



June 9, 2005

Program Coordinator
FFIEC
3501 Fairfax Drive
Arlington, VA 22226

Re: Proposed Interagency Advisory: Limitation of Liability and ADR Provisions in External Audit Engagement Letters

Dear Program Coordinator:

I am writing on behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions, in response to the Agencies' request for comment on the proposed interagency advisory regarding the use of limitation of liability provisions and certain alternative dispute resolution provisions in external audit engagement letters. The proposed advisory has been issued by 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) due to an observed increase in the types and frequency of these provisions in certain financial institutions' external audit engagement letters.

The Agencies have stated that the use of these provisions may have a negative impact on the integrity of audits due to decreased auditor objectivity, impartiality and performance, potentially affecting the safety and soundness of the institution. NAFCU agrees with the Agencies and also believes that provisions limiting auditor liability and a financial institution's recourse during an alternative dispute resolution may also have a negative impact on the consumers of financial statements. As the ultimate end user of financial information, consumers must be able to rely on the integrity of financial statements to make informed and sound investment decisions. NAFCU supports the Agencies' proposed advisory and submits the following comments.

Scope of the Advisory

The Agencies have requested comments regarding the applicability of the advisory to all financial institutions even in instances where an external audit is not required by law, regulation or order. NAFCU believes that all external audit engagement

letters should fall under the purview of the proposed advisory to maintain auditor objectivity, impartiality and performance and thus the integrity of the audit. Also, as stated earlier, consumers of financial statements must be able to rely on audit integrity. The inconsistent application of the advisory could make it difficult for consumers to know how much weight to give a financial statement because he or she would lack complete knowledge of the circumstances under which the statement was prepared. For these reasons, NAFCU supports the application of the proposed advisory to all financial institution external audit engagement letters.

Advisory's Impact on Engagement Letter Negotiation

The Agencies have requested comments regarding the impact the advisory may have on an institution's ability to negotiate the terms of an audit engagement letter and the possibility of increased fees for audit services. NAFCU believes that the advisory would have an impact on the negotiation process, most likely making it more complicated, time-consuming and costly. However, NAFCU understands that financial institutions are experiencing difficulty negotiating contracts that adequately address safety and soundness concerns in relation to auditor liability. Therefore, NAFCU believes an advisory letter addressed to all financial institutions strongly encouraging them to resist provisions limiting auditor liability may have a positive effect on auditors' willingness to negotiate.

Advisory's Impact on External Audit Expense

Auditors' willingness to negotiate the terms of their liability will most likely increase the cost of coverage. This increase in cost is to be expected. Unable to externalize the risk of added exposure to the institution, auditors will seek to offset the potential liability through increased fees and by passing along the costs for their own increased liability insurance. While the increased costs of doing business are never welcome, NAFCU believes that maintaining the benefits and the integrity of the external auditing process outweighs the increased costs.

Examples of Limitation of Liability Provisions

The Agencies have requested comments regarding the examples of liability limiting provisions provided in Appendix A. NAFCU believes that these examples are clear and will help institutions identify problem provisions.

In addition to these examples, NAFCU suggests that the Agencies consider including the following examples as provisions that attempt to limit auditor liability:

- A provision that requires an institution to reimburse an auditor for losses incurred by the auditor due to the auditor's own negligence. This type of indemnification provision may not be prevalent, but where it is present, it permits an auditor to

escape liability for negligence, a proposition that runs counter the principles of civil liability.

- A provision that states that the institution acknowledges that only the institution's management may rely on the auditor's report. This type of limitation negates the purpose of the audit as it is the report that an institution's creditors, partners, shareholders, members and regulator use to evaluate the health of the institution.
- A provision that requires an auditor to report only illegal acts that are consequential, not all illegal acts regardless of their nature. Illegal acts, regardless of their nature, have an impact on the safety and soundness of an institution and should be reported.
- A provision that requires an auditor to report issues of control that bear on the financial statements only for the period under audit. This type of provision prevents an institution from taking remedial action and increases the potential for mistakes or even wrongful acts.

Valid Provisions Limiting Auditor Liability

The Agencies have requested comments as to whether there could be a valid business reason for limiting auditor liability. NAFCU is aware that auditor engagement letters often include a provision that requires an institution to indemnify and hold harmless the auditor for liability arising from misrepresentations made by management. Auditors may not rely solely upon the representations of management; however, misinformation or fraudulent information may prevent or delay discovery of unsafe and unsound conditions. Therefore, NAFCU believes auditors should not bear responsibility or liability for misrepresentations and that indemnification provisions in this regard serve a valid business purpose.

Nullification of Limitation of Liability Provisions

The proposed advisory strongly recommends that financial institutions take appropriate action to nullify limitation of liability provisions in 2005 audit examination letters that have already been executed. The Agencies have requested comments regarding the appropriateness of the recommendation. While supporting the Agencies' proposed advisory, NAFCU believes that attempts to nullify existing audit contracts due to liability limiting provisions may prove too difficult, costly and time consuming. Furthermore, such efforts may damage professional relationships and make it difficult for an institution to secure audit services in the future. For these reasons, NAFCU recommends that the advisory apply beginning with 2006 letters of engagement.

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Alternative Dispute Resolution (ADR)

NAFCU supports the section in the advisory regarding ADR provisions that limit auditor liability. NAFCU notes that provisions that require the parties to adhere to mandatory arbitration procedures may be of particular concern when the arbitrator is chosen by the audit firm, as a pre-existing relationship between the audit firm and the arbitrator casts doubt on the arbitrator's independence and suggests bias. NAFCU recommends that the advisory encourage financial institutions to consider carefully the arbitrator chosen by an auditor and to require that any arbitration proceeding adhere to the current rules promulgated by an independent rule-making organization, such as the American Arbitration Association.

NAFCU would like to thank you for this opportunity to share its views on this proposed advisory. Should you have any questions or require additional information, please call me or Gwen Baker, NAFCU's Director of Regulatory Affairs, at (703) 522-4770 or (800) 336-4644 ext. 266.

Sincerely,

A handwritten signature in cursive script, appearing to read "Fred R. Becker, Jr.", written in dark ink.

Fred R. Becker, Jr.
President/CEO

FRB/whh