



April 1, 2005

Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, DC 20549-0609

Re: SEC Roundtable on Implementation of Sarbanes-Oxley  
Internal Control Provisions  
File No. 4-497

Dear Mr. Katz:

America's Community Bankers ("ACB")<sup>1</sup> is pleased to submit comments on the implementation of section 404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")<sup>2</sup> in connection with a public roundtable being held by the Securities and Exchange Commission ("SEC") on April 13. This issue is of great interest and concern to our members. ACB has received a good deal of information about section 404 implementation from our members and has continually brought this information to the attention of regulators.<sup>3</sup>

ACB and its public members appreciate the enormous benefits that can be achieved with a more focused approach to internal controls. Banking organizations with \$500 million or more in assets have been subject to internal control reporting and attestation requirements under banking law since 1991. The banking industry knows first hand how important an internal control requirement is to the safe and sound operation of a company. However, there is clear evidence that the implementation of the section 404 requirements is resulting in a good deal of unnecessary burden and costs, even for the banking institutions that already were subject to similar requirements under banking law. Much of the burden and costs are resulting from the requirements of Auditing Standard No. 2 issued by the Public Company Accounting Oversight Board ("PCAOB"). External auditors, fearing the consequences of improperly implementing

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<sup>1</sup> America's Community Bankers is the member-driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit [www.AmericasCommunityBankers.com](http://www.AmericasCommunityBankers.com).

<sup>2</sup> Pub. L. 107-204 (2002).

<sup>3</sup> See letter from Diane Casey-Landry, President of ACB, to William McDonough, Chairman of the Public Company Accounting Oversight Board, dated November 4, 2004, and letter from Diane Casey-Landry to Donald Powell, Chairman of the Federal Deposit Insurance Corporation, dated September 21, 2004. Both are available at [www.americascommunitybankers.com](http://www.americascommunitybankers.com).

this new standard, are approaching it in a very stringent and conservative manner further adding to the burden.

We appreciate the efforts of both the SEC and the PCAOB to explore the way in which the internal control requirements are being implemented and being open to issuing additional guidance or revising the requirements to reduce unnecessary burden. This letter provides examples of some of the implementation problems that ACB members have been reporting. We believe, however, that it would be useful for both the SEC and the PCAOB members to work through the implementation process with select public companies and public auditors to see first hand how a fairly straight-forward requirement in section 404 is resulting in a great deal of unnecessary and costly work on the part of both company management and public auditors.

This letter also contains a number of suggestions that are based on the comments we have received from members.

### **Burden and Cost Generally**

Many ACB community bank members are expressing serious concern that the cost of section 404 compliance will significantly outweigh the benefits of the resulting improvements in internal control processes and management's understanding of the effectiveness of these controls. In particular, they do not believe that the effort and expense resulting from additional certifications, documentation and testing requirements are commensurate with the risk from operations. In response to their regulatory and supervisory environment, these institutions are generally run more conservatively than companies in unregulated industries and the management teams typically have a very keen understanding of the risks facing the institutions and the controls in place to identify and manage those risks. In light of the noncomplex structure of the operations and business of many community banks, we believe that some of the costs, particularly the audit fee increases, are resulting from the reluctance of audit firms to exercise appropriate professional discretion in determining auditing scope for smaller, less complex companies. We believe this reluctance stems from the audit firms' reasonable fear that any exercise of discretion that results in an audit of appropriately limited scope may subject them to criticism or sanction by the PCAOB.

ACB is concerned that many community banks simply do not have the internal resources to meet the high threshold required by the PCAOB standard as it is being implemented by auditors. Banks in this position are facing significant external consulting costs, as well as increases in their auditing fees. There have been many published reports about the increase in auditing fees for all public companies, but the smaller companies are less capable of absorbing these costs. Some community banks are reporting audit and attestation fee estimates up to 75 percent higher than what they have paid in the past and some community banks are reporting total fees that equal up to 20 percent of net income. Our members also are facing a significant increase in legal fees associated with section 404. While we understand that companies will incur the most significant costs during the first year of section 404 compliance, there is strong evidence indicating that compliance costs will remain at a substantial level.

