



June 9, 2005

123 Haven Street, Reading, Massachusetts 01867
(781) 662-0100 (978) 446-9200

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

Re: Proposed Interagency Advisory on Limitations of Liability and Alternative
Dispute Resolution Provisions in External Audit Engagement Letters

Dear Sirs/Ladies:

MASSBANK is pleased to submit this comment letter in response to the FFIEC's *Federal Register* notice and request for comments 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 "Advisory").

MASSBANK is a BIF-insured, state-chartered savings bank with its principal office in Reading and branch offices located in ten other towns and communities in Middlesex County, Massachusetts. Shares of MASSBANK Corp., MASSBANK's parent holding company, are traded on the Nasdaq Stock Market under the symbol "MASB". As of December 31, 2004, MASSBANK Corp. and the Bank had consolidated total assets of \$976.2 million and deposits of \$849.5 million.

Having recently changed outside auditors rather than accede to such provisions, MASSBANK has a particular interest in limitation of liability and alternative dispute resolution ("ADR") provisions in outside auditors' engagement letters. MASSBANK Corp. has been subject to the independent financial audit and independent auditor attestation requirements of Section 36(c) of the Federal Deposit Insurance Act, as added by Section 112 of the Federal Deposit Insurance Corporation Act of 1991 ("FDICIA"), since 1993, and to the Sarbanes-Oxley Act's requirement that the outside auditor attest to management's assessment of internal controls since its inception in 2004. From its formation in 1986 through 2004, MASSBANK Corp. engaged KPMG, LLP (or a predecessor firm), to audit its annual corporate financial statements and, after FDICIA, to provide the attestation reports required by that legislation. Effective this year, MASSBANK replaced KPMG as its outside auditor largely because of KPMG's insistence that MASSBANK agree to the insertion in its engagement agreement of limitation of liability and ADR provisions of the types discussed in the Advisory.

A copy of MASSBANK's last engagement agreement with KPMG is attached at Tab A. A copy of KPMG's proposed new form of engagement agreement, with the proposed limitation of liability and ADR inserts highlighted, is attached at Tab B. A

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copy of MASSBANK's Form 8-K reporting to the Securities Exchange Commission its change of outside auditors is attached to this letter at Tab C.

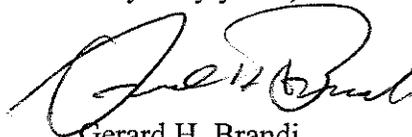
In seeking to replace its outside auditors in 2004, MASSBANK made inquiries of a number of qualified CPA firms regarding their willingness to submit independent audit engagement proposals to MASSBANK Corp. As a result of those inquiries, MASSBANK determined that the "Big Four" CPA firms were either not taking on additional financial institution audit clients or unwilling to do so without limitation of liability and/or ADR provisions. Subsequently, MASSBANK Corp. identified and engaged the regional CPA firm of Parent, McLaughlin & Nangle, CPAs, Inc., Boston, Massachusetts ("PMN"), to provide independent audit services. PMN did not propose and MASSBANK Corp.'s engagement letter with PMN does not contain any limitation of liability or ADR provision such as those described in the proposed Advisory.

MASSBANK believes that inserting limitation of liability and ADR provisions in outside auditor engagement letters is inconsistent with the "independence" requirement for outside auditors imposed by FDICIA and other statutory and regulatory provisions requiring independent audit and attestation reports. MASSBANK believes that the Advisory is an appropriate regulatory response to parallel attempts by the Big Four CPA firms to avoid the legal and financial responsibility the independence requirement imposes on outside auditors. MASSBANK applauds the FFIEC and the federal banking agencies for developing and publishing the proposed Advisory, and urges them to adopt the Advisory as soon as possible in substantially its present form.

In the attached Appendix, MASSBANK responds specifically to each of the numbered questions listed in the FFIEC Notice and Request for Comments.

If you have any questions or would like any additional information, please feel free to contact the undersigned.

Very truly yours,



Gerard H. Brandi
President & Chief Executive Officer.

Enclosures

9Q8039

**APPENDIX TO JUNE 9, 2005
COMMENTS OF MASSBANK, READING, MASSACHUSETTS
ON PROPOSED INTERAGENCY ADVISORY REGARDING UNSAFE
AND UNSOUND USE OF
LIMITATION OF LIABILITY AND ALTERNATIVE DISPUTE
RESOLUTION PROVISIONS
IN OUTSIDE AUDITORS' ENGAGEMENT LETTERS**

- 1. The advisory, as written, indicates that limitation of liability provisions are inappropriate for all financial institution external audits.**
 - a. Is the scope appropriate? If not, to which financial institutions should the advisory apply and why?**

MASSBANK believes that the larger question is whether individual institutions should be required to negotiate the terms on which audit services the government requires them to obtain will be provided. Absent government intervention, the balance of market forces can ordinarily be expected to provide an appropriate range of price and liability terms for outside audit services. The provision of such services without contractual provisions limiting the auditors' legal and financial responsibility for their audits would presumably be available at a higher fee than might be charged by the same audit firm for such services where its liability exposure is contractually limited.

However, the intervention of government in the form of statutory and regulatory requirements that financial institutions obtain specified audit services, coupled with lawsuits aimed at shifting the financial costs of bank failures from the bank and savings association insurance funds to the failed institutions' outside auditors has apparently prompted CPA firms to attempt to limit their legal responsibility for audit engagements. As a result, financial institutions like MASSBANK find it difficult to obtain audit services from the largest CPA firms, at any *price*, without contractual limitation of liability or alternative dispute resolution ("ADR") provisions.

As a result of governmental actions, and the response of the Big Four CPA firms, engagement letters defining the terms on which their audit services are available are not open to negotiation, based on price, but are essentially "contracts of adhesion," offered to captive financial institution clients on a "take it or leave it" basis.

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Where government intervention has made the demand for outside audit services inelastic, it is not meaningful to leave to “negotiation” between auditor and audit client the legal responsibility provisions of audit engagement agreements. Under these circumstances, it is necessary for government to re-balance the market for required financial institution audit services by imposing a corollary requirement that independent audit firms stand fully behind their audit and attestation reports for financial institution clients.

b. Should the advisory apply to financial institution audits that are not required by law, regulation, or order?

In markets that have not been distorted by government intervention, MASSBANK believes that private market forces provide the best mechanism for balancing the competing needs of buyers and sellers of professional audit services. Where government has not made demand inelastic by imposing a regulatory requirement that particular services be purchased by a particular class of institutions, institutions can decide for themselves whether to purchase particular audit services, at what price, on what contractual terms, and from whom. The resulting competition among service providers will ensure that an appropriate range of price and contract terms is available. MASSBANK does not believe that government intervention in the form of the Advisory is necessary in private markets for audit services that financial institutions are not required by law, regulation or order to obtain.

2. What effects would the issuance of this advisory have on financial institutions’ ability to negotiate the terms of audit engagements?

MASSBANK believes that the Advisory would significantly enhance the ability of most insured financial institutions to obtain independent audit services on satisfactory contract terms. In the current market for financial institution audit services, characterized by government-mandated demand and rigidly segmented sellers, most financial institutions do not have a meaningful ability to negotiate key engagement terms. For the most part, independent audit firms offer their services to financial institutions on a “take it or leave it basis,” on terms and conditions the audit firms define without meaningful negotiation with their prospective clients. Because of the stratification of audit firms and government mandated demand, there is no compulsion on audit firms to negotiate engagement terms with most financial institutions. Accordingly, government intervention in the form of the Advisory is the only effective way to ensure that outside audit services are provided on terms that make the auditor legally responsible for the quality of services provided.

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3. Would the advisory on limitation of liability provisions result in an increase in external audit fees?

Issuance of the Advisory would undoubtedly be cited by some CPA firms as justification for charging even higher audit fees to financial institutions. However, MASSBANK experienced no reduction in audit fees when, after many years without such provisions, KPMG modified its engagement agreement to include limitation of liability and ADR provisions. MASSBANK believes that because of the previously described structural distortions in the market for financial institution audit services, there appears to be little if any price competition among the largest accounting firms for this business. Accordingly, the current level of fees is substantially higher than it would be if there were no market distortions and forces of supply and demand were allowed to determine the market price for financial institution audit services. Auditors' fee levels have substantially increased (*see* M. Brewster, "Are the Big Four Gouging?" www.chiefexecutive.net, March 2005, copy attached at Tab D) and would appear to be more than sufficient to provide fair profits to accounting firms even without contractual limitations of liability and ADR provisions.

a. If yes, would the increase be significant?

MASSBANK does not believe that issuance of the Advisory provides justification for any increase in financial institution audit fees above their current unprecedented levels.

b. Would it discourage financial institutions that voluntarily obtain audits from continuing to be audited?

No. The Advisory should not apply to audits voluntarily obtained without governmental compulsion.

c. Would it result in fewer audit firms being willing to provide external audit services to financial institutions?

No. In MASSBANK's view, because of market distortions, the fees currently charged to financial institutions for independent audit services are sufficiently high and at the upper end, competition is sufficiently

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limited to provide ample profit incentive for audit firms to continue to offer such services, even without contractual terms limiting their legal responsibility for the quality of services rendered.

4. The advisory describes three general categories of limitation of liability provisions.

a. Is the description complete and accurate?

In MASSBANK's view, there is no such thing as an exhaustive list of the types of contractual provisions or other mechanisms which may be utilized to limit auditors' legal responsibility for the quality of their audit services for financial institutions. Whenever a list of specific forbidden clauses is finalized, additional provisions or mechanisms that are not on the list will be devised to accomplish the same substantive results.

