

Federal Reserve Bank of San Francisco
101 Market Street, San Francisco, California 94105

February 23, 2006

**BANKING SUPERVISION AND REGULATION:
EXTERNAL AUDITOR LIMITATION OF
LIABILITY PROVISIONS**

To State Member Banks, Bank
Holding Companies, U.S. Branches
and Agencies of Foreign Banks,
and Others Concerned,
in the Twelfth Federal Reserve District

**Federal Financial Regulatory Agencies Issue Interagency Advisory on External Auditor
Limitation of Liability Provisions**

The federal financial regulatory agencies have announced the issuance of a final advisory that addresses safety and soundness concerns that may arise when financial institutions agree to limit their external auditors' liability. The agencies' primary concern is that limiting the liability of external auditors in engagement letters may reduce the reliability of audits.

The *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters* informs financial institutions that they should not enter into external audit engagement letters that incorporate unsafe and unsound limitation of liability provisions with respect to audits of financial statements and internal control over financial reporting. Generally, this includes provisions that: (1) indemnify the external auditor against claims made by third parties (including punitive damages); (2) hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution; or (3) limit the remedies available to the client financial institution. The advisory does not treat provisions that waive the right of financial institutions to seek punitive damages against their external auditors as unsafe and unsound.

The advisory is effective for audit engagement letters executed on or after the date it is published in the Federal Register. The advisory does not apply to previously executed engagement letters. Nevertheless, the agencies encourage any financial institution subject to a multi-year audit engagement letter containing unsafe and unsound limitation of liability provisions to seek to amend its engagement letter to be consistent with the advisory for periods ending in 2007 or later.

The agencies may take appropriate supervisory action if unsafe and unsound limitation of liability provisions are included in external audit engagement letters executed on or after the date the advisory is published in the Federal Register. The advisory is attached and will be published in the Federal Register shortly.

Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's Internet site, at <http://www.frbsf.org/banking/letters>.

For additional information about the advisory, please contact our Banking Supervision and Regulation Department at (415) 974-3028.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Attachment: *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters*