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## **STANDING ADVISORY GROUP MEETING**

### **EMERGING ISSUE – THE EFFECTS ON INDEPENDENCE OF INDEMNIFICATION, LIMITATION OF LIABILITY, AND OTHER LITIGATION-RELATED CLAUSES IN AUDIT ENGAGEMENT LETTERS**

**FEBRUARY 9, 2006**

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#### **Introduction**

The Standing Advisory Group ("SAG") will discuss the possible effects of the inclusion of indemnification, limitation of liability, and other litigation-related clauses (collectively referred to as "litigation-related clauses") in audit engagement letters. The discussion will focus on how these clauses relate to the independence and objectivity of the auditor. This briefing paper provides background information about the existing independence guidance, new proposals currently under consideration by other standards-setting bodies, and the types of litigation-related clauses that currently are used.

#### **Background**

Audit engagement letters sometimes include provisions that seek to manage the external auditor's liability risk in an audit in various ways, including, in some cases, express limitations on liability. As used in this paper, an indemnification clause is an agreement in which the audit client agrees to compensate the auditor for any losses resulting from litigation arising out of the engagement, including losses to third parties such as investors. Other limitations on liability may protect the auditor only from liability to the audit client, or only against certain kinds of damages. For example, an engagement letter might cap the auditor's liability to the client at the amount of audit fees that the client paid. Such a provision would not limit any exposure that the auditor

<p>This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.</p>
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might have to third parties.<sup>1/</sup> Other litigation-related clauses do not limit the amount of the auditor's liability but impose other requirements in the event of litigation. For example, an engagement letter might require the client to bring any actions within a set time period, or prevent the client from transferring a claim to another party.

A registered public accounting firm must be independent of its audit client to perform an audit of an issuer. The Securities and Exchange Commission's ("SEC") Codification of Financial Reporting Policies provides that auditor independence is impaired "[w]hen an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission . . ."<sup>2/</sup> The codification explains that this type of indemnification clause removes or greatly weakens "one of the major stimuli" to the auditor's objective and unbiased consideration of the problems encountered in a particular engagement. The SEC staff reiterated this position in Frequently Asked Questions and further noted that "including in engagement letters a clause that a registrant would release, indemnify, or hold [the auditor] harmless from any liability and costs resulting from knowing misrepresentations by management would also impair the firm's independence."<sup>3/</sup>

Conversely, Ethics Ruling Number 94 under Rule 101 of the American Institute of Certified Public Accountants' ("AICPA") Code of Professional Conduct, which is included in the Board's interim independence standards,<sup>4/</sup> states that the auditor's

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<sup>1/</sup> Limitation of liability and other agreements between the auditor and the audit client might, however, bind anyone who brings an action on behalf of the client, including shareholders in a derivative action (but not a class action) or a trustee appointed for the client in bankruptcy, for example.

<sup>2/</sup> Securities and Exchange Commission ("SEC") "Codification of Financial Reporting Policies," section 602.02.f.i. (See Appendix A of this briefing paper.)

<sup>3/</sup> SEC, Office of the Chief Accountant, *Application of the Commission's Rules on Auditor Independence Frequently Asked Questions*, Other Matters – Question 4 (December 13, 2004). (See Appendix A of this briefing paper for the specific question and answer.)

<sup>4/</sup> The Board adopted as its interim independence standards (See PCAOB Rule 3600T) the American Institute of Certified Public Accountants ("AICPA") Code of

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independence is not impaired if the engagement letter includes "a clause that provides that the client would release, indemnify, defend, and hold the member . . . harmless from any liability and costs resulting from knowing misrepresentations by management."<sup>5/</sup> Auditors must, of course, comply with the SEC's auditor independence requirements as well as those of the Board in an audit of a public company. Because SEC independence requirements prohibit indemnification agreements in audit engagement letters, Ethics Ruling Number 94 has no practical effect with respect to audits of public companies.<sup>6/</sup>

Additionally, Ethics Ruling Number 95 under Rule 101 of the AICPA Code of Professional Conduct, which is included in the Board's interim independence standards, states that independence would not be impaired if the auditor and the audit client agreed to alternative dispute resolution ("ADR") to resolve disputes relating to past services.<sup>7/</sup>

### Current Developments

Many of the litigation-related clauses in use today are not specifically addressed by the existing regulatory framework governing auditor independence. In 2005, two different standards-setting bodies issued proposals seeking comment regarding

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Professional Conduct Rule 101 and Rule 191, related interpretations and rulings, as they existed on April 16, 2003, to the extent not superseded or amended by the Board.

<sup>5/</sup> AICPA Code of Professional Conduct, ET sec. 191, *Ethics Rulings on Independence, Integrity, and Objectivity*, "Ethics Ruling No. 94, Indemnification Clause in Engagement Letters." (See Appendix B of this briefing paper for the specific question and answer.)

<sup>6/</sup> PCAOB Rule 3600T notes that the interim independence standards do not supersede the SEC auditor independence rules and, to the extent that a provision of the SEC rules is more restrictive (or less restrictive) than the interim standards, the auditor must comply with the more restrictive rule.

<sup>7/</sup> AICPA Code of Professional Conduct, ET sec. 191, *Ethics Rulings on Independence, Integrity, and Objectivity*, "Ethics Ruling No. 95, Agreement With Attest Client to Use ADR Techniques." (See Appendix B of this briefing paper for the specific question and answer.)

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different types of litigation-related clauses and their effect on the auditor's independence.

On May 10, 2005, the Federal Financial Institutions Examination Council ("FFIEC") issued a proposed advisory for public comment that would alert financial institutions' boards of directors, audit committees, management, and external auditors "to the safety and soundness implications of provisions that limit the external auditor's liability in a financial statement audit."<sup>8/</sup> Specifically, the proposed advisory stated that "limitation of liability provisions,"<sup>9/</sup> by their very nature, "can remove or greatly weaken an external auditor's objective and unbiased consideration of problems encountered in the external audit engagement and induce the external auditor to depart from the standards of objectivity and impartiality required in the performance of a financial statement audit."<sup>10/</sup> Appendix A of the proposed advisory describes eight different types of provisions that would generally be considered unsafe and unsound practices when included in financial institutions' external audit engagement letters or agreements

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<sup>8/</sup> The Federal Financial Institutions Examination Council ("FFIEC") issued the proposal, *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters*, for public comment on behalf of the Office of Thrift Supervision, U.S. Department of Treasury; the Board of Governors of the Federal Reserve System Board; the Federal Deposit Insurance Corporation; the National Credit Union Administration; and the Office of the Comptroller of the Currency, U.S. Department of Treasury. Comments were due on June 9, 2005. (See Appendix D of this briefing paper for the proposed advisory.) The proposal has not yet been adopted.

<sup>9/</sup> The proposed advisory uses the term "limitation of liability provisions" to collectively refer to agreements that: (1) indemnify the auditor against third-party claims; (2) hold harmless or release the auditor from liability for claims or potential claims that might be asserted by the client; or (3) limit the remedies available to the client.

