Grant Thornton

Accountants and Business Advisors

June 9, 2005

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

Transmitted by email to: FFIEC-Comments@fdic.gov

Dear FFIEC officials:

Grant Thornton LLP (Grant Thornton) appreciates the opportunity to comment on the FFIEC's May 10, 2005 proposed interagency advisory, *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters* (the "Proposed Advisory"). Grant Thornton is the U.S. member firm of Grant Thornton International, one of the six global accounting, tax and business advisory organizations. Grant Thornton is the leading accounting, tax and business advisory firm whose principal strategic focus is serving middle-sized businesses such as community banks. With over $600 million in annual revenues, Grant Thornton ranks as the fifth largest U.S. accounting and business advisory firm. The Financial Institutions Practice is one of our firm's four largest industry concentrations – with in excess of 300 financial institutions clients nationwide.

Responses to requests for comments

Scope of Proposed Advisory

Grant Thornton concurs with the FFIEC basic premise that "in order for an external audit to be effective, the external auditor must be independent in both fact and appearance, and they must perform all necessary procedures to comply with generally accepted auditing standards established by the AICPA and, if applicable, the standards of the PCAOB." As indicated in the Proposed Advisory, the SEC indemnification prohibition in Section 602.02.f.i. of the SEC's Codification of Financial Reporting Policies are applicable to public financial institutions that file with the SEC or the financial institution regulatory agencies, federally insured depository institutions with $500 million or more in total assets and Office of Thrift Supervision ("OTS") regulated financial institutions with a CAMELS rating of 3, 4, or 5 and OTS-regulated holding companies.

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As discussed in subsequent paragraphs, Grant Thornton does not support a number of provisions in the Proposed Advisory. However, we believe that the scope of any approved engagement letter restrictions should apply equally to all audit and attest engagements that require independence. Therefore, if the Agencies collectively conclude that certain indemnification provisions inherently weaken the external auditor's objectivity, impartiality, and performance of the audit in accordance with professional standards, the Agencies should jointly propose that the auditors of all financial institutions that have external audits follow these rules and apply the same to all independent accountants who perform directors' examinations. Currently, the Agencies "encourage" rather than require institutions below the FDICIA threshold to obtain external audits and permit insured depository institutions to have directors' examinations in lieu of an external audit. We are concerned that the requirement is targeted only at one service requiring independence, external audits, and not at an alternative service also requiring independence, directors' exams.

Effects of advisory on financial institution's ability to negotiate terms of audit engagements

An audit engagement letter represent the documentation of the mutual understanding with the financial institution client's governing board, audit committee, and/or management (collectively hereafter referred to as the "client") regarding certain matters as outlined in Statement on Auditing Standards No. 83, *Establishing an Understanding with the Client* (AU Section 310), including professional, regulatory, and statutory requirements, fee arrangements, and other provisions. While Grant Thornton LLP's quality control policies require a written audit engagement letter, AU Section 310 requires documentation of the understanding in the audit documentation, preferably through a written communication with the client but does not require an engagement letter. Therefore, the Proposed Advisory should strongly encourage a written audit engagement letter to document the financial institution client's understanding with its external auditor. Further, we believe that it is unclear to many readers that the Proposed Advisory addresses only "audit" services rather than also addressing all non-audit, professional services that an external auditor may be engaged to perform.

Grant Thornton believes that the key to AU Section 310 is the word "mutual," which means that the client and the auditor willfully agree to legally binding contractual terms and conditions. Terms and conditions required by professional, regulatory, or statutory requirements should not be negotiable. Terms and conditions that are an auditor's firm policies arising from its risk management requirements are subject to negotiation, but generally require approval by firm-designated individuals.

The terms and conditions that the Proposed Advisory cites as objectionable, such as indemnification clauses, are risk management provisions that are not stipulated by professional standards or regulatory or statutory requirements. Therefore, depending upon the facts and circumstances, including the requirements of the auditing firm's professional liability insurance carrier and the perceived audit risk of the financial institution client, the auditor and the client may not be able to mutually agree on the inclusion of certain terms and conditions, which may terminate the auditor-client relationship.