The proposed Advisory describes contractual client indemnification or hold harmless and limitation of remedies provisions. Examples of other mechanisms which might be utilized to achieve the same substantive results include: use of thinly capitalized limited liability partnerships, special purpose entities or other forms of limited liability entities to perform audit services; combinations of comprehensive audit client representations and warranties with auditor-absolving client default, indemnification and set-off provisions; inconvenient or impracticable notice, service of process, jurisdiction or venue provisions; onerous preconditions to filing suit, e.g., notice and opportunity to cure provisions, standing and third party beneficiary limitations, etc. To be effective, the Advisory should speak in general terms of the substantive result to be avoided and should not be limited to any specific listing of forbidden formulations or provisions.

b. Is there any aspect of the advisory or terminology that needs clarification?

The advisory should make it clear that to be meaningful, an outside auditor's certification must be backed legally and financially, either by placing substantial capital at risk, by providing applicable liability insurance coverage, or by some combination of the two.

5. Appendix A of the advisory contains examples of limitation of liability provisions.

a. Do the examples clearly and sufficiently illustrate the types of provisions that are inappropriate?

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Please see our response to Question 4.a., above.

- b. Are there other inappropriate limitation of liability provisions that should be included in the advisory? If so, please provide examples.**

The limitation of liability/ADR provision KPMG proposed to insert in its audit engagement letter with MASSBANK Corp. reads in its entirety as follows:

“Any dispute or claim arising out of or relating to the engagement letter between the parties, the services provided thereunder, or any other services provided by or on behalf of KPMG or any of its subcontractors or agents to the Company or at its request (including any dispute or claim involving any person or entity for whose benefit the services in question are or were provided) shall be resolved in accordance with the dispute resolution procedures set forth in Appendix II, which constitute the sole methodologies for the resolution of all such disputes. By operation of this provision, the parties agree to forego litigation over such disputes in any court of competent jurisdiction. * * *”

Proposed Appendix II to the KPMG audit engagement letter, referenced in the proposed insert above, provides for mandatory arbitration of disputes and includes a contractual limitation of liability provision. It provides in pertinent part (emphasis added):

“Appendix II

“Dispute Resolution Procedures

“The following procedures are the sole methodologies to be used to resolve any controversy or claim (“dispute”). If any of these provisions are determined to be invalid or unenforceable, the remaining provisions shall remain in effect and binding on the parties to the fullest extent permitted by law.

* * * *

“Arbitration

“Arbitration shall be used to settle the following disputes: (1) any dispute not resolved by mediation 90 days after the issuance by one of

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the parties of a written Request for Mediation (or, if the parties have agreed to enter or extend the mediation, for such longer period as the parties may agree) or (2) any dispute in which a party declares, more than 30 days after receipt of a written Request for Mediation, mediation to be inappropriate to resolve that dispute and initiates a Request for Arbitration. Once commenced, the arbitration will be conducted either (1) in accordance with the procedures in this document and the Rules for Non-Administered Arbitration of the CPR Institute for Dispute Resolution (“CPR Arbitration Rules”) as in effect on the date of the engagement letter or contract between the parties, or (2) in accordance with other rules and procedures as the parties may designate by mutual agreement. In the event of a conflict, the provisions of this document and the CPR Arbitration Rules will control.

“The arbitration will be conducted before a panel of three arbitrators, two of whom may be designated by the parties using either the CPR Panels of Distinguished Neutrals or the Arbitration Rosters maintained by any United States office of the Judicial Arbitration and Mediation Service (JAMS). If the parties are unable to agree on the composition of the arbitration panel, the parties shall follow the screened selection process provided in Section B, Rules 5, 6, 7, and 8 of the CPR Arbitration Rules. Any issue concerning the extent to which any dispute is subject to arbitration, or any dispute concerning the applicability, interpretation, or enforceability of these procedures, including any contention that all or part of these procedures are invalid or unenforceable, shall be governed by the Federal Arbitration Act and resolved by the arbitrators. No potential arbitrator shall be appointed unless he or she has agreed in writing to abide and be bound by these procedures.

“The arbitration panel shall issue its final award in writing. *The panel shall have no power to award non-monetary or equitable relief of any sort. Damages that are inconsistent with any applicable agreement between the parties, that are punitive in nature, or that are not measured by the prevailing party’s actual damages, shall be unavailable in arbitration or any other forum.* In no event, even if any other portion of these provisions is held to be invalid or unenforceable, shall the arbitration panel have power to make an award or impose a remedy that could not be made or imposed by a court deciding the matter in the same jurisdiction.

“Discovery shall be permitted in connection with the arbitration only to the extent, if any, expressly authorized by the arbitration panel upon a showing of substantial need by the party seeking discovery.

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“All aspects of the arbitration shall be treated as confidential. The parties and the arbitration panel may disclose the existence, content or results of the arbitration only as provided in the CPR Arbitration Rules. Before making any such disclosure, a party shall give written notice to all other parties and shall afford such parties a reasonable opportunity to protect their interests.

“The award reached as a result of the arbitration will be binding on the parties, and confirmation of the arbitration award may be sought in any court having jurisdiction.”

- 6. Is there a valid business purpose for financial institutions to agree to any limitation of liability provision? If so, please describe the limitation of liability provision and its business purpose.**

If a financial institution is not at risk and desires only to have a second pair of experienced and knowledgeable eyes examine its financial statements and accounts as an aid to management in consideration for a significantly lower fee, it may be appropriate for the institution to agree with the auditor on an appropriate limitation of liability and/or ADR provision. However, to the extent such provisions undermine the “independence” of the audit, they also reduce the audit’s utility and reliability.

- 7. The advisory strongly recommends that financial institutions take appropriate action to nullify limitation of liability provisions in 2005 audit engagement letters that have already been accepted. Is this recommendation appropriate? If not, please explain your rationale (including burden and cost).**

For most if not all financial institutions, one of the primary purposes of obtaining an audit is to satisfy the statutory and regulatory requirement of an “independent” audit report. A report prepared by an auditor who, because of provisions in his or her engagement agreement, is not “independent” with respect to the client financial institution, will fail in its central and intended purpose.

To the extent that newly inserted and non-negotiable limitations of liability/ADR provisions in existing audit engagement letters undermine or rebut the auditors’ claim to be “independent,” they also defeat the basic purpose of the engagement -- to satisfy applicable statutory and regulatory requirements of an “independent audit.” The Federal banking agencies’ clarification of what is meant by “independent” in the context of an outside auditor’s engagement therefore provides an entirely appropriate

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occasion to revisit and modify existing engagement agreements in order to eliminate such inconsistencies and fully effectuate the parties' original intent.

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TAB A



KPMG LLP
99 High Street
Boston, MA 02110-2371

Telephone 617 988 1000
Fax 617 988 0800

February 5, 2004

MASSBANK Corp.
123 Haven Street
Reading, MA 01867

Attention: Mr. Peter W. Carr, Audit Committee Chairman

This letter will confirm our understanding of our engagement to provide professional services to MASSBANK Corp. (the "Company").

Audit Services

We will issue a written report upon our audit of the consolidated balance sheets of the Company as of December 31, 2004 and 2003, the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2004, which are to be included in the annual report (Form 10-K) proposed to be filed by the Company under the Securities Exchange Act of 1934.

Should the Company wish to include or incorporate these consolidated financial statements and our report thereon by reference into a future filing under the Securities Act of 1933 or other offering document, we would consider our consent to the inclusion of our report and the terms thereof at that time.

We have a responsibility to conduct and will conduct the audit in accordance with auditing standards generally accepted in the United States of America with the objective of expressing an opinion as to whether the presentation of the consolidated financial statements, taken as a whole, conforms with accounting principles generally accepted in the United States of America. It should be understood that our report and the consolidated financial statements may be subject to review by the Securities and Exchange Commission staff and to the application by them of their interpretation of the relevant rules and regulations.

In conducting the audit, we will perform tests of the accounting records and such other procedures as we consider necessary in the circumstances to provide a reasonable basis for our opinion on the consolidated financial statements. We also will assess the accounting principles used and significant estimates made by management, and evaluate the overall consolidated financial statement presentation.

Our report will be addressed to the Board of Directors of the Company and will be in a form that is in accordance with the published rules and regulations of the Securities and Exchange Commission. We cannot provide assurance that an unqualified opinion will be rendered. Circumstances may arise in which it is necessary for us to modify our report or withdraw from the engagement. In such circumstances, our





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findings or reasons for withdrawal will be communicated to the audit committee. Our opinion will be dated upon completion of our review of your financial statements, including footnotes.

We will read the other information in your annual report (Form 10-K) and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the consolidated financial statements. However, our audit does not include the performance of procedures to corroborate such other information (including forward-looking statements).

The Company agrees that all records, documentation, and information we request in connection with our audit will be made available to us, that all material information will be disclosed to us, and that we will have the full cooperation of the Company's personnel. As required by auditing standards generally accepted in the United States of America, we will make specific inquiries of management about the representations embodied in the consolidated financial statements and the effectiveness of internal control, and obtain a representation letter from management about these matters. The responses to our inquiries, the written representations, and the results of audit tests, among other things, comprise the evidential matter we will rely upon in forming an opinion on the consolidated financial statements.