<sup>10/</sup> *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters*, Section IV. Proposed Advisory, *Limitation of Liability Provisions* (issued by FFIEC for public comment May 10, 2005).

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related to the financial statement audit.<sup>11/</sup> Under the proposed advisory, agreements to submit to binding alternative dispute resolution procedures also would "present safety and soundness concerns when they incorporate additional limitations of liability, or when mandatory ADR agreements operate under rules of procedure that may limit auditor liability."<sup>12/</sup>

On September 15, 2005, the AICPA issued for public comment a proposed new interpretation, 101-16 under Ethics Rule 101 – *Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters*, that would supersede Ethics Ruling Number 94, described above.<sup>13/</sup> The proposed ethics interpretation, which would apply to auditors of non-public companies, describes the different types of litigation-related clauses that the AICPA believes impair the auditor's independence because they create an "unacceptable threat to a member's independence that could not be mitigated sufficiently through the application of safeguards."<sup>14/</sup> The interpretation also describes several types of litigation-related clauses, including agreements in which the auditor

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<sup>11/</sup> The proposed advisory makes clear that the list is not all-inclusive and that the inclusion of "any other language that would produce similar effects is generally considered an unsafe and unsound practice."

<sup>12/</sup> *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters*, Section IV. Proposed Advisory, *Alternative Dispute Resolution Agreements and Jury Trial Waivers* (issued by FFIEC for public comment May 10, 2005).

<sup>13/</sup> Comments were due by December 16, 2005. If adopted, this proposal also will supersede "Ethics Ruling No. 95, Agreement With Attest Client to Use ADR Techniques."

<sup>14/</sup> AICPA Professional Ethics Executive Committee, *Proposed Interpretation 101-16, Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters, Under Rule 101, Independence, Attest Services Engagements* (September 15, 2005). (See Appendix C of this briefing paper for proposed interpretation.)

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would not be liable to the client for punitive damages and to submit disputes to ADR,<sup>15/</sup> that the AICPA believes do not impair the auditor's independence.

The AICPA believes that agreements in which the auditor would not be liable to the client for punitive damages would not impair the auditor's independence because the member would still remain "exposed to clients, and also to lenders, shareholders and other non-clients, for damages for any *actual* harm caused."<sup>16/</sup> The AICPA believes that the possibility that actual damages might be awarded against the auditor and that such damages could be significant would serve as a sufficient safeguard to mitigate the threats to the auditor's independence."<sup>17/</sup>

The AICPA's proposed interpretation applies only to attest services (including audits of financial statements). Further, the proposed interpretation states that litigation-related clauses related to non-attest services do not impair the auditor's independence.

### Specific Indemnification and Limitation of Liability Clauses

The following table provides a summary comparison of the current SEC Codification and staff FAQ regarding indemnification agreements; the AICPA proposed interpretation on indemnification, limitation of liability, and ADR clauses; and the FFIEC proposed interagency advisory on limitation of liability and certain ADR provisions.

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<sup>15/</sup> Under the AICPA proposal, an agreement to resolve disputes through ADR only would impair independence if it limits the auditor's liability for actual damages or incorporates "a provision, procedure, or rule that would impair independence under the preceding guidance . . ."

<sup>16/</sup> AICPA Professional Ethics Executive Committee, *Proposed Interpretation 101-16*, Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters, Under Rule 101, Independence, *Attest Services Engagements* (September 15, 2005). (See Appendix C of this briefing paper for proposed interpretation.)

<sup>17/</sup> The AICPA proposal defines actual damages as "audit fees and other out of pocket costs as well as incidental or consequential damages" and punitive damages as "monetary recoveries by plaintiffs in private civil litigation that are in addition to actual damages."

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Type of Clause	AICPA Proposed Interpretation	FFIEC Proposed Advisory
This table provides general information for discussion purposes only. It does not provide guidance for interpreting the AICPA and FFIEC proposals.		
Auditor indemnified against claims based on auditor's negligence <sup>18/</sup>	Impairs independence <sup>19/</sup>	Unsafe and unsound practice <sup>20/</sup>
Auditor indemnified against claims based on knowing misrepresentation by audit client's management <sup>21/</sup>	Does not impair independence	Unsafe and unsound practice

<sup>18/</sup> Under the SEC staff FAQ, "when the accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, the accountant is not independent."

<sup>19/</sup> Specifically, under the AICPA proposal, "[a]n indemnification or limitation of liability provision that seeks to limit or eliminate the member's liability with respect to actual damages arising from the member's negligence, willful misconduct, or fraudulent behavior would impair independence."

<sup>20/</sup> The FFIEC proposal states that the inclusion of limitation of liability provisions in audit engagement letters "will generally be considered an unsafe and unsound practice." That proposal describes a limitation of liability provision as any agreement to indemnify the auditor against third party claims; hold harmless or release the auditor from claims asserted by the client; or limit the remedies available to the client.

<sup>21/</sup> Under the SEC staff FAQ, an agreement to "release, indemnify or hold [the auditor] harmless from any liability and costs resulting from knowing misrepresentations by management" impairs independence.

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Type of Clause	AICPA Proposed Interpretation	FFIEC Proposed Advisory
Auditor indemnified against claims based on audit client's negligence	Impairs independence <sup>22/</sup>	Unsafe and unsound practice
Auditor's liability limited to the amount of fees paid	May impair independence <sup>23/</sup>	Unsafe and unsound practice
Limitation of period during which audit client could otherwise file claim	Impairs independence	Unsafe and unsound practice
Limitation on audit client's right to assign or transfer claim	Impairs independence	Unsafe and unsound practice
Exclusion of punitive damages <sup>24/</sup>	Does not impair independence	Unsafe and unsound practice

<sup>22/</sup> Specifically, under the AICPA proposal, "[a]n indemnification or limitation of liability provision that seeks to limit or eliminate a member's liability with respect to actual damages arising from the client's negligence would impair independence."

<sup>23/</sup> Under the AICPA proposal, independence would be impaired if the auditor's liability for actual damages is limited in actions based on the auditor's negligence, willful misconduct or fraudulent behavior, or on the client's negligence. Independence would not be impaired if the auditor's liability for actual damages is limited in actions based on the client's knowing misrepresentation, willful misconduct, or fraudulent behavior. The proposal defines actual damages to include "audit fees and other out-of-pocket costs as well as incidental or consequential damages . . ." Under the proposal, therefore, a limitation on liability to the amount of fees paid would impair independence if it applied in those circumstances in which a limitation on actual damages would impair independence. As a result, if the provision applied to all claims by the client, it would impair independence under the proposal.

<sup>24/</sup> In a number of relevant contexts, including actions under the Securities Exchange Act of 1934, the law itself excludes the possibility of punitive damages. See, e.g., 15 U.S.C. § 78bb(a).

