CPA Mutual INSURANCE COMPANY OF AMERICA RISK RETENTION GROUP

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June 9, 2005

VIA FACSIMILE & EMAIL

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

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

Dear Sir or Madam:

The Federal Financial Institutions Examination Council ("FFIEC") has requested public comment with respect to 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"). CPA Mutual Insurance Company of America Risk Retention Group ("CPA Mutual"), the first national mutual insurance company founded by CPA's to address the professional liability needs of the accounting profession, commends the FFIEC for recognizing the need to address independence issues related to the use of limitation of liability provisions in audit engagement letters and welcomes the opportunity to comment on the proposed Advisory.

The Advisory states that the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration and the Office of the Comptroller of the Currency (collectively, the "Agencies") have observed an increase in the frequency with which limitation of liability or alternative dispute resolution ("ADR") provisions are included in audit engagement letters. In connection with this, the Advisory asserts that such provisions may weaken an auditor's objectivity, impartiality and performance and, therefore, present safety and soundness concerns. Based on these concerns, the Advisory provides that the inclusion of limitation of liability provisions in audit engagement letters that are inconsistent with the Advisory "will generally be considered an unsafe and unsound practice." The Advisory further provides that it applies to "any agreement

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that a financial institution enters into with its external auditor that limits the external auditor's liability with respect to financial statement audits."

The Advisory generally defines limitation of liability provisions as agreements where: (1) the auditor is indemnified against claims made by third parties; (2) the auditor is held harmless or released from liability for claims that might be asserted by the client; or (3) the client agrees to limit remedies that would otherwise be available against the auditor. While ADR provisions and jury trial waiver agreements are discussed separately from limitation of liability provisions, all of these concepts constitute risk management mechanisms. In discussing such mechanisms, it is useful to consider the liability framework in which they are applied. As auditor liability can be analyzed in terms of client liability and third party liability, risk management mechanisms can be assessed based on scope (whether the mechanism potentially mitigates client liability, third party liability or both) and effect (the level of risk mitigation provided or potentially provided by the mechanism in connection with either or both liability categories).

Given that "independence in appearance" is an essential component of independence, scope and effect are relevant factors in assessing the independence implications of risk management mechanisms.[1] In connection with this, CPA Mutual concurs with the FFIEC's conclusion that the scope and effect of some risk management mechanisms are so significant that they might reasonably be viewed as impairing independence. While the first and seventh limitation of liability provision examples in Appendix A of the Advisory appear to fall within this category, as the scope and effect of risk management mechanisms vary significantly, not all such mechanisms give rise to legitimate independence concerns.[2]

Although CPA Mutual believes that the protection of financial institutions is a vital public interest and supports the FFIEC's decision to impose limitations on the use of indemnification provisions in audit engagement letters, other compelling public policy interests also deserve consideration. In connection with this, CPA Mutual respectfully submits that, in its present form, the scope of the Advisory exceeds the reasonable boundary of its supporting rationale and unnecessarily impinges on the public interest in reducing dispute resolution costs and ensuring the availability of reasonably affordable audit services and the equitable distribution of financial risk.[3]

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[1] The AICPA *Conceptual Framework for AICPA Independence Standards* provides that "independence" consists of both "independence of mind" and "independence in appearance." Independence of mind is defined as "the state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism." Independence of appearance is defined as "the avoidance of circumstances that would cause a reasonable and informed third party having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised." While the Advisory makes reference to the potential impairment of both objectivity and independence, there does not appear to be a conceptual distinction between these terms and the Advisory clearly relies on independence concerns as the rational for prohibiting indemnification provisions.

[2] With respect to the other Appendix A examples, CPA Mutual, believes that further study is appropriate and that the FFIEC should conduct public hearings and seek further public input.