The management of the Company has responsibility for the consolidated financial statements and all representations contained therein. Management also is responsible for identifying and ensuring that the Company complies with laws and regulations applicable to its activities, for preventing and detecting fraud, for adopting sound accounting policies, and for establishing and maintaining effective internal control over financial reporting to maintain the reliability of the consolidated financial statements and to provide reasonable assurance against the possibility of misstatements that are material to the consolidated financial statements.

Our audit is planned and performed to obtain reasonable, but not absolute assurance about whether the consolidated financial statements are free of material misstatement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, there is a risk that material errors, fraud (including fraud that may be an illegal act), and other illegal acts may exist and not be detected by an audit performed in accordance with auditing standards generally accepted in the United States of America. Also, an audit is not designed to detect matters that are immaterial to the consolidated financial statements.

To the extent that they come to our attention, we will inform management about any material errors and any instances of fraud or illegal acts. Further, to the extent that they come to our attention, we will inform the audit committee about fraud and illegal acts that involve senior management, fraud that in our judgment causes a material misstatement of the consolidated financial statements of the Company, and illegal acts, unless clearly inconsequential, that have not otherwise been communicated to the audit committee. In the case of illegal acts which in our judgment would have a material effect on the



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consolidated financial statements of the Company, we are also required to follow the procedures set forth in the Private Securities Litigation Reform Act of 1995, which under certain circumstances would require us to communicate our conclusions to the Securities and Exchange Commission.

Management is responsible for adjusting the consolidated financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the consolidated financial statements being reported upon taken as a whole.

In planning and performing our audit, we will consider the Company's internal control in order to determine the nature, timing and extent of our audit procedures for the purpose of expressing an opinion on the consolidated financial statements and not to provide assurance on internal control.

While we are not being engaged to report on the Company's internal control and are not obligated to search for reportable conditions, we will communicate reportable conditions to you to the extent they come to our attention. Reportable conditions are significant deficiencies in the design or operation of internal control which could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the consolidated financial statements. The definition of "reportable conditions" does not include potential future internal control problems, i.e., control problems coming to our attention that do not affect the preparation of consolidated financial statements for the period under audit. We will, however, examine management's assertion regarding the effectiveness of MASSBANK's internal control over financial reporting as of December 31, 2004, as required by Section 112 of the FDIC Improvement Act of 1991 (FDICIA). Furthermore, we will attest to, and report on, management's assessment of the effectiveness of the Company's internal controls and procedures for financial reporting as of December 31, 2004, as required by Section 404 of the Sarbanes-Oxley Act.

Quarterly Review Services

We will review the condensed consolidated balance sheets of the Company as of March 31, June 30, and September 30, 2004, and the related condensed consolidated statements of income, changes in stockholders' equity and cash flows for the quarterly and year-to-date periods then ended, which are to be included in the quarterly reports (Form 10-Q) proposed to be filed by the Company under the Securities Exchange Act of 1934. We will also review the selected quarterly financial data specified by Item 302 of Regulation S-K, which is required to be included in the annual report (Form 10-K) proposed to be filed by the Company under the Securities Exchange Act of 1934.

We have a responsibility to conduct our reviews in accordance with the provisions of Statement on Auditing Standards No. 100, *Interim Financial Information*, issued by the American Institute of Certified



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Public Accountants. The objective of a review of interim financial information is to provide us with a basis for communicating whether we are aware of any material modifications that should be made to such interim financial information for it to conform with accounting principles generally accepted in the United States of America. Our procedures will be substantially less in scope than an audit of financial statements performed in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we will not express an opinion on the Company's interim financial information.

Our reviews will consist principally of performing analytical procedures applied to financial data and making inquiries of Company personnel responsible for financial and accounting matters. Our reviews will include obtaining sufficient knowledge of the Company's business and its internal control as it relates to the preparation of both annual and interim financial information to (a) identify the types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence, and (b) select the inquiries and analytical procedures that will provide us with a basis for communicating whether we are aware of any material modifications that should be made to the interim financial information for it to conform with accounting principles generally accepted in the United States of America.

At the conclusion of each review of interim financial information, we will obtain a representation letter from management confirming certain representations made during the review. It should be understood that the management of the Company is responsible for the fair presentation of the Company's interim financial information in conformity with accounting principles generally accepted in the United States of America and for establishing and maintaining effective internal controls and procedures for financial reporting. Further, management is responsible for making all financial records and related information available to us. Management is also responsible for identifying and ensuring that the Company complies with the laws and regulations applicable to its activities.

A review does not contemplate tests of internal controls or accounting records, tests of responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an audit. Further, a review is not designed to provide assurance on internal control or to identify reportable conditions. However, we will communicate to the audit committee any reportable conditions that come to our attention.

Our review cannot be relied upon to disclose errors, fraud or illegal acts that may exist. However, to the extent that they come to our attention in completing our quarterly review procedures, we will inform management about any material errors and any instances of fraud or illegal acts. Further, to the extent that they come to our attention, we will inform the audit committee about fraud and illegal acts that involve senior management, fraud that in our judgment causes a material misstatement of the interim financial information, and illegal acts, unless clearly inconsequential, that have not otherwise been communicated to the committee.



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If we become aware of matters during our review that cause us to believe that interim financial information, filed or to be filed with the Securities and Exchange Commission, is probably materially misstated as a result of a departure from accounting principles generally accepted in the United States of America, we will discuss the matter with management and, if appropriate, communicate such matters to the audit committee.

Management is responsible for adjusting the interim financial information to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the current-year period(s) under review are immaterial, both individually and in the aggregate, to the interim financial information taken as a whole.

As agreed, we will not issue a written report upon completion of each review. However, we will inform you if we are aware of any material modifications that should be made to the quarterly financial information for it to be in conformity with accounting principles generally accepted in the United States of America. Should conditions not now foreseen preclude us from completing a review, we will advise you and the audit committee of the Company promptly. The Company agrees that it will not state in any document filed with the Securities and Exchange Commission or issued to stockholders that the interim financial information was reviewed by us, as such statement may require us to issue a written report.

Registration Statements and Other Offering Documents

We understand that the consolidated financial statements and our written report thereon, as described above, are to be included by the Company in its annual report (Form 10-K), and that in so doing the Company will be incorporating by reference these consolidated financial statements and schedules and our report thereon in previously filed and effective Forms S-3 and S-8. Prior to issuing our consent to the incorporation by reference in these registration statements of our report(s) with respect to the consolidated financial statements described above, we will perform procedures as required by Statement on Auditing Standards No. 37, *Filings Under Federal Securities Statutes*, including, but not limited to, reading information incorporated by reference in these registration statements and performing subsequent event procedures.

Should the Company wish to include or incorporate by reference these consolidated financial statements and our report thereon into a future filing under the Securities Act of 1933, or an exempt offering, prior to our consenting to include or incorporate by reference our report on such consolidated financial statements, we will be required to perform procedures as required by Statement on Auditing Standards No. 37, *Filings Under Federal Securities Statutes*, including, but not limited to, reading other information incorporated by reference in the registration statement or other offering document and performing subsequent event procedures. Our reading of the other information included or incorporated by reference in the offering document will consider whether such information, or the manner of its presentation, is



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materially inconsistent with information, or the manner of its presentation, appearing in the consolidated financial statements. However, we will not perform procedures to corroborate such other information (including forward-looking statements). The specific terms of our future services with respect to future filings or other offering documents will be determined at the time the services are to be performed.

* * * *

The work papers for this engagement are the property of KPMG LLP (KPMG). However, we may be requested to make certain work papers available to the Federal Deposit Insurance Corporation ("FDIC") or Massachusetts Office of Commissioner of Banks or other bank regulators pursuant to authority given to it by law or regulation. If requested, access to such work papers will be provided under the supervision of KPMG personnel. Furthermore, upon request, we may provide photocopies of selected work papers to FDIC or Massachusetts Office of Commissioner of Banks or other bank regulators. These regulators may intend, or decide, to distribute the photocopies or information contained therein to others, including other government agencies.

In the event KPMG is requested pursuant to subpoena or other legal process to produce its documents relating to this engagement for the Company in judicial or administrative proceedings to which KPMG is not a party, the Company shall reimburse KPMG at standard billing rates for its professional time and expenses, including reasonable attorney's fees, incurred in responding to such requests.

While the audit report may be sent to the Company electronically by the KPMG engagement partner for the Company's convenience, only the manually signed audit report constitutes the Company's record copy.

Based upon our discussions with and representations of management, we estimate that our fees for 2004 audit services, FDICIA reporting, and quarterly review services, will be \$153,000, including expenses. We also estimate that our fees for the 2004 audit of the MASSBANK Employee's Stock Ownership Plan and Trust will be \$7,000, including expenses. This estimate is based on the level of experience of the individuals who will perform the services. While the 2003 audit included additional procedures performed to substantially comply with the proposed new attestation standard on internal controls and procedures for financial reporting, additional procedures may need to be performed once the applicable attestation standard is finalized (such as the proposed provision for the external auditor to perform detail "walk-throughs" and the proposed provision to evaluate the effectiveness of the audit committee's oversight). We expect that the audit opinion will be dated the same as the Sarbanes-Oxley 404 attestation report, which will be subsequent to the completion of the audit work on the consolidated financial statements and footnotes. Should the scope of our services change, we will notify you of any such circumstances as they are assessed.



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Circumstances encountered during the performance of these services that warrant additional time or expense could cause us to be unable to deliver them within the above estimates. We will endeavor to notify you of any such circumstances as they are assessed.

We shall be pleased to discuss this letter with you at any time. For your convenience in confirming these arrangements, we enclose a copy of this letter. Please sign and return it to us.