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Type of Clause	AICPA Proposed Interpretation	FFIEC Proposed Advisory
Agreement to use ADR	Impairs independence only if it also limits the auditor's liability for actual damages or incorporates a provision that would impair independence	Presents safety and soundness concerns if it incorporates additional limitations of liability or if ADR rules may limit auditor liability
Unsuccessful party to pay adversary's legal fees	Does not impair independence	Silent
Auditor's liability limited to the amount of losses occurring during periods audited	May impair independence <sup>25/</sup>	Unsafe and unsound practice

The following examples illustrate each type of litigation-related clause discussed in this paper.

### **Auditor Indemnified Against Claims Based on Auditor's Negligence**

This clause protects the auditor from all liability arising from the auditor's negligence.

Example: Audit client hereby indemnifies the auditor and holds them harmless from all claims, whether a claim be in tort, contract or otherwise, for any damages relating to the auditor's services provided under this engagement letter.

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<sup>25/</sup> As in the case of a limitation on liability to the amount of fees paid, a clause limiting the auditor's liability to the amount of losses occurring during periods audited would limit the auditor's potential liability for actual damages. Thus, under the proposal, this clause should be treated, for independence purposes, as a limitation on liability for actual damages. (See footnote 23 for the relevant analysis.)

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### **Auditor Indemnified Against Claims Based on Knowing Misrepresentation by Audit Client's Management**

This clause protects the auditor from all liability arising from the audit client's knowing misrepresentation by management.

Example: Audit client hereby indemnifies the auditor and its partners, principals and employees and holds them harmless from all claims, liabilities, losses, and costs arising in circumstances where there was a misrepresentation by the audit client's management, regardless of whether such person was acting in the audit client's interests.

### **Auditor Indemnified Against Claims Based on Audit Client's Negligence**

This clause protects the auditor from all liability arising from the audit client's negligence.

Example: The audit client shall indemnify, hold harmless, and defend the auditor against any and all claims, damages, demands, actions, costs, and charges arising out of, or by reason of the audit client's negligent acts or failure to act hereunder.

### **Auditor's Liability Limited to the Amount of Fees Paid**

This clause limits the auditor's liability to the amount of the professional fees the audit client paid for the services performed regardless of the extent of damages.

Example: In the event of any litigation proceedings as a result of the work performed by the auditor, the auditor's liability for damages is limited to the amount of the total fees paid to the auditor by the company for the work performed in connection with this engagement.

### **Limitation of Period During Which Audit Client Could Otherwise File Claim**

This clause limits the audit client's ability to assert a claim against the auditor to a fixed period of time that is shorter than the applicable statute of limitations.

Example: It is agreed by the audit client and the auditor or any successor in interest that no claim arising out of services rendered pursuant to this

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agreement by, or on behalf of, the audit client shall be asserted more than two years after the date of the last audit report issued by the auditor.<sup>26/</sup>

### **Limitation on Audit Client's Right to Assign or Transfer Claim**

This clause limits the audit client's legal right to assign or transfer a claim or potential claim to another party, such as in connection with a sale or merger of the audit client.

Example: The audit client agrees that it will not, directly or indirectly, agree to assign or transfer any claim against the auditor arising out of this agreement to anyone.

### **Exclusion of Punitive Damages**

This clause protects the auditor from being liable for punitive damages.

Example: In no event will the auditor's liability under the terms of this agreement include responsibility for punitive damages.

### **Agreement to Use Alternative Dispute Resolution**

This clause requires the audit client to submit disputes with the auditor to mandatory and binding ADR, such as binding arbitration or some other binding non-judicial dispute resolution process. Additionally, this type of clause may be paired with another type of limitation of liability clause, such as an exclusion of punitive damages.

Example: The audit client agrees to mandatory and binding alternative dispute resolution in lieu of a jury trial, and the auditor is not responsible for punitive damages under this agreement.

### **Unsuccessful Party to Pay Adversary's Legal Fees**

This clause is an agreement between the auditor and the audit client that the unsuccessful party in a lawsuit or ADR will pay the legal fees and expenses of the successful party.

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<sup>26/</sup> The example assumes that the applicable statute of limitations is longer than two years.

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Example: The audit client and auditor agree that, in the event of a dispute between the parties, the unsuccessful party will pay the legal fees and expenses of the successful party.

### **Auditor's Liability Limited to the Amount of Losses Occurring During Periods Audited**

This clause limits the auditor's liability to the amount of any losses that occurred during periods covered by the audit. Losses that occurred in later periods for which the auditor is not engaged are not recoverable.

Example: In the event the audit client is dissatisfied with the auditor's services, it is understood that the auditor's liability, if any, arising from this engagement, will be limited to the amount of any losses occurring during the periods covered by the audit, and shall not include any losses occurring in later periods for which the auditor is not engaged as the auditor.

### **Discussion Questions –**

1. In general, does the inclusion of any litigation-related clause discussed in this paper in an audit engagement letter compromise the auditor's objectivity or otherwise affect the auditor's behavior or does it depend on the nature of the litigation-related clause?
2. Would it make a difference if the litigation-related clause immunized the auditor against all liability versus limiting the liability only between the auditor and the audit client but did not have an effect on the auditor's liability for third-party claims?
3. Do the following litigation-related clauses compromise the auditor's objectivity or otherwise affect the auditor's behavior such that they may impair the auditor's independence and, therefore, should be prohibited?
  - a. Auditor indemnified against claims based on audit client's negligence
  - b. Auditor's liability limited to the amount of fees paid

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- c. Limitation of period during which audit client could otherwise file claim
- d. Limitation on audit client's right to assign or transfer claim
- e. Exclusion of punitive damages
- f. Other litigation-related clauses
  - Agreement to use ADR,
  - Unsuccessful party to pay adversary's legal fees, or
  - Auditor's liability limited to the amount of losses occurring during periods audited.

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

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### APPENDIX A

#### **SEC, Office of the Chief Accountant, *Application of the Commission's Rules on Auditor Independence Frequently Asked Questions, Other Matters – Question 4.***

##### **Question 4 (issued December 13, 2004)**

**Q:** Has there been any change in the Commission's long standing view (Financial Reporting Policies – Section 600 – 602.02.f.i. "Indemnification by Client") that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question?

**A:** No. When an accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, the accountant is not independent. Further, including in engagement letters a clause that a registrant would release, indemnify or hold harmless from any liability and costs resulting from knowing misrepresentations by management would also impair the firm's independence.

#### **SEC "Codification of Financial Reporting Policies," Section 602.02.f.i – Indemnification by Client.**

Inquiry was made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the Commission under the Securities Act or the Exchange Act would be considered independent if he had entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the filing of a registration statement with the Commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement, "from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act, as amended, or at 'common law,' other than for their willful misstatements or omissions."

When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular

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engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. Consequently, the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation.

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### ***APPENDIX B***

**AICPA, Code of Professional Conduct, ET Section 191, *Ethics Rulings on Independence, Integrity, and Objectivity*, "Ethics Ruling No. 94, Indemnification Clause in Engagement Letters."**

#### **94. Indemnification Clause in Engagement Letters**

**.188** *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?

**.189** *Answer*—No.

#### **95. Agreement With Attest Client to Use ADR Techniques**

**.190** *Question*—Alternative dispute resolution (ADR) techniques are used to resolve disputes (in lieu of litigation) relating to past services, but are not used as a substitute for the exercise of professional judgment for current services. Would a predispute agreement to use ADR techniques between a member or his or her firm and a client cause independence to be impaired?

**.191** *Answer*—No. Such an agreement would not cause independence to be impaired since the member (or the firm) and the client would not be in threatened or actual positions of material adverse interests by reason of threatened or actual litigation.

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### APPENDIX C

**AICPA Professional Ethics Executive Committee, *Proposed Interpretation 101-16, Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters, Under Rule 101, Independence (September 15, 2005).***

#### **PROPOSED INTERPRETATION 101-16, INDEMNIFICATION, LIMITATION OF LIABILITY, AND ADR CLAUSES IN ENGAGEMENT LETTERS, UNDER RULE 101, INDEPENDENCE**

##### ***[Explanation]***

Since September 2004, the Professional Ethics Executive Committee (PEEC, or committee) has been actively studying the use of indemnification and limitation of liability provisions in member engagement letters and has engaged in numerous discussions and deliberations regarding the impact such provisions may have on a member's independence. In deliberating these issues, the PEEC considered guidance issued by other regulators, including the Securities and Exchange Commission (SEC), as well as the Proposed Advisory issued by the Federal Financial Institutions Examination Council (FFIEC) on May 10, 2005, *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters*. However, the PEEC was mindful that there are critical differences between public or regulated entities and nonpublic companies with respect to regulatory oversight and requirements; investor and marketplace communications, access, and interactions; and board of directors and audit committee composition, responsibilities, and procedures.

The PEEC believes that certain indemnification or limitation of liability provisions would result in an unacceptable threat to a member's independence that could not be mitigated sufficiently through the application of safeguards. For example, in cases where the member seeks to limit or eliminate his or her liability with respect to actual damages arising from the member's negligence or the client's negligence, independence would be considered to be impaired. In such cases, the threat to independence posed by a member's performance of insufficient attest procedures in reliance on the belief that he or she is protected through an indemnification or limitation of liability clause could not be reduced to an acceptable level. In addition, certain other provisions were identified by the PEEC as impairing a member's independence such as a limitation of the period during which the client would be otherwise legally entitled to file

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a claim and any limitation on the client's legal right to assign or transfer a claim or potential claim to its successors or assigns.

On the other hand, the PEEC believes that an indemnification or limitation of liability provision that seeks to limit or eliminate a member's liability arising from the client's knowing misrepresentation, willful misconduct, or fraudulent behavior would not impair independence. This has been a long-standing position of the committee with respect to knowing misrepresentations, as reflected in ethics ruling no. 94 under Rule 101, *Indemnification Clause in Engagement Letters* [ET section 191.188], and the committee believes that position should be expanded to specifically include willful misconduct and fraudulent behavior. (Ethics ruling no. 94 is proposed for deletion as the guidance would be reflected in the proposed interpretation.) Specifically, the PEEC continues to believe that permitting a member and his or her client to agree to a limitation of liability or indemnity for claims resulting from knowing misrepresentations by management is fundamentally fair both to the client and to the member, and also furthers the public interest. Such a limitation of liability or indemnity is a significant deterrent to management fraud and shifts to the client, which is where it properly belongs, the responsibility for management's deliberate and improper misrepresentations. For example, such a clause would apply where a client intentionally misleads an auditor or lies to an auditor. However, the use of such a clause does not relieve the member, in the case of an audit, of the responsibility to comply with generally accepted auditing standards (GAAS) and does not eliminate his or her liability to shareholders, regulators or others for audits not conducted in accordance with those standards. The committee believes that the use of this type of limitation of liability and indemnification provision encourages management to completely and accurately disclose and communicate all pertinent matters to the member, and that result benefits the financial statement users.

The PEEC also believes that a limitation of liability agreement, in which a member would not be liable to a client for *punitive* damages, would not impair the member's independence provided the member remains liable to the client for actual damages. Specifically, the member still remains exposed to clients, and also to lenders, shareholders and other nonclients, for damages for any *actual* harm caused. The committee believes that the amount of actual damages can be significant, and can often equal hundreds of times (or more) the fees generated in connection with the engagement. Accordingly, the committee believes that the possibility that actual damages might be awarded against a member in favor of clients and/or nonclients serves as a sufficient safeguard to mitigate the threats to a member's independence. The committee also agreed that any agreement to limit or exclude punitive damage

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claims brought by lenders, shareholders, or other nonclient third parties should not be permitted and accordingly, independence would be considered impaired if a member enters into an agreement to be indemnified from third-party claims for punitive damages.

The proposed interpretation makes clear that the use of indemnification or limitation of liability provisions does not relieve a member from the requirement to exercise due professional care and comply with all professional standards (for example, in the case of an audit, specific performance standards under GAAS) as required by Rule 201, *General Standards* [ET section 201], and Rule 202, *Compliance With Standards* [ET section 202].

The proposed interpretation also provides guidance on arrangements whereby a member and client agree to use arbitration, mediation, or other alternative dispute resolution (ADR) methods to resolve a dispute between them, or agree to waive a jury trial. The PEEC does not believe independence would be impaired when a member and his or her client agree to use an ADR procedure to resolve disputes between them provided such a provision does not limit a member's liability for actual damages. Specifically, ADR clauses merely determine the forum in which a dispute will be heard and decided, and facilitate dispute resolution between the member and the client. However, if an ADR clause incorporates an indemnification or limitation of liability provision that would impair independence, then the ADR clause would also impair independence. In addition, the PEEC does not believe that waiver of a jury trial would impair independence provided such a provision does not limit a member's liability for actual damages. Such a waiver merely specifies one procedural aspect of a how a dispute will be resolved.

Finally, the proposed interpretation states that independence would not be impaired if a member and the client agree that the unsuccessful party in a lawsuit or ADR between them will pay the legal fees and expenses of the successful party, and the interpretation clarifies that an indemnification or limitation of liability provision related to nonattest services performed for a client (that is, where the provision relates only to the nonattest services engagement and not the attest engagement) would not impair a member's independence with respect to that client.

