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BY E-MAIL AND FAX

Program Coordinator
Federal Financial Institutions Examination Council
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FFIEC-Comments@fdic.gov
703-516-5487

Re: Comments on Proposed Interagency Advisory Concerning the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters

Dear Sir or Madam:

Introduction

We are pleased to submit these comments on the proposed Interagency Advisory published May 10, 2005, in the Federal Register. We are a national, full-service accounting and consulting firm, founded in 1910 as Seidman & Seidman. We currently have 33 offices across the United States and, with approximately 2,000 partners and staff, serve about 10,000 clients, of which more than 300 are publicly owned and several dozen are financial institutions.

Liability Limitations

We are concerned about the proposed prohibition of liability limitations, such as releases and indemnifications, in auditor engagement letters. The prohibition appears to rest on two assumptions: (1) that such limitations impair auditor independence; and (2) that their use diminishes the motivation of auditors vigorously to apply professional standards. We disagree strongly with both assumptions.

With respect to independence impairment, at least where the limitation provision involves a release or indemnification for liability arising from the deliberate fraudulent statements of management, the governing opinion of the American Institute for Certified Public Accountants, AICPA Ethics Ruling No. 94 (1993), holds otherwise. This makes sense. It is difficult to see how an auditor's objectivity can be improperly influenced by knowing he or she will not be responsible if he or she is lied to.

The second assumption, that fear of financial liability—including punitive damages—is a significant motivation for diligence on the part of auditors, is, in our view, equally flawed. Instead, professional discipline, internal quality control measures, external inspections and, most fundamentally, the desire to maintain a reputation for professional excellence are the primary factors that promote careful work.

For similar reasons the historical requirement that auditors practice only in general partnerships—and subject themselves to far more drastic unlimited personal liability for malpractice judgments against those partnerships—was justified on the assumption that such unlimited personal liability was needed to motivate care. When limited liability partnerships became the preferred form of accounting organizations in the mid-1990's, there was no noticeable widespread departure from professional standards.

Rather the liability limitations that the proposal seeks to bar are the responses of audit firms to both the perception and reality that unlimited tort liability imposed an unsustainable economic burden, directly in judgments and legal fees and indirectly in the cost of professional liability insurance. This burden has, in our view, not promoted care but instead driven auditors away from types of clients thought to be more risky. By denying auditors even the possibility of negotiating liability limitation provisions with financial institution clients, the proposal would make it more likely that auditors would avoid such clients as a class (as we ourselves are considering in response to the proposal) or seek greater fees to offset the greater exposure. Thus the proposal would have the surely unintended effect of making the vast majority of financial institutions who have little likelihood of asserting claims against their auditors worse off to advantage the few who might.

We think liability limitations in engagement letters should be treated as available options subject to negotiation between each institution and its auditor. The parties to these contracts are, in general, both sophisticated and both equipped with competent legal advice. Even smaller institutions can obtain substantially the same advice through trade associations and industry publications. A flat regulatory bar would be a crude and insensitive response to the problem.

Alternative Dispute Resolution

We think we have a useful perspective on the use of alternative dispute resolution provisions (ADR) in engagement letters, as this firm pioneered that practice as early as 1992, in a pilot program, and then nation wide a few years later. So we have had better than a dozen years experience with ADR.

We have found overwhelming client acceptance of ADR provisions. We have made ADR a requirement in our engagement letters; over the years and thousands of engagement letters, only a small handful of clients have raised issues with this. And most of those have accepted it after negotiated modification of our model language, to which we are always amenable.

While we have very few disputes with clients or former clients, we have now experienced several arbitrations pursuant to these provisions. In our view, the experience has been very successful for all sides. In that regard, we have found the ADR mechanism to be cheaper and faster than litigation.

Moreover, we have observed the quality of arbitrators chosen in our controversies to be very high—often experts in the relevant fields themselves. Thus, in our view, the outcomes of such disputes tend to be more rational, and therefore more predictable, than conventional litigation, including bench trials. After all, not every judge is an expert in auditing and the related professional standards.

We don't claim that ADR is a panacea. We offer the benefit of our experience, which is that it can be a useful tool that auditors and clients should be permitted to consider as an option to reduce dispute resolution costs and delays. We would happy to provide further details if that would be useful for the Council to consider.

Respectfully submitted,

BDO Seidman, LLP