



National Association of State Boards of Accountancy

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Via e-mail to: lsnyder@aicpa.org

Re: Proposal of Professional Ethics Division, Proposed Interpretation 501-8 Under Rule 501:
Failure to follow requirements of governmental bodies, commissions, or other regulatory
agencies on indemnification and limitation of liability agreements with a client.

To the Members of the Professional Ethics Executive Committee (PEEC):

We appreciate the opportunity to offer comments to the Professional Ethics Executive Committee (PEEC) of the American Institute of Certified Public Accountants (AICPA) on the Proposed Interpretation 501-8 (Proposal). The National Association of State Boards of Accountancy's (NASBA) goal is to increase the effectiveness of State Boards of Accountancy. In furtherance of that objective, our Regulatory Response Committee (Committee) offers the following comments on the Proposal.

The Proposal would add Section 501-8, "Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Agreements With a Client to the Acts Discreditable Section of the Code of Professional Conduct (Code) of the AICPA." The Proposal affects members that agree to provide audit or other attest services to clients.

The Code presently does not permit a member to enter into an indemnification agreement, except as provided by Ethics Ruling 94 on Independence, Integrity and Objectivity: Indemnification Clause in Engagement Letters (ET §191.94). This section provides that an engagement letter can include an indemnification clause for knowing misrepresentations by management. ET § 191.94 would not apply where such an agreement would violate the requirements of a governmental body, commission or other regulatory agency (collectively, a "Governmental Entity"). The Code presently does not permit a member to enter into any limitation of liability agreement. An

interpretation by PEEC of Section 101 would be required to cover such an agreement or to expand the scope of ET § 191.94. Any agreement providing for limitation of liability or indemnification, other than one permitted by ET § 191.94, would place a member in violation of the independence requirements of the Code as presently written and would subject the member to the disciplinary process of PEEC and boards of accountancy. A clear statement about what is presently prohibited by the Code should precede the proposal.

The Proposal provides that a member should not enter into an indemnification or limitation of liability agreement with a client if the agreement would place the client or the member in violation of the requirements of the governmental body, commission, or other regulatory agency (Governmental entity) to which they are subject. Failure to follow the provisions of Section 501-8 would cause the member to be considered to have committed an act discreditable to the profession. The Proposal also states that the member would be considered to have committed an act discreditable to the profession if such agreement would cause the member to be disqualified from providing audit or other attest services to the client.

The Proposal does not state that the entering into an indemnification or limitation of liability agreement that would violate the requirements of a Governmental Entity would also cause the member to not be independent of a client if an audit, or other attest service, was performed for the client. The Committee believes that the violation of independence should be specifically addressed when the final proposal is drafted.

The explanatory notes to the proposed section include commentary by PEEC on the results of a research project that it commissioned. PEEC has not published the research paper; consequently, the methodology used to perform the research, the conclusions reached and the adequacy and completeness of PEEC's interpretation of the results could not be properly evaluated by third parties, including the boards of accountancy of the states contacted. Of particular note to the Committee is PEEC's comment that the results of the research indicated that, "Of the state boards of accountancy *contacted*, [emphasis added] no state board rule or accountancy act provision permits or prohibits the use of indemnification and limitation of liability provisions." The proposal could stand without this reference as this "result" has no bearing on the proposed addition to Section 501.

The Committee is concerned that the "no state board" comment in the Proposal will unintentionally act as a green light to members and encourage them to include such provisions in current engagement letters. The Committee strongly urges PEEC to delete the above referenced result in the final proposal. Also, the Committee believes that no research "indications" should be used in the final proposal unless that research is published.

The Committee is not surprised by the commentary in the explanatory section of the Proposal that comment letters on the 2005 and 2006 exposure drafts contained "diverse views with no clear consensus amongst stakeholders" (see page 4 of the Proposal). However, the Committee would be surprised if stakeholders, other than CPAs, would not support the prohibition of indemnity and liability limitation agreements in engagement letters. The Committee suggests

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that the final proposal break out the general results of the comment letters by category of stakeholder.

The Proposal states that PEEC will continue to monitor auditor liability reform efforts and events on this subject and will consider what, if any, additional guidance may be appropriate. The Committee believes that the issue of auditor liability reform may be the subject of future legislative action in the United States and that guidance by PEEC might be helpful for its members after enactment of such legislation.

The Committee feels that the Proposed Section 501-8 with the changes proposed in this letter would be useful additions to the Acts Discreditable Section of the Code.

We hope these comments will assist PEEC in the furtherance of its work.

Sincerely,

A handwritten signature in black ink that reads "Samuel K. Cotterell". The signature is written in a cursive style with a prominent initial 'S'.

Samuel K. Cotterell, CPA
NASBA Chair

A handwritten signature in black ink that reads "David A. Costello". The signature is written in a cursive style with a prominent initial 'D'.

David A. Costello, CPA
NASBA President & CEO