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### PROPOSED INTERPRETATION 101-16, *INDEMNIFICATION, LIMITATION OF LIABILITY, AND ADR CLAUSES IN ENGAGEMENT LETTERS*, UNDER RULE 101, INDEPENDENCE

[*Text of Proposed Interpretation*]

#### Terminology

The following specifically identified terms are used in this interpretation as indicated:

- A. **Member.** The term *member* includes both a member and his or her firm.
- B. **Indemnification.** An *indemnification* is a client's agreement to compensate a member for loss, damage or costs sustained or incurred by that member as a result of claims made against the member by a third party (for example, a lender or shareholder). An indemnification does not insulate a member from claims asserted by the client.
- C. **Limitation of Liability Provisions.** A *limitation of liability provision* is a client's agreement to restrict the damages the client could recover from a member arising out of the member's performance of professional services. A limitation of liability provision does not insulate a member from claims asserted by third parties.
- D. **ADR.** The term *ADR* refers to an alternative dispute resolution proceeding.
- E. **Actual Damages.** *Actual damages* consist of audit fees and other out-of-pocket costs as well as incidental or consequential damages that are caused by the wrongful conduct (for example, economic losses).<sup>1/</sup>
- F. **Punitive Damages.** *Punitive damages* are monetary recoveries by plaintiffs in private civil litigation that are in addition to actual damages. Such damages may be available, depending on circumstances and the

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<sup>1/</sup> This term is defined solely for purposes of this interpretation and the laws in a particular jurisdiction may not define damages in this manner. Accordingly, members should consult their legal advisers when drafting engagement letters or similar arrangements to ensure that the types of damages are properly described.

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law of the relevant jurisdiction, absent exclusion by contract, to punish someone found liable in civil litigation.<sup>2/</sup>

### Interpretation

This interpretation provides guidance to members concerning the impact that certain indemnification and limitation of liability provisions may have on a member's independence when included in engagement letters or other agreements entered into with a client. Certain types of indemnification and limitation of liability provisions pose an unacceptable threat to a member's independence. The interpretation also provides guidance on arrangements whereby a member and client agree to use arbitration, mediation, or other ADR methods to resolve a dispute between them, or an agreement to waive a jury trial.

In all cases, the inclusion of an indemnification or limitation of liability provision does not relieve a member from the requirement to exercise due professional care and comply with all professional standards (for example, in the case of an audit, specific performance standards under generally accepted auditing standards (GAAS)) as required by Rule 201, *General Standards* [ET section 201], and Rule 202, *Compliance With Standards* [ET section 202].

Members should refer to ethics interpretation 101-6 [ET section 101.08] and ethics ruling no. 96 under rule 101 [ET section 191.192] for guidance on the impact on independence of threatened or actual litigation or ADR between the client and the member.

### Attest services engagements

The following describe the impact of indemnification, limitation of liability, and certain other provisions in connection with an attest engagement.

#### Member's negligence, willful misconduct, or fraudulent behavior

An indemnification or limitation of liability provision that seeks to limit or eliminate the member's liability with respect to actual damages arising from the member's negligence, willful misconduct, or fraudulent behavior would impair independence.

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<sup>2/</sup> Ibid.

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### Client's negligence

An indemnification or limitation of liability provision that seeks to limit or eliminate a member's liability with respect to actual damages arising from the client's negligence would impair independence.

### Client's knowing misrepresentation, willful misconduct, or fraudulent behavior

An indemnification or limitation of liability provision that seeks to limit or eliminate a member's liability with respect to actual or punitive damages arising from the client's knowing misrepresentation, willful misconduct, or fraudulent behavior would not impair independence.

### Unsuccessful party to pay adversary's fees (loser pays arrangement)

Independence would not be impaired if a member and the client agree that the unsuccessful party in a lawsuit or ADR between them will pay the legal fees and expenses of the successful party.

### Punitive damages

A limitation of liability provision, in which a member would not be liable to a client for punitive damages, would not impair the member's independence provided the member remains liable to the client for actual damages.

### Other limitations

A limitation of the time period during which the client would be otherwise legally entitled to file a claim, or a limitation or exclusion of actual damages occurring prior to the date on which such claims legally lapse, would impair independence. In addition, any limitation on the client's legal right to assign or transfer a claim or potential claim to its successors or assigns would impair independence.

### ADR and waiver of jury trial

An agreement between a member and client to use arbitration, mediation, or other ADR method to resolve a dispute between them, or an agreement between a member and client to waive a jury trial in a dispute between them, would not impair the member's independence provided such provisions do not limit the member's liability for actual

## **STANDING ADVISORY GROUP MEETING**

damages.<sup>3/</sup> However, if an ADR clause incorporates a provision, procedure, or rule that would impair independence under the preceding guidance, the ADR clause would impair independence.

### **Nonattest services engagements**

An indemnification or limitation of liability provision related to nonattest services performed for a client would not impair a member's independence with respect to that client.

### **Transition**

Independence would not be impaired as a result of the more restrictive requirements of this interpretation for engagements commenced prior to [*effective date dependent on publication date in the Journal of Accountancy*] where the member complied with all applicable independence interpretations and rulings in effect prior to [*effective date dependent on publication date in the Journal of Accountancy*].

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<sup>3/</sup> Some jurisdictions may limit or fail to give effect to certain of these arrangements.

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### ***APPENDIX D***

**Federal Financial Institutions Examination Council, *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters* (May 10, 2005).**

#### **FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL**

**Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters**

**AGENCY:** Federal Financial Institutions Examination Council.

**ACTION:** Proposed interagency advisory; request for comment.

**SUMMARY:** The Federal Financial Institutions Examination Council (FFIEC), on behalf of the Office of Thrift Supervision (OTS), Treasury; the Board of Governors of the Federal Reserve System (Board); the Federal Deposit Insurance Corporation (FDIC); the National Credit Union Administration (NCUA); and the Office of the Comptroller of the Currency (OCC), Treasury (collectively, the Agencies), is seeking public comment on a 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. The proposal advises financial institutions' boards of directors, audit committees, and management that they should ensure that they do not enter any agreement that contains external auditor limitation of liability provisions with respect to financial statement audits.

**DATES:** Comments must be received on or before June 9, 2005.

**ADDRESSES:** Comments should be directed to: FFIEC, Program Coordinator, 3501 Fairfax Drive, Room 3086, Arlington, VA 22226; by e-mail to *FFIEC-Comments@fdic.gov*; or by fax to (703) 516-5487. Comments will be available for public inspection during regular business hours at the above address. Appointments to inspect comments are encouraged and can be arranged by calling the FFIEC at (703) 516-5588.

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### **FOR FURTHER INFORMATION CONTACT:**

*OTS:* Jeffrey J. Geer, Chief Accountant, at [jeffrey.geer@ots.treas.gov](mailto:jeffrey.geer@ots.treas.gov) or (202) 906-6363; or Patricia Hildebrand, Senior Policy Accountant, at [patricia.hildebrand@ots.treas.gov](mailto:patricia.hildebrand@ots.treas.gov) or (202) 906-7048.

*Board:* Terrill Garrison, Supervisory Financial Analyst, at [terryll.garrison@frb.gov](mailto:terryll.garrison@frb.gov) or (202) 452-2712.

*FDIC:* Harrison E. Greene, Jr., Senior Policy Analyst (Bank Accounting), Division of Supervision and Consumer Protection, at [hgreene@fdic.gov](mailto:hgreene@fdic.gov) or (202) 898-8905; or Michelle Borzillo, Counsel, Supervision and Legislation Section, Legal Division, at [mborzillo@fdic.gov](mailto:mborzillo@fdic.gov) or (202) 898-7400.