[3] With regard to the public interest in the equitable distribution of financial risk, regulations should neither unreasonably favor nor unreasonably penalize particular professions or business interests. While all professionals must be accountable for the services they provide, this does not require acceptance of unlimited financial risk. Over the past several years malpractice insurance rates for accountants have increased significantly. As a result of

The Advisory applies to "any agreement" that "limits the external auditor's liability with respect to financial statement audits" and provides that the use any such agreement will "will generally be considered an unsafe and unsound practice" without regard to the scope or effect of the agreement. Clearly, however, many risk management mechanisms can not reasonably be construed as giving rise to legitimate independence concerns.[4] Consider, for example, a provision which requires the losing party in a dispute to pay the winning party's legal fees. As such a provision may ultimately work to either the advantage or disadvantage of an auditor and would only work to the advantage of the auditor in the event of an adjudication that the auditor's conduct was not wrongful, there does not appear to be a reasonable basis to assert that the inclusion of such a provision in an auditor's engagement letter would impair the auditor's independence.[5] Further, the use of such clauses furthers the public interest in reducing dispute resolution costs and ensuring the availability of reasonably affordable audit services and the equitable distribution of financial risk.[6] Nevertheless, such a provision would appear to fall within the scope of the Advisory and be prohibited.

Another reasonable use of risk management mechanisms is to enforce scope limitations that are expressly agreed upon by the parties. While audit fees are determined by a variety of factors, engagement risk is a significant component. As noted, auditor liability is composed of client liability and third party liability. If an auditor and a client agree to a scope limitation for the engagement, the risk of the engagement is diminished and this may be reflected in the audit fee.[7] To provide some level of protection from the risk that the client will not abide by the agreed scope limitation, the auditor's engagement letter might reasonably include a provision with provides that the client agrees to indemnify the auditor with respect to third party liability claims not contemplated in the engagement. In such situations, the auditor's acceptance of third party risk was never contemplated and the indemnity agreement is only applicable if the client violates a condition under which the services were provided. While the use of an indemnity

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rampant litigation and soaring insurance premium increases in the medical profession, various states have imposed limits on the damages that can be recovered in medical malpractice cases. States which have enacted such laws have clearly done so based on the belief that the consequences of unlimited civil liability justify the imposition of reasonable limitations on recoverable damages even where the existence of malpractice is undisputed. Thus, states have clearly recognized that there is a public interest in the equitable distribution of financial risk with respect to professional services which serve an important societal function. If such limitations are justifiable in situations involving death and personal injury and where the limitation is imposed by the state and does not arise from a contractual agreement between the parties, a strong case can be made for the existence of a public interest in allowing auditors to utilize reasonable risk mitigation provisions as a substitute for increased audit fees.

[4] As independence and objectivity concerns are the only basis upon which the Advisory relies for the conclusion that limitation of liability provisions constitute an unsafe and unsound practice, there is no supporting rational for the application of the Advisory to risk management mechanisms which do not raise such concerns.

[5] If independence or objectivity is not impaired, how can the use of such a provision reasonably be deemed an unsafe and unsound practice?

[6] The public interest in reducing dispute resolution costs would be served because such provisions tend to discourage frivolous litigation and unreasonable settlement positions. The public interest in ensuring the availability of reasonably affordable audit services would likewise be served because the lost productivity, litigation expenses and increased insurance premiums caused by frivolous litigation must be reflected in audit fees to maintain the financial viability of audit services. The public interest in the equitable distribution of financial risk would be served because auditing is an important societal function and such a provision might discourage frivolous litigation.

[7] While the most common scope limitation is an agreement that the audit opinion will only be relied upon by the client or certain specifically identified persons or entities, various permutations are possible.

provision in such circumstances does not appear to present a legitimate independence concern and furthers the public interests noted above, it would nevertheless fall within the scope of the Advisory and be prohibited.[8]

Of greater concern, however, is the prohibition on risk management mechanisms intended to address client fraud. While recent regulations and changes in professional standards will likely increase the probability of auditors detecting fraud, it is widely recognized that a perfectly performed audit may not disclose material fraud. Although there is clearly a public interest in preventing and detecting fraud in financial institutions and auditors should not be permitted to totally abdicate responsibility for their work, the Advisory seeks to prohibit auditors from utilizing risk management mechanisms which might mitigate liability exposure arising from any kind of fraud. Where the fraud in question is being perpetrated against the financial institution, as occurs with embezzlements, such a prohibition appears consistent with public policy interests. Where the fraud is perpetrated by the management of a financial institution and can be legally imputed to the institution, however, the public policy justifications for prohibiting auditors from utilizing such risk management mechanisms are tenuous.

