VIA EMAIL

June 9, 2005

Program Coordinator
Federal Financial Institutions Examination Council
3501 Fairfax Drive, Room 3086
Arlington, VA 22226

E-mail: FFIEC–Comments@fdic.gov

Dear Sir or Madam:

The American Institute of Certified Public Accountants (AICPA) Professional Ethics Executive Committee (PEEC) and Depository Institution Expert Panel (DIEP) appreciate the opportunity to comment on the *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters* (the "Proposed Advisory"). The AICPA is the largest professional association of certified public accountants in the United States, with more than 330,000 members in business, industry, public practice, government and education. Throughout its history the AICPA has been deeply committed to auditor independence. It is a core tenet of the accounting profession, which has a more than 100-year history of working to uphold auditor independence. All members of the profession engaged in auditing and attest services are required to maintain independence from audit and attest clients in accordance with detailed and regularly updated independence rules, interpretations and ethics rulings.

General Comments

The AICPA has been actively studying the use of indemnification and limitation of liability provisions in auditor engagement letters since Fall 2004. The PEEC and its task force (the "Indemnification Task Force") have engaged in numerous discussions and deliberations regarding the impact such provisions may have on an auditor's independence and objectivity. While the AICPA has reached preliminary positions on certain provisions identified in the Proposed Advisory, we believe these issues are complex and require further input and deliberation to determine whether they could adversely affect an auditor's independence or objectivity.

We do not believe that the 30-day comment period provides sufficient time for interested parties to fully consider these issues and make an informed response. To ensure that these issues receive adequate due process, we recommend that the Agencies hold public hearings to solicit input from financial institutions, auditors, regulators and other interested parties before placing restrictions on the use of these provisions. In addition, we welcome the Agencies' input and participation on the PEEC's Indemnification Task Force and believe it would best serve the profession and the financial institution community to have uniform rules applicable to audits of financial institutions that are not subject to the SEC independence rules.

Safety and Soundness

We recognize that the Agencies have approached this matter from a "safety and soundness" concern. However, the Proposed Advisory states that such concern is based on the following assumption:

> *"…When a financial institution executes an agreement that limits the external auditor's liability, the external auditor's objectivity, impartiality, and performance may be weakened or compromised and the usefulness of the external audit for safety and soundness purposes may be diminished. Since limitation of liability provisions can impair the external auditor's independence and may adversely affect the external auditor's performance, they present safety and soundness concerns for all financial institution external audits."*

As previously noted, the AICPA continues to deliberate the impact that various types of indemnification and limitation of liability provisions have on an auditor's independence and objectivity and have preliminarily concluded that while certain provisions may adversely affect independence or objectivity, others would not (see discussion below under *Examples of Limitation of Liability Provisions)*. In addition, the AICPA is not convinced that the use of such provisions poses an unacceptable risk that the auditor's performance would not comply with professional standards (e.g., "*lead to the use of less extensive or less thorough procedures than would otherwise be followed…"*). Specifically, regardless of whether indemnification or limitation of liability provisions are included in an engagement letter, the auditor must comply with all professional standards, including specific performance standards under Generally Accepted Auditing Standards (GAAS). A failure to comply with such standards would result in a violation of AICPA Rule 202 – *Compliance With Standards,* as well as their own state's licensing requirements.

In order to conclude that the use of all limitation of liability provisions result in a safety and soundness concern due to independence or objectivity, we believe the Agencies should first substantiate that such provisions adversely impact the auditor's independence or objectivity and, therefore, have the potential to affect the auditor's performance. The AICPA does not believe that the Agencies have put forth sufficient rationale in the Proposed Advisory to support this conclusion.

In evaluating whether or not limitation of liability provisions impair an auditor's independence or objectivity, the AICPA utilizes its Conceptual Framework for Independence Standards. The Conceptual Framework sets forth a risk-based approach whereby an auditor's relationship with a client is analyzed to determine whether it poses an unacceptable risk to independence. Such an analysis involves identifying and assessing the extent to which a threat to independence exists, and, if it does, whether it can be effectively mitigated or eliminated through the use of safeguards. We are concerned that in reaching the conclusion that "*limitation of liability provisions can impair the external auditor's independence,*" the Agencies have not identified the relevant threats to the auditor's independence nor have they considered whether any safeguards exist that could sufficiently mitigate such threats.

Specific Comments

Examples of Limitation of Liability Provisions

Appendix A of the Proposed Advisory provides examples of certain limitation of liability provisions identified by the Agencies in audit engagement letters. Although the AICPA continues to study the use and impact of many of these clauses on an auditor's independence and objectivity, we have reached tentative conclusions on certain indemnification and limitation of liability provisions.

<u>''Release From Liability for Auditor Negligence'' Provision</u>

The AICPA believes that any provision that would release the auditor for all liabilities related to his or her own negligent acts (e.g., limit the auditor's liability to losses caused by his or her willful misconduct or fraudulent behavior) would impair independence.

<u>''Knowing Misrepresentations by Management'' Provision</u>

Under current AICPA independence rules, auditor independence is not deemed to be impaired when the audit engagement letter includes indemnity provisions for knowing misrepresentations by management. Specifically, AICPA Ethics Ruling No. 94, *Indemnification Clause in Engagement Letters*, issued in November 1993, states:

> *Question - A member proposes to include in engagement letters a clause that provides that the client would release, indemnify, defend, and hold the member (and his or her partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. Would the inclusion of such an indemnification clause in engagement letters impair the member's independence with respect to the client?*
>
> *Answer - No.*

The PEEC continues to study this issue, however, for the reasons discussed below, a significant majority of PEEC members continue to believe that permitting an auditor and his or her client to agree to a release or indemnity for claims resulting from knowing misrepresentations by management is fundamentally fair both to the company and to the auditor, and also furthers the public interest. Many also believe that such a release or indemnity is a significant deterrent to management fraud. Accordingly, such provisions should not be viewed as an unsafe and unsound practice.

