Selden Fox, LTD.

A PROFESSIONAL CORPORATION
CERTIFIED PUBLIC ACCOUNTANTS
619 Enterprise Drive
Oak Brook, Illinois 60523-8835

630-954-1400
630-954-1327 FAX

email@seldenfox.com
www.seldenfox.com

June 8, 2005

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

Re: Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters

Council Members:

We are a certified public accounting firm of approximately 40 CPAs. We audit the annual financial statements of non-public federally insured savings banks (under $500 million) and federally insured credit unions ($3 - $500 million). We appreciate the opportunity to comment on FFIEC's proposal regarding limitation of liability and certain alternative dispute resolution provisions in external audit engagement letters.

OVERALL

Although we understand and appreciate the spirit of your proposal, we believe it may go too far because it implicitly suggests that the responsibility for the "safety and soundness" of the financial institution is shifted from the directors and officers of the institution to the external auditor. While, perhaps not your intent, you risk the directors and officers perceiving that they are off the hook for the safety and soundness of the financial institution as long as the external auditor does not catch them. We believe this sends a dangerous signal to those solely responsible for the veracity of the institution's financial reporting. As you are aware, the external auditor's role is limited to expressing an opinion on the financial institution's historical financial statements.

LIMITATION OF LIABILITY CLAUSES

The proposal states that limitation of liability provisions can impair the external auditor's independence. Have there been studies performed to make this link to independence? The AICPA's Ethics Ruling No. 94 states that the following indemnification clause in an engagement letter **would not impair** a CPA's independence:

> "The client agrees to release, indemnify, and holds us, and …, harmless from any liability and costs resulting from knowing misrepresentations by management."

The request for comment seems to be an *all or nothing* type of proposal. There are many valid business reasons for limitation of liability provisions in external auditor engagement letters with its client. Remember, it is management's responsibility for the financial institution's financial statements, for establishing and maintaining effective internal control over financial reporting and for ensuring that the financial institution complies with the laws and regulations applicable to its activities. The auditor is responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that the auditor obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected.

If management knowingly misrepresents significant facts to the external auditor, it is virtually impossible for the auditor to uncover the true facts of a situation. Therefore, we believe that the aforementioned indemnification clause in engagement letters does not impair independence, nor does it present safety and soundness concerns when it is included in an engagement letter.

Further, Rule 404 of Sarbanes-Oxley SEC Rules and Regulations specifically elevate management's responsibility by requiring reports on internal control over financial reporting and their certification of disclosure in Exchange Act periodic reports. In addition, in the state of Illinois, there is legislation making it a crime to lie to your auditor. Thus, if it is a crime, why is the auditor not entitled to civil protection? In legal parlance, the issue is always whether the institution will be bound by the acts of management, in the sense that the entity is in the shoes of management that acted wrongfully and cannot then sue the auditor. The limitation of liability provision in engagement letters is just an extension of this defense.

FFIEC's proposal seems contrary to the emphasis being placed on enhanced management's responsibility. The bottom line is if management knowingly lies to the external auditor, the external auditor should not be held liable for any liability or costs caused by those knowing misrepresentations of management. Management is in a position, on a daily basis, to adopt polices and procedures to enhance internal controls, to promote the safety and soundness of the financial institution and to ensure the accuracy of its financial statements. Auditors perform audit tests only once a year and management's representations are an important part of those audit procedures.

Management's ethical tone at the top; its sound judgment and competence; separation of duties, and strict internal controls are the primary safeguards against material errors and fraud. Management, not the external auditor, can control these factors. The elimination of the limitation of liability clauses from engagement letters could make management believe that they can rely on the external auditor to *insure* against material errors or fraud. This certainly does not promote the safety and soundness of a financial institution.

Conclusion Regarding Liability to Clients – We question why the FFIEC wishes to interfere with a financial institution's freedom of contract rights. The price of the audit will always reflect the responsibility of management and exposure to the auditor. Therefore we believe, a properly drafted limitation of liability clause should be allowed in audit engagement letters where the auditor could only be held liable for negligence in performing the financial statement audit and that negligence actually caused the client loss from damage. The auditor should be allowed to limit their liability when knowing misrepresentations of management contributed to the loss.

