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February 26, 2007

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100 F. Street, NE  
Washington, D.C. 20549-1090

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, D.C. 20006-2803

Re: SEC File Number S7-24-06 and PCAOB Rulemaking Docket Number 021

Ladies and Gentlemen:

The Independent Community Bankers of America (ICBA)<sup>1</sup> appreciates the opportunity to offer comments in connection with the SEC's guidance under Section 404 of the Sarbanes-Oxley Act ("SEC Guidance") and the PCAOB's proposed auditing statement, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would supersede Auditing Standard Number 2 (referred to hereafter as Auditing Standard No. 5 or "AS5").

### **ICBA's Position**

While the SEC guidance and proposed AS5 may curtail excessive testing of controls and reduce some of the unnecessary documentation required by SOX 404 audits, we still have doubts that it will reduce 404 audit costs, particularly for smaller public companies. ICBA recommends at

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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).*

least another one year delay in the Section 404 due dates for non-accelerated filers so that calendar year filers will have until the due date for their 2008 annual report to file their management internal control reports and the due date for their 2009 annual report to file the auditor's attestation report. The additional one year delay would give the SEC and the PCAOB an opportunity to evaluate the cost effectiveness of their controls on accelerated filers and would also give the non-accelerated filers that have no experience with Section 404 additional time to understand and apply the new guidance and establish a new internal control framework.

To indicate that it is serious about reducing costs, ICBA also believes that the SEC should propose a quantitative benchmark or goal for the new standard that is tied to a reduction in overall SOX 404 audit costs. ICBA's specific recommendations regarding AS5 and the SEC include (1) making the SEC Guidance more specific, (2) defining terms such as "material deficiency" more clearly and (3) eliminating the "principal evidence" provision in AS2. While a risk-based and scalable new standard may reduce some of the high costs of SOX Section 404, ICBA still advocates that smaller public companies should be partially or fully exempted from Section 404 in order to be competitive with larger companies and foreign competition.

### **General Comments Concerning AS5 and the SEC Guidance**

We commend the SEC and the PCAOB for its attempt to create a scalable, top-down approach for SOX 404 audits. As noted in the release for the SEC Guidance, the SEC Advisory Committee on Smaller Public Companies raised a number of concerns regarding the ability of smaller companies to comply cost-effectively with the requirements of SOX 404. Some of the concerns stemmed from the implementation of AS2 and the fact that auditors were engaged in excessive testing of controls and requiring unnecessary documentation to comply with SOX 404.

While the SEC guidance and proposed AS5 may curtail excessive testing of controls and reduce some of the unnecessary documentation required by SOX 404 audits, we still have doubts that it will reduce 404 audit costs, particularly for smaller public companies. We note, for instance, that AS5 has not been field tested so that there is no evidence to suggest that, despite the proposed standard's focus on scalability and risk-based testing, that auditors will significantly change their audit procedures or reduce the time they take to perform a 404 audit.

**ICBA recommends at least another one year delay in the Section 404 due dates for non-accelerated filers so that calendar year filers will have until the due date for their 2008 annual report to file their management internal control reports and the due date for their 2009 annual report to file the auditor's attestation report.** The one-year delay would accomplish several things. First, it would give the SEC and the PCAOB an opportunity to evaluate the cost effectiveness of their controls on accelerated filers. If, for instance, the SEC Guidance and AS5 have little impact on SOX 404 audit costs for the 2007 and 2008 accelerated filers, then the SEC and the PCAOB will have time to revise the guidance and the new standard before it is fully implemented by the non-accelerated filers. Second, a one-year delay would also give the non-accelerated filers that have no experience with Section 404 additional time to understand and apply the new guidance and establish a new internal control framework.

**ICBA also believes that the SEC and the PCAOB should propose a quantitative benchmark or goal for the new standard that is tied to a reduction in overall SOX 404 audit costs.** For instance, the SEC should state that the goal is to reduce average internal control audit costs by a certain percentage—say 20%—with a commitment that if the revised standard does not meet that goal, then the standard will be revised further. It is too ambiguous for the SEC or the PCAOB to state that the goal is to increase the “cost effectiveness of the 404 audit” or “to reduce unnecessary audit procedures” particularly when there has been no field testing of the new standard and therefore no assurance that it will have any impact. A specific benchmark or goal would convey to the industry that the SEC and the PCAOB is serious about reducing the overall costs of SOX 404 and is committed to achieving that goal.

