Crowe

Crowe Chizek and Company LLC
Member Horwath International

330 East Jefferson Boulevard
Post Office Box 7
South Bend, Indiana 46624-0007
Tel 574.232.3992
Fax 574.236.8692
www.crowechizek.com

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Sent via email to FFIEC-Comments@fdic.gov and via fax to 703-516-5487

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

Re: Public comment on proposed "Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters"

Dear Program Coordinator:

Thank you for the opportunity to comment on the proposed "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") prepared by the Federal Financial Institutions Examination Council ("FFIEC") which was published May 10, 2005 in the Federal Register.

Safety and Soundness vs. Independence and Objectivity

The fundamental premise (really an assumption) of the proposed Advisory is that any financial institution's limiting the liability of its external auditor raises safety and soundness concerns, so entering into such agreements is generally deemed by FFIEC in the proposed Advisory to be an unsafe and unsound practice. The financial institution regulatory agencies (the "Agencies") have the authority to stipulate what "safety and soundness" constitutes. However, the proposed Advisory cites concerns about a perceived lack of auditor independence and objectivity (as opposed to "safety and soundness"), without providing a conceptual or empirical basis for linking limit of liability or indemnification provisions to independence and objectivity. Further, the proposed Advisory does not provide evidence or support as to the specific threats to auditor independence and objectivity that are asserted would be created by a limitation of the unlimited liability that can exist, or whether appropriate safeguards may exist that would sufficiently mitigate any threat to auditor independence and objectivity. Since FFIEC has not provided an explanation or rationale of why limitation of liability provisions might create a threat to independence or objectivity, we suggest that FFIEC remove references to "independence", to "objectivity", or to other audit professional standards from any final advisory if one is adopted. These references should not be used by FFIEC as a basis for the drastic action it is proposing, and any such references are incomplete as audit professional standards now allow certain auditor indemnifications. Examples of specific references used in the proposed advisory, and our comment on each, follow:

Reference:
"In addition, such provisions may not be consistent with the auditor independence standards of the U.S. Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and the American Institute of Certified Public Accountants (AICPA)."
Comment:
The standards of the SEC and PCAOB are only relevant to public companies (plus certain financial institutions subject to existing regulations) which as discussed below are subject to differential laws and regulations based on the differences between public and non-public companies. Thus, a comparison of SEC and PCAOB standards is not relevant to financial institutions that are not public companies, and non-public companies would be the primary class of financial institutions affected by most aspects of the proposed Advisory. Further, the tentative conclusion in the proposed Advisory that "such provisions may not be consistent … with the auditor independence standards of the … (AICPA)" is not correct as current professional standards explicitly allow certain indemnifications as not impairing independence, and we understand that the AICPA has not reached conclusions on many of the issues addressed in the proposed Advisory.

Reference:
"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."
Comment:
The above statement is a very general assumption as to impairment of independence that is not supported by facts or evidence, and is not based on a documented conceptual framework or analysis of independence. Further, there has been no causal relationship documented between inclusion of limitation of liability provisions in an audit engagement letter and any effect on the subsequent performance of the auditor. To the contrary, the most highly publicized alleged violations of auditing standards have been with respect to audits where limitation of liability provisions were not used. Further, the limitations of liability provisions only limit liability of the auditor to the institution, not to others (such as shareholders or regulators), so the auditor has ample exposure.

Reference:
"Auditor Independence" This section contains four paragraphs.
Comment:
The section labeled "*Auditor Independence*" primarily recites existing requirements that public companies, and certain financial institutions subject to Part 363 or OTS regulation, must comply with. These are not new, so we suggest this reminder of existing requirements should be eliminated from any final advisory on safety and soundness, moved to an appendix, or reduced to a footnote reference.

Reference:
"Appendix B - SEC's Codification of Financial Reporting Policies, Section 602.02.f.i and the SEC's December 13, 2004, FAQ on Auditor Independence"
Comment:
The content of this appendix is already part of the public record, and does not directly relate to the safety and soundness issue in the proposed Advisory relevant to financial institutions not subject to the SEC codification quoted. We suggest this entire Appendix be eliminated, or reduced to a footnote reference.

