America's Community Bankers Shaping Our Future

May 7, 2004

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

Re: Public Company Accounting Oversight Board; Notice of Filing of Proposed Rule on Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* PCAOB-2004-03; 69 FR 20672 (April 16, 2004)

Dear Mr. Katz:

America's Community Bankers ("ACB")[1] is pleased to comment on the proposed rule issued by the Public Company Accounting Oversight Board ("PCAOB") to establish standards for the audit of internal control over financial reporting.[2] The proposal was issued as required by sections 404(b) and 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").[3]

Sarbanes-Oxley was passed to strengthen public company corporate governance and financial disclosure in an effort to restore investor confidence in the public markets. To further the public interest in the preparation of complete and accurate public company audit reports, Sarbanes-Oxley mandated the creation of the PCAOB to oversee and regulate the public company auditing profession. The proposed standard would establish professional guidelines to govern the independent auditor's attestation of and reporting on management's assessment of the effectiveness of internal control over financial reporting.

ACB Position

The PCAOB issued a proposed standard for the audit of internal control over financial reporting for public comment in October of 2003. ACB filed comments on that proposal indicating concern about, among other things, the burden and expense of the proposal on community bank

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[1] ACB represents the nation's community banks. ACB members, whose aggregate assets total more than $1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.
[2] 69 Fed. Reg. 20672 (April 16, 2004).
[3] Pub. L. 107-204 (2002).

members that are public companies. We also were concerned about the burden on private community bank members that are required to obtain internal control attestations under banking law, believing that the PCAOB standard could also become the standard for these attestations as well.

We are pleased to see that the PCAOB addressed some of our concerns by reducing the burden of the walkthrough requirement and allowing the auditor more flexibility in using the work of company employees. We are particularly heartened by the PCAOB's clearly stated recognition of the cost and burden of the proposal, particularly on small and medium-sized companies. We encourage the PCAOB to be vigilant in monitoring the impact of the proposal to insure that costs of the audit are in line with the objectives of the standard.

Cost and Burden

Our main concern with the PCAOB's initial proposal was the cost and burden of the standards, particularly on small and medium-sized community banks. These banks would have found the extensive walkthrough requirements and limits on the reliance of the work of others to be prohibitively burdensome and costly. The proposed Appendix E that discussed the application of the standard to small and medium-sized businesses was not very useful. Some of these concerns were addressed through the narrowing of the walkthrough requirement, permitting more reliance on internal auditors, and replacement of Appendix E with a reference to the framework developed by the Committee of Sponsoring Organizations of the Treadway Commission.

Most importantly, however, we appreciate the substantial focus placed on the burden of the standard. In the PCAOB release of the audit standard at the March 9 public meeting, the PCAOB indicated that it would be vigilant in its inspections of accounting firms and conversations with issuers to see that the cost and expense of meeting the standard is not increased for its own sake. The PCAOB also indicated that it expects the auditor to exercise reasonable professional judgment in determining the extent of the audit and perform only those tests that are necessary to ascertain the effectiveness of a company's internal control. It further stated that the nature and extent of controls that are necessary depends, to a great extent, on the size and complexity of the company. Similar comments have been made by board members in public forums since the release of the revised standard. Since fear of liability may induce auditors to broadly interpret the audit requirements, particularly in the early years, we encourage the Board to closely monitor the impact on small and medium-sized businesses and make changes to the standard or issue clarifications if it finds that the auditors err on the side of doing too much in the audit of small and medium-sized companies.

We note that changes were made to the walkthrough requirements. The proposed standard included a requirement that the auditor perform a walkthrough for all of the company's significant processes. While acknowledging the benefit of this requirement to the overall audit, such a broad requirement would have resulted in significant expense. Under the revised proposal, auditors will not be forced to perform walkthroughs on such a large universe of transactions. Instead, the auditor can use judgment in considering risk and materiality to determine which transactions and events within a given significant process require a walkthrough.

Similarly, the PCAOB revised the restrictions on using the work of others. The proposal limited the use of testing performed by management and others in a number of areas, which would result in unnecessary cost and burden. We felt that auditors should be able to place a greater reliance on a company's internal auditors, particularly in the case of financial institutions. Banking law and regulation require that an insured depository institution have an internal audit function and that function is evaluated during safety and soundness examinations. The role of the internal auditor was acknowledged and enhanced in the revised proposal. The standard as now written would allow the auditor to exercise substantial judgment in deciding how much he or she can rely on the work of others. A particular list of restrictions has been replaced by a focus on the nature of the controls being tested and the competence and objectivity of the individuals performing the work.

Audit Committee Evaluation

We continue to believe that it is not appropriate for the auditor to evaluate the audit committee. It introduces a conflict of interest for the auditor and the committee at a time when Sarbanes-Oxley aims to reduce and eliminate, to the extent possible, conflicts that could result in the reporting of incomplete or inaccurate financial results. The PCAOB observed that conflict is, to some extent, inherent in the duties that society expects of auditors. But inherent conflicts have not been handled very well in the recent past by auditors, so the introduction of a conflict into the relationship between the audit committee and the auditor is unwise. If the audit committee has concerns about some aspects of the auditor's work or processes, it may consider how raising of the issue will be perceived by the auditor in the evaluation process before speaking up. The PCAOB did revise the proposal so that the evaluation is not a separate evaluation, but instead is part of the auditor's evaluation of the control environment. This is a positive step. Still, investors should not be encouraged to rely on the auditor's evaluation of the audit committee because of the conflicts created by this requirement. Investors in financial institutions instead should take comfort that the role of the audit committee is subject to examination by bank regulators.

ACB appreciates the opportunity to comment on this important matter. If you have any questions, please contact the undersigned at (202) 857-3121 or via e-mail at cbahin@acbankers.org, or Diane Koonjy at (202) 857-3144 or via e-mail at dkoonjy@acbankers.org.

Sincerely,

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