Conclusion Regarding Liability to Third Parties – Again, we question why the FFIEC would be concerned with an institution's decision to limit exposure of the auditor to claims made by third parties. The cost of the audit should be commensurate with the exposure to risk. Therefore, limitation of liability to third parties should also be allowed if the audit was performed without the external auditor's knowledge that the client intended for a third party to rely on the financial statements, and without the third party actually relying on the financial statements being audited.

ALTERNATIVE DISPUTE RESOLUTION (ADR) AGREEMENTS AND JURY TRIAL WAIVERS

The applicability of the proposal regarding ADR agreements is unclear. Most states have held that sound public policy encourages the use of ADR procedures. In an era where courts are encouraging and mandating ADR procedures, there is no support for the proposition that they are objectionable. Further, pre-trial mediation does not impair the rights of the audited financial institution but rather makes a serious effort to resolve or at least understand differences before going through litigation and thus saves costs for all parties concerned. Accordingly the use of properly crafted ADR agreements should be encouraged. If FFIEC believes that *limitation of liability* clauses are the issue, the proposal should be modified to point out that limitation of liability clauses could also be found in an ADR agreement with the external auditor. Such clauses can also impact safety and soundness issues that were previously addressed in the proposal.

APPLICABILITY TO ALL FINANCIAL INSTITUTIONS

The proposal makes it clear that the limitation of liability provisions "applies to all financial institutions, whether the financial institution is public or not, and whether the external audit is required or voluntary. "

In essence the proposal would extend SEC regulation to non-public companies. Also, it appears that certain of the conclusions reached in the proposal are even more restrictive that the current SEC regulations. Non-public financial institutions are not subject to the same risks or the same regulations and corporate governance as public financial institutions. For instance, public financial institutions are subject to corporate governance requirements that include specifics relating to the responsibilities of board of directors, audit committees and the interaction that each committee member must have. In addition, public financial institutions and their management that misrepresent financial information are subject to enforcement authority of the SEC. No similar enforcement exists for nonpublic financial institutions. Applicability to all institutions will subject all to increased costs of compliance, which may not be warranted given the economic position of an institution.

State-chartered credit unions currently have the opportunity of being privately insured rather than federally insured. Accordingly, they are not subject to the rules and regulations of the National Credit Union Administration (NCUA). If the provisions of this document are adopted, state-chartered credit unions might consider private insurance to avoid the issue and possible increase in audit fees resulting from the elimination of limitation of liability clauses in engagement letters.

OUTSTANDING ENGAGEMENT LETTERS

We disagree that any outstanding engagement letters should be modified to reflect the conclusions of this proposal. Any final provisions should be applied on a prospective basis only. Under the proposed discussion, it is possible that an institution would try to renegotiate an agreement for a service that has already been (or is substantially) completed during 2005. The external auditor has prepared and accepted a fee estimate based on the original negotiated terms and analysis of risk. Modifying outstanding engagement letters would breach a contract with the external auditor; requiring reconsideration of the fee estimate on short notice.

INCREASE IN AUDIT FEES/REFUSAL OF ENGAGEMENT

External auditors should not be viewed as insurance policies because the focus of financial veracity should be on the directors and officers of the institution. Perhaps, the focus should not be employing the lowest bidder as auditor, but the most qualified. The removal of limitation of liability clauses would lead to significantly higher audit fees as the risk of performing the audit has significantly increased.

Because of good business practices, we audit many credit unions that are not required to be audited. Any increase in fees as a result of removing limitation of liability provisions would discourage these financial institutions from having an independent financial statement audit. Rather they would have internal supervisory committee examinations by volunteers who have little training in performing such exams. Accordingly this would increase the risk of safety and soundness issues of these institutions.

It is difficult to say whether fewer audit firms would be willing to provide external audit services to these financial institutions. The increase in possible unfounded litigation could certainly discourage CPA firms from providing this service. Any CPA firm that incorporates a strong loss prevention program may walk away from such engagements if the professional fees are not commensurate with the risk.

The officers of Selden Fox, Ltd. appreciate the opportunity to respond to this proposal. We are available to answer any questions the Agencies or Council might have. Please contact Sharon J. Gregor, Vice President of Accounting and Assurance Services at 630-954-1400.

Very truly yours,

SELDEN FOX, LTD

Sharon J. Gregor
Vice President