Those community banks who have gone through the 404 implementation process have not found material weaknesses, and any weaknesses that were found were insignificant. Some shareholder advocates will point to the companies that have found problems or that have not yet been able to report results as evidence of the need for the requirements. However, most of the problems brought to light to date seem relatively minor and would not result in significant financial statement reporting problems.

While a clean report may give investors additional comfort about the integrity of financial results, investors did not appear to be clamoring for more scrutiny and have comfort knowing that the banking industry is heavily regulated. Furthermore, the internal control requirements do not appear to be associated with the type of fraudulent activity that triggered the passage of Sarbanes-Oxley. For all of the costs being incurred by shareholders as companies implement section 404, there is no certainty that the corporate scandals of the past would have been prevented had 404 been in place earlier. There also is no certainty that they will not reoccur. The issue in those scandals was not internal controls, but fraudulent activity by management and “tone at the top.” At some point, most small companies will have to review whether the benefits of being a public company justify the cost to investors of compliance with the securities laws, including Sarbanes-Oxley. Many small companies already have made the choice to go private, including Sturgis Bancorp, Madison Bancshares, Home Financial Bancorp and Fidelity Federal Bancorp. Others are looking for merger partners.

The time devoted to section 404 compliance is taking time away from other matters. Executive officers must spend a great deal of time on the minutia required by the auditors at the expense of a focus on daily operations, long-term performance and strategic planning. Internal audit and other departments also are spending significant time with 404, taking away focus and efforts from other required activities. For example, we have heard reports that, in some instances, community banks have abandoned regular risk audits for this fiscal year to concentrate on 404 compliance. Also, compliance with 404 is adversely affecting the way companies are managed. Some members are indicating that they are being forced to centralize decision-making because the price to be paid for a problem or gap in an area would be too high. It is not in anyone’s best interest to have this requirement dictate corporate strategy or otherwise adversely affect the ability of companies to operate efficiently.

### **Documentation Requirement**

Community banks report that the level of documentation being required is unnecessarily intensive. As regulated banking institutions, they previously were required to have effective internal controls in place, which already required a substantial amount of documentation on their processes. However, the depth and breadth of the documentation being required and the number of controls needing documentation is much greater than what was required in the past. The external auditors are taking the position that if a policy, procedure or practice is not supported by a formal written policy, it does not exist and it is not being followed. Small banks sometimes utilize informal policies or procedures that are followed in practice, but these are ignored by the auditor if there is no formal narrative or flow charts walking someone through the operation. While this type of documentation is important for major processes, it seems to be an

overcompensating measure when auditors apply it to every single operation of the bank as is being done during the implementation of 404.

It would be helpful for the SEC and PCAOB members to perform field visits to gain a better, first-hand understanding of the actual documentation requirements being imposed on smaller public companies and see what is actually being required by the auditors. This type of review could help the SEC and PCAOB members better identify the changes that should be made to reduce the burden of this requirement.

### **Testing Requirement**

The testing requirement is probably the most costly aspect of Section 404 implementation and the cost that is likely to be most significant in future compliance efforts. The testing of controls is redundant in the sense that the same controls are tested internally, sometimes by different people within the company, and then again by auditors. For the banking industry, examiners may also test internal controls. When the PCAOB initially proposed Auditing Standard No. 2, the ability for auditors to rely on the work performed by others was severely circumscribed. That aspect of the proposal received a good deal of comment. The PCAOB tried to give some leeway in the final standard, but the language used in the standard has led to confusion in application. Although some community banks are reporting that the auditor relied on testing performed by internal audit to some extent, most of ACB's public members who responded reported that there was no reliance by the auditor on internal testing. This is especially unfortunate because banking institutions tend to have independent, competent and dedicated internal audit functions and the testing done by internal audit should receive a great deal of deference by the auditor.

There are also major concerns on the degree of testing being required. Requiring audit firms to test every control annually is unnecessary and excessive. The increased requirements on the testing of controls has placed an enormous strain on smaller companies that do not have the necessary internal resources to perform much of the testing work. Those companies will have to expend significant resources each year to hire third parties to do the testing. Even for some organizations that possess the internal resources to perform the testing, the breadth and depth of the requirement go beyond what should be required to construct reasonable, cost-efficient controls and takes focus away from other work that must be completed. Many of ACB's public members have had to hire additional internal audit staff for this reason.

