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September 15, 2006

Nancy M. Morris, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting; File No. S7-11-06

Dear Sir or Madam:

The Independent Community Bankers of America (ICBA)<sup>1</sup> appreciates the opportunity to offer comments on the Securities and Exchange Commission Concept Release Concerning Management's Reports on Internal Control under Section 404 of the Sarbanes-Oxley Act. The SEC has published the Concept Release to request comment on the need for further guidance concerning management's evaluation and assessment of internal control over financial reporting.

### **ICBA's Position**

#### ***AS2 Should Provide a Clear Standard***

In the absence of any direct guidance from the SEC or the Public Company Accounting Oversight Board as to how to conduct an internal control assessment, management has been forced to rely on Auditing Standard No. 2 (AS2)<sup>2</sup> issued by the Public Company Accounting Oversight Board (PCAOB). Unfortunately, AS2 is so vague that it does not provide a clear enough internal control standard for issuers or auditors.

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<sup>1</sup>*The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

*With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than \$876 billion in assets \$692 billion in deposits, and more than \$589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at [www.icba.org](http://www.icba.org).*

<sup>2</sup>*An Audit of Internal Control Over Financial Reporting in Conjunction with an Audit of Financial Statements issued by the Public Company Accounting Oversight Board in March, 2004.*

**ICBA believes that the SEC and the PCAOB should revise AS2 to clarify many of its terms. For instance, AS2 should be clear as to what is considered “material” for an internal control audit so that excessive testing is curtailed and audit firms are comfortable enough with testing only essential functions that are directly related to financial reporting.** ICBA believes that “materiality” should be defined as a threshold amount or a formula so that both management and the auditors readily understand what needs to be covered.

ICBA supports the COMPETE Act<sup>3</sup>, introduced by Rep. Tom Feeney (R-Fla.), that directs the SEC and the PCAOB to use a 5% de minimus standard (e.g., 5% of profits) under AS2 for noting material weaknesses. The COMPETE Act also directs the SEC and PCAOB to clarify other terms used in AS2 such as “reasonable,” “significant,” and “sufficient.” It is important that these terms be clearly defined so that management understands its responsibility when it performs an internal controls assessment. We would also encourage the use of as many illustrative examples as possible when defining these terms. At the outset of an audit, management should also be able to meet with their auditors and mutually decide on what processes should be covered based on a clearly defined standard of what is “reasonable” or what is “material.”

We also suggest that the SEC identify in AS2 those entity-level controls that it will always consider material and relevant and give examples of entity and transaction-level controls that are not material. ICBA supports the idea of placing greater reliance on assuring that issuers have appropriate entity-level controls, along with management processes that assure these controls are effective.

We have heard from some community bankers that requesting advice from outside auditors or others can itself be construed as a “material weakness” by the outside audit firms. This position discourages companies from seeking expert advice on difficult internal control issues. AS2 should encourage issuers to seek advice and should clarify that seeking guidance will never be used as evidence of a “material weakness.”

### *AS2 Should be Scalable*

**ICBA recommends that the application of AS2 be tiered to the size and complexity of the institution, so that, for instance, the same amount and type of testing that is done at a large bank with numerous affiliates and subsidiaries is not done at a community bank.** An internal control audit of a community bank should not require the testing of records of 25% of a bank’s workforce or cover 100% of its processes. In the case of a community bank, auditors should be comfortable with testing only those processes that are essential to the reporting of financial results.

ICBA endorses the recommendations of the SEC Advisory Committee on Smaller Public Companies that called for Section 404 reforms that are “scaled” and “proportional” to the size of the company and the level of revenues. For those large banks with high revenues, AS2 should require increased internal controls to prevent fraud and other operational risks. For smaller banks with less complex systems, AS2 should require less internal controls including less documentation and testing. “Scalable” does not mean different standards or different levels of assurance. It does, however, mean acknowledging that what might be necessary for one company may not be required for another.

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<sup>3</sup> HR 5404, known as the “Competitive and Open Markets that Protect and Enhance the Treatment of Entrepreneurs Act.”

### *AS2 Must Be More Risk-Based*

Even though auditors maintain that they are taking a risk-based approach to the AS2 audit, the evidence from publicly held community banks appears to be that the implementation of AS2 has resulted in very rigid, prescriptive audits with auditors utilizing a “bottom–up” rather than a “top-down” approach. This is true even after the issuance of the May 2005 guidance from the PCAOB. The accounting profession and in particular the increasingly dominant Big Four accounting firms have adopted this approach without exception resulting in the continuation of high audit fees and internal costs for smaller public companies.