Likely Effect on Number of Audit Firms Providing Audit Services to Financial Institutions

Question 3 c in the proposed advisory asks: "Would it [the proposed Advisory] result in fewer audit firms being willing to provide external audit services to financial institutions?" We believe that a likely result of this regulation will be a reduction in the number of qualified external auditors to the financial institution industry, and in particular for institutions that exhibit more than average risk. As explained below, the proposed Advisory seeks to shift economic risk from others responsible for the risk to external auditors, and those auditors will need to address that additional risk. We believe that the proposed Advisory will cause some firms to conclude that they will not serve financial institutions, and will cause most firms to strengthen their client acceptance and continuation policies such that they will not conduct work for certain financial institutions that may qualify as clients under their current policies. A natural reaction will be to terminate audit engagements that have certain risk characteristics, and those that become uneconomic.

While any final FFIEC guidance will not result in auditors of non-public companies being directly subject to the regulation of the SEC and PCAOB, the content of the proposed Advisory trends toward establishing requirements now relevant only to public companies applicable to non-public companies. That will make some audit firms conclude to not provide external audit services to financial institutions, or reduce their exposure to the industry. For continuing audits, increases in audit scope beyond those procedures normally considered to be adequate may be required to reflect the greater risk exposure as auditors may respond to this regulation by concluding there is a need to spend greater efforts to determine if management is truthfully representing the presence or absence of conditions, management's intentions, and so on. The new regulation in the proposed Advisory will also be an effective barrier to entry for audit firms that might otherwise choose to begin providing external audit services to financial institutions. Smaller audit firms may not be able to obtain insurance coverage allowing them to provide audit services to financial institutions. Thus, the proposed Advisory will result in fewer alternatives for financial institutions for external audit services. The Agencies should not embrace regulation that promotes that result. Some financial institutions will struggle to retain qualified service providers, and some that will have to change external auditors will likely attract service providers that may not be well capitalized or insured. This result also adds risks to the Agencies. New, or troubled, higher risk financial institutions may have difficulty finding a high quality service provider, so this new regulation could also have the unintended consequence of reducing safety, soundness, and competition in the financial institution industry.

Differences of Public and Non-Public Financial Institutions, and Effect on proposed Advisory

The proposed Advisory contains conclusions that are based in large part on the Securities and Exchange Commission's (SEC) regulation. Such regulation relates to public companies and certain financial institutions that are already subject to specific financial institution regulation as explained in the proposed Advisory. The guidance in the proposed Advisory would effectively extend on a selective basis SEC regulation to auditors of non-public companies but not to management. We also note that the proposed Advisory's conclusions are much broader and more restrictive than current SEC regulation which could mean that non-public financial institutions would be subject to stricter rules than public ones. We encourage FFIEC not to extend, and not make more restrictive, a regulation currently applicable only to public companies to non-public companies. There are substantial differences between the characteristics of public companies and non-public companies and the users of their financial statements that should be considered in establishing regulations. We will not offer a detailed review of the numerous significant differences between public and non-public companies, but note the following in summary of some of the reasons why regulations deemed appropriate for public companies are not always appropriate for non-public companies:

- Public companies, by definition, have a class of interest holders, public shareholders, whose rights are separate from and independent of the management of the company.
- Laws and regulations, which include penalties for management, and the corporate governance requirements for public companies are substantially different than for non-public companies. These include requirements relative to Boards of Directors, Audit Committees, and the amount of interaction and responsibilities that each committee member must have. Management of a public company reports directly to this chain of command; non-public companies may not have similar governance requirements.
- Public companies have statutory oversight. Specifically, public companies must comply with voluminous requirements of the SEC, the Exchanges, and other laws and

regulations. There are specific laws and regulation that require accuracy and completeness of financial information for public companies. Public companies that misrepresent financial information are subject to enforcement authority of the SEC; no similar enforcement regime is effective for non-public companies.

- Public companies and their management have legal requirements that dictate management's reporting and its responsibilities for accuracy of financial information. Some of those requirements relate to timely publication of significant events and financial information, and requirements for external auditor involvement both at year end and quarterly. There are not similar requirements for non-public companies.
- Public companies are required to have a comprehensive internal control assessment by management and the auditor under Section 404 of the Sarbanes-Oxley Act of 2002. There is no comparable requirement for non-public companies.
- Effective implementation of these additional responsibilities by public companies acts to reduce the probability of fraud or error in financial statements by placing responsibility to do so on management where it belongs.