### **Relationship with the Auditor**

Contentious relationships are developing between external auditors and senior management of community banks. As we indicated above, external auditors are reluctant to exercise discretion and limit the scope of their review for fear of criticism or sanction from the PCAOB. While this may have a perceived benefit of providing much needed regulation to govern the audit profession, ACB is extremely concerned about the problems this is causing. Because there is a clear lack of formal guidance to help external auditors exercise proper judgment, they are being overly conservative in their 404 implementation efforts and taking hard-line, abrupt positions

during the audit process. The auditor's conservative positions are requiring that controls for every transaction and activity of a bank be documented and tested. Additionally, auditors will no longer consult with management on accounting and internal control matters. Unlike in the past when auditors and bank management engaged in open and healthy dialogue, there is now more of an adversarial or confrontational relationship. Banks are being forced to proceed with little or no discourse with the auditor, then being told after the fact by the auditors that they did it wrong. This seems to promote a process that is doomed to fail.

Not only does this add to the costs being imposed on small businesses in obtaining outside counsel or hiring internal resources, it is leading to some institutions deciding against certain, legitimate and beneficial transactions. These banks are less likely to expend the resources when there is significant risk that the external auditor will not agree with the bank's position, whether obtained externally or determined internally.

We also want to address the resource issues at the public auditing firms. Some smaller companies are having trouble finding auditors and consultants willing to do the work because those firms are too busy with other clients. While that may ease up a bit now that the SEC has delayed implementation for non-accelerated filers, some auditing firms do not want to take on the liability of a smaller company. Some smaller companies have been asked by the larger audit firms to take their business to another firm, while others are finding that the audit firm cannot get the work done on time.

Busy auditors and fee increases are one thing, but those institutions that have, at least for now, accepted a doubling in their audit fees to maintain their longstanding audit relationships, are finding senior partners-in-charge replaced with junior staffers to perform the audit work. Many bank CEOs and CFOs have expressed concern and frustration that their staffs are training the external auditors during the audit process. Furthermore, this seriously reduces the confidence that bank management has in its external auditor review, even if the bank has the utmost confidence in its internal processes and financial statements. Their concern is that the external audit is forced upon them at enormous costs, with little or nothing gained as a result of the "junior staff" review being done by the external auditor. When bank management raises the matter with senior officials at the auditing firms, they are told that the firms' auditors are stretched thin. The banks are sometimes urged to retain a new firm.

Another issue we would like to bring to your attention is the disclaimer clauses that auditors are inserting in engagement letters. Many of these disclaimers absolve the auditor from anything other than gross negligence and even in those cases, limit damages to the fees paid. Bank regulators have discussed this issue and are working on a response that would prohibit auditors of regulated depository institutions from including these disclaimers in engagement letters. We believe that the SEC and the PCAOB should also review this issue with regard to other public companies. It is not appropriate for auditors to include these disclaimers, particularly in light of the substantial fees they are now collecting for their work.

### **Private FDICIA Banks**

An unfortunate consequence of the section 404 requirements is that provisions of Auditing Standard No. 2 are being inappropriately applied to private institutions. As you are aware, depository institutions with \$500 million or more in assets have been subject to internal control reporting and attestation requirements under Section 36 of the Federal Deposit Insurance Corporation Improvement Act (“FDICIA”) since 1991. Many of our members are reporting that their external auditor is applying Auditing Standard No. 2 in FDICIA engagements. At ACB’s request, the Federal Deposit Insurance Corporation (“FDIC”) issued a supervisory letter indicating that the attestation standard for FDICIA private banks was not changed by Sarbanes-Oxley and that AT 501 issued by the American Institution of Certified Public Accountants should govern FDICIA attestations. However, many privately held and mutual FDICIA banks continue to experience substantial audit fee increases coupled with serious strains on internal resources because some audit firms are still applying Auditing Standard No. 2 to the FDICIA banks.

