Massachusetts Bankers Association

June 13, 2005

FFIEC
Program Coordinator
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E-mail: FFIEC-comments@fdic.gov

SUBJECT: "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 Sir/Madam:

The Massachusetts Bankers Association (MBA), which represents 210 commercial, savings, and cooperative banks and savings and loan members in Massachusetts and New England, appreciates the opportunity to comment in support of the above referenced FFIEC Advisory, which directs financial institutions' boards or directors and audit committees and management to ensure that they do not enter any agreement that contains external auditor limitations and liability provisions with respect to financial statement audits.

As afore mentioned, the proposal seeks comments on proposed guidance restricting limitation of liability provisions in external audit engagement letters. This would apply regardless of the size of the financial institution, whether the financial institution is public or not, and whether the external audit is required or voluntary.

Background

In the normal course of business a financial institution will sign a written engagement letter with the accounting firm regarding the services to be performed in connection with the external audit of the institution. The engagement letter typically covers: the objective of the external audit; the reports to be prepared; the responsibilities of management and the external auditor; and fees/billing.

The Agencies state they have recently observed an increase in the types and frequency of provisions in certain external audit agreements seeking to exempt accountants from liability with their work on bank financial statements. The agencies state that the limitation of liability provisions can be generally categorized as an agreement by a financial institution client to:

- Indemnify the external auditor against claims made by third parties;
- Hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution; or
- Limit the remedies available to the client financial institution.

The agencies believe such provisions may weaken an external auditor's objectivity, impartiality, and performance and therefore, conclude that inclusion of these provisions in financial institution engagement letters raises safety and soundness concerns. Under the FFIEC proposed advisory, this language would be prohibited. The Association generally supports this prohibition with the following suggestions and comments.

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The Advisory also includes certain alterative dispute resolution (ADR) provisions in engagement letters as presenting safety and soundness concerns. The FFIEC agencies are concerned that provisions requiring the client financial institution to submit disputes over auditor services to binding arbitration or some other binding non-judicial dispute resolution process (mandatory ADR) would be "effectively agreeing to waive the right to full discovery, limit appellate review, and limit or waive other rights and protections available in ordinary litigation proceedings." The proposed advisory notes particularly that ADR agreements with auditors "present safety and soundness concerns" when they include specific limitations on liability such as:

- Capping the amount of actual damages that may be claimed;
- Prohibiting claims for punitive damages or other remedies; or
- Shortening the time within which the client financial institution may file a claim.

The Advisory cautions financial institutions not to enter into pre-dispute mandatory ADR arrangements that include limitation of liability provisions, whether the limitations on liability form part of an audit engagement letter or are set out separately. While the proposed Advisory does not expressly prohibit ADR provisions, the Agencies recommend that financial institutions document their business rationale for agreeing to mandatory ADR or any other provisions that alter their legal rights. The Association supports this provision with respect to mandatory ADRs.

According to the advisory, bank regulators may take appropriate supervisory action if limitation of liability provisions are included in external audit engagement letters or related agreements that are executed after the date of the Advisory (May 10, 2005). The proposed advisory does not allow for grandfathering of existing audit engagement letters. For any such letter or related agreement already accepted for a fiscal 2005 or subsequent financial statement audit (ending on or after January 1, 2005), the agencies strongly recommend they consult with legal counsel and the external auditor and take appropriate action to have any limitation of liability provision nullified.

Since auditors will have no duty to comply with the requests of financial institutions, we would like to strongly express that the Agencies recognize any good faith attempts by banks to have the language removed in the event that they are unsuccessful. Similarly, we are particularly concerned that unless professional auditing standards are also addressed, there is little incentive for audit firms to change their current practices. Without this collaborative outreach, banks could experience significant audit fee increases to compensate for the auditors' increased liability exposure. This is particularly relevant to non-public financial institutions with "voluntary" external audits. As a result, we would encourage the FDIC to work with the accounting industry and their governing bodies (i.e. SEC, AICPA, etc.) before implementing final guidance.

Thank you for your consideration of our views.

Sincerely,

Daniel J. Forte
President

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