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Program Coordinator
Federal Financial Institutions Examination Council
3501 Fairfax Drive
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June 9, 2005

Dear Sir or Madam:

PricewaterhouseCoopers LLP ("PwC") appreciates the opportunity to comment on the proposal to limit in financial audit engagement letters with FDIC- or NCUA-insured depositories the use of provisions relating to indemnification or limitations of liability.

PwC is a nationwide accounting and professional services firm. We have been appointed as auditors for a number of FDIC-insured depositories and their holding companies, as well as for NCUA-insured credit unions.

The Proposal

The five agencies regulating federally insured depository institutions[1] jointly seek comment on a proposal[2] that would advise these institutions and their directors of the agencies' view that an institution's safety and soundness would be impaired by limitations on an independent auditor's liability in engagement agreements for financial audits. The proposal lists eight specific examples of what the Agencies view as problematic liability limitations.

The proposal notes that these liability limitations already are inappropriate in engagement letters for institutions required annually to have an independent audit: i.e., (a) an SEC registrant, (b) a bank larger than $500 million and thus subject to the audit requirements of 12 CFR, Part 363, and (c) certain other institutions that OTS requires to have an independent audit.[3] Adoption of the proposal thus would affect primarily the smaller FDIC-insured institutions for which an independent audit is not required and credit unions.

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[1] These agencies are the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration—collectively referred to herein as "the Agencies."
[2] 70 FR 24576 (May 10, 2005).
[3] While NCUA regulations require the financial statements of a credit union larger than $500 million annually to be audited by a state-licensed auditor, the auditor's engagement letter need not adhere to the SEC or PCAOB independence standards. 12 CFR §§715.5, 715.6, and 715.9. AICPA independence standards permit, *inter alia*, financial statement audit engagement letters to indemnify the auditor against knowing misrepresentations of management. *See infra*, at 3.

PwC Position

PwC generally supports the agencies' intent to promote auditor independence. PwC, however, suggests two areas in which the advisory may conflict with sound public policy as reflected in the statutes and other Agency issuances referred to below.

1. Knowing Management Misrepresentations

The Agencies propose to advise banks and credit unions that it would be an unsafe and unsound practice to include in an audit engagement letter a provision that "releases and indemnifies the external audit firm from any claims, liabilities, and costs attributable to any knowing misrepresentations by management." We suggest that, for the following reasons, such indemnification provisions are:

- Likely to discourage knowing management misrepresentations;
- Likely to enhance the bank financial reporting on which the Agencies rely;
- Unlikely to weaken the external auditors' objectivity, impartiality, and performance; and
- Unlikely to diminish the quality of financial reporting available to depositors, investors, and the Agencies.

We share the Agencies' concern about knowing management misrepresentations. Such misrepresentations occur only rarely during the thousands of financial audits performed each year at banks and public companies. But when they do occur they present a problem not only for investors and for bank and securities regulators, but also for the independent auditors who were the targets of these deceptions.

As a result, Section 303 of the Sarbanes-Oxley Act of 2002 declared it:

> Unlawful. . . for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.[4]

In adopting its regulation to implement this prohibition the SEC explained:

> Because the financial statements are prepared by management and the auditor conducts an audit or review of those financial statements, the auditor would not directly "render [the] financial statements materially misleading." Rather, the auditor might be improperly influenced to, among other things, issue an unwarranted report on the financial statements, including suggesting or acquiescing

[4] 15 USC §7242.

> in the use of inappropriate accounting treatments or not proposing adjustments required for the financial statements to conform with generally accepted accounting principles. An auditor also might be coerced, manipulated, misled, or fraudulently influenced not to perform audit or review procedures that, if performed, might divulge material misstatements in the financial statements. Other examples of activities that would fall within the rule would be for an officer, director, or person acting under an officer or director's direction, to improperly influence an auditor either not to withdraw a previously issued audit report when required by generally accepted auditing standards, or not to communicate appropriate matters to the audit committee.[5]

Since knowing management misrepresentations often occur through entries made in a bank's or company's books and records, these provisions of the securities laws reinforce the long-standing criminal statute making it a federal felony for a bank officer, director, or employee to make a false entry in the bank's books, records, or reports with the intent to injure or defraud the bank or any other company or to deceive bank examiners or regulators. 18 USC §1005.

PwC suggests that indemnification against knowing management misrepresentation is an appropriate way for an audit firm, who is the target of unlawful and perhaps criminal behavior, to protect itself from deceitful management; and that, in these narrow circumstances, the indemnification serves a public purpose and does not impair the auditor's objectivity and independence.

