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April 1, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File Number 4-497, Roundtable on Implementation of Internal Control Reporting Provisions

Dear Mr. Katz,

The American Bankers Association (ABA) appreciates the willingness of the Securities and Exchange Commission (SEC) to hold a roundtable discussion on the implementation of Section 404 of the Sarbanes-Oxley Act of 2002 (the Act). The Chairman of the ABA's Accounting Committee, William J. Brunner, Chief Financial Officer of First Indiana Corporation, looks forward to representing the ABA at the April 13 roundtable. The ABA, on behalf of the more than 2 million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership — which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks — makes ABA the largest banking trade association in the country.

The ABA fully supports the establishment and use of strong internal controls, which are critical not only to provide users of financial statements with reasonable assurance about the integrity of financial statements, but also to provide management with a foundation for appropriately managing a company's risks. However, we are very concerned about the huge time and cost burdens associated with compliance, as well as business opportunity costs. The purpose of this letter is to share our concerns and to provide some solutions for your consideration.

The banking industry has had a significant amount of experience with management reporting on internal controls and auditor attestations, because the FDIC Improvement Act of 1991 (FDICIA) and the corresponding banking regulations have required similar reporting for banks with total assets of $500 million or more. Although representatives from the banking agencies have indicated that some individual institutions needed to improve their FDICIA processes during the Section 404 implementation, the banking industry has quality internal control processes and was well equipped to implement Section 404. Because of our industry's prior experience with management reporting, we

believe we are also qualified to provide useful feedback regarding the Section 404 process for your consideration. Many recommendations are provided in this letter; however, we strongly encourage the SEC to focus on the most important recommendations, which relate to: the impact on small companies, the unnecessary duplication of work, and the overly strict interpretations of the rules by the accounting firms.

ABA Concerns about Section 404

Our two main concerns are the costs of implementation for all banking institutions and the impact on community banks.

Costs of Implementation for All Banking Institutions

Many of our members believe that the Section 404 process has improved the awareness of internal controls, improved some employees' understanding of the important interplay between internal controls and risk management, and strengthened the audit process through more thorough audit procedures. At the same time, there is broad agreement among bankers that the Section 404 implementation process has gone too far with respect to costs and the level of detail required by the accounting firms when compared with these benefits. Too much management time and too many shareholder dollars are being consumed with a high level of detailed testing rather than spending the time and dollars providing products and services to customers.

Several recent surveys have confirmed that compliance with Section 404 is extremely costly for companies of all sizes. We will not re-hash all of the cost information in this letter, because it has been well publicized. However, we would like to provide two specific examples, because they clearly demonstrate the costs that bankers are facing.

Example 1

The fees for a bank with approximately $2 billion in total assets are as follows:

2003 audit fees for financial audit and FDICIA reporting:	$255,000
2004 engagement letter for financial audit and Section 404: (Note: There was agreement that this would likely be revised later in the year to reflect PCAOB's final rules.)	$258,000
2004 audit fees for financial audit, FDICIA, and Section 404	$433,000

As can be seen from the above, the final fee for 2004 was 70% more than the 2003 fee.

Example 2

The fees for a bank with approximately $1.5 billion in total assets are as follows:

2003 audit fees for financial audit and FDICIA reporting:	$193,000
2004 audit fees for financial audit, FDICIA, and Section 404:	$600,000
2005 expected fees for financial audit, FDICIA, and Section 404:	$700,000

For this bank, the 2004 fee was 211% more than its 2003 fee.

It should be noted that these costs exclude the internal costs related to the implementation and compliance with Section 404, and these banks had no material weaknesses to report in their SEC filings. Both banks prepared management reports and attestations under FDICIA (prior to the Sarbanes-Oxley Act of 2002); therefore, one could assume that the fee would have been higher if the bank had not been subject to FDICIA. These examples are consistent with information being reported to the ABA staff by ABA members and are not isolated instances.

