rates.

.21 The term *sensitivity analysis* describes a general class of models that are designed to assess the risk of loss in market-risk-sensitive instruments, based upon hypothetical changes in market rates or prices. Sensitivity analysis does not refer to any one, specific model and may include duration analysis or other "sensitivity" measures. The disclosures are dependent upon assumptions about theoretical future market conditions and, therefore, are not derived from the accounting records.

.22 The term *value at risk* describes a general class of models that provide a probabilistic assessment of the risk of loss in market-risk-sensitive instruments over a selected period of time, with a selected likelihood of occurrences based upon selected confidence intervals. Value-at-risk disclosures are extremely aggregated and, in addition to the assumptions made for sensitivity analyses, may include additional assumptions regarding correlation between asset classes and future market volatilities. As a result, these disclosures are not derived from the accounting records.

.23 Of the three disclosure alternatives, the tabular presentation contains the most limited number of assumptions and least complex mathematical calculations. Furthermore, certain information, such as contractual terms, included in a tabular presentation is derived from the accounting records. Accordingly, accountants may perform limited procedures related to tabular presentations to the extent that such information is derived from the accounting records.

.24 The modeling techniques and underlying assumptions utilized for sensitivity analysis and value-at-risk disclosures generally will be highly complex. The resultant disclosures may be substantially different from the basic historical financial input derived directly from the accounting records. Due to the hypothetical and forward-looking nature of these disclosures and the potentially limited usefulness of any procedures that may be performed, accountants should not agree to make any comments or perform any procedures related to sensitivity analysis or value-at-risk disclosures.

.25 When performing procedures related to tabular presentation disclosures, the accountant will need to consider whether the entity's documentation of its contractual positions in derivatives, commodities and other financial instruments is subject to the entity's controls over financial reporting and whether it provides a complete record of the entity's market-risk-sensitive instruments. In addition, the accountant should disclaim as to the reasonableness of the assumptions underlying the disclosures.

.26 Item 305 requires registrants to stratify financial instruments according to market risk category, i.e., interest rate risk, foreign exchange risk, and equity price risk. Item 305 stipulates that, if an instrument is at risk in more than one category, the instrument should be included in the disclosures for each applicable category. In reporting findings from agreed-upon procedures relating to market risk categories, the accountant should not provide any findings that the company's stratifications are complete or comply as to form with Item 305 requirements and should disclaim with respect to the company's determination of market risk categories.

.27 Item 305 encourages registrants to provide quantitative and qualitative information about market risk in terms of, among other things, the magnitude of actual past market movements and estimates of possible near-term market movements. Accountants should not agree to perform any procedures related to such market data.

.28 The accountant should establish a clear understanding with the underwriter as to the limitations of the procedures to be performed with respect to the market risk disclosures. Further, accountants should consider the need to utilize a specialist in performing procedures related to those disclosures.

.29 The following examples, based upon example H of section 634 paragraph .64, provide very simplified procedures, findings and limitations related to Item 305 tabular presentation disclosures. In practice, the procedures generally will be substantially more complex.

Symbol

Procedures and Findings

- ✓ Compared with a schedule prepared by the Company from its accounting records. 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. However, we make no comment as to the appropriateness or completeness of the Company's classification of its market-risk-sensitive instruments into market risk categories, nor as to its determination of the expected maturity dates or amounts. (Note: This is an example of procedures related to tabular presentations of face amounts, carrying amounts, fair values and notional amounts which stratify such amounts as to interest rate risk.)
- ⊗ Compared with a schedule prepared by the Company from its accounting records to calculate weighted average fixed interest rates and weighted average fixed pay and receive rates, and found such percentages 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. However, we make no comment as to the appropriateness of the Company's methodology in calculating weighted average fixed rates.

(Note: It may be necessary to provide a more complete description of the procedures performed in other circumstances.)

We make no comment as to the appropriateness or completeness of the Company's determination of the Regulation S-K requirements for quantitative and qualitative disclosures about market risks or with respect to the reasonableness of the assumptions underlying the disclosures.

[The following is an extract from a registration statement that illustrates how an accountant can document procedures performed on a tabular presentation of market risk disclosures made in accordance with Item 305 of Regulation S-K.]

INTEREST RATE SENSITIVITY

The table that follows provides information about the Company's derivative financial instruments and other financial instruments that are sensitive to changes in interest rates, including interest rate swaps and debt obligations. For debt obligations, the table presents principal cash flows and related weighted average interest rates by expected maturity dates. For interest rate swaps, the table presents notional amounts and weighted average interest rates by expected maturity dates. Notional amounts are used to calculate the contractual payments to be exchanged under the contract. Weighted average variable rates are based on implied forward rates in the yield curve at the reporting date. The information is presented in U.S. dollar equivalents, which is the Company's reporting currency. The instrument's actual cash flows are denominated in both U.S. dollars (\$US) and German deutschmarks (DM), as indicated in parentheses.

	<i>Expected maturity dates</i>					<i>Total</i>	<i>Fair Value</i>
	<i>19X2⁴</i>	<i>19X3⁴</i>	<i>19X4⁴</i>	<i>19X5⁴</i>	<i>There-after⁴</i>		
<i>Liabilities</i>	<i>(\$US equivalent in millions)</i>						
Long-Term Debt:							
Fixed Rate (\$US)	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX√	\$XXX√
Average interest rate	XX%	XX%	XX%	XX%	XX%	XX%⊗	
Fixed Rate (DM)	XXX	XXX	XXX	XXX	XXX	XXX√	XXX√
Average interest rate	XX%	XX%	XX%	XX%	XX%	XX%⊗	
Variable Rate (\$US)	XXX	XXX	XXX	XXX	XXX	XXX√	XXX√
Average interest rate	XX%	XX%	XX%	XX%	XX%	XX% ⁴	
<i>Interest Rate Derivatives</i>	<i>(\$US equivalent in millions)</i>						
<i>Interest Rate Swaps:</i>							
Variable to Fixed (\$US)	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX√	\$XXX√
Average pay rate-fixed	XX%	XX%	XX%	XX%	XX%	XX%⊗	
Average receive rate-variable	XX%	XX%	XX%	XX%	XX%	XX% ⁴	
Fixed to Variable (\$US)	XXX	XXX	XXX	XXX	XXX	XXX√	XXX√
Average pay rate-variable	XX%	XX%	XX%	XX%	XX%	XX% ⁴	
Average receive rate-fixed	XX%	XX%	XX%	XX%	XX%	XX%⊗	

[Issue Date: August 1998; Revised: June 2009.]

⁴ No findings should be expressed on amounts in these columns because these disclosures include either management's expectations of future cash flows or the use of implied forward rates applied to such expected cash flows. Accordingly, such information does not meet the criteria of section 634 paragraph .55.