Very truly yours,

KPMG LLP

Jeanette Fritz
Partner

cc: Mr. Gerard H. Brandi
President and Chief Executive Officer

ACCEPTED:

MASSBANK Corp.

Mr. Peter W. Carr
Audit Committee Chairman

April 1, 2004

Date ✓

**APPENDIX TO MASSBANK COMMENTS
JUNE 9, 2005**

TAB B



KPMG LLP
99 High Street
Boston, MA 02110-2371

Telephone 617 988 1000
Fax 617 988 0800
Internet www.us.kpmg.com

September 13, 2004

The Audit Committee of MassBank Corp.
c/o Peter W. Carr, Audit Committee Chairman
56 Counting House Way
Falmouth, MA 02540

Dear Peter:

We have enclosed an updated engagement letter for MassBank Corp. The engagement letter has been revised to reflect the changes in the business and accounting regulatory environment related to the integrated audit of internal control with an audit of financial statements. Further, there is a new section regarding dispute resolution.

If you should have any questions or comments on the letter please do not hesitate to contact me at (617) 988-1109.

Very truly yours,

Jeanette Fritz
Partner

cc: Reginald Cormier



KPMG LLP
99 High Street
Boston, MA 02110-2371

Telephone 617 988 1000
Fax 617 988 0800
Internet www.us.kpmg.com

MASSBANK Corp.
123 Haven Street
Reading, MA 01867

September 2, 2004

Attention: Mr. Peter W. Carr, Chairman of the Audit Committee:

This letter will confirm our understanding of our engagement to provide professional services to MASSBANK Corp. (the "Company").

Objectives and limitations of services

Integrated Audit Services

We will perform an audit of the Company's consolidated financial statements and an audit of its internal control over financial reporting (collectively, the Integrated Audit).

Based on our Integrated Audit, we will issue our reports on:

- The consolidated financial statements of the Company as set forth in Appendix I.
- Schedules supporting such financial statements;
- Management's assessment regarding the effectiveness of the Company's internal control over financial reporting and the effectiveness of internal control over financial reporting as set forth in Appendix I.

These reports will be included in the annual report Form 10-K proposed to be filed by the Company under the Securities Exchange Act of 1934.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of the financial reporting and preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that



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receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

The Public Company Accounting Oversight Board (PCAOB), created as a result of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), has the authority to establish auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports for issuers, as that term is defined in the Sarbanes-Oxley Act, subject to oversight by the SEC.

We have a responsibility to conduct and will conduct the:

- (a) audit of the consolidated financial statements in accordance with the standards of the PCAOB (United States), with the objective of expressing an opinion as to whether the presentation of the consolidated financial statements and schedules, taken as a whole, conforms with U.S. generally accepted accounting principles.
- (b) audit of internal control over financial reporting in accordance with the standards of the PCAOB (United States), with the objective of obtaining reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

It should be understood that the consolidated financial statements and schedules, management's assessment of the effectiveness of internal control over financial reporting, and our reports thereon may be subject to review by the Securities and Exchange Commission (SEC) staff and to the application by them of their interpretation of the relevant rules and regulations.

Our Integrated Audit will include:

- (a) performing tests of the accounting records and such other procedures, as we consider necessary in the circumstances, to provide a reasonable basis for our opinions.
- (b) assessing the accounting principles used and significant estimates made by management, and evaluating the overall consolidated financial statement presentation.
- (c) obtaining an understanding of internal control over financial reporting, evaluating management's related assessment, testing and evaluating the design and operating effectiveness of internal control over financial reporting, and performing such other procedures as we considered necessary in the circumstances.



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Our Integrated Audit:

- (a) will be planned and performed to obtain reasonable, but not absolute, assurance about whether the consolidated financial statements are free of material misstatement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, there is a risk that material errors, fraud (including fraud that may be an illegal act), and other illegal acts may exist and not be detected by an Integrated Audit performed in accordance with the standards of the PCAOB (United States). Also, an audit is not designed to detect matters that are immaterial to the consolidated financial statements. Our Integrated Audit will be planned and performed with an objective to obtain reasonable assurance that no material weaknesses exist in internal control over financial reporting as of the Company's fiscal year end and that the consolidated financial statements are free from material misstatement.
- (b) cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our reports will be addressed to the board of directors of the Company and will be in a form that is in accordance with the published rules and regulations of the SEC and the standards of the PCAOB (United States). We cannot provide assurance that unqualified opinions will be rendered. Circumstances may arise in which it is necessary for us to modify our reports or withdraw from the engagement.

As part of our Integrated Audit, we will read the other information in your annual report Form 10-K and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the consolidated financial statements or is inconsistent with the results of our audit of internal control over financial reporting. However, our Integrated Audit does not include the performance of procedures to corroborate such other information (including forward-looking statements).



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FDIC Improvement Act of 1991 (FDICIA)

We will examine management's assertion regarding the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, as required by Section 112 of the FDIC Improvement Act of 1991 (FDICIA).

Quarterly Review Services

We will review the condensed consolidated balance sheets of the Company as of March 30, June 30 and September 30, 2004 and the related condensed consolidated statements of income, changes in stockholders' equity and cash flows for the quarterly and year-to-date periods, which are to be included in the quarterly reports (Form 10-Q) proposed to be filed by the Company under the Securities Exchange Act of 1934. We will also review the selected quarterly financial data specified by Item 302 of Regulation S-K, which is required to be included in the annual report (Form 10-K) proposed to be filed by the Company under the Securities Exchange Act of 1934.

We have a responsibility to conduct our reviews in accordance with the provisions of the standards of the PCAOB (United States). The objective of a review of interim financial information is to provide us with a basis for communicating whether we are aware of any material modifications that should be made to such interim financial information for it to conform with U.S. generally accepted accounting principles. Our procedures will be substantially less in scope than an Integrated Audit performed in accordance with the standards of the PCAOB (United States), the objective of which is the expression of opinions regarding the financial statements taken as a whole and internal control over financial reporting. Accordingly, we will not express an opinion on the Company's interim financial information.

Our reviews will consist principally of performing analytical procedures applied to financial data and making inquiries of the Company personnel responsible for financial and accounting matters. Our reviews will include obtaining sufficient knowledge of the Company's business and its internal control as it relates to the preparation of both annual and interim financial information to (a) identify the types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence, and (b) select the inquiries and analytical procedures that will provide us with a basis for communicating whether we are aware of any material modifications that should be made to the interim financial information for it to conform with U.S. generally accepted accounting principles.



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A review does not contemplate tests of internal controls or accounting records, tests of responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an Integrated Audit. Thus, a review does not provide assurance that we will become aware of all significant matters that would be disclosed in an Integrated Audit. Further, a review is not designed to provide assurance on internal control or to identify significant deficiencies or material weaknesses and cannot be relied on to detect errors, fraud or illegal acts.

As agreed, we will not issue a written report completion of each review. The Company understand that any reference to interim financial information as revised by us when such information is included in documents issued to stockholders or third parties (including the SEC) will necessitate the issuance of a written review report, which must accompany the interim financial information in the document.

Registration Statements and Other Offering Documents

We understand that the consolidated financial statements and schedules, management's assessment regarding the effectiveness of internal control over financial reporting, and our written audit reports thereon, as described above, are to be included by the Company in its annual report (Form 10-K), and that in so doing, the Company will be incorporating by reference the consolidated financial statements and schedules, management's assessment regarding the effectiveness of internal control over financial reporting, and our reports thereon in previously filed and effective Form S-8. Prior to issuing our consent to the incorporation by reference in these registration statements of our reports with respect to the consolidated financial statements and schedules and internal control over financial reporting described above, we will perform procedures as required by the standards of the PCAOB (United States), including, but not limited to, reading information incorporated by reference in these registration statements and performing subsequent event procedures.

Should the Company wish to include or incorporate by reference the consolidated financial statements, management's assessment regarding the effectiveness of internal control over financial reporting, and our audit reports thereon into a future filing under the Securities Act of 1933, or an exempt offering, prior to our consenting to include or incorporate by reference our reports on the consolidated financial statements and internal control over financial reporting, we would consider our consent to the inclusion of our reports and the terms thereof at that time. We will be required to perform procedures as required by the standards of the PCAOB (United States), including, but not limited to, reading other information incorporated by reference in the registration statement or other offering document and performing subsequent event procedures.



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Our reading of the other information included or incorporated by reference in the offering document will consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the consolidated financial statements or is inconsistent with the results of our audit of internal control over financial reporting. However, we will not perform procedures to corroborate such other information (including forward-looking statements). The specific terms of our future services with respect to future filings or other offering documents will be determined at the time the services are to be performed.

Comfort Letters

Should a comfort letter be requested in connection with a future filing under the Securities Act of 1933, or an exempt offering, the specific terms of our services will be determined at that time. Prior to our issuance of a comfort letter, management of the Company agrees to supply us with a representation letter that will, among other things, confirm that no events have occurred that would require adjustments to (or additional disclosures in) the audited consolidated financial statements or management's assessment regarding the effectiveness of the Company's internal control over financial reporting as of December 31, 2004 referred to above and confirm the Company's responses to certain inquiries made in connection with our issuance of the comfort letter.

Our responsibility to communicate with the Audit Committee

In conjunction with management, who is responsible for establishing the Company's accounting policies, we will discuss our judgments of the quality and understandability, not just the acceptability, of the Company's accounting policies and disclosures, prior to the filing of our audit reports with the SEC. We believe verbal communication is the appropriate forum to provide open and frank dialogue.



