

# INTERAGENCY ADVISORY ON THE UNSAFE AND UNSOUND USE OF LIMITATION OF LIABILITY 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 external auditors’ liability in audit engagements.

Limits on external auditors’ liability may weaken the external auditors’ objectivity, impartiality, and performance and, thus, reduce the Agencies’ ability to rely on Audits. Therefore, certain limitation of liability provisions (described in this Advisory and Appendix A) are unsafe and unsound. 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).

## SCOPE

This Advisory applies to engagement letters between financial institutions and external auditors with respect to financial statement audits, audits of internal control over financial reporting, and attestations on management’s assessment of internal control over financial reporting (collectively, “Audit” or “Audits”).

This Advisory does not apply to:

- Non-Audit services that may be performed by financial institutions’ external auditors;
- Audits of financial institutions’ 401K plans, pension plans, and other similar audits;
- Services performed by accountants who are not engaged to perform financial institutions’ Audits (e.g., outsourced internal audits, loan reviews); and
- Other service providers (e.g., software consultants, legal advisors).

While the Agencies have observed several types of limitation of liability 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

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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.

auditor's liability with respect to Audits in an unsafe and unsound manner.

## **BACKGROUND**

A properly conducted 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 is to form an opinion on the financial statements taken as a whole. When planning and performing the audit, the external 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. In addition, certain financial institutions are required to file audited financial statements and internal control audit/attestation reports with one or more of the Agencies. The Agencies encourage financial institutions not subject to mandatory audit requirements to voluntarily obtain 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 Federal Deposit Insurance Corporation (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 financial institution's audit. The engagement letter commonly describes the objective of the audit, the reports to be prepared, the responsibilities of management and the external auditor, and other significant arrangements (e.g., fees and billing). The Agencies encourage boards of directors, audit committees, and management to closely review all of the provisions in the audit engagement letter before agreeing to sign. As with all agreements that affect a financial institution's legal rights, legal counsel should carefully review audit engagement letters to help ensure that those charged with engaging the external auditor make a fully informed decision.

While the Agencies have not observed provisions that limit an external auditor's liability in the majority of external audit engagement letters reviewed, they have observed a significant increase in the types and frequency of these provisions. These provisions take many forms, making it impractical to provide an all-inclusive list. This Advisory describes the types of objectionable limitation of liability provisions and provides examples.<sup>3</sup>

Financial institutions' boards of directors, audit committees, and management should also be aware that certain insurance policies (such as error and omission policies

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<sup>2</sup> Published in the Federal Register on September 28, 1999 (64 FR 52319). 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.

and director and officer liability policies) might not cover losses arising from claims that are precluded by limitation of liability provisions.

## **LIMITATION OF LIABILITY PROVISIONS**

The provisions the Agencies deem unsafe and unsound 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, other than claims for punitive damages; or
- Limit the remedies available to the client financial institution, other than punitive damages.

Collectively, these categories of provisions are referred to in this Advisory as “limitation of liability provisions.”

Provisions that waive the right of financial institutions to seek punitive damages from their external auditor are not treated as unsafe and unsound under this Advisory. Nevertheless, agreements by clients to indemnify their auditors against any third party damage awards, including punitive damages, are deemed unsafe and unsound under this Advisory. To enhance transparency and market discipline, public financial institutions that agree to waive claims for punitive damages against their external auditors may want to disclose annually the nature of these arrangements in their proxy statements or other public reports.

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 Audits as part of their assessment of the safety and soundness of a financial institution.

In order for Audits to be effective, the external auditors must be independent in both fact and appearance, and must perform all necessary procedures to comply with

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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.

auditing and attestation standards established by either the AICPA or, if applicable, the PCAOB. When financial institutions execute agreements that limit the external auditors' liability, the external auditors' objectivity, impartiality, and performance may be weakened or compromised, and the usefulness of the Audits for safety and soundness purposes may be diminished.

By their very nature, limitation of liability provisions can remove or greatly weaken external auditors' objective and unbiased consideration of problems encountered in audit engagements and may diminish auditors' adherence to the standards of objectivity and impartiality required in the performance of Audits. The existence of such provisions in external audit engagement letters may lead to the use of less extensive or less thorough procedures than would otherwise be followed, thereby reducing the reliability of Audits. Accordingly, financial institutions should not enter into external audit arrangements that include unsafe and unsound limitation of liability provisions identified in this Advisory, regardless of (1) the size of the financial institution, (2) whether the financial institution is public or not, or (3) whether the external audit is required or voluntary.