The argument advanced in support of prohibiting limitation of liability provisions in such situations is that they may "lead to the use of less extensive or less thorough procedures than would otherwise be followed..." or otherwise impair performance. Even if one accepts that any mitigation of the liability risk related to client fraud negatively impacts auditor performance, this line of reasoning leads to a circular conclusion because prohibiting an auditor from mitigating this risk must necessarily result in a corresponding reduction in the risk assumed by the financial institution. Therefore, if allowing auditors to mitigate this risk is an unsafe and unsound practice, allowing financial institutions to mitigate their risk by banning the use of limitation of liability provisions is an equally unsafe and unsound practice.

Regardless of potential behavioral influences, however, courts in a number of jurisdictions have recognized that public policy considerations prohibit client claims against auditors where management fraud is imputable to the client. Thus, the Advisory will not uniformly prohibit auditors from being protected against client claims where management fraud is imputable to the client, it will only serve to prevent auditors in jurisdictions where such protections do not currently exist from using a contractual mechanism to enjoy the same protections that auditors in other jurisdictions already have as a matter of law. Because the Advisory's prohibition on limiting auditor liability in situations involving imputable client fraud will benefit some auditors while disadvantaging others and there is compelling public interest in preventing those who have engaged in fraud from seeking legal redress against those who have not, CPA Mutual urges the FFIEC to consider whether this specific effect of the Advisory may be contrary to the public interest.[9]

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[8] Why would protection from a presumably nonexistent risk cause a reasonable third party to believe that an auditor's objectivity or professional skepticism has been impaired when, as here, the indemnity obligation is wholly unrelated to the conduct of the auditor?

[9] While it appears that the analysis supporting this position is equally applicable to both indemnification and hold harmless provisions, CPA Mutual urges the FFIEC to permit hold harmless provisions in such situations even if it concludes that indemnity provisions should be prohibited. It should also be noted that a provision which is limited to imputable fraud has less effect than a provision which applies to any knowing misrepresentation by management because not all such misstatements would constitute imputable fraud. As the SEC determination cited in the

While the Advisory does not appear to proscribe all ADR agreements, the Advisory's reference to ADR provisions which do not include any limitation of liability provisions carries a negative connotation. Of particular concern, is the discussion regarding waiver of jury trial agreements. Although the Advisory does not appear to expressly prohibit such agreements, the discussion implies that they will be viewed with disfavor. As disputes arising from audits of financial institutions often involve highly complex factual and legal issues, they are well suited for resolution by judges with experience in complex commercial issues. While the Advisory suggests that waiving a jury trial might reduce the value of a financial institution's claim in an audit dispute, jury trail waivers clearly do not present any independence concerns and the Advisory presents no compelling public policy argument in support of the negative inference it raises with respect to such agreements.[10] As it has been widely recognized that encouraging ADR is in the public interest, CPA Mutual respectfully suggests that the Advisory be revised to clearly indicate that use of ADR provisions which do not include unacceptable limitation of liability provisions will not be deemed an unsafe and unsound practice.[11]

As the above examples illustrate, risk management mechanisms can take numerous different forms, be radically different in their scope and effect, and may be directly correlated with audit fees. Thus, they form a continuum. At one extreme, they can seek to insulate an auditor from all liability under all circumstances. At the other, they may provide little or no risk mitigation. While CPA Mutual supports the FFIEC's initiative to proscribe unreasonable limitation of liability provisions, we respectfully suggest that the scope of the Advisory is presently overbroad and does not appear supported by the proffered rationale. Therefore, CPA Mutual urges the FFIEC to conduct public hearings and further consider whether prohibiting auditors from utilizing risk management mechanisms which do not impair independence is in the public interest.

Respectfully submitted,

Douglas H. Thompson, Jr.
President
CPA Mutual Insurance Company of America Risk Retention Group

Advisory involved a clause which allowed for auditor indemnification in the event of any knowing misrepresentation by management, the SEC's conclusion is not necessarily applicable to a provision which is only applicable to imputable fraud.

[10] To the extent that the Advisory's comments regarding jury trials is accurate, public policy would appear to favor the fair adjudication of disputes over the enhancement of a financial institution's claim.

[11] The Alternative Dispute Resolution Act of 1998 is an example of the government's recognition of the value of promoting ADR.