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We will report to you, in writing, the following matters prior to the filing of our audit reports with the SEC:

- All significant deficiencies¹ and material weaknesses² identified during the Integrated Audit. If a significant deficiency or material weaknesses exists because of the oversight of the company's external financial reporting and internal control over financial reporting by the audit committee, we report such deficiency in writing to the board of directors.
- Audit adjustments arising from the Integrated Audit that could, in our judgment, either individually or in aggregate, have a significant effect on the Company's financial reporting process. In this context, audit adjustments, whether or not recorded by the entity, are proposed corrections of the financial statements that, in our judgment, may not have been detected except through the auditing procedures performed.
- Uncorrected misstatements aggregated during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in aggregate.
- All relationships between KPMG LLP and its related entities and the Company and its related entities that, in our judgment, may reasonably be thought to bear on independence.
- Alternative treatments within GAAP for accounting policies and practices related to material items that have been discussed with management during the current audit period, including i) ramifications of the use of such alternative disclosures and treatments and the treatment preferred by us and ii) the process used by management in formulating particularly sensitive accounting estimates.
- Disagreements with management or other serious difficulties encountered in performance of our audit or review services.

¹ A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects an entity's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with U.S. generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

² A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.



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- Critical accounting policies and practices applied in the consolidated financial statements and our assessment of management's disclosures regarding such policies and practices, including why certain policies and practices are or are not considered critical, and how current and anticipated future events impact those determinations.
- Other matters required to be communicated by the standards of the PCAOB (United States).

We will also read minutes, if any, of audit committee meetings for consistency with our understanding of the communications made to you and determine that you have received copies of all material written communications between ourselves and management. We will also determine that you have been informed of i) the initial selection of, or the reasons for any change in, significant accounting policies or their application during the period under audit, ii) the methods used by management to account for significant unusual transactions, and iii) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

To the extent that they come to our attention, we will inform you and management about any material errors and any instances of fraud or illegal acts. Further, to the extent they come to our attention, we will also communicate to you fraud that involves senior management or that, in our judgment, causes a material misstatement of the financial statements and illegal acts that come to our attention, unless they are clearly inconsequential. In the case of illegal acts which, in our judgment, would have a material effect on the consolidated financial statements of the Company, we are also required to follow the procedures set forth in the Private Securities Litigation Reform Act of 1995, which under certain circumstances requires us to communicate our conclusions to the SEC.

If, during the performance of our Integrated Audit procedures, circumstances arise which make it necessary to modify our reports or withdraw from the engagement, we will communicate to you our reasons for withdrawal. Similarly, if during performance of our quarterly review services we become aware of matters that cause us to believe the interim information filed, or to be filed, with the SEC, is probably materially misstated as a result of a departure from U.S. generally accepted accounting principles, we will discuss such matters with management and, if appropriate, communicate such matters to you.

In addition, if we become aware of information that relates to the consolidated financial statements and/or management's assessment regarding the effectiveness of internal control over financial reporting after we have issued our reports or completed our interim review procedures, but which was not known to us at the date of our reports or completion of our interim review procedures, and which is of such a nature and from such a source that we would have investigated that information had it come to our attention during the course of our Integrated



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Audit and/or interim review procedures, we will, as soon as practicable; (1) communicate such an occurrence to you; and (2) undertake an investigation to determine whether the information is reliable and whether the facts existed at the date of our reports or completion of our interim review procedures. In conducting that investigation, we will have the full cooperation of the Company's personnel. If the subsequently discovered information is found to be of such a nature that (a) our reports or completion of our interim review procedures would have been affected if the information had been known as of the date of our reports or completion of our interim review procedures and (b) we believe that the reports or interim review procedures are currently being relied upon or are likely to be relied upon by someone who would attach importance to the information, appropriate steps will be taken to prevent further reliance on our reports or interim review procedures. Such steps include appropriate disclosures by the Company of the newly discovered facts and the impact to the financial statements.

Audit committee responsibilities

The audit committee is directly responsible for the appointment of KPMG as independent auditor, determining our compensation, and oversight of our Integrated Audit work, including resolution of disagreements between management and us regarding financial reporting. We understand that we report directly to the audit committee. The audit committee is responsible for preapproval of all audit and nonaudit services provided by us.

Management responsibilities

The management of the Company is responsible for the fair presentation, in accordance with U.S. generally accepted accounting principles, of the consolidated financial statements, schedules, and interim financial information and all representations contained therein. Management also is responsible for identifying and ensuring that the Company complies with laws and regulations applicable to its activities, and for informing us of any known material violations of such laws and regulations. Management also is responsible for preventing and detecting fraud, including the design and implementation of programs and controls to prevent and detect fraud, for adopting sound accounting policies, and for establishing and maintaining effective internal control over financial reporting and procedures for financial reporting to maintain the reliability of the consolidated financial statements or interim financial information and to provide reasonable assurance against the possibility of misstatements that are material to the consolidated financial statements or interim financial information. Management is also responsible for informing us, of which it has knowledge, of all deficiencies in the design or operation of such controls.



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The management of the Company is also responsible for:

1. Accepting responsibility for the effectiveness of the Company's internal control over financial reporting;
2. Evaluating the effectiveness of the Company's internal control over financial reporting using a suitable control criteria;
3. Supporting its evaluation with sufficient evidence, including documentation; and
4. Presenting a written assessment of the effectiveness of the Company's internal control over financial reporting as of the Company's fiscal year end.

If management does not fulfill these responsibilities above, we cannot complete the Integrated Audit.

Management of the Company agrees that all records, documentation, and information we request in connection with our Integrated Audit will be made available to us, that all material information will be disclosed to us, and that we will have the full cooperation of the Company's personnel. As required by the standards of the PCAOB (United States), we will make specific inquiries of management about the representations embodied in the consolidated financial statements or interim financial information and the effectiveness of internal control over financial reporting, and obtain a representation letter from management about these matters. The responses to our inquiries, the written representations, and the results of audit tests, among other things, comprise the evidential matter we will rely upon in forming an opinion on the consolidated financial statements, management's assessment of internal control and the effectiveness of internal control over financial reporting.

Management is responsible for adjusting the annual consolidated financial statements and interim financial information to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the consolidated financial statements being reported upon, or the interim information being reviewed, taken as a whole.



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Dispute Resolution

Any dispute or claim arising out of or relating to the engagement letter between the parties, the services provided thereunder, or any other services provided by or on behalf of KPMG or any of its subcontractors or agents to the Company or at its request (including any dispute or claim involving any person or entity for whose benefit the services in question are or were provided) shall be resolved in accordance with the dispute resolution procedures set forth in Appendix II, which constitute the sole methodologies for the resolution of all such disputes. By operation of this provision, the parties agree to forego litigation over such disputes in any court of competent jurisdiction. Mediation, if selected, may take place at a place to be designated by the parties. Arbitration shall take place in New York, New York. Either party may seek to enforce any written agreement reached by the parties during mediation, or to confirm and enforce any final award entered in arbitration, in any court of competent jurisdiction.

Notwithstanding the agreement to such procedures, either party may seek injunctive relief to enforce its rights with respect to the use or protection of (i) its confidential or proprietary information or material or (ii) its names, trademarks, service marks or logos, solely in the courts of the State of New York or in the courts of the United States located in the State of New York. The parties consent to the personal jurisdiction thereof and to sole venue therein only for such purposes.

Other matters

This letter shall serve as the Company's authorization for the use of e-mail and other electronic methods to transmit and receive information, including confidential information, between KPMG LLP (KPMG) and the Company and between KPMG and outside specialists or other entities engaged by either KPMG or the Company. The Company acknowledges that e-mail travels over the public Internet, which is not a secure means of communication and, thus, confidentiality of the transmitted information could be compromised through no fault of KPMG. KPMG will employ commercially reasonable efforts and take appropriate precautions to protect the privacy and confidentiality of transmitted information.

Further, for purposes of the services described in this letter only, the Company hereby grants to KPMG a limited, revocable, non-exclusive, non-transferable, paid up and royalty-free license, without right of sublicense, to use all names, logos, trademarks and service marks of the Company solely for presentations or reports to the Company or for internal KPMG presentations and intranet sites.



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KPMG is a limited liability partnership comprising both certified public accountants and certain principals who are not licensed as certified public accountants. Such principals may participate in the engagements to provide the services described in this letter.

Without our prior written approval, the Company will not solicit for employment, nor will the Company hire, any current or former partner or any professional employee of KPMG LLP or any of its affiliated member firms, in a financial reporting oversight role (as defined in the SEC independence rules) if such partner or professional employee previously participated in the audit of the Company's consolidated financial statements or quarterly review procedures until the applicable "cooling off" period under the SEC independence rules has expired. That period would commence with the latest date on which the individual participated in the annual audit or quarterly review procedures and would expire upon the filing by the Company of its Form 10-K for the succeeding fiscal year.

Work Paper Access By Regulators and Others

The work papers for this engagement are the property of KPMG. In the event KPMG is requested pursuant to subpoena or other legal process to produce its documents relating to this engagement for the Company in judicial or administrative proceedings to which KPMG is not a party, the Company shall reimburse KPMG at standard billing rates for its professional time and expenses, including reasonable attorney's fees, incurred in responding to such requests.