*NCUA:* Karen Kelbly, Chief Accountant, at [kelblyk@ncua.gov](mailto:kelblyk@ncua.gov) or (703) 518-6389.

*OCC:* Brent Kukla, Accounting Fellow, at [brent.kukla@occ.treas.gov](mailto:brent.kukla@occ.treas.gov) or (202) 874-4978.

### **SUPPLEMENTARY INFORMATION:**

#### **I. Background**

The 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. While these provisions do not appear in a majority of financial institution engagement letters, the provisions are becoming more prevalent. The Agencies believe such provisions may weaken an external auditor's objectivity, impartiality, and performance; therefore, inclusion of these provisions in financial institution engagement letters raises safety and soundness concerns.

While these provisions take many forms, they can be generally categorized as an agreement by a financial institution that is a client of an external auditor to:

- Indemnify the external auditor against claims made by third parties;
- Hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution; or

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- Limit the remedies available to the client financial institution.

Collectively, these and similar types of provisions are referred to in the proposed advisory as limitation of liability provisions.

### II. Comments

The FFIEC has approved the publication of the proposed advisory on behalf of the Agencies to seek public comment to fully understand the effect of the proposed advisory on the inappropriate use of limitation of liability provisions on external auditor engagements. While public comments are welcome on all aspects of this advisory, the Agencies are specifically seeking comments on the following questions. Please provide information that supports your position.

1. The advisory, as written, indicates that limitation of liability provisions are inappropriate for all financial institution external audits.
  - a. Is the scope appropriate? If not, to which financial institutions should the advisory apply and why?
  - b. Should the advisory apply to financial institution audits that are not required by law, regulation, or order?
2. What effects would the issuance of this advisory have on financial institutions' ability to negotiate the terms of audit engagements?
3. Would the advisory on limitation of liability provisions result in an increase in external audit fees?
  - a. If yes, would the increase be significant?
  - b. Would it discourage financial institutions that voluntarily obtain audits from continuing to be audited?
  - c. Would it result in fewer audit firms being willing to provide external audit services to financial institutions?
4. The advisory describes three general categories of limitation of liability provisions.

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- a. Is the description complete and accurate?
  - b. Is there any aspect of the advisory or terminology that needs clarification?
5. Appendix A of the advisory contains examples of limitation of liability provisions.
- a. Do the examples clearly and sufficiently illustrate the types of provisions that are inappropriate?
  - b. Are there other inappropriate limitation of liability provisions that should be included in the advisory? If so, please provide examples.
6. Is there a valid business purpose for financial institutions to agree to any limitation of liability provision? If so, please describe the limitation of liability provision and its business purpose.
7. The advisory strongly recommends that financial institutions take appropriate action to nullify limitation of liability provisions in 2005 audit engagement letters that have already been accepted. Is this recommendation appropriate? If not, please explain your rationale (including burden and cost).

### **III. Paperwork Reduction Act**

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. Chapter 35), the Agencies have reviewed the proposed advisory and determined that it does not contain a collection of information pursuant to the Act.

### **IV. Proposed Advisory**

The text of the proposed advisory follows:

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### **Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters**

#### *Purpose*

This advisory, issued jointly by the Office of Thrift Supervision (OTS), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC) (collectively, the Agencies), alerts financial institutions<sup>1/</sup> boards of directors, audit committees, management, and external auditors to the safety and soundness implications of provisions that limit the external auditor's liability in a financial statement audit. While the Agencies have observed several types of these provisions in external audit engagement letters, this advisory applies to any agreement that a financial institution enters into with its external auditor that limits the external auditor's liability with respect to financial statement audits.

Agreements by financial institutions to limit their external auditors' liability or to submit to certain alternative dispute resolution (ADR) provisions that also limit the external auditors' liability may weaken the external auditors' objectivity, impartiality, and performance and thus, reduce the Agencies' ability to rely on external audits. Therefore, such agreements raise safety and soundness concerns, and entering into such agreements is generally considered to be an unsafe and unsound practice.

In addition, such provisions may not be consistent with the auditor independence standards of the U.S. Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and the American Institute of Certified Public Accountants (AICPA).

#### *Background*

A properly conducted external audit provides an independent and objective view of the reliability of a financial institution's financial statements. The external auditor's objective in an audit of financial statements is to form an opinion on the financial statements taken as a whole. When planning and performing the audit, the external

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<sup>1/</sup> As used in this document, the term financial institutions includes banks, bank holding companies, savings associations, savings and loan holding companies, and credit unions.

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auditor considers the financial institution's internal control over financial reporting. Generally, the external auditor communicates any identified deficiencies in internal control to management, which enables management to take appropriate corrective action. For these reasons, the Agencies encourage all financial institutions to obtain external audits of their financial statements. The Federal Financial Institutions Examination Council's (FFIEC) Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations<sup>2/</sup> notes "[a]n institution's internal and external audit programs are critical to its safety and soundness." The policy also states that an effective external auditing program "can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by" the FDIC.

Typically, a written engagement letter is used to establish an understanding between the external auditor and the financial institution regarding the services to be performed in connection with the external audit of the financial institution. The engagement letter commonly describes the objective of the external audit, the reports to be prepared, the responsibilities of management and the external auditor, and other significant arrangements (e.g., fees and billing). As with any important contract, the Agencies encourage boards of directors, audit committees, and management to closely review all of the provisions in the external audit engagement letter before agreeing to sign. To assure that those charged with engaging the external auditor make a fully informed decision, any agreement such as an engagement letter that affects the financial institution's legal rights should be carefully reviewed by the financial institution's legal counsel.

While the Agencies have not observed provisions that limit an external auditor's liability in the majority of external audit engagement letters reviewed, the Agencies have observed a significant increase in the types and frequency of these provisions. These provisions take many forms,<sup>3/</sup> but they can be generally categorized as an agreement by a financial institution that is a client of an external auditor to:

- Indemnify the external auditor against claims made by third parties;

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<sup>2/</sup> Published in the Federal Register on September 28, 1999 (64 FR 52319–27). The NCUA, a member of the FFIEC, has not adopted the policy statement.

<sup>3/</sup> Examples of auditor limitation of liability provisions are illustrated in Appendix A.

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- Hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution; or
- Limit the remedies available to the client financial institution.

Collectively, these and similar types of provisions will be referred to in this advisory as "limitation of liability provisions."

Financial institutions' boards of directors, audit committees, and management should also be aware that certain financial institution insurance policies (such as error and omission policies and director and officer liability policies) may not cover the financial institutions' losses arising from claims that are precluded by the limitation of liability provisions.

### *Limitation of Liability Provisions*

Many financial institutions are required to have their financial statements audited while others voluntarily choose to undergo such audits. For example, banks, savings associations, and credit unions with \$500 million or more in total assets are required to have annual independent audits.<sup>4/</sup> Certain savings associations (for example, those with a CAMELS rating of 3, 4, or 5) and savings and loan holding companies are also required by OTS regulations to have annual independent audits.<sup>5/</sup> Furthermore, financial institutions that are public companies<sup>6/</sup> must have annual independent audits. The Agencies rely on the results of external audits as part of their assessment of the safety and soundness of a financial institution's operations.