ICBA has other specific recommendations with regard to the SEC guidance and AS5. These include the following:

### **The SEC Guidance Should Be More Specific**

The SEC states that the purpose of the new Guidance is not to prescribe any specific method or set of procedures for management to follow in performing its evaluation of internal controls. According to the SEC, this will give managers flexibility with regard to its evaluation. However, ICBA believes that the SEC Guidance is too broad and ambiguous. Since AS5 is more detailed and prescriptive, we are concerned that management will eventually turn to proposed AS5 as the guidebook for internal control evaluations and will eventually ignore the SEC Guidance altogether.

In the case of non-accelerated filers that have not begun their SOX 404 audits, the temptation will be for management to use the more specific and detailed AS5 for guidance rather than the SEC Guidance since it lays out more clearly what the auditors will expect in the way of an internal control framework. Over time, we predict that the SEC guidance will become less relevant to smaller public companies—exactly the scenario that the SEC wanted to avoid—and that management will rely more on their auditors to determine how a good internal control framework should be implemented.

**ICBA recommends that the SEC Guidance should be more specific and include more illustrations of how the guidance should be implemented particularly for smaller public companies.** For instance, AS5 indicates clearly how an auditor should assess a company’s control environment but the SEC Guidance only makes a passing reference to it and does not provide any specific evaluation criteria or any information on what constitutes a poor control environment. AS5 lists a number of specific factors for identifying significant accounts but the SEC Guidance has no parallel guidance for management and has few illustrations to help managers identify significant accounts. AS5 sets forth certain specific points for auditors to consider in evaluating the effectiveness of IT systems for smaller companies whereas the SEC Guidance has no such comparable discussion of IT systems.

ICBA also recommends that there be a closer alignment between the broad and principle-based SEC Guidance and the more prescriptive AS5. Both management and the auditors should be able to look to both documents for a consistent and detailed approach to assessing internal

controls. AS5 should focus on how to audit the company’s internal controls whereas the SEC Guidance should concentrate on how an internal control framework should be established. If both documents are closely aligned and are detailed enough for users, then we will avoid the problem of one becoming less relevant than the other.

### **Defined Terms Need to be Clearer**

While we agree that the SEC and the PCAOB have made some progress with clarifying some of the defined terms used in AS2, there is more room for improvement. Specifically, there is still confusion about what constitutes a “material weakness” and how management should identify material weaknesses. AS2 currently defines a material weakness as a control deficiency, or a combination of control deficiencies, that result in more than a remote likelihood that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected. In the proposed AS5 and SEC Guidance, the SEC and the PCAOB uses the same definition but substitutes “reasonable possibility” for “more than a remote chance.”

While “reasonable possibility” is clearer than “more than a remote chance” and possibly raises the threshold to some degree, the definition still requires management and the auditors to prove a negative—that no material weaknesses exist—as opposed to affirmatively proving the effectiveness of internal controls. This negative approach--proving that no material weaknesses exist--places an enormous burden on auditors and management who must attest to the internal control financial reporting and encourages them to be very conservative with their testing and documentation.

**ICBA believes that there should be a more precise definition of “material weakness” or “material deficiency” that is tied to the impact on a company’s earnings.** Last year, ICBA supported the COMPETE Act<sup>2</sup>, introduced by Rep. Tom Feeney (R-Fla.), that directed the SEC and the PCAOB to use a 5% de minimus standard (e.g., 5% of profits) under AS2 for noting material deficiency. Furthermore, if management and the auditors must prove the negative--that there are no “material deficiencies” in their internal controls--then there should be greater clarity as to how companies both large and small can achieve that goal. The guidance should also indicate at what point a combination of control deficiencies gives rise to a material weakness. Illustrations of different control deficiencies that rise to a material weakness would be useful. Both the SEC Guidance and AS5 should be clear enough so that management does not have to consult with their auditors every time there is an issue about a “material deficiency.”

There are other examples of defined terms that need to be clarified. For instance, the SEC Guidance indicates that management is required to assess whether a company’s internal controls are effective in providing “reasonable assurance” regarding the reliability of financial reporting. “Reasonable assurance” is defined as assurance that would “satisfy prudent officials in the conduct of their own affairs.” This definition is too vague. At a minimum, the SEC should provide illustrations so that companies have a clearer idea of what it means to be “reasonably assured.” As mentioned above, the guidance should be clear enough that management does not have to constantly refer to experts (i.e., an outside auditor) to understand the definitions.