Effect on external audit fees and availability of external auditing firms
We believe it is likely that financial institutions will see an increase in external audit fees if the Proposed Advisory is approved in its present form, although it may be difficult to attribute any change in fee level to this one change in the current environment. Such a rebalancing of risk and reward would naturally result from the increase in risk applicable to firms that continue to be willing to serve this market. Frequently, the auditing firm's professional liability carrier will consider the exclusion of any risk management clauses in determining the extent of coverage and the costs of the firm's insurance. For example, if the professional liability carrier doesn't exclude coverage for the audit of a troubled financial institution, such as an institution operating under a memorandum of understanding, professional insurance costs may increase substantially due to the insurer's perceived risk of the institution's failure. Therefore, one should assume that the increased professional liability insurance costs will be passed through to the financial institutions in increased fees.

Additionally, we believe that all external auditing firms will need to re-evaluate client acceptance and client continuation criteria. As with decisions made with respect to the costs and benefits of registering with the PCAOB, certain external auditing firms may decide that the risk and the costs associated with an auditing depository institutions far outweigh the anticipated benefits in entering into or continuing with a depository institution audit practice, particularly if the firm has a small or limited practice in the industry. Other auditing firms may accept engagements only for financial institutions that meet certain risk metrics, which may exclude all troubled financial institutions.

Indemnification categories and examples

We understand that the general categories of indemnifications covered by the FFIEC are indemnifications that:

- indemnify the external auditor against claims made by third parties
- indemnify the external auditor against claims or potential claims made by the client
- limit the remedies available to the client financial institution.

Indemnification provisions
In addition, Grant Thornton takes exception to the implication in the Proposed Advisory that external audit firms that use certain risk management clauses in audit engagement letter do so merely in order that the firms do not have to perform the audit in accordance with

professional standards. In the event that the Agencies noted engagement letter language that made them question the "objectivity, impartiality, and performance" of the external auditor, one would assume that the examiners would have made appropriate inquiry and review of relevant audit documentation to ascertain whether the audit engagement had in fact been performed in accordance with professional standards. However, there does not appear to be any linkage to causality in the Proposed Advisory or support provided that such matters have been identified. Indeed, if that were the case, one would expect that Agencies to cite such matters when they have reviewed and relied upon the work of external auditors when performing regulatory examinations.

As external auditors, we recognize our obligation under the professional standards (SAS 99, *Consideration of Fraud in a Financial Statement Audit*) "to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." In the context of the engagement letter, we outline management's responsibilities for the internal controls over financial reporting and that are required to confirm these responsibilities through written representations at the end of the audit. Management needs to understand that we do rely on their integrity in order to effectively plan and perform an audit. The indemnification for "knowing misrepresentations" communicates a commitment that financial institution management and its governing board understand their responsibilities to perform honestly and legally.

Intentional wrongdoing of management should rest with the financial institution. Under federal securities laws, it is unlawful for an officer, director, or significant shareholder to knowingly misrepresent or mislead the auditors. This is not the case for the non-public financial institutions that are not subject to the federal securities laws.

We firmly believe that it is in the public interest to establish an understanding in engagement letters that the financial institution and its governing board have accepted responsibility for their acts. Further, we reject the assertion that indemnification of auditors for "knowing misrepresentation" causes an auditor to lose independence or perform a less responsible audit.

Limitations on liability
The Proposed Advisory does not clearly identify the specific issues with respect to each of these general categories nor does it indicate how the examples of limitation of liability provisions included in Appendix A fit into this category.

Exclusion of remedies
Provided that there is not a provision otherwise prohibited by independence rules, Grant Thornton does not believe a punitive damages exclusion (or the like, whether it be an exclusion of consequential, special or other similar categories of non-compensatory damages) harms the financial institution client or its successors. Grant Thornton does not understand how excluding any damages in excess of purely compensatory damages potentially poses an independence threat.

ADR and jury trial waivers
The introduction into the Proposed Advisory's discussion of alternative dispute resolution language (ADR) and jury waiver clauses, to the extent that such provisions do not include limitation on liability and indemnification provisions, is confusing and warrants clarification. Grant Thornton considers ADR and jury waiver clauses as agreements that facilitate the speedy and effective remedy of disputes between the client and the Firm. These provisions are merely a mechanism for dispute resolution. Grant Thornton uses ADR or jury waiver provisions in our engagement letters with clients where we are subject to the SEC independence rules. Grant Thornton does not believe that such language inherently impairs its independence since it is procedural in nature.

Grant Thornton requests that the final Advisory make clear that ADR and jury waiver provisions are not in and of themselves a concern of the Agencies.

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Grant Thornton LLP appreciates the opportunity to comment on the Agencies' Proposed Advisory.

Very truly yours,

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