However, we may be requested to make certain work papers available to the PCAOB, Federal Deposit Insurance Corporation, Massachusetts Office of Commissioner of Banks or other bank regulator pursuant to authority given to it by law or regulation. If requested, access to such work papers will be provided under the supervision of KPMG personnel. Furthermore, upon request, we may provide photocopies of selected work papers to the PCAOB, Federal Deposit Insurance Corporation, Massachusetts Office of Commissioner of Banks or other bank regulator. The PCAOB, Federal Deposit Insurance Corporation, Massachusetts Office of Commissioner of Banks or other bank regulators may intend, or decide, to distribute the photocopies or information contained therein to others, including the SEC and other government agencies. We agree to communicate to you on a timely basis any requests by the PCAOB for direct contact with members of the Audit Committee.

Additional Reports and Fees for Services

Appendix I to this letter list the additional reports we will issue as part of this engagement and our fees for professional services to be performed per this letter.



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In addition, fees for any special audit-related projects, such as research and/or consultation on special business or financial issues, will be billed separately from the audit fees for professional services set forth in Appendix I and may be subject to written arrangements supplemental to those in this letter.

We have forwarded a copy of this letter to Mr. Reginald E. Cormier, Chief Financial Officer.

We shall be pleased to discuss this letter with you at any time. For your convenience in confirming these arrangements, we enclose a copy of this letter. Please sign and return it to us.

Very truly yours,

KPMG LLP

Jeanette Fritz
Partner

cc: Mr. Reginald E. Cormier
Chief Financial Officer

ACCEPTED:

MASSBANK Corp.

Authorized Signature

Chairman of the Audit Committee

Date

Appendix I

Fees for Services

Based upon our discussions with and representations of MASSBANK Corp., our fees for services we will perform are estimated as follows:

Integrated Audit:

Audit of consolidated balance sheets of the Company as of December 31, 2004 and 2003, the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2004, (includes quarterly reviews)	\$153,000
Audit of internal control over financial reporting: Our initial estimate of the fees related to our audit of internal control over financial reporting as of December 31, 2004	\$ 46,000 and \$77,000
Total integrated audit fee	\$199,000 - \$230,000

However, we are unable to assure you that we can complete the audit of internal control over financial reporting within this estimated range due to the following:

- the Company has not yet provided us with the complete documentation of its internal control over financial reporting;
- the Company has not completed its tests of design effectiveness or operating effectiveness; and
- Management of the Company has not rendered its own assessment of internal control over financial reporting;

We will provide you updates of our estimate of fees as management provides us this information to us and, we will finalize our professional fees once we have completed our work and know the extent of actual professional hours that were expended.

Other Reports:

Another report that we will issue as part of this engagement is as follows:

<u>Report</u>	<u>Fee</u>
The MASSBANK Employee's Stock Ownership Plan and Trust.	\$7,000

The above estimates are based on the level of experience of the individuals who will perform the services. Expenses for items such as travel, telephone, postage, and typing, printing, and reproduction of financial statements are included in the fees quoted above. Circumstances encountered during the performance of these services that warrant additional time or expense could cause us to be unable to deliver them within the above estimates. We will endeavor to notify you of any such circumstances as they are assessed.

Our fees will be billed as charges are incurred. The ethics of our profession prohibit the rendering of professional services where the fee for such services is contingent, or has the appearance of being contingent, upon the result of such services. Accordingly, in order to avoid the possible implication that our fee is contingent upon the success of the contemplated offering, it is important that our bills be paid promptly when rendered. If a situation arises in which it may appear that our independence would be questioned because of significant unpaid bills, we may be prohibited from signing our audit report and consent.

Appendix II

Dispute Resolution Procedures

The following procedures are the sole methodologies to be used to resolve any controversy or claim ("dispute"). If any of these provisions are determined to be invalid or unenforceable, the remaining provisions shall remain in effect and binding on the parties to the fullest extent permitted by law.

Mediation

Any party may request mediation of a dispute by providing a written Request for Mediation to the other party or parties. The mediator, as well as the time and place of the mediation, shall be selected by agreement of the parties. Absent any other agreement to the contrary, the parties agree to proceed in mediation using the CPR Mediation Procedures (effective April 1, 1998) issued by the Center for Public Resources, with the exception of paragraph 2 which shall not apply to any mediation conducted pursuant to this agreement. As provided in the CPR Mediation Procedures, the mediation shall be conducted as specified by the mediator and as agreed upon by the parties. The parties agree to discuss their differences in good faith and to attempt, with facilitation by the mediator, to reach a consensual resolution of the dispute. The mediation shall be treated as a settlement discussion and shall be confidential. The mediator may not testify for any party in any later proceeding related to the dispute. No recording or transcript shall be made of the mediation proceeding. Each party shall bear its own costs in the mediation. Absent an agreement to the contrary, the fees and expenses of the mediator shall be shared equally by the parties.

Arbitration

Arbitration shall be used to settle the following disputes: (1) any dispute not resolved by mediation 90 days after the issuance by one of the parties of a written Request for Mediation (or, if the parties have agreed to enter or extend the mediation, for such longer period as the parties may agree) or (2) any dispute in which a party declares, more than 30 days after receipt of a written Request for Mediation, mediation to be inappropriate to resolve that dispute and initiates a Request for Arbitration. Once commenced, the arbitration will be conducted either (1) in accordance with the procedures in this document and the Rules for Non-Administered Arbitration of the CPR Institute for Dispute Resolution ("CPR Arbitration Rules") as in effect on the date of the engagement letter or contract between the parties, or (2) in accordance with other rules and procedures as the parties may designate by mutual agreement. In the event of a conflict, the provisions of this document and the CPR Arbitration Rules will control.

The arbitration will be conducted before a panel of three arbitrators, two of whom may be designated by the parties using either the CPR Panels of Distinguished Neutrals or the Arbitration Rosters maintained by any United States office of the Judicial Arbitration and Mediation Service (JAMS). If the parties are unable to agree on the composition of the arbitration panel, the parties shall follow the screened selection process provided in Section B, Rules 5, 6, 7, and 8 of the CPR Arbitration Rules. Any issue concerning the extent to which any dispute is subject to arbitration, or any dispute concerning the applicability, interpretation, or enforceability of these procedures, including any contention that all or part of these procedures are invalid or unenforceable, shall be governed by the Federal Arbitration Act and resolved by the arbitrators. No potential arbitrator shall be appointed unless he or she has agreed in writing to abide and be bound by these procedures.

The arbitration panel shall issue its final award in writing. The panel shall have no power to award non-monetary or equitable relief of any sort. Damages that are inconsistent with any applicable agreement between the parties, that are punitive in nature, or that are not measured by the prevailing party's actual damages, shall be unavailable in arbitration or any other forum. In no event, even if any other portion of these provisions is held to be invalid or unenforceable, shall the arbitration panel have power to make an award or impose a remedy that could not be made or imposed by a court deciding the matter in the same jurisdiction.

Discovery shall be permitted in connection with the arbitration only to the extent, if any, expressly authorized by the arbitration panel upon a showing of substantial need by the party seeking discovery.

All aspects of the arbitration shall be treated as confidential. The parties and the arbitration panel may disclose the existence, content or results of the arbitration only as provided in the CPR Arbitration Rules. Before making any such disclosure, a party shall give written notice to all other parties and shall afford such parties a reasonable opportunity to protect their interests.

The award reached as a result of the arbitration will be binding on the parties, and confirmation of the arbitration award may be sought in any court having jurisdiction.

**APPENDIX TO MASSBANK COMMENTS
JUNE 9, 2005**

TAB C

8-K/A 1 d8ka.htm FORM 8-K/A

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 8-K/A**CURRENT REPORT
PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of Report (Date of earliest event reported): March 31, 2005

MASSBANK Corp.*(Exact name of registrant as specified in its charter)***Delaware**
*(State or other jurisdiction of
incorporation or organization)***0-15137**
*Commission file number***04-2930382**
*(I.R.S. Employer
Identification No.)***123 Haven Street, Reading, Massachusetts 01867**
*(Address of principal executive offices) (Zip code)***Registrant's telephone number, including area code: (781) 662-0100****Not Applicable**
(Former name or former address, if changed since last report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

- Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
 - Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
 - Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
 - Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))
-

Item 4.01. Changes in Registrant's Certifying Accountant.

On March 31, 2005, the Audit Committee of the Board of Directors of MASSBANK Corp. (the "Company") replaced KPMG LLP ("KPMG") as the Company's independent registered public accountants with Parent, McLaughlin & Nangle. KPMG resigned as the Company's independent registered public accountants as of such date. The reports issued by KPMG on the Company's financial statements for each of the past two fiscal years did not contain an adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles. During the Company's two most recent fiscal years and through the date hereof, there were no disagreements with KPMG on any matter of accounting principle or practice, financial statement disclosure or auditing scope or procedure, which, if not resolved to KPMG's satisfaction, would have caused them to make reference to the subject matter in connection with their report of the Company's financial statements for such years; and there were no "reportable events" as defined in Item 304(a)(1)(v) of Regulation S-K.

The Company provided a copy of the foregoing disclosure to KPMG prior to the filing of its original report regarding the change in Certifying Public Accountant on Form 8-K on April 5, 2005. Attached as Exhibit 16.1 hereto is a copy of a letter from KPMG dated April 8, 2005 stating that KPMG agrees with such statements.

On March 31, 2005, the Company engaged Parent, McLaughlin & Nangle to serve as the Company's independent registered public accountants for the fiscal year ended December 31, 2005. During the fiscal years ended December 31, 2004 and December 31, 2003, and through the date hereof, the Company did not consult with Parent, McLaughlin & Nangle with respect to the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on the Company's consolidated financial statements, or any other matters or reportable events as set forth in Items 304(a)(2)(i) and (ii) of Regulation S-K.