Professional standards of the American Institute of Certified Public Accountants ("AICPA") long have permitted an auditor to include in its audit engagement letter protection against knowing management misrepresentations, as shown by the following inquiry and response:

> *Question*—A member or his or her firm proposes to include in engagement letters a clause that provides that the client would release, indemnify, defend, and hold the member (and his or her partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. Would inclusion of such an indemnification clause in engagement letters impair independence?
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> *Answer*—No.[6]

Each of the major firms auditing bank financial statements considers the risks presented by a particular client in determining whether to accept a financial audit engagement. Permitting auditors to negotiate an indemnification from their clients for claims against the auditor by third parties where the client has engaged in intentionally fraudulent behavior mitigates one of those risks. When management of a bank commits a financial fraud intended to deceive the bank's auditor, the indemnification provision permits the auditor, who neither fostered nor

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[5] SEC Release No. 34-47890 (May 20, 2003).
[6] AICPA Professional Standards, ET § 191, ¶ 94.

benefited from the fraud, and who conducted an audit conforming to generally accepted auditing standards, to shift to the responsible party—i.e., the bank—whatever losses the third parties seek to recover. Indeed, removing a financial incentive for bank management to be truthful with their auditors may be viewed as being contrary to the best interests of the users of the bank's financial statements.

The stated purpose of the Agencies' proposal is to avoid provisions in audit engagement letters that might ". . .weaken the external auditors' objectivity, impartiality, and performance and thus, reduce the Agencies' ability to rely on external audits." PwC suggests existing standards and regulations provide sufficient assurance that auditors will perform a professional, objective, and impartial audit without additionally being liable when the auditor becomes the target of a deceitful management.

- First, most audit firms affected by the Agencies' proposal are subject to regulatory and professional standards, which are mandated or reviewed by the Public Company Accounting Oversight Board ("PCAOB"). These standards include:
  - Determining the scope of the audit based on professional literature and the risk associated with the particular client;
  - Assigning qualified personnel to the audit, including periodic rotation of the partners assigned to the audit;
  - Structured work papers documenting the audit steps performed and the results of those audit steps;
  - Determining the significance of audit results and how those results are to be reported,
  - Second partner review of significant audit steps;[7] and
  - Internal review of compliance with the firm's standards.

  Adherence to these standards is further assured by periodic peer reviews and by annual PCAOB inspections.

- Second, bank auditors are subject to increasing regulation and possible disciplinary action by the banking agencies themselves,[8] not to mention also state boards of accountancy, the AICPA, the SEC and the PCAOB.

- Third, protections that the client may provide against the client's own knowing misrepresentations do not preclude third parties from suing the auditor. Even if the auditor has negotiated with the client an indemnification against third party claims resulting from knowing misrepresentations by client management, the auditor has no assurance that the client at some later time will be solvent and able to make good on its indemnification. And, when the client remains solvent, there is no equitable reason for forcing the auditor to

[7] PwC's internal risk management policies require a second partner review of the audit of every FDIC- or NCUA-insured depository.
[8] *See*, 68 FR 48265 (Aug. 13, 2003): regulations adopted by four of the five Agencies empowering them to remove, suspend, or debar accountants from performing audit services for FDIC-insured banks and their parent holding companies.

bear the loss or for providing the fraud-committing client with the windfall that would result from barring indemnifications for knowing management misrepresentations.

The Agencies' proposal notes that:

- Bank auditors already are required to abide by the independence rules of the AICPA and, in most instances, those of the SEC;
- The positions of the SEC and the AICPA conflict with regard to indemnification for management misrepresentations[9]; and
- An AICPA task force currently is studying how indemnifications against management misrepresentations may affect an auditor's independence.[10]

PwC respectfully suggests that the Agencies may wish to be informed by the data being gathered by, and to consider the results of, the AICPA task force's study before adopting a rule that may conflict with the auditing profession's ongoing intensive consideration of the possible effect of an indemnification on an auditor's independence and the quality of financial statement audits.

In summary, PwC believes that the Agencies should not prohibit insured depositories from agreeing with their auditors to limit the auditor's liability resulting from, and indemnifying its auditor against third party claims attributable to, knowing misrepresentations by the client's management. Such indemnification provisions help to effectuate the public policy—imbedded in §303 of the Sarbanes-Oxley Act and in 18 USC §1005—of protecting depositors, investors, and the Agencies by prohibiting management from making false statements to its auditors.