In order for an external audit to be effective, the external auditors must be independent in both fact and appearance, and they must perform all necessary

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<sup>4/</sup> For banks and savings associations, see Section 36 of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. 1831m) and Part 363 of the FDIC's regulations (12 CFR part 363). For credit unions, see Section 202(a)(6) of the Federal Credit Union Act (12 U.S.C. 1782(a)(6)) and Part 715 of the NCUA's regulations (12 CFR part 715).

<sup>5/</sup> See OTS regulation at 12 CFR 562.4.

<sup>6/</sup> Public companies are companies subject to the reporting requirements of the Securities Exchange Act of 1934.

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procedures to comply with generally accepted auditing standards established by the AICPA and, if applicable, the standards of the PCAOB. When a financial institution executes an agreement that limits the external auditor's liability, the external auditor's objectivity, impartiality, and performance may be weakened or compromised and the usefulness of the external audit for safety and soundness purposes may be diminished.

Since limitation of liability provisions can impair the external auditor's independence and may adversely affect the external auditor's performance, they present safety and soundness concerns for all financial institution external audits. By their very nature, these provisions can remove or greatly weaken an external auditor's objective and unbiased consideration of problems encountered in the external audit engagement and induce the external auditor to depart from the standards of objectivity and impartiality required in the performance of a financial statement audit. The existence of such provisions in an external audit engagement letter may lead to the use of less extensive or less thorough procedures than would otherwise be followed, thereby reducing the benefits otherwise expected to be derived from the external audit. Accordingly, financial institutions should not enter into external audit arrangements that include any limitation of liability provisions. This applies 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.

### *Auditor Independence*

Currently, auditor independence standard-setters include the AICPA, the SEC, and the PCAOB. Depending upon the audit client, an external auditor is subject to the independence standards of one or more of these standard-setters. For all credit unions under NCUA's regulations, and for other non-public financial institutions that are not required to have annual independent audits pursuant to Part 363 of the FDIC's regulations or pursuant to OTS's regulations, the Agencies' rules require only that an external auditor meet the AICPA independence standards; they do not require the financial institution's external auditor to comply with the independence standards of the SEC and the PCAOB.

In contrast, for financial institutions subject to the audit requirements in Part 363 of the FDIC's regulations or subject to OTS's regulations, the external auditor should be in compliance with the AICPA's Code of Professional Conduct and meet the

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independence requirements and interpretations of the SEC and its staff.<sup>7/</sup> In this regard, in a December 13, 2004, Frequently Asked Question (FAQ) on the application of the SEC's auditor independence rules, the SEC reiterated its long-standing position that when an accountant and his or her client enter into an agreement which seeks to provide the accountant immunity from liability for his or her own negligent acts, the accountant is not independent. The FAQ also states that including in engagement letters a clause that would release, indemnify, or hold the auditor harmless from any liability and costs resulting from knowing misrepresentations by management would impair the auditor's independence.<sup>8/</sup> The SEC's FAQ is consistent with Section 602.02.f.i. (Indemnification by Client) of the SEC's Codification of Financial Reporting Policies. (Section 602.02.f.i. and the FAQ are included in Appendix B.)

Based on this SEC guidance and the Agencies' existing regulations, limitation of liability provisions are already inappropriate in auditor engagement letters entered into by:

- Public financial institutions that file reports with the SEC or with the Agencies;
- Financial institutions subject to Part 363; and
- Certain other financial institutions that OTS regulations at 12 CFR 562.4 require to have annual independent audits.

In addition, many of these limitation of liability provisions may violate the AICPA independence standards. Because limitation of liability provisions may impair an auditor's independence and may adversely affect the external auditor's objectivity,

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<sup>7/</sup> See FDIC Regulation 12 CFR Part 363, Appendix A—Guidelines and Interpretations; Guideline 14, Role of the Independent Public Accountant—Independence; and OTS Regulation 12 CFR 562.4(d)(3)(i), Qualifications for independent public accountant.

<sup>8/</sup> AICPA Ethics Ruling 94 (ET § 191.188–189) currently concludes that indemnification for "knowing misrepresentations by management" does not impair independence. At this writing, the AICPA's Professional Ethics Executive Committee has formed a task force that is studying the use of indemnification clauses in engagement letters and how such clauses may affect an auditor's independence.

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impartiality, and performance, the provisions present safety and soundness concerns for all financial institution external audits.

### *Alternative Dispute Resolution Agreements and Jury Trial Waivers*

The Agencies have also observed that some financial institutions are agreeing in their external audit engagement letters to submit disputes over external auditor services to mandatory and binding alternative dispute resolution, binding arbitration, or some other binding non-judicial dispute resolution process (collectively referred to as mandatory ADR) or to waive the right to a jury trial. By agreeing in advance to submit disputes to mandatory ADR, the financial institution is effectively agreeing to waive the right to full discovery, limit appellate review, and limit or waive other rights and protections available in ordinary litigation proceedings. While ADR may expedite case resolution and reduce costs, financial institutions should consider the value of the rights being waived. Similarly, by waiving a jury trial, the financial institution may effectively limit the amount it might receive in any settlement of its case. The loss of these legal protections can reduce the value of the financial institution's claim in an audit dispute.

The Agencies recognize that ADR procedures and jury trial waivers may be efficient and cost-effective tools for resolving disputes in some cases. However, financial institutions should take care to understand the ramifications of agreeing to submit audit disputes to mandatory ADR or to waive a jury trial before an audit dispute arises.

In particular, pre-dispute mandatory ADR agreements in external audit engagement letters present safety and soundness concerns when they incorporate additional limitations of liability, or when mandatory ADR agreements operate under rules of procedure that may limit auditor liability. Examples of such limitations on liability include provisions:

- Capping the amount of actual damages that may be claimed;
- Prohibiting claims for punitive damages or other remedies; or
- Shortening the time in which the financial institution may file a claim.

Thus, financial institutions should not enter into pre-dispute mandatory ADR arrangements that incorporate limitation of liability provisions, whether the limitations on liability form part of an audit engagement letter or are set out separately.

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The Agencies encourage 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. Financial institutions should also review the rules of procedure referenced in the ADR agreement to ensure that the potential consequences of such procedures are acceptable to the institution. In addition, financial institutions should recognize that ADR agreements may themselves contain limitation of liability provisions as described in this advisory.

### *Conclusion*

Financial institutions' boards of directors, audit committees, and management should ensure that they do not enter any agreement that contains external auditor limitation of liability provisions with respect to financial statement audits. In addition, financial institutions should document their business rationale for agreeing to any other provisions that alter their legal rights.

The inclusion of limitation of liability provisions in external audit engagement letters and other agreements that are inconsistent with this advisory will generally be considered an unsafe and unsound practice. The Agencies may take appropriate supervisory action if such provisions are included in external audit engagement letters or other agreements related to financial statement audits that are executed (accepted or agreed to by the financial institution) after the date of this advisory. Furthermore, 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.

