



June 9, 2005

FFIEC  
Program Coordinator  
3501 Fairfax Drive  
Room 3086  
Arlington, VA 22226

Re: Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters, 70 FR 24576 (May 10, 2005)

Dear Sir or Madam:

America's Community Bankers ("ACB")<sup>1</sup> is pleased 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" issued by the Federal Financial Institutions Examination Council ("FFIEC.") The proposal advises financial institution boards of directors, audit committees and management that they should not enter into any engagement letter that contains external auditor limitation of liability provisions with respect to financial statements audits.

### **ACB Position**

ACB supports the proposed guidance and the agencies' efforts to curb inappropriate use of limitation of liability provisions in external auditor engagement letters. We hope that this guidance will provide all financial institutions with the necessary leverage to obtain more reasonable engagement letter language. However, we are concerned that without similar action by the Securities and Exchange Commission ("SEC"), the Public Company Accounting Oversight Board ("PCAOB") and American Institute of Certified Public Accountants ("AICPA"), the agencies' guidance will not be effective in achieving the desired objective and could result in unintended consequences.

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<sup>1</sup> America's Community Bankers represents the nation's community banks. ACB members, whose aggregate assets total more than \$1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

## **Background**

Some external auditors have included provisions in engagement letters that seek to limit the liability of the accounting firms in a financial statement audit. In many situations these provisions, including dispute resolution provisions (“DRPs”), appeared in engagement letters after the terms of the engagement had been negotiated. Despite their objections to these clauses and provisions, financial institutions are generally not successful in getting the audit firm to amend the language in the engagement letter. Therefore, these restrictive clauses are becoming increasingly common in the terms of the engagements for financial institution financial statement audits. The type of clause that seeks to limit the liability of the auditor is not in the best interests of the institution, or indeed, the regulators. In addition, ACB believes that the inclusion of alternative DRPs must only be agreed to if the institution understands all of the implications of the arrangements.

## **Engagement Letters for FDICIA or SEC Mandated Audits**

ACB agrees that most limits on liability are prohibited under professional independence standards for financial statement audits required by SEC rules and/or Federal Deposit Insurance Corporation regulations and rules. Notwithstanding those standards, ACB is aware that a growing number of clauses, for example, clauses that limit auditor liability and DRPs, are being included in engagement letters for all sizes of financial institutions. For these required audits, we would expect that the agencies, the SEC and PCAOB would swiftly and abruptly address any circumstances where external audit firms are attempting to limit their liability in violation of the rules or professional standards that govern these audit engagements.

We urge the agencies to develop a process through which all financial institutions can resolve situations where they disagree with their auditors on the appropriateness or inclusion of limitation of liability clauses or DRPs. This process would require a coordinated effort among the agencies and the SEC and PCAOB for publicly held and FDICIA banks. This resolution process would relieve financial institutions of the onerous task of trying to negotiate or remove improper uses of limitation of liability clauses or DRPs. ACB is concerned that without parallel guidance or coordinated efforts from the SEC and PCAOB, the agencies’ guidance may not have any impact on troublesome limitation of liability language or DRPs being included in these engagement letters. We also strongly urge the agencies to work with the SEC and PCAOB to ensure that financial institutions and their auditors are following the appropriate guidance.

## **Engagement Letters for Private, Small Financial Institutions**

Many financial institutions that are not publicly traded and under \$500 million in assets “voluntarily” retain the services of an external accounting firm for a financial statement audit. These institutions are having the most difficulty negotiating an amended agreement when presented with an engagement letter that contains any form of auditor limitation of liability clauses and DRPs. These institutions obtain external audits because they have a commitment to accurate and quality financial reporting and a culture of strong corporate governance. Because these audits are technically not required under banking or securities law, auditors are generally

afforded the flexibility to include very restrictive clauses, often times adjusting this language during the audit process.

Some accounting firms that currently perform these voluntary audits have indicated that without some form of limitation of liability clauses, their liability exposure is extensive. These firms have expressed a need for some form of limitation on their liability for these audits, so it is likely that privately held banks under \$500 million will not be able to negotiate the removal or modification of the clauses, notwithstanding the agencies' guidance. The proposed guidance broadly precludes a financial institution from entering into "any agreement that contains external auditor limitation of liability provisions with respect to financial statement audits." In order to comply with the proposed guidance, financial institutions wishing to obtain a voluntary audit would be forced to have their auditors remove the clauses, in which case the firm will likely apply a "liability" premium to compensate for the increased exposure. Alternatively, some audit firms may decide that they will no longer perform these voluntary audits if they cannot continue to limit their liability. We are concerned that these unintended consequences will likely culminate with many financial institutions finding it more difficult or too costly to continue to engage an external accounting firm for a financial statement audit.

We support reasonable guidance that will help ensure that audit firms cannot force the inclusion of inappropriate clauses into financial institution financial audit engagement letters. However, this cannot come with the consequence of smaller institutions bearing an even greater cost to obtain an external financial statement audit. If the auditors are forced to remove the clauses, we are concerned that there will be dramatic fee increases to compensate for liability insurance premiums or that smaller financial institutions may be dropped as audit clients altogether. Again, we urge the agencies to work closely with the AICPA and the audit firms to better understand their liability exposure in voluntary audits, and develop a process by which banks can resolve disagreements on the use of limitation of liability clauses and DRPs in the engagement letters.

## **Conclusion**

ACB appreciates the agencies' efforts in trying to protect financial institutions from abusive limitations of auditor liability while maintaining the integrity of the external audit process. Given that auditors are bound by professional standards, which in many cases currently allow certain limitation of liability clauses where there is "knowing misrepresentations by management," we are concerned that this interagency guidance may not be effective in preventing the inclusion of the limitations of liability clauses. Without a corresponding update to the professional standards by the appropriate agencies, banks will still have difficulty negotiating out the clauses, and audit firms will find it difficult to adhere to the agencies' guidance. In order for the guidance to be effective and accurate, we strongly encourage the agencies to have further dialogue with the Big Four and second tier accounting firms, the SEC, PCAOB and banking organizations before proceeding with this guidance. ACB stands ready to further discuss these concerns and we look forward to further dialogue with the agencies on this important issue.

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We appreciate the opportunity to comment on this proposed guidance. Should you have any questions, please contact the undersigned at 202-857-3121 or via email at [cbahin@ACBankers.org](mailto:cbahin@ACBankers.org), or Dennis Hild at 202-857-3158 or via email at [dhild@ACBankers.org](mailto:dhild@ACBankers.org).

Sincerely,

A handwritten signature in cursive script that reads "Charlotte M. Bahin".

Charlotte M. Bahin  
Senior Vice President  
Regulatory Affairs