2. Alternative Dispute Resolution and Waivers of Jury Trial

The Agencies' proposal addresses mandatory alternative dispute resolution ("ADR") mechanisms, such as arbitration and the waiver of jury trials, in a way that will discourage financial institutions from agreeing in advance with their auditors to using these widely accepted, efficient, and cost effective means of resolving disputes. The stated rationale for discouraging arbitration is that <u>some</u> arbitration agreements also contain provisions limiting the auditor's liability or financial institution's remedies.[11]

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[9] We note that OCC does not object to a bank indemnifying a third party service provider (other than an auditor) from damages resulting from the bank's mere, unknowing negligence. *See*, OCC Bulletin 2001-47, Third Party Relationships (Nov.1, 2001), p. 12.
[10] *See*, 70 FR 24579, n. 8 and accompanying text (May 10, 2005).
[11] PwC agrees that liability limitations prohibited by applicable independence standards of the AICPA, SEC, and PCAOB are no more acceptable in the ADR provision of a financial statement audit engagement letter than elsewhere in that letter.

Read precisely, the proposal continues to permit audit engagement letters for insured depositories to mandate arbitration of disputes or to waive jury trials. But the proposal contains a number of caveats about ADRs[12], including:

- An expression of safety and soundness concerns associated with damage caps, prohibitions on punitive damages, or a shortened time period within which to assert a claim against an auditor;
- Cautions against limits on discovery or rights of appeal;
- The possibility that ". . .by waiving a jury trial, the financial institution may effectively limit the amount it might receive in any settlement of its case;"
- Encouragement to all financial institutions ". . .to review each proposed external audit engagement letter presented by an audit firm and understand the limitations on the ability to recover effectively from an audit firm in light of any mandatory ADR agreement or jury trial waiver;"
- Advice to financial institutions to ". . . review the rules of procedure referenced in the ADR agreement to ensure that the potential consequences of such procedures are acceptable to the institution;"
- A recognition that ". . .ADR agreements may themselves contain limitation of liability provisions as described in this advisory;" and
- A requirement that ". . . financial institutions should document their business rationale for agreeing to any other provisions that alter their legal rights."

This extensive list of caveats will foster with bank boards of directors and bank examiners an impression that mandatory ADR or waivers of jury trials should be avoided.

This unfortunate impression is magnified by the contrast between the Agencies' proposed advice concerning agreements with auditors and their advice concerning agreements with other third parties. Regarding, for example, outsourcing agreements for technology services, the FFIEC advises only:

> **Dispute Resolution.** The institution should consider including a provision for a dispute resolution process that attempts to resolve problems in an expeditious manner as well as a provision for continuation of services during the dispute resolution period.[13]

This sensible advice encourages a bank to seek a speedy and efficient means of resolving contract dispute with its technology outsourcer without being undercut by a list of caveats such as the Agencies propose for contracts with bank auditors.

OCC gives similar advice to a national bank entering into contracts with any third-party provider:

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[12] 70 FR at 24579
[13] FFIEC Information Technology Examination Handbook, *Outsourcing Technology Services*, at 16 (June, 2004).

> *Dispute resolution.* The bank should consider whether the contract should establish a dispute resolution process (arbitration, mediation, or other means) for the purpose of resolving problems between the bank and the third party in an expeditious manner, and whether it should provide that the third party continue to perform during the dispute resolution period. [14]

The OCC does not accompany this advice to banks with a list of cautionary caveats like those the Agencies propose for contracts with auditors.

This prior advice from the Agencies implicitly recognizes the strong public policy in favor of arbitration, as reflected in the Federal Arbitration Act, and by the courts in most jurisdictions. The speed and efficiency of arbitration or other mandatory ADR is favored, even though the dispute is not heard by a judicial officer, discovery may be more limited, facts and damages are not decided by a jury, and appellate rights are limited.

And—whatever the limitations typically associated with mandatory arbitration—they do not apply when the bank and its auditor simply agree to waive a jury. Even though a jury is waived to encourage a speedier judicial resolution, the dispute still is heard by a judicial officer, governed by standard discovery rules, and any decision is subject to full appellate review. The case is simply more efficient and less costly to try because it will be decided by a judge rather than a jury.

The Agencies' proposal offers no reason, and PwC is aware of none, why the advantages to both a bank and its vendors of ADRs or a waiver of jury trials should be any less in a contract with a bank auditor than in a contract with any other bank vendor. These advantages include lower costs both to the bank and its vendor, who then may be able to contract for services at a lower price or fee. Why, then, should the Agencies go out of their way to emphasize solely for audit engagement contracts the potential disadvantages of agreeing in advance to a widely accepted, efficient, and cost effective means of resolving potential disputes?

PwC accordingly suggests that:

- Any discussion in the Agency proposal of ADRs should be made consistent with the Agencies advice concerning all other bank contracts with third-party providers, and with the public policies favoring ADRs; and

- The Agencies should delete from their proposal the references to waivers of jury trials.

Sincerely yours,

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

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[14] OCC Bulletin 2001-47, "Third-Party Relationships," at 12 (Nov. 1, 2001).