Such a release or indemnity shifts to the client, which is where it properly belongs, the responsibility for management's deliberate and improper misrepresentations. For example, such a clause would apply where a client intentionally misleads an auditor or lies to an auditor. This type of clause does not release or indemnify the auditor from other claims or liabilities that may be asserted. Instead, the clause is exclusively directed at claims resulting from management's knowing misrepresentations.

The Agencies present no evidence that audit quality is diminished by the existence of a release or indemnification for management's knowing misrepresentations. The use of such a clause does not relieve the auditor of the responsibility to conduct an audit in accordance with GAAS and does not eliminate an auditor's liability to shareholders, regulators or others for audits not conducted in accordance with those standards. In addition, such a provision does not reduce an auditor's responsibility for the detection of management fraud. The auditor's responsibility as it relates to fraud is described in Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*. The auditor's responsibility under that standard is the same regardless of whether the auditor is or is not released or indemnified for management's knowing misrepresentations.

Fairness dictates that responsibility for management's intentional wrongdoing should rest with the company. The company and its board of directors are responsible for the acts of the company's management and are responsible for the preparation and presentation of the company's financial statements. The auditor is responsible for conducting an audit in accordance with GAAS. Management representations, which complement other audit procedures, are an integral part of an audit. They are required by GAAS and are confirmed in writing by management in its representation letter to the auditor given in connection with every audit. The auditor is entitled to rely upon the written representation letter as evidence of the representations explicitly or implicitly made to the auditor during the audit. The company should not be able to shift to the auditor the responsibility for its own failure. The use of this release and indemnification provision encourages management to completely and accurately disclose and communicate all pertinent matters to the auditor, and that result benefits the financial statement users.

<u>''No [Punitive] Damages'' Provision</u>

A significant majority of PEEC members believe that limiting an auditor's liability *to the client* for *punitive* damage claims will not impair independence or objectivity, provided the auditor remains liable for *actual* damages — that is, the auditor remains exposed to clients, and also to lenders, shareholders and other non-clients, for damages for any actual harm caused. Actual damages in accountant malpractice or securities law cases can be significant – often hundreds of times (or more), the fees generated in connection with the engagement. The possibility that actual damages might be awarded against an auditor in favor of clients and/or non-clients serves as a significant, real and sufficient deterrent against an auditor's wrongful conduct and adequately mitigates the threats to an auditor's independence and objectivity.

In addition, by definition, a limitation on punitive damages can have no affect on the safety and soundness of the financial institution. Punitive damages are defined as damages in excess of all the actual damages and are awarded to punish the wrongdoer in particular circumstances. Since the financial institution can recover all of its actual damages, its safety and soundness is secured.

Thus, we believe that exclusion of punitive damage liability *to the client* should not be viewed as impairing independence or objectivity.

''Indemnification for Management Negligence'' Provision

A significant majority of PEEC members believe that indemnifying the auditor for the client's negligence would impair the auditor's independence.

Other Limitation of Liability Provisions

With respect to the other limitation of liability provisions listed in Appendix A to the Proposed Advisory, the AICPA is still in the process of deliberating the potential threats to auditor independence caused by such provisions and expects to issue guidance after full consideration and due process, including exposure for public comment, is afforded these matters.

Alternative Dispute Resolution Agreements and Jury Trial Waivers

The AICPA does not believe independence is impaired or objectivity affected when a client and the auditor agree to use an alternate dispute resolution (ADR) procedure (e.g., arbitration or mediation) to resolve disputes between them. ADR clauses merely determine the forum in which a dispute will be heard and decided, and facilitate dispute resolution between the client and the auditor. However, we agree that if an ADR clause incorporates a limitation of liability provision, where it has been determined that such provision by itself would impair independence or affect objectivity, then the inclusion of such provision as part of the ADR clause would also impair independence.

In addition, the AICPA does not believe that a jury trial waiver would impair independence or objectivity because such a waiver merely specifies one procedural aspect of a how a dispute will be resolved.

While we would agree that it is good business practice for all financial institutions to review each proposed external audit engagement letter to "understand the limitations on the ability to recover effectively from an audit firm in light of any mandatory ADR agreement or jury trial waiver," we recommend that the Final Advisory make clear that the inclusion of such clauses are not considered to impair independence or constitute an unsafe and unsound practice. For example, we would recommend that a statement be included *at the beginning* of the ADR discussion stating that, "*ADR or waiver of jury trial agreements included in external audit engagement letters would not present safety and soundness concerns provided they do not incorporate inappropriate limitation of* *liability provisions or operate under rules of procedure that inappropriately limit auditor liability.*"

Increase in External Audit Fees

The Proposed Advisory seeks comment on whether a prohibition on the use of limitation of liability provisions would result in an increase in external audit fees. In our opinion, any time an auditor is asked to assume more risk, it will likely result in either an increase in fees or limit the availability of such services. Accordingly, we would expect that over time the Agencies could expect to see an increase in audit fees to financial institutions and fewer audit firms willing to provide such audit services. In addition, as a result of the increased audit fees, we would expect to see fewer financial institutions undergo voluntary audits.

Conclusion

The AICPA appreciates the opportunity to comment on the Agencies' Proposed Advisory. We are firmly committed to working with the Agencies and encourage the Agencies to work with the PEEC's Indemnification Task Force to develop guidance on these important issues.

We welcome the opportunity to meet with you to clarify any of our comments and recommendations.

Sincerely,

Bruce P Webb

Bruce Webb, Chair
PEEC

Carol H. Larson

Carol Larson, Chair
DIEP