ICBA believes that AS2 should be a top-down, risk-based standard for internal controls. Under a revised AS2, auditors should not be so focused on the detail and sheer breath of the internal controls that there is little room for judgment and perspective over the overall process goals. Documentation and testing should be directed to those areas that pose the most risk and wherever possible, auditors should rely on the work of internal auditors. Prior to implementing AS2, the PCAOB should also conduct a pilot program to determine if the new standard is sufficiently risk-based and clear for management and audit firms.

### *ICBA Supports Exempting Smaller Public Companies from Section 404*

**While a risk-based and scalable AS2 would probably reduce some of the high costs of SOX Section 404, ICBA still believes that smaller public companies should be partially or fully exempted from Section 404 in order to be competitive with larger companies and foreign competition.** Even with a revised auditing standard, we believe that smaller public companies would still be subject to unnecessarily extensive auditing of detailed control processes under Section 404 by auditors excessively concerned about their liability and being second guessed by the PCAOB.

**ICBA strongly endorses the primary recommendations of the SEC’s Advisory Committee on Smaller Public Companies including (a) exempting micro-cap companies (with equity capitalizations of \$128 million or less) that have revenue of less than \$125 million from the internal control attestation requirements of SOX Section 404 and (b) exempting small-cap companies (with equity capitalizations of between \$128 million and \$787 million) that have revenue of less than \$250 million from the external audit requirements of SOX Section 404.** We agree with the Advisory Committee that with more limited resources, fewer internal personnel and less revenue with which to offset the costs of Section 404 compliance, both micro-cap and small-cap companies have been disproportionately impacted by the burdens associated with Section 404 compliance. We also agree that the benefits of documenting, testing and certifying the adequacy of internal controls, while of obvious importance for large companies, are of less value for micro-cap and small-cap companies, that rely to a greater degree on “tone at the top” and high-level monitoring controls, to influence accurate financial reporting.

The proportionately larger costs for smaller public companies to comply with Section 404 adversely affect their ability to compete with larger public companies and even with foreign competition. This reduction in the competitiveness of U.S. smaller public companies hurts their capital formation ability and, as a result, hurts the U.S. economy.

For community banks, Section 404 costs have been particularly significant. ICBA's 2005 survey of Section 404 costs for community banks revealed that the average community bank would spend during 2005 more than \$200,000 and devote over 2,000 internal staff hours to comply with Section 404.<sup>4</sup> These costs far outweigh the benefits for these small companies.

We also believe that the enhanced corporate governance controls proposed by the Advisory Committee will ensure that there are sufficient investor protections in place if smaller public companies become fully or partially exempted from SOX Section 404. These include (1) adherence to standards relating to audit committees in conformity with Rule 10A-3 under the Securities Exchange Act of 1934<sup>5</sup> and (2) the adoption of a code of ethics for all directors, officers and employees. It is also important to note that smaller public companies will still be subject to other SOX requirements even if they are fully or partially exempted from SOX Section 404 including the CEO and CFO certification requirements and the requirements to disclose all material weaknesses known to management, including those uncovered by the external auditor and reported to the audit committee.

## Conclusion

AS2 should be revised to provide a clearer, scalable and more risk-based standard for both management and auditors. The PCAOB should clarify terms used in AS2 such as "material," "reasonable" and "significant" and management should be encouraged to seek outside advice for difficult internal control questions. Internal controls should be "scaled" or "proportional" to the size and revenue of a company. Documentation and testing should be directed to those areas that pose the most risk and wherever possible, auditors should rely on the work of internal auditors. While a risk-based and scalable AS2 would probably reduce some of the high costs of SOX Section 404, ICBA still believes that smaller public companies should be partially or fully exempted from Section 404 in order to be competitive with larger companies and foreign competition.

ICBA appreciates the opportunity to comment on SEC's Concept Release. If you have any questions about our letter, please do not hesitate to contact me at 202-659-8111 or [Chris.Cole@icba.org](mailto:Chris.Cole@icba.org).

Sincerely,



Christopher Cole  
Regulatory Counsel

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<sup>4</sup> For a complete description of ICBA's Section 404 Survey of Community Banks, see ICBA's comment letter to the SEC dated March 31, 2005 concerning the formation and goals of the Advisory Committee.

<sup>5</sup> 15 U.S.C. 78a *et seq.*