Fundamentally, since many laws, regulations and corporate governance requirements are deemed necessary only for public companies and are not made applicable to non-public companies, differences in relationships between non-public financial institutions and their external auditors should be permitted, including proper allocation of business risk that reflects the different characteristics of public and non-public entities. Through both statute and regulation, policy makers have consistently concluded that the corporate governance, regulatory oversight and audit standards for public companies should be different than for non-public companies. We believe this is because those policy-makers correctly understand that the balance between cost and benefit for these non-public companies, including their stakeholders, is different. We agree with this belief and thus do not believe applying public company independence requirements, such as limits of liability and indemnification provisions, is necessarily or automatically proper for situations involving non-public companies.

The proposed Advisory effectively extends regulations currently applicable to auditors of public companies to auditors of non-public companies, without similarly extending the responsibilities of the companies subject to audit or their management. Requiring the auditor to operate under a more restrictive set of rules, while permitting the financial institutions subject to audit to operate under a less restrictive set of rules, would have the unintended consequence of reducing management's and increasing the auditor's relative responsibility for the company's financial reporting. This is inconsistent with the thinking of the Sarbanes-Oxley Act of 2002 and later regulation by the PCAOB and SEC, which clearly, and forcefully, requires management of public companies to perform at a higher level than they have in the past, and higher than required of non-public companies.

We also believe that holding auditors, but not the companies subject to audit, to public company standards sends the wrong message to Directors and Management about where responsibility for proper financial reporting rests. In our view, this imbalance can be properly addressed by permitting limitation of liability clauses, but limiting such clauses to situations where management caused and the auditor did not cause the event creating an economic loss. This holds the auditor responsible for their own actions, including inadequate work, while not placing the auditor in the position of 'insurer' for the misdeeds of those that engage the auditor and must provide needed information to the auditor.

Types of Limitation of Liability and Indemnification Provisions and Reasons for Use

There are a variety of limitations of liability and indemnification provisions in use by external audit firms. Some such provisions may adversely affect auditor objectivity, but others may not. It is not automatic that any limitation of liability provision, in today’s litigious environment, will adversely affect auditor independence or objectivity. Generally, limitations of liability and indemnification provisions can be grouped into two categories: 1) those that would limit any auditor liability in any circumstances; and 2) those that would limit auditor liability when there is no fault on the part of the auditor. While the Agencies appear to be most concerned about the former, the proposed Advisory paints all such provisions with the same broad strokes, and the examples provided only address provisions which are not conditioned on lack of fault or causation on the part of the auditor, which are essentially hold harmless provisions. We believe that limitation of liability and indemnification provisions that apply only where the auditor is not found at fault do not impair an auditor’s independence, do not affect the safety and soundness of the entity being audited, and should be allowed. Those provisions can reduce the incidence and cost of frivolous lawsuits, without placing any limits or restrictions on valid actions resulting from faulty services by the external auditor. Such provisions do not present any “safety and soundness” issues, as they do not impact the external auditor’s objectivity, impartiality, or ultimate performance of the engagement. Thus, a limitation of liability that is conditioned on lack of fault by the auditor does not weaken the Agencies’ ability to rely on the external audit. We believe that, if FFIEC proceeds with the proposed Advisory, it should distinguish between the types of provisions that it quotes in Appendix A in numbers 1 and 8 which are similar to “hold harmless” provisions regardless of fault, as opposed to a limitation of liability or indemnification provision that is conditioned on a lack of fault on the part of the auditor.

There are many valid business reasons that a financial institution and its external auditor should be able to enter into an agreement that provides a properly drafted limitation of auditor liability, especially when it is only effective when there is lack of fault by the auditor or lack of causation by the auditor of damage. Such provisions can result in the appropriate allocation of business risk, and prevent the unwarranted shifting of liability or legal expense from a financial institution, or its management, to the institution’s blameless external auditor. We are not aware of any empirical evidence that the quality, or performance, of an audit is lessened by appropriate limitation of liability provisions. If a limitation of liability or indemnification provision is conditioned on a lack of fault by the auditor, such provision does nothing to lessen the importance to the auditor to provide audit services in complete conformity with professional standards, including the auditor's responsibility for detection of fraud. The responsibility for performance of services in conformity with professional standards is unrelated to whether the auditor and client agree on limitation of liability provisions. The proposed Advisory results in a fundamental shift of responsibility for economic losses from the financial institution responsible for claims and economic loss to the external auditor, and that result is not good public policy.

