



# RESCINDED

OCC 2005-21

**Subject: Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters**  
**Date: May 10, 2005**

**To: Chief Executive Officers of All National Banks, Department and Division Heads, and All Examining Personnel**

**Description: Request for Comment**

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the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters" The purpose of the advisory is to alert financial institutions to the safety and soundness implications of provisions that limit the external auditor's liability in a financial statement audit. The guidance would apply to all financial institutions, regardless of size, whether or not the financial institution is a public company, or whether the external audit is required or voluntary.

All interested parties are invited to submit written comments to the FFIEC. All comments, which will be shared among the agencies, will be accepted on or before June 9.

For further information, please contact your OCC district accountant or the OCC's Chief Accountant's office at (202) 874-5180.

Zane D. Blackburn  
Chief Accountant

**Related Links**

- [Interagency Advisory 70 FR 24576](#)

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**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.

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**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](mailto: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.

**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 [terrill.garrison@frb.gov](mailto:terrill.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
- 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.

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:

##### **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

<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.

of financial statements 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. 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;
- 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 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 independence requirements and interpretations of the SEC and its staff.<sup>7</sup> In this regard, in a

<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.

<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.

<sup>7</sup>See FDIC Regulation 12 CFR Part 363, Appendix A—Guidelines and Interpretations; Guideline 14,

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, 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.

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 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.

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.

## 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.

#### 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 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 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 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.)

Dated: May 4, 2005.

**Tamara J. Wiseman,**  
*Executive Secretary, Federal Financial  
Institutions Examination Council.*

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