Financial institutions' boards of directors, audit committees, and management should also check with their insurers to determine the effect, if any, on their ability to recover losses as a result of the external auditors' actions that were not recovered because of the limitation of liability provisions.

As indicated in the Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, the Agencies' examiners will consider the policies, processes, and personnel surrounding a financial institution's external auditing program in determining whether (1) the engagement letter covering external auditing activities is

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adequate and does not raise any safety and soundness concerns and (2) the external auditor maintains appropriate independence regarding relationships with the financial institution under relevant professional standards.

### Appendix A

#### Examples of Limitation of Liability Provisions

Presented below are some of the types of limitation of liability provisions (with an illustrative example of each type) that the Agencies observed in financial institutions' external audit engagement letters. The inclusion in external audit engagement letters or agreements related to the financial statement audit of any of the illustrative provisions (which do not represent an all-inclusive list) or any other language that would produce similar effects is generally considered an unsafe and unsound practice.

1. *"Release From Liability for Auditor Negligence" Provision*

In this type of provision, the financial institution agrees *not* to hold the audit firm liable for *any* damages, *except* to the extent determined to have resulted from the willful misconduct or fraudulent behavior by the audit firm.

*Example:* In no event shall [the audit firm] be liable to the Financial Institution, whether a claim be in tort, contract or otherwise, for any consequential, indirect, lost profit, or similar damages relating to [the audit firm's] services provided under this engagement letter, except to the extent finally determined to have resulted from the willful misconduct or fraudulent behavior of [the audit firm] relating to such services.

2. *"No Damages" Provision*

In this type of provision, the financial institution agrees that in *no event* will the external audit firm's liability include responsibility for *any* claimed incidental, consequential, punitive, or exemplary damages.

*Example:* In no event will [the audit firm's] liability under the terms of this Agreement include responsibility for any claimed incidental, consequential, or exemplary damages.

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### 3. *"Limitation of Period To File Claim" Provision*

In this type of provision, the financial institution agrees that *no* claim will be asserted after a fixed period of time that is shorter than the applicable statute of limitations, effectively agreeing to limit the financial institution's rights in filing a claim.

*Example:* It is agreed by the Financial Institution and [the audit firm] or any successors in interest that no claim arising out of services rendered pursuant to this agreement by, or on behalf of, the Financial Institution shall be asserted more than two years after the date of the last audit report issued by [the audit firm].

### 4. *"Losses Occurring During Periods Audited" Provision*

In this type of provision, the financial institution agrees that the external audit firm's liability will be limited to any losses occurring during periods covered by the external audit, and will *not* include any losses occurring in later periods for which the external audit firm is not engaged. This provision may not only preclude the collection of consequential damages for harm in later years, but also may preclude any recovery at all. It appears that the external audit firm would have no liability until the external audit report is actually delivered and any liability thereafter might be limited to the period covered by the external audit. In other words, it might limit the external audit firm's liability to the period before there is any liability. Read more broadly, the external audit firm might be liable for losses that arise in subsequent years only if the firm continues to be engaged to audit the client's financial statements in those years.

*Example:* In the event the Financial Institution is dissatisfied with [the audit firm's] services, it is understood that [the audit firm's] liability, if any, arising from this engagement will be limited to any losses occurring during the periods covered by [the audit firm's] audit, and shall *not* include any losses occurring in later periods for which [the audit firm] is not engaged as auditors.

### 5. *"No Assignment or Transfer" Provision*

In this type of provision, the financial institution agrees that it will *not* assign or transfer any claim against the external audit firm to another party. This provision could limit the ability of another party to pursue a claim against the external auditor in a sale or merger of the financial institution, in a sale of certain assets or line of business of the financial institution, or in a supervisory merger or receivership of the financial institution. This provision may also prevent the financial institution from subrogating a claim against

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its external auditor to the financial institution's insurer under its directors' and officers' liability or other insurance coverage.

*Example:* The Financial Institution agrees that it will not, directly or indirectly, agree to assign or transfer any claim against [the audit firm] arising out of this engagement to anyone.

### 6. *"Knowing Misrepresentations by Management" Provision*

In this type of provision, the financial institution releases and indemnifies the external audit firm from any claims, liabilities, and costs attributable to any knowing misrepresentation by management.

*Example:* Because of the importance of oral and written management representations to an effective audit, the Financial Institution releases and indemnifies [the audit firm] and its personnel from any and all claims, liabilities, costs, and expenses attributable to any knowing misrepresentation by management.

### 7. *"Indemnification for Management Negligence" Provision*

In this type of provision, the financial institution agrees to protect the external auditor from third party claims arising from the external audit firm's failure to discover negligent conduct by management. It would also reinforce the defense of contributory negligence in cases in which the financial institution brings an action against its external auditor. In either case, the contractual defense would insulate the external audit firm from claims for damages even if the reason the external auditor failed to discover the negligent conduct was a failure to conduct the external audit in accordance with generally accepted audited standards or other applicable professional standards.

*Example:* The Financial Institution shall indemnify, hold harmless and defend [the audit firm] and its authorized agents, partners and employees from and against any and all claims, damages, demands, actions, costs and charges arising out of, or by reason of, the Financial Institution's negligent acts or failure to act hereunder.

### 8. *"Damages Not To Exceed Fees Paid" Provision*

In this type of provision, the financial institution agrees to limit the external auditor's liability to the amount of audit fees the financial institution paid the external

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auditor, regardless of the extent of damages. This may result in a substantial unrecoverable loss or cost to the financial institution.

*Example:* [The audit firm] shall not be liable for any claim for damages arising out of or in connection with any services provided herein to the Financial Institution in an amount greater than the amount of fees actually paid to [the audit firm] with respect to the services directly relating to and forming the basis of such claim.

**Note:** The Agencies also observed a similar provision that limited damages to a predetermined amount not related to fees paid.

### **Appendix B**

#### **SEC's Codification of Financial Reporting Policies, Section 602.02.f.i and the SEC's December 13, 2004, FAQ on Auditor Independence**

*Section 602.02.f.i—Indemnification by Client, 3 Fed. Sec. L. (CCH) ¶ 38,335, at 38,603–17 (2003):*

Inquiry was made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the Commission under the Securities Act or the Exchange Act would be considered independent if he had entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the filing of a registration statement with the Commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement, "from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act, as amended, or at 'common law,' other than for their willful misstatements or omissions."

When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other

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cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. Consequently, the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation. (Emphasis added.)

*U.S. Securities and Exchange Commission; Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions; Other Matters—Question 4 (Issued December 13, 2004):*

Q: Has there been any change in the Commission's long standing view (Financial Reporting Policies—Section 600—602.02.f.i. "Indemnification by Client") that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question?

A: No. When an accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, the accountant is not independent. Further, including in engagement letters a clause that a registrant would release, indemnify or hold harmless from any liability and costs resulting from knowing misrepresentations by management would also impair the firm's independence. (Emphasis added.)

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