<sup>2</sup> HR 5404, known as the “Competitive and Open Markets that Protect and Enhance the Treatment of Entrepreneurs Act.”

## **The “Principal Evidence” Provision in AS2 Should Be Eliminated**

ICBA commends the PCAOB for proposing a new auditing standard, *Considering and Using the Work of Others in an Audit*, which would replace AU section 322 and provide direction to auditors for using the work of others in both the audit of internal control reporting and the audit of the financial statements. We agree that a single, unified framework for the auditor’s use of the work of others would remove barriers to the integration of the internal control audit and the audit of financial statements. We understand that the new standard will replace the provisions in AS2 that dealt with using the working others.

We also applaud the PCAOB for eliminating (or not including in the new standard) the “principal evidence” provision in AS2 which required the auditor’s own work to provide the principal evidence for the auditor’s opinion. The “principal evidence” provision contributed to the high cost of SOX 404 audits because it was interpreted by many auditors to mean that under no circumstances could the auditor rely on the work of others. For instance, the work of internal auditors was often ignored by outside auditors because of the “principal evidence” provision in AS2.

**ICBA recommends that the proposed new standard and SEC Guidance also address the use of bank examination reports when considering the work of others in an audit of internal controls.** Bank examiners frequently check and report on internal controls as part of their safety and soundness examinations of financial institutions. These reports would provide valuable insight into a bank’s internal controls and are performed by highly competent and objective examiners. ICBA believes that bank examination reports would be useful evidence for management when conducting an evaluation of internal controls.

## **The SEC Guidance Should Provide a Clear Safe Harbor for Management**

As proposed, the SEC Guidance says that the proposed amendments to Rules 13a-15(c) and 15d-15(c) will make the SEC Guidance “similar” to a non-exclusive safe harbor. **ICBA recommends that the SEC provide a clear safe harbor for management under the Securities and Exchange Act of 1934 provided that management has complied with all aspects of the SEC Guidance.** A clear safe harbor would make it more likely that management will detect material weaknesses and disclose them since management will have some legal protection under the Exchange Act. Furthermore, management will be more likely to rely on its own interpretation of the guidance and not constantly seek advice from auditors.

The SEC rules contain a number of safe harbors that have been very successful, including Rule 144A under the Securities Act of 1933 which provides a safe harbor from registration for re-sales of privately placed securities to qualified institutional buyers and Regulation D, which is a safe harbor from registration for certain private placements of securities. In each case, these safe harbors have provided a clear way for parties to comply under the securities laws. The SEC should provide a clear safe harbor for management under the Exchange Act that provides legal protection similar to these other safe harbors.

## **Even With a Scalable AS5, ICBA Still Endorses a Small Company 404 Exemption**

ICBA commends the SEC and the PCAOB for its endorsement of a scalable approach to SOX 404 audits. Proposed AS5, for instance, does include a section on scalability that includes a description of the attributes of smaller, less-complex companies that make them different from larger and more complex companies. That section also includes a discussion of six areas of the audit that are often affected by the attributes of smaller, less-complex companies. For each of these areas, the proposed standard describes the principles the auditor should apply in order to obtain sufficient competent evidence in a reasonable manner. We understand that this part of the proposed AS5 will provide the foundation for planned guidance on auditing internal control in smaller companies to be issued later this year.

**While a risk-based and scalable new standard may 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>3</sup> These costs far outweigh the benefits for these small companies.

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<sup>3</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.

## Conclusion

Since proposed AS5 has not been field tested, ICBA recommends at least another one year delay in the Section 404 due dates for non-accelerated filers so that calendar year filers will have until the due date for their 2008 annual report to file their management internal control reports and the due date for their 2009 annual report to file the auditor's attestation report. To indicate that it is serious about reducing costs, ICBA also believes that the SEC should propose a quantitative benchmark or goal for the new standard that is tied to a reduction in overall SOX 404 audit costs. While a risk-based and scalable new standard may 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 offer comments in connection with the SEC's guidance under Section 404 of the Sarbanes-Oxley Act and the PCAOB's proposed auditing statement, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. 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