## **AUDITOR INDEPENDENCE**

Currently, auditor independence standard-setters include the SEC, PCAOB, and AICPA. Depending upon the audit client, an external auditor is subject to the independence standards issued by one or more of these standard-setters. For all credit unions under the NCUA's regulations, and for other non-public financial institutions that are not required to have annual independent audits pursuant to either Part 363 of the FDIC's regulations or § 562.4 of the 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 either in Part 363 of the FDIC's regulations or in § 562.4 of the OTS's regulations, the external auditor should be in compliance with the AICPA's Code of Professional Conduct and meet the 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 staff 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

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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 accountants*.

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, certain limits on auditors' liability are already inappropriate in audit 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 (12 CFR 562.4) require to have annual independent audits.

In addition, certain of these limits on auditors' liability may violate the AICPA independence standards. Notwithstanding the potential applicability of auditor independence standards, the limitation of liability provisions discussed in this Advisory present safety and soundness concerns for all financial institution Audits.

#### **ALTERNATIVE DISPUTE RESOLUTION AGREEMENTS AND JURY TRIAL WAIVERS**

The Agencies have observed that some financial institutions have agreed in engagement letters to submit disputes over external audit services to mandatory and binding alternative dispute resolution, binding arbitration, other binding non-judicial dispute resolution processes (collectively, "mandatory ADR") or to waive the right to a jury trial. By agreeing *in advance* to submit disputes to mandatory ADR, financial institutions may waive the right to full discovery, limit appellate review, or limit or waive other rights and protections available in ordinary litigation proceedings.

The Agencies recognize that mandatory ADR procedures and jury trial waivers may be efficient and cost-effective tools for resolving disputes in some cases. Accordingly, the Agencies believe that mandatory ADR or waiver of jury trial provisions in external Audit engagement letters do not present safety and soundness concerns, provided that the engagement letters do not also incorporate limitation of liability provisions. The Agencies encourage institutions to carefully review mandatory ADR and jury trial provisions in engagement letters, as well as any agreements regarding rules of procedure, and to fully comprehend the ramifications of any agreement to waive any available remedies. Financial institutions should ensure that any mandatory ADR provisions in Audit engagement letters are commercially reasonable and:

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<sup>8</sup> In contrast to the SEC's position, AICPA Ethics Ruling 94 (ET §191.188-189) currently concludes that indemnification for "knowing misrepresentations by management" does *not* impair independence. On September 15, 2005, the AICPA published for comment its proposed interpretation of its auditor independence standards. In that proposal the AICPA specifically identified limitation of liability provisions that impair auditor independence under the AICPA's standards. Most of the provisions cited in this Advisory were deemed to impair independence in the AICPA's proposed interpretation. At this writing, the AICPA has not issued a final interpretation.

- Apply equally to all parties;
- Provide a fair process (e.g., neutral decision-makers and appropriate hearing procedures); and
- Are not imposed in a coercive manner.

## **CONCLUSION**

Financial institutions' boards of directors, audit committees, and management should not enter into any agreement that incorporates limitation of liability provisions with respect to Audits. In addition, financial institutions should document their business rationale for agreeing to any other provisions that limit their legal rights.

This Advisory applies to engagement letters executed on or after February 9, 2006. 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' 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 raises any safety and soundness concerns, and (2) the external auditor maintains appropriate independence regarding relationships with the financial institution under relevant professional standards. The Agencies may take appropriate supervisory action if unsafe and unsound limitation of liability provisions are included in external Audit engagement letters or other agreements related to Audits that are executed (accepted or agreed to by the financial institution) on or after February 9, 2006.

## APPENDIX A

### Examples of Unsafe and Unsound 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 Audits of any of the illustrative provisions (which do not represent an all-inclusive list) or any other language that would produce similar effects is 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 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 compensatory (incidental or consequential) damages claimed by the financial institution.

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

#### 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 could preclude any recovery at all. It appears that no claim of liability could be brought against the external audit firm until the external audit report is actually delivered. Under such a clause, any claim for liability thereafter might be precluded because the losses did not occur during the period covered by the external audit. In other words, it might limit the external audit firm's liability to a period before there could be 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 a 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 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 auditing 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 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 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 that 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.)