This is not surprising since AT 501 is in the process of being revised and is rumored to be very similar to Auditing Standard No. 2. It also is understandable that auditors view the PCAOB standard as “best practices” for what is appropriate for all companies – private or public. This is a troubling development that we continue to discuss with the bank regulators. The PCAOB standard, as discussed above, is more extensive and intrusive than what the private FDICIA banks have experienced in the past. Even if regulators view the benefits as exceeding the significant costs of section 404 for public companies, it is hard to see how the benefits of applying Auditing Standard No. 2 could outweigh the enormous costs and burden to private banking institutions. These institutions are subject to stringent banking laws and regulations and regular examinations. They do not broadly seek funds from public investors so the consequences of an internal control problem are not nearly as severe. We continue to work with the bank regulators and public auditors in finding a solution to this problem.

### **Suggestions for Change**

*Audit Opinion on Internal Controls.* We believe that the PCAOB, in conjunction with the SEC, should re-assess the requirement for an audit of internal controls. When issuing Auditing Standard No. 2, the PCAOB adopted an expanded interpretation of the Sarbanes-Oxley requirements. Two sections of Sarbanes-Oxley address the attestation of management’s assessment of the internal control structure. Section 103(a)(2)(A) stipulates that the PCAOB develop an auditing standard that would require the external auditor to “*describe in each audit report the scope of the auditor’s testing of the internal control structure and procedures of the issuer, required by section 404(b)...*” Following this wording, Section 404(b) of Sarbanes-Oxley directs public company auditors to “*attest to, and report on, the assessment made by management.*” In contrast, Auditing Standard No. 2 requires a detailed integrated audit of internal control and financial statements and requires the auditor to opine directly on the effectiveness of internal controls.

Conducting a thorough and detailed review of how management reaches its conclusions about internal controls can be as effective, but considerably more efficient and less burdensome, than the required audit. Requiring an independent audit of internal control over financial reporting is

duplicative of work performed by a company's internal audit function and senior management and has resulted in the cost, burden and frustration arising from Auditing Standard No. 2. While additional guidance for auditors, as suggested later in this section, could reduce some of the unnecessary burden, we think it would be beneficial to at least consider a totally different approach. As we predicted when the audit requirement was initially proposed, public auditors are interpreting their responsibilities under the standard quite broadly and, in an effort to avoid future liability, are erring on the side of doing too much, rather than not doing enough.

We urge the PCAOB to rethink whether a separate audit of internal controls is really necessary and scale back these standards to a reasonable level of inquiry that allows an auditor to opine on the conclusions reached by management. There are other protections recently put in place that will protect the investing public and that make a more burdensome standard inappropriate. For instance, the chief executive officer and chief financial officer must certify each quarter as to the accuracy of the company's financial statements and their responsibility for establishing and maintaining internal controls.<sup>4</sup> They also must certify that the internal controls have been designed to provide reasonable assurance about the reliability of the financial statements and that they have evaluated the effectiveness of the internal controls. The certifications with regard to the accuracy of the financial statements are made under the threat of criminal liability if the officer knowingly makes a false certification. These new requirements coupled with a thorough review of management's assessment of the internal control environment by the external auditor should provide the protections needed by investors.

If the SEC and the PCAOB continue to believe that an audit is appropriate and necessary, we offer the following additional suggestions for making the requirement less burdensome.

*Documentation.* We urge the SEC and PCAOB to issue guidance reinforcing language in the framework adopted by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") that many controls are informal and undocumented, yet still exist, can be tested and evaluated, and can be highly effective. The presumption that if a control is not documented, it does not exist, must be changed.

*Testing.* This is the area where we believe additional guidance and changes to Auditing Standard No. 2 could significantly reduce the burden and cost on smaller companies. Particularly since the testing must be performed every year. More reliance on testing by internal audit and other competent personnel or third party consultants should be permitted and encouraged in clear and unambiguous language without any confusing ambiguity. The requirement that the auditor's own work provide the principal evidence for the auditor's opinion should be removed as this language leads to confusion over what is permitted. Guidance should also allow auditors to rotate the testing so not every control needs to be tested every year. A three-year interval for each control, other than the most significant controls, should be sufficient.