Item 9.01 Financial Statements and Exhibits.

(c) Exhibits

<u>Exhibit No.</u>	<u>Title</u>
16.1	Letter from KPMG LLP dated April 8, 2005

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be filed on its behalf by the undersigned hereunto duly authorized.

MASSBANK Corp.

Dated: April 11, 2005

By: /s/ Reginald E. Cormier

Name: Reginald E. Cormier
 Title: Senior Vice President, Treasurer
 and Chief Financial Officer

EXHIBIT INDEX

<u>Exhibit No.</u>	<u>Title</u>
16.1	Letter from KPMG LLP dated April 8, 2005

EX-16.1 2 dex161.htm LETTER FROM KPMG LLP DATED APRIL 8, 2005

Exhibit 16.1



KPMG LLP
99 High Street
Boston, MA 02110-2371

Telephone 617 988 1000
Fax 617 988 0800
Internet www.us.kpmg.com

April 8, 2005

Securities and Exchange Commission
Washington, D.C. 20549

Ladies and Gentlemen:

We were previously principal accountants for MASSBANK Corp. and, under the date of March 14, 2005, we reported on the consolidated financial statements of MASSBANK Corp. as of December 31, 2004 and 2003 and for the years ended, management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2004 and the effectiveness of internal control over financial reporting as of December 31, 2004. On March 31, 2005, we resigned. We have read MASSBANK Corp.'s statements included under item 4.01 of its Form 8-K dated April 5, 2005 and we agree with such statements, except that we are not in a position to agree or disagree with MASSBANK Corp.'s statement that the decision to appoint Parent, McLaughlin & Nangle was approved by the Audit Committee of the Board of Directors or that Parent, McLaughlin & Nangle was not engaged regarding the application of accounting principles to a specified transaction or the type of audit opinion that might be rendered on MASSBANK Corp.'s consolidated financial statements.

Very truly yours,

KPMG LLP

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

**APPENDIX TO MASSBANK COMMENTS
JUNE 9, 2005**

TAB D



CHIEF EXECUTIVE

March 2005
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Are the Big Four Gouging?

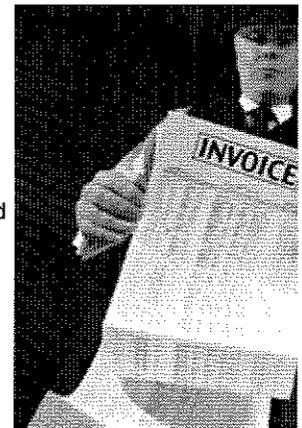
Nearly three years after the passage of Sarbanes-Oxley, audit costs at public companies are soaring, spurring outrage among CEOs.

BY MIKE BREWSTER

COVER STORY

As a licensed certified public accountant and a former auditor at one of the Big Four accounting firms, David A. Smith, CEO of PSS/World Medical, thought he understood a basic axiom of auditing: The more rigorous a company's financial controls, the less likely that an employee is cooking the books.

That's why Smith thought that his company's auditing costs would begin to decline in June 2004, when a major new auditing standard governing public companies was approved by the Securities and Exchange Commission. He figured the fees that PSS/World Medical's auditor, KPMG, charged for verifying the company's internal controls—work required under the Sarbanes-Oxley Act—would be offset by the fact that the auditors wouldn't have to do as many traditional audit tasks at the medical supply company's 50 distribution centers.



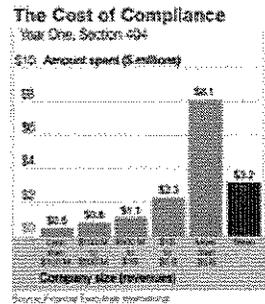
But Smith and his fellow executives at the \$1.35 billion company, based in Jacksonville, Fla., were surprised. During discussions about the audit with KPMG partners in January, they learned that the firm's auditors had spent more hours—not fewer—doing the traditional financial statement audit projects that PSS/World Medical's total audit costs for fiscal 2005 will be double those of the previous year. "If you are going to attest to our internal controls, and you say we can rely on them, then we see a reduction in fees associated with the substantive testing?" says Smith, who once worked for Coopers & Lybrand, a precursor to PricewaterhouseCoopers. "We haven't seen any of that. It's gouging."

KPMG, like the rest of the Big Four firms, does not publicly comment on its work with individual

The explosive rise of Big Four audit fees appears to be one of the many unintended consequences of Sarbanes-Oxley, one that has CEOs like Smith shaking their heads in bafflement, resignation in more than a few cases, outright anger. Regardless of size, geographic location and industry, public companies are facing skyrocketing accounting fees—and management teams can do little about it. Smith says of KPMG: "We're going to push back on fees, but I don't have much power to improve performance because they know we can't switch; it's too much of a pain."

Nearly three years after passage of the most far-reaching corporate governance legislation in U.S. history—driven by accounting scandals at Enron and WorldCom—the world's biggest auditing firms are realizing large increases in revenue. The surge in business is being enjoyed particularly by the Big Four, which in addition to KPMG includes PricewaterhouseCoopers, Deloitte Touche and Ernst & Young. A recent survey by the Corporate Executive Board, a consulting firm, found that the Big Four raised audit fees during 2004 by an average of between 78 percent and 134 percent.

Leaders at some of the Big Four firms say rising auditing costs are the result of market forces a CEOs, of all people, should understand. "Fees are market-driven—based on competition, our efforts and the cost of recruiting the best people," says Bob Lipstein, a KPMG partner who head firm's Sarbanes-Oxley Section 404 services. How would Lipstein respond to chief executives w/ the current situation? "CEOs," he says, "have to start getting value out of the information that's out of the controls work." Another basic reality, say the auditors, is that the government forced Andersen out of business because of its role at Enron and that dramatically reduced competition marketplace.



The rise in audit fees is a sensitive issue for the Big Four. Two of the Deloitte and Ernst & Young, declined requests to be interviewed for article.

The Big Four's revenues are likely to climb even faster in 2005, as attest to their clients' compliance with Section 404 of Sarbox, which public companies to certify to the SEC that their financial controls are. In a July 2004 survey of 224 public companies with average revenue \$2.5 billion, conducted by the trade association Financial Executive International (FEI), executives predicted a 40 percent increase in the fees their companies would be charged by external auditors. Recent interviews with several CEOs and third-party experts found that many of them expect even higher rates of growth for auditing costs.

On-the-Job Audit Training

That's because the Financial Executives survey was done prior to the July 2004 release of the final version of the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 2, a broad, open-ended directive regarding Section 404-related audits. Among the increased responsibilities auditors face under the standard is a mandate to evaluate all financial controls designed to prevent material fraud. As public companies scramble to include their internal controls certifications in their annual reports to the SEC, auditors are spending enormous amounts of time applying the new standard. Colleen Sayther, president and CEO of FEI, estimates that average total fee increases from 2003 to 2004 will be somewhere between 100 and 200 percent.

One issue is whether the Big Four had adequate time to prepare for all these changes. They say they didn't, but not everyone agrees. Lynn Turner, former chief accountant at the SEC under Arthur Levitt, the agency chairman who famously battled the accounting industry in the late 1990s, says the firms had more than 18 months between the passage of Sarbanes-Oxley and the release of Standard No. 2 to prepare a new audit. "They didn't do it," says Turner, now managing director of the analytical research firm Glass, Lewis & Co. and chairman of the audit committee at Sun Microsystems. "Now, you have a bunch of auditors getting on-the-job internal controls training, which is asinine."

There is a good reason why the enormous number of hours auditors spend examining internal controls is not translating into efficiencies in the financial statement audit, says Turner. In the past, he argues, auditors simply weren't doing a good job on financial statement audits, much less looking at internal controls. Now, partners and managers at the Big Four are struggling to improve both kinds of audits and keep regulators happy. "Today, the audit firms are realizing that someone is coming in to see [their work], and the PCAOB can take away a partner's license," Turner says. "So they better do the basic audit right, as well as the internal control audit."

In addition to the soaring costs, another problem public companies face is their auditors' inability to accurately predict how many hours will be involved. Bill Zollars, CEO of Yellow Roadway, a \$3 billion trucking company based in Overland Park, Kan., ran into this issue with KPMG. First, it was difficult for his management team to obtain a forecast of the hours KPMG would need to complete its 2004 audit, because the

The Road to Sarb: Oxley

- **June 2000** SEC C Arthur Levitt propose barring auditing firms providing most kinds consulting services to audit clients.
- **November 2000** T approves a watered-c version of Levitt's prc including a provision mandating that comp annually disclose auc consulting fees.
- **October 2001** Eni announces a \$638 m third-quarter loss and billion reduction in shareholder equity.
- **December 2001** E files for Chapter 11 bankruptcy protector
- **March 2002** Arthu Andersen is indicted charges of obstructio justice, based on shr documents related to Enron audit.
- **June 2002** Anders found guilty of obstru justice, effectively lea the firm's demise. Wt announces that it ove earnings for all of 200 the first quarter of 200

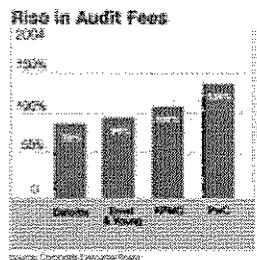
accounting firm was reluctant to make any forecast before Standard No. 2 was released. The number of hours KPMG eventually projected turned out to be too low by roughly half. "It's hard to tell what value you're getting for all that money spent, and it was hard to tell how much effort on their part was required," says Zollars. "Nobody likes surprises. And I think a lot of companies are surprised at how much it costs." KPMG declined to comment on its work for Yellow Trucking.

the first quarter of 2004, the firm reported \$3.8 billion. (Later estimates placed the fraud at close to \$1 billion.)

