June 10, 2005

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

Dear Sir or Madame:

The Independent Community Bankers of America welcomes the opportunity to comment on the Federal Financial Institutions Examination Council's 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.

In general, ICBA supports the proposed Interagency Advisory, but is very concerned that it will likely result in higher audit fees for community banks. It may result in fewer audit firms willing to conduct community bank external audits. These factors will make community banks less likely to voluntarily obtain audits. Any new guidance should only apply for new engagements.   Also, we do not think that all mandatory alternative dispute resolution agreements (ADRs) should be prohibited.

Purpose and Summary of Proposal
The federal banking agencies have observed an increase in the types and frequency of provisions in certain financial institutions' external audit engagement letters that limit the auditors' liability. Consequently, they are proposing an advisory on the inappropriate use of limitation of liability provisions in external auditor engagements. The agencies are specifically concerned about whether the advisory would increase external audit fees or would result in fewer audit firms being willing to provide external audit services to financial institutions.

The Interagency Advisory warns financial institutions not to enter into external audit arrangements that include any limitation of liability provisions that would (1) indemnify the external auditor against claims made by third parties, (2) hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution, or (3) limit the remedies available to the client financial institution. According to the banking agencies, this would apply regardless of the size of the financial institution, whether the financial institution is public or not, and whether the external audit is required or voluntary.

INDEPENDENT COMMUNITY BANKERS of AMERICA *The Nation's Voice for Community Banks*[sm]
One Thomas Circle, NW Suite 400 Washington, DC 20005 ■ (800)422-8439 ■ FAX: (202)659-1413 ■ Email:info@icba.org ■ Web site:www.icba.org

ICBA Comments

In general, community banks support the interagency guidance on audit engagement letters. Limitation of liability provisions can impair the external auditor's independence and may adversely affect the auditor's performance. Auditors should be completely accountable for their work and banks should have the ability to pursue claims against their auditors without limitation particularly for losses or damages that are due to the auditor's negligence. However, community banks also have a number of concerns that the guidance will result in higher audit fees and access to fewer audit firms.

Fewer Audit Firms, Higher Fees

Some community banks have told ICBA that their current audit firm is not now including language in their auditing contracts that limits liability. Others are concerned about their ability to negotiate the removal of such provisions. But most community banks believe that the guidance may make it more difficult for them to engage an auditor. In their view, not all firms will be willing to remove the limiting statements from their audit engagements. Since this would not be a requirement for industries other than banking, some community banks are concerned that auditors will not accommodate banks with the language change. The audit firms may be influenced by their liability insurance carriers to keep liability limitation provisions in their engagement letters.

Due to the increased demand on auditing firms from the internal control attestation requirements of Section 404 of the Sarbanes-Oxley Act, the market domination of the Big Four accounting firms has increased. As the Big Four accounting firms drop smaller companies as clients, community banks are having a more difficult time finding audit firms that have the expertise to understand banking and the new Section 404 requirements. If auditing firms are prohibited from using limitation of liability provisions in their audit engagement letters for banks, community banks fear that their access to the Big Four will become even more limited. Also, community banks are very concerned that smaller audit firms that many rely on for external audits will exit the business due to fears over liability. As a result of these factors, they will have fewer and fewer audit firms to choose from.

Bankers are in agreement that auditors will further increase their fees due to the increased liability, should the regulatory agencies go forward with the Interagency Advisory. This is particularly troublesome at a time when audit fees have dramatically increased due to provisions of the Sarbanes-Oxley Act. A recent survey by ICBA of publicly held banks indicates that the internal control attestation requirements of Section 404 is a major financial burden to community banks and that the average community bank will spend more than $200,000 and devote over 2,000 internal staff hours to comply with Section 404. Furthermore, it is anticipated that audit fees will increase an average of $87,198 or approximately 52% of total annual financial statement audit fees. The Sarbanes-Oxley Act has not only dramatically increased the outside audit costs of publicly held community banks, but also has increased the external audit costs of all banks, including those that are subject to the requirements of Part 36 of the Federal Deposit Insurance

Act[1], those that are required under state law to have audits, and those that voluntarily have outside audits.

Higher external audit fees and fewer choices among audit firms places additional burdens on community banks that are required to have audits. These factors are also strong disincentives for banks to seek voluntary audits.

For these reasons, ICBA recommends that the final guidance permit certain types of limitation of liability provisions as legitimate risk management tools. For instance, we suggest that provisions that limit punitive damages be permitted. These kinds of damages do not serve a compensatory purpose and do not compensate a plaintiff for its losses or damages. Furthermore, there does not appear to be any safety and soundness reasons for limiting them.

Alternative Dispute Resolution

The guidance also states that financial institutions should not enter into any pre-dispute, ADR agreements that incorporate limitation of liability provisions that cap the amount of actual damages that may be claimed, prohibit claims for punitive damages, or shorten the time in which the financial institution may file a claim. These provisions present safety and soundness concerns whether they form part of an audit engagement letter or are set out separately, the guidance states.

In ICBA's view, not all mandatory alternative dispute resolution agreements should be prohibited. Provided that bank management has consulted with its auditing committee and with legal counsel, ADRs are a legitimate tool for limiting the costs of resolving disputes without jeopardizing the safety and soundness of the bank.

Implementation

According the proposed guidance, the inclusion of limitation of liability provisions in external audit engagement letters will generally be considered an unsafe and unsound practice and the agencies may take appropriate supervisory action if such provisions are included in audit engagement letters executed after the date of the advisory.

If boards of directors, audit committees, or management have already accepted an external audit engagement letter or related agreement for a fiscal 2005 or subsequent financial statement audit (i.e., fiscal years ending on or after January 1, 2005), the agencies strongly recommend that boards of directors, audit committees, and management consult with legal counsel and the external auditor and take appropriate action to have any limitation of liability provision nullified. Community banks have

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[1] FDICIA amended Section 36 of the Federal Deposit Insurance Act (12 U.S.C. 1831m). All insured depository institutions that have assets of $500 million or more, whether or not they are public companies, are subject to the provisions of Section 36 of the Federal Deposit Insurance Act and the FDIC's implementing regulations and guidelines (12 CFR Part 363). Section 36 and Part 363 require an annual management report, and impose annual auditing and attestation, and audit committee requirements on covered depository institutions. Part 363 allows the holding company of a covered insured depository institution to fulfill these requirements for the institution. In addition, the FDIC's implementing guidelines reference and incorporate the SEC's requirements and interpretations concerning auditor independence.

expressed concerns to ICBA that this may not be possible or, if it can be accomplished, it will be with higher audit fees. Thus, we urge that the advisory apply only to new engagements.

We appreciate the opportunity to comment. For more information, call Chris Cole, Regulatory Counsel or Ann Grochala, Director, Lending and Accounting Policy at 202-659-8111.

Sincerely,

Karen M. Thomas

Karen M. Thomas
Executive Vice President
Director, Government Relations Group