*Guidance for Auditors.* The SEC and the PCAOB should carefully review and evaluate the manner in which auditing firms are implementing the section 404 requirements and provide

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<sup>4</sup> Sections 302 and 906 of Sarbanes-Oxley; Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 57276 (Sept. 9, 2003).

corrective guidance where problems are found. Initial reports from community banks suggest that there is a significant amount of inconsistency and confusion regarding the level of work being required by auditors. Different approaches are generating inconsistency in the fee increases being imposed on community banks. The issue of insufficient staff at the external auditing firms raises the concern of whether the firms can adequately meet their auditing responsibilities. The lack of sufficient, qualified staff also discourages the firms from taking a more tailored and customized approach to auditing the smaller companies. Fear of second-guessing also plays a role, and the one-size-fits-all approach becomes the rule regardless of the size or complexity of the organization.

We understand that SEC staff advocates a private response to this problem, such as adoption by COSO of a more tailored internal control framework for small companies. However, in light of the strong oversight role played by the SEC and the PCAOB, together with the fact that the section 404 requirements are so new, we also look for leadership from the SEC and the PCAOB on this issue. Even if COSO does adopt a more tailored framework, that does not mean that auditors would change their approach to Auditing Standard No. 2 for the smaller companies without guidance from the PCAOB. Also, we suggest that appropriate guidance needs to be issued to reduce the burden on larger companies as well. It would be helpful if the PCAOB would evaluate the audit practices and provide guidance on more reasonable approaches.

It also would be helpful to have guidance on how much assistance the auditor can give on the front end without jeopardizing auditor independence. While some PCAOB members have been speaking out on this issue in public forums encouraging more communication between company management and public auditors, formal written guidance would be very useful.

*Relief for Banking Institutions.* We question the necessity of having the significant costs of section 404 compliance and Auditing Standard No. 2 imposed on an industry that is already heavily regulated and subject to routine examination by government regulators – often multiple agencies -- on a regular basis. Many of the new requirements for public companies under Sarbanes-Oxley are similar to the requirements imposed on banks for many years under FDICIA. However, the FDICIA institutions are still experiencing significant costs and burdens in meeting the new standards of the section 404 requirements and Auditing Standard No. 2. Many of these institutions are not convinced that their auditors have clearly explained what additional work is being required to warrant the tremendous fee increases.

Federal banking regulators recognized years ago that internal control reporting and attestation requirements for the smaller community banks would be unduly burdensome, so the requirements were applied only to those institutions with \$500 million or more in assets. Regulators felt comfortable with this approach since these smaller institutions are still subject to the full scope of banking laws and regulations, are required to have an adequate internal control structure in place, and, most importantly, are subject to regular safety and soundness examinations. Now, however, these smaller publicly held banks are facing additional significant burden in order to prepare for the application of Auditing Standard No. 2 by their external auditor. The fear is that these added costs could erode retained earnings and weaken capital adequacy, creating very real safety and soundness concerns. ACB believes that the SEC and the

PCAOB should recognize the substantial level of regulation and independent oversight of the banking industry and grant some appropriate relief.

We urge the SEC and the PCAOB to consider allowing regulated depository institutions to meet the Sarbanes-Oxley requirements by complying with the current approach to the internal control reporting and attestation requirements contained in federal banking law. ACB believes that the federal banking regulators, in close consultation with the SEC and PCAOB, are fully capable of evaluating whether the banking law standards need to be updated. If a full exemption is not deemed appropriate, we believe that, at a minimum, relief consistent with the FDICIA exemption for smaller community banks should be seriously considered. And, for the larger depository institutions, compliance with section 404 should then also constitute compliance with any related banking law requirement.

ACB appreciates the opportunity to comment on this important matter and is available to assist the SEC in any way we can to better understand the section 404 implementation issues. ACB remains committed to working with the SEC and the PCAOB to reach a workable solution for this important corporate governance and risk management requirement. If you have any questions, please contact the undersigned at (202) 857-3121 or via e-mail at [cbahin@acbankers.org](mailto:cbahin@acbankers.org), Diane Koonjy at (202) 857-3144 or via e-mail at [dkoonjy@acbankers.org](mailto:dkoonjy@acbankers.org), or Dennis Hild at (202) 857-3158 or via e-mail at [dhild@acbankers.org](mailto:dhild@acbankers.org).

Sincerely,



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Chief Accountant

Office of the Comptroller of the Currency