Another major problem with eliminating the right of innocent auditors to indemnification or reimbursement is that it leaves the auditors exposed to frivolous and unfounded litigation, regardless of fault. Typically, when any action is brought against an audited entity, the accountants are added as additional defendants merely because they are regarded as having "deep pockets." Even where the accountant is ultimately successful, the cost in legal fees and expenses and diversion of internal resources, can amount to many times the fees which the accountants were paid. Any accounting firm with a vigilant risk management or loss prevention program will hesitate (or decline) to take such risks, or increase its fees before taking on such an engagement, and nothing is gained in the way of safety and soundness (not to mention fairness) by exposing an innocent accountant to enormous cost and expense when it is not at fault.

An appropriately drafted limitation of liability or indemnification provision is a common feature and accepted in many contracts in wide use today throughout the business and consumer world. Such provisions are not only common but are explicitly permitted by state legislation (for example, the Uniform Commercial Code) and by federal legislation (for example, the Magnuson-Moss Act). All financial institutions likely have a variety of contracts or agreements that have similar provisions, including ones where it is the financial institution limiting its liability to its own lending or deposit customers. The proposed Advisory states that the Agencies believe that entering into limitation of liability or indemnification provisions create unsafe and unsound practices, including leading to a lack of objectivity by the service provider, but limits comments only to external audit services. What about other services, such as vendors, service organizations, actuaries, marketing agencies, appraisers, those who construct facilities, etc.? Service and sales agreements with such entities may also include this very typical provision regarding limitation of liability. Also, officers and directors are typically indemnified and their liability is limited by the business judgment rule defense which protects them from claims of errors of judgment and other forms of negligence. Is FFIEC considering eliminating these liability limitations and indemnifications of officers and directors, who have the responsibility for the operation of the entity, its financial reporting, and safety and soundness?

Non-Attest Services

The external auditor sometimes performs non-attest services for audit clients, especially when the client is a non-public company. If these services are provided internally, or by a non-accountant, limit of liability and indemnification would be permitted. Any final advisory should make clear that inclusion of limitation of liability, indemnification, or ADR provisions in agreements for non-attest services pose no safety or soundness concerns. While it seems a reader should deduce that conclusion from the title and language of the proposed Advisory, we encourage FFIEC to state this explicitly if the proposed Advisory is advanced.

Indemnification for Management's Misrepresentations

Another valid business reason for a limitation of liability or indemnification occurs where management agrees to indemnify the auditor for management's own misrepresentations. This is consistent with good public policy, and good corporate governance. Management should be responsible for its actions and representations, and should bear the consequences of misrepresentations to the external auditor. Shifting responsibility and consequences of management misrepresentations from management or the financial institution to the external auditor is not in the public interest. Management is in the position, and has the responsibility, to adopt practices and internal controls and checks and balances, to hire and fire, to supervise, to investigate, to adopt proper credit criteria, and to otherwise manage the institution to promote safety and soundness and the accuracy of its financial statements and representations on a daily basis, while the external auditor can only test transactions periodically. Provisions that promote honest and full communication of issues to the auditor and responsible and sound conduct by management should be allowed. Instead of barring such provisions, it would be in the best public interest for the Agencies to encourage such provisions. Also, laws applicable to public companies make it a crime to lie to the auditor. If FFIEC concludes that auditors should not be indemnified for losses from client misrepresentation, then FFIEC should also adopt regulation making misrepresentation to auditors subject to severe penalties similar to those provided for public companies in the Sarbanes-Oxley Act of 2002.

Alternative Dispute Resolution, Jury Trial Waiver, and Mediation

The proposed Advisory's discussion of alternative dispute resolution (ADR) agreements and jury trial waivers is difficult to understand and should be clarified. Such provisions, which are increasingly common in commercial agreements, are used to stipulate the forum and methods for resolving disputes, and usually include no limitation of liability, indemnification, or other limitation of damage recovery. We suggest that the discussion of ADR or jury trial waiver be rewritten to make clear that the Agencies have not concluded that the use of such provisions should be limited. The proposed Advisory correctly points out that these provisions can increase efficiency and be cost-effective for all parties to an agreement. Courts in virtually all states, as well as the U.S. Supreme Court, have held that sound public policy encourages the use of ADR procedures. Safety and soundness are not promoted by forcing disputes prematurely or unnecessarily into already overburdened courts where they may never be resolved or by requiring trial by jury of issues beyond the ken of the average juror. We suggest that the discussion be focused on informing financial institutions that inclusion of a liability limitation or indemnification in an ADR or jury trial waiver provision (as in any other provision) can impact the effect of the provision, but that use of ADR is encouraged.

