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May 8, 2006

Nancy M. Morris
Federal Advisory Committee Management Officer
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

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

Re: Internal Control Roundtable/File Number 4-511

Dear Sir or Madam:

The Independent Community Bankers of America (ICBA)¹ appreciates the opportunity to offer comments in connection with the SEC and PCAOB Internal Control Roundtable scheduled for May 10, 2006.

Summary of ICBA's Position

ICBA remains concerned about the disproportionate regulatory burden that publicly held community banks and holding companies and other smaller public companies face from Section 404 of the Sarbanes Oxley Act of 2002 or "SOX."² Unless something is done to ease that burden, the number of community banks going private will increase. ICBA strongly endorses the recommendations made by the SEC Advisory Committee on Smaller Public Companies³ for

¹*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.

² Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002)

³ See their Final Report to the Commission on www.sec.gov

reducing the costs of Section 404 on smaller public companies. More guidance needs to be issued by the PCAOB on what constitutes adequate internal controls and Auditing Standard No. 2 should be tiered to the size and complexity of the company.

Costs of Section 404 Remain Excessive

Even though some of our members that are accelerated SEC filers have indicated that the costs of complying with Section 404 of SOX have declined during 2005, ICBA remains deeply concerned about the burden that these costs have placed on publicly held community banks and holding companies. The costs of Section 404 on top of the enormous regulatory burden that community banks already face from the vast array of other types of regulation such as the anti-money laundering rules under the Bank Secrecy Act and the privacy rules under the Gramm-Leach-Bliley Act—to name two of the 129 regulations catalogued by banking regulators—have had a severe and disproportionate impact on the profitability and competitiveness of community banks. By providing funding and lending to households, businesses and municipalities, community banks play a vital role in the economic well being of countless individuals, neighborhoods, businesses, organizations and communities throughout the country. But that role is being threatened by the burden of regulations such as Section 404.

For instance, Mark Schroeder, President and Chief Executive Officer of German American Bancorp in Jasper, Indiana, recently testified before the House Small Business Committee that even though German American's Section 404 costs had dropped significantly last year, the bank holding company had still incurred \$350,000 in direct Section 404 costs and \$150,000 in indirect costs for 2005 and that these costs were likely to continue for the foreseeable future.⁴ For many community banks and holding companies, these Section 404 costs on top of other regulatory costs are becoming intolerable.

While the banking industry as a whole has been profitable particularly over the past five years, smaller community-based banks and thrifts, especially when confronted with increasing competition from a variety of fronts and growing regulatory and compliance costs, have not been nearly as profitable. As shown by FDIC statistics, many smaller institutions have significantly lower returns on assets (ROA) and returns on equity (ROE). The erosion of this profitability by regulations such as Section 404, which weigh more heavily on smaller banks that have a smaller asset base against which to spread the costs, is causing many community bankers to consider selling or merging. The loss of community-based financial institutions would be a great loss to local communities, but unless there is a drastic reversal of public policy and a reduction in regulatory burden, the community bank may very well go the way of the corner grocery store and the local hardware store.

For many publicly held community banks and holding companies, the immediate response to the high costs of SOX has been to “go private” and cease being registered SEC filers. Since the

⁴ See the testimony of Mark A. Schroeder, President and CEO of German American Bancorp, before the House Small Business Committee on May 3, 2006. Mr. Schroeder represented ICBA at the hearing concerning Sarbanes Oxley Section 404. German American has consolidated assets of about \$1 billion and is an accelerated filer.

beginning of 2003, over 75 community banks have filed to go private.⁵ The reasons cited in these filings uniformly include the increased legal and auditing “hard costs” and management/staff time “soft costs” associated with the Exchange Act, but unquestionably Section 404 compliance is the biggest concern. **Unless something is done to ease the burden of Section 404, the number of banks seeking to go private may turn into a flood.**

Auditing Standard No. 2 Should Be Tiered for Smaller Public Companies

Part of the problem with the high costs of SOX Section 404 is due to the fact that neither Auditing Standard No. 2 (AS2)⁶ nor any other source provides a clear definition or guide for management as to what constitutes adequate internal controls. Moreover, 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.

While a separate auditing standard for smaller public companies would probably reduce some of the high costs of SOX Section 404, ICBA 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 separate auditing standard, we believe that smaller public companies would still be subject to extensive auditing of detailed control processes under Section 404 by auditors excessively concerned about their liability and being second guessed by the PCAOB.

ICBA continues to believe that the PCAOB should issue additional guidance under AS2 on what should be considered “material” for an internal control audit. This guidance should be clear enough so that excessive testing would be curtailed and audit firms could be comfortable enough with testing only essential functions that are directly related to financial reporting. Furthermore, “materiality” should be defined as a threshold amount or a formula so that both management and the auditors understand what needs to be covered. Congressman Tom Feeney (R-Fla.) indicates that he will be introducing a bill shortly in the House of Representatives that would direct the PCAOB to clarify terms that are used in AS2 such as “material,” “reasonable,” “significant,” and “sufficient.” His bill would also require the PCAOB to use a “5% de minimus standard” for noting material weaknesses. At the outset of an audit, management should be able to meet with their auditors and mutually decide on what processes should be covered based on a clearly defined standard of “materiality.”