- **July 2002** President George W. Bush signs the Sarbanes-Oxley Act into law.

The amount of money that companies are spending to comply with Section 404, in particular, is eye-popping. Yellow Roadway, for example, has spent about \$7 million in audit and related consulting fees to meet the new requirements, and approximately double that amount on internal expenses related to Section 404 compliance. On average, public companies spent more than \$3.1 million last year on 404 compliance, according to Financial Executives International. That figure was driven up by the fact that companies with revenues of \$5 billion or more spent \$8 million on average. (See chart, page 22.) To be sure, says Zollars, "it's not all the accounting firms' fault. The law has been a lot more invasive than it was intended to be."

- **June 2004** SEC issues Auditing Standard No. 5, establishing guidelines for auditing public companies' internal controls.



How did it reach this point? Recent shocks to the accounting industry prompted the firms to try to squeeze fees out of lucrative clients while jettisoning risky and non-profitable ones. First, Andersen's demise in late 2002 threw thousands of public companies onto the auditing market, stretching the auditing staffs of the Big Four perilously thin and driving up hourly rates. Then, the passage of Sarbanes-Oxley barred accounting firms from providing most consulting services to their audit clients, eliminating a major revenue stream for the firms and placing a premium on audit fees. Finally, the looming specter of the PCAOB, which conducts annual inspections of the major accounting firms and wields unprecedented power to discipline them.

After the results of the first PCAOB inspections of the Big Four were made public last August, the amount of audit work related to internal controls skyrocketed, according to Sayther of Financial Executives International. "The inspection reports were not that flattering," she says, "and when the Big Four they were going to be second-guessed every step of the way, the scope of the work basically quadrupled."

Some CEOs believe the power of the oversight board, together with the risks of doing a bad audit embodied by the implosion of Andersen—has forced the Big Four into a highly expensive and conservative approach. "One of the few firms was put out of business, so they're running scared," says Nigbor, chairman of the board of Benchmark Electronics, a \$1.8 billion manufacturer in Angleton, Texas.

Audit Fees: Art or Science?

These more painstaking audits eat up additional partner and manager hours, expensive time—that, ultimately, is paid for by shareholders. As Alan Annex, a corporate governance analyst at the New York law firm Greenberg Traurig, says: "Right now, all the firms are erring on the side of overcaution. They're tracking the minutiae of hundreds of processes, from how companies operate to how they sign contracts."

What's especially maddening about audit fees for many companies is that the accounting firms sometimes seem to employ as much art as science in setting their fees. Projected annual fees are based on the complexity of a company's accounting and are rarely fixed, meaning that if auditors spot a new or an extra process to check, they go ahead and do it and bill for it later.

Jeff Rodek, chairman of the Santa Clara, Calif., software maker Hyperion, likens the effort to comply with Section 404 to "running the high hurdles in the dark." Steep audit fees, he says, is one of those things "We expected fees to go up," Rodek says, "but the initial request was more than we expected. Yet the higher fees, less choice and switching auditors implies that something is wrong." Rodek believes that his company's audit fees will be 50 percent higher than they were last year.

According to several CEOs, the Big Four are factoring the risk of a wayward audit into their fees. Fasola, chairman of RCN, a Princeton, N.J.-based telecommunications company that recently parted ways with PricewaterhouseCoopers to go to a second-tier firm, estimated that what the Big Four

"practice protection," or insurance and legal costs, comes to about \$250,000 per partner. That's substantial percentage of the annual revenues that the average partner brings in.

In fairness, pricing for risk has long been part of the audit. The \$25 million in audit fees that Enr Arthur Andersen in 2000 was the second highest among public companies that year, even more \$23.9 million that General Electric paid KPMG. "On the face of it, there was no way that you could Enron should cost more to audit than GE, which had something like 45 major subsidiaries," says Cheffers, a former PwC auditor who runs AccountingMalpractice.com, a Web site that advises on litigation risk. "The fact is that Andersen knew Enron was a risk and charged accordingly." For SEC Chairman Arthur Levitt believes it's only fair for risk to be a key pricing factor. "The CEOs are grousing," Levitt says, "but we're asking auditors to do a lot more than they used to. Before, internal controls were an afterthought. Now, they are front and center."

While the Accounting Oversight Board plays a direct watchdog role over the Big Four, other regulators are also keeping a close eye. New York Stock Exchange CEO John Thain, speaking at Chief Executive CEO summit in Palm Beach, Fla., in December, noted the lack of choice for large public companies when it came to purchasing audit services. "Part of the reason that accounting firms have had a *blanche*," Thain said, "is that there are basically only four of them, and they're employed by every company that has to do this. And they simply have the ability to charge high amounts."

The SEC's chief accountant, Don Nicolaisen, said at an accounting conference in late January in New York that he was hearing complaints from companies accusing their auditors of performing time-consuming, duplicative tasks. Nicolaisen went on to wonder aloud about whether Auditing Standard 2 was being implemented in a manner "more costly than it needs to be."

Maurice Taylor, CEO of Titan International, certainly thinks so. Taylor says of the PricewaterhouseCoopers auditors assigned to the Quincy, Ill.-based manufacturer: "These aren't auditors, these are kids. They are trying to read the law, but they don't know what they're doing."

PricewaterhouseCoopers Vice Chairman John O'Connor defends his firm's ability to audit internal controls. "I think next year you'll see more of an integrated audit," O'Connor says. "It was hard this year when Standard No. 2 came out so late, and there was not a lot of interpretive guidance."

Despite the prestige of a Big Four audit, no firms have a stranglehold on the auditing business of the largest U.S. companies. Partly because of the Big Four's tarnished reputation in light of the accounting scandals, a national or even a regional firm is now a viable option for many companies. In fact, first- and third-tier accounting firms are seeing significant increases in business. According to the research firm Audit Analytics, in two-thirds of the cases in which a Big Four firm and its client parted ways between from January through August 2004, it was the client that broke off the relationship.

The issue may be one of quality as well as cost. "Over the long term, our fees are probably a little less than the Big Four's," says Ed Nusbaum, CEO of Grant Thornton, a leading second-tier firm. "But the Big Four's real problem isn't that their fees are going up. It's that their fees are going up and their service is getting worse." RCN's Fasola believes a company is "better off" being a high-priority client of a second-tier firm than a low-priority client of a Big Four firm.

Pricing for Risk

For smaller and non-U.S. companies, some relief on the regulatory front may be on the way. The SEC announced in early February that it would consider allowing "appropriate delay" for such companies to comply with Section 404 of Sarbanes-Oxley. Their current deadline for compliance is this summer. However, large U.S.-based companies have no such leeway.

What's more, for a truly global audit—and that's what most major companies need—the internal controls reach of the Big Four is a must. The bad news is that it appears fees won't be going down anytime soon. "The rates will likely have some increases, based on our cost increases," says O'Connor.

While the Big Four talk of becoming more efficient as they get up to speed on internal controls, observers remain skeptical. "The Big Four love Sarbanes-Oxley," says Ron Baker, author of *Firm Future*, a book that argues that accounting and law firms should bill not by the hour but by the value added. Baker suggests that the public auditing franchise be taken away from CPAs to trigger greater competition and, in turn, lower prices.

But for the foreseeable future, that isn't going to happen. The PCAOB, which sets audit standards in the United States, and the International Auditing and Assurance Standards Board, which sets standards for the rest of the world, appear committed to maintaining exacting audit standards, meaning upward pressure on fees.

From the point of view of overall public policy, the question is whether the cost and time involved in complying with ever-tightening standards is making boards more conservative and risk-averse, therefore acting as a constraint on the ability of chief executives to take risks and increase sales. A majority of CEOs probably believe that the answer to that question is, "Of course." But unless they communicate that message to Washington, without sounding like cry babies, there's little chance of reducing but even more auditor hours, higher audit fees and greater CEO frustration.

Mike Brewster is author of *Unaccountable: How the Accounting Profession Forfeited a Public Trust* (Wiley & Sons, 2003).

On the Auditing Wars

Lynn Turner, an industry insider, offers a historical perspective.



Lynn Turner has been involved in the accounting industry for nearly 30 years. He recently served as point man for SEC Chairman Arthur Levitt's ban on non-audit services by the Big Four accounting firms from selling consulting services to their audit clients. He is currently managing director of the analytical research firm Glass, Lewis & Co. and was chairman of the audit committee at Sun Microsystems. Excerpts from an interview with Chief Executive:

On the ability of the Big Four to audit internal controls: "When I joined the auditing profession in July of 1976, we did a lot of testing on internal controls. If the controls were working the way they should, it gives you great confidence that the numbers are good. Today, many Big Four partners have never tested internal controls. That fell out of vogue in the early 1980s."

On the competition that drove down audit fees in the 1980s and 1990s: "When the firms were forced to go to competitive bidding in the 1970s, corporations did a fantastic job of playing one firm off another from then on. The firms had to reduce hours to lower fees, and that reduced the quality of audit that wasn't as good."

On the impact of Sarbanes-Oxley: "There are a number of institutions, as a result of their SOX compliance, that have found controls weaknesses. A lot of companies haven't had the right controls in place, and over time in years, they're being forced to invest in the finance function."

On the value of an audit: "People need to realize this is a very important function of the capital markets. It's worth a lot more than the 99 bucks an hour companies were paying for a long time."

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