Pre-trial mediation, especially, has gained favor to the point where many states and courts have made it mandatory. Sensible people of all political persuasions recognize the problems and cost associated with our overly litigious society. A typical provision requiring mediation before the filing of any litigation does not impair in any way the rights of the audited financial institution or any of its interest holders. It does not apply to the latter at all; with respect to the institution itself, it merely requires what common sense and good business judgment would dictate, and what the judiciary has the right to expect, that there be a serious effort to resolve or at least understand differences before resorting to litigation. No rights are forfeited. To the extent the Agencies propose regulations prohibiting pre-trial or pre-filing mediation, they are clearly regulating contrary to the overwhelming trend on both a state and federal level of favoring mediation and other alternative dispute resolution provisions, with no corresponding gain in "safety and soundness."

Effective Date and Retroactive Application

The proposed Advisory suggests that any engagement letter for fiscal 2005 be modified to reflect the conclusions of any final advisory. We recommend that if a final advisory is adopted, it be applied on a prospective basis. An example of the application of the current proposal:

> Assume an institution with a fiscal year end of March 31, 2005 and its audit has been completed under an engagement letter which had some provision that a final advisory would state presents safety and soundness concerns. In this case the application of the proposed implementation date would require the institution to attempt to renegotiate an agreement for a service that was already completed.

It is also unfair to the financial institution and its external auditor where they accepted and priced an engagement, and set its scopes, based on the negotiated terms. If this regulation is made retroactive, engagement acceptance, client continuation, and pricing of engagements will have to be re-performed; this may result in auditor changes that the Agencies should not promote. There may also be potential Constitutional issues involved in regulatory agencies' forcing a retroactive voiding of contractual obligations.

Effect on Financial Institution Industry External Audit Costs

The proposed Advisory includes several questions relative to the impact this new regulation might have on the cost of providing external audit services to financial institutions, and whether any external audit fee increases would be significant. We believe that the proposed Advisory will increase costs to financial institutions. The cost drivers of providing professional services are too dynamic, and some result from external factors which are too unpredictable (such as the effect of litigation), to attempt to project the timing or significance of cost increases. We do not know if this proposed Advisory, if adopted, would prompt an immediate increase in audit fees for many non-public financial institutions. However, because this new regulation proposes to fundamentally shift liability away from financial institutions and their management to external auditors, it is likely that fees and other costs will increase. This liability shift for business losses from the entity responsible for such losses to external auditors will increase the amount of litigation that audit firms will need to address. The shift in liability will not go unnoticed by those few insurance companies that still offer professional insurance to external audit firms, and may increase the cost and decrease the availability of such insurance. As a result of the increase in risk, increase in operating costs such as insurance, legal fees and other loss prevention costs, likely changes in audit relationships, and likely reduction in qualified external audit firms (discussed above), fee arrangements will change over time to reflect the upward pressure on cost factors for serving some companies in the financial institution industry. The result for the overall financial institution industry from this additional regulation from FFIEC will clearly be increased costs.

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By way of summary, it does not appear that the proposed Advisory comprehensively addresses the stated problem of "safety and soundness" of financial institutions. The primary cause of "safety and soundness" issues at financial institutions are management decisions, such as over-aggressive lending; defalcations, primarily embezzlement; and inadequate insurance such as fidelity bonds. The annual financial statement audit, with its focus on presentation of financial statements and the use of materiality as the determinant of the scope of testing, is widely recognized as not able to prevent or detect all irregularities such as embezzlement or evaluate business judgments such as the choice among lending practices which may result in future losses or the decision to purchase particular investment securities. The primary safeguards against errors and irregularities are management honesty, vigilance, judgment and competence; separation of functions and division of responsibility; internal controls; and other actions which are the day-to-day responsibility of management. Anything that encourages management to relax its vigilance or relieves it of responsibility, or lulls management into believing that it can rely on the external auditor (as opposed to management or the company's insurance) to prevent, detect or insure against such irregularities, does not promote safety and soundness of a financial institution, but instead has the opposite effect.

We hope our comments help the Agencies in their consideration of the proposed Advisory. If you have any questions, please contact Wes Williams.

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