Furthermore, 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

⁵ This data on community banks going private was provided by the law firm of Powell Goldstein, LLP.

⁶ *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.

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 also believes that Section 404 does not require an independent audit of management's assessment of internal controls. The statute only requires the external auditor to "attest to and report on the assessment made by management of the issuer." Nevertheless, the PCAOB adopted an expanded interpretation of the statutory provisions by issuing AS2 that in turn requires a detailed integrated audit of internal controls and that further requires the external auditor to opine on the effectiveness of the internal controls. The elimination of the separate audit would significantly lessen the compliance burdens imposed by Section 404 without impairing any investor protections.

ICBA Endorses the SEC Advisory Committee's Recommendations

ICBA strongly endorses the recommendations made by the Advisory Committee on Smaller Public Companies for reducing the costs of SOX for those companies. **With the exception of its recommendation to amend SEC Rule 12g5-1 to interpret "held of record" to mean held by actual beneficial holders, ICBA endorses all of the recommendations made by the Advisory Committee.**

Among the Advisory Committee's primary recommendations, ICBA strongly endorses (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 Section 404 SOX 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 404.⁷ These costs far outweigh the benefits for these small companies. Furthermore, there has been little attempt by either the SEC or the PCAOB to tailor, or "scale" regulation to

⁷ 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.

address the disproportionate costs and burden that micro-cap and small-cap companies now experience.

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 (the “Exchange Act”)⁸ 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. Furthermore, if the SEC fully or partially exempted micro-cap and small-cap companies, only 6% of all public companies in the U.S. in terms of market capitalization would be affected.

As for the other primary recommendations made by the Advisory Committee, we strongly support (1) incorporating the scaled disclosure accommodations currently available to small business issuers under Regulation S-B into Regulation S-K and making them available to micro-cap companies, and (2) incorporating the scaled financial statement accommodations currently available to small business issuers under Regulation S-B into Regulation S-K or Regulation S-X and making them available to all micro-cap and small-cap companies. We are particularly pleased that the Advisory Committee has recommended that smaller public companies be required to file only two years of audited income statements. Eliminating the third year of audited income statements will reduce costs and simplify disclosure while not adversely impacting investor protection in any significant way.

ICBA also endorses all of the Advisory Committee’s secondary recommendations. However, we do have serious concerns about amending SEC Rule 12g5-1 to mean held by actual beneficial holders in lieu of “held of record.” If Rule 12g5-1 were amended, small public companies would be forced to make extensive inquiries of broker-dealers and banks that hold their stock in nominee name just to verify whether they are over or under the 500-shareholder threshold under Section 12 of the Exchange Act. Furthermore, in order to verify beneficial ownership, they would need to determine who has investment control and voting control in each instance where a stock holding is held by a trust, a family corporation or by an affiliated stockholder. Since it is much easier for smaller public companies to count the number of stockholders on their stockholder ledger than to determine and count beneficial owners, ICBA believes that amending Rule 12g5-1 is unnecessary and will just increase the regulatory burden on smaller public companies.

However, we do agree with the Advisory Committee’s recommendations that the SEC’s Office of Economic Analysis conduct a study to consider whether the 500-shareholder threshold under Section 12 of the Exchange Act should be modified or raised. This standard has not changed since 1964 and should be updated for inflation. ICBA recommends that the 500-shareholder requirement under Section 12 of the Exchange Act be increased to reflect the

⁸ 15 U.S.C. 78a *et seq.*

increased size of companies and the increased value of the dollar. ICBA also recommends that Sections 12(g)(4) and 15(d) of the Exchange Act also be updated so that the threshold for de-registration is increased from 300 shareholders to a higher number that reflects the size of small companies and the value of the dollar.

ICBA also strongly supports the Advisory Committee's recommendation to form a task force of SEC and banking regulators to consider ways to reduce duplicative regulatory reporting. Publicly held banks and holding companies file extensive quarterly call report information with the banking regulators including balance sheet and income statement information with very detailed schedules about each of their significant assets, liabilities and capital items. Call report information is often due at the same time that publicly held banks or holding companies are required to file their SEC Form 10-K and 10-Q information resulting in a major burden for them particularly at yearend. The task force should study how bank regulatory call reports can be synchronized with the SEC reports to eliminate duplicative reporting as well as the feasibility of the SEC extending incorporation by reference privileges to call report information filed by banks and bank holding companies.

Conclusion

ICBA remains concerned about the disproportionate regulatory burden that publicly held community banks and holding companies and other smaller public companies face from Section 404 of the Sarbanes Oxley Act of 2002. ICBA strongly endorses the recommendations made by the SEC Advisory Committee for reducing the costs of Section 404 on smaller public companies. AS2 should be tiered to the size and complexity of a company and the PCAOB should issue additional guidance under AS2 on what constitutes adequate internal controls.

ICBA appreciates the opportunity to offer comments in connection with the SEC and PCAOB Internal Control Roundtable scheduled for May 10, 2006. If you have any questions about our letter, please do not hesitate to contact me at 202-659-8111 or Chris.Cole@icba.org.

Sincerely,



Christopher Cole

Regulatory Counsel