Section 404 clearly expanded the focus on internal controls, driving into companies a fuller awareness of the culture of internal controls. However, for the banking industry, which has been reporting on internal controls under FDICIA, those incremental benefits generally do not outweigh the incremental costs. The incremental costs appear to be truly excessive, particularly when one considers the close relationship between the requirements of the Act (and the SEC regulations relating to Section 404) and FDICIA.

Impact on Community Banks

Community banks are simply being buried by the enormous volume of unnecessary paperwork and procedures being required in the Section 404 process. Many community banks are SEC registrants, and the "one size fits all" nature of the Section 404 process is so overwhelming that some have either de-listed or are considering de-listing. This is because their boards believe the costs of being an SEC registrant are outweighing the benefits (primarily due to current interpretations of Section 404). Community banks already spend much of their time on regulatory compliance required from banking regulators, and the additional time and cost of Section 404 is often difficult to justify to shareholders.

The ABA was contacted by the Government Accountability Office (GAO), as part of its due diligence, for its study of the impact of the Act on small businesses. We met with GAO and provided the staff with our views regarding the impact of Section 404 on community banks. One of the points we made was that many

small banks are being force to change accounting firms for their annual audits because of overpricing. Some community banks prefer using a particular firm because of its banking expertise or other factors, but the costs have become prohibitive. This is likely an unintended consequence of Section 404, which could, in fact, result in the use of a firm with less banking experience and a lower quality audit.

We believe the following comments from a community banker (approximately $140 million in total assets) frames the small banks' concerns very well: "For a bank this size, the SOX [Section] 404 documentation will require such excessive amounts of time of management and accounting staff that we will be very hard pressed to complete the regular work including year-end close, call reporting, regular SEC reporting, and working with independent auditors. As CFO of a bank this small, I am required to be very hands-on in accounting as well wearing many different hats…Our biggest problem now is manpower with expertise to do the job. We do not have the option to outsource due to the cost of doing so. But, the amount of work for us is as much as for a bank ten times our size."

ABA Suggested Solutions

We propose improving the efficiencies of Section 404 implementation by:

- Improving the rules – The ABA would like to work with the SEC and the Public Company Accounting Oversight Board (PCAOB) to streamline rules relating to Section 404 to eliminate processes that are unnecessary or duplicative.
- Improving the accounting firms' interpretations of the rules – The ABA would like to work with the SEC, PCAOB, and the accounting firms to achieve a more meaningful and targeted approach in the interpretation and application of the PCAOB's rules relating to Section 404.

We believe that guidance will be needed to achieve efficiency opportunities, and we strongly encourage the SEC and the PCAOB to use a public forum for providing further guidance. We request that the guidance not be delivered in speeches various conferences, because those events are not attended by all registrants, and speeches often include information on a variety of topics. Instead, providing information on the official websites of the SEC and PCAOB, with the information clearly labeled, would be very useful.

Improving the Rules

<u>SEC</u>

The ABA recommends that the SEC:

- Evaluate whether Section 404 as currently applied is fulfilling the purpose for which it was intended and consider whether the costs are excessive in light of the benefits achieved for certain types of industries and sizes of companies.
- Consider differentiating the rules for small businesses by making the rules less burdensome.
- Update the number of shareholders that currently trigger SEC registration requirements. A company is be deemed public if it is listed on a national securities exchange, traded on the NASDAQ or the OTC Bulletin Board, or has $10 million in assets and 500 shareholders. Since the 500 shareholder threshold has not been adjusted since its initial enactment in 1964, we propose updating this threshold to a level between 1,500 and 3,000 shareholders. Additionally, a company cannot seek to de-register until the number of outstanding shareholders drops below 300. We propose a corresponding update in the threshold for de-registration to a number of shareholders consistent with a new threshold registration number, somewhere in a range between 900 and 1,800 shareholders.
- Freeze the accelerated filing dates until the Section 404 procedures are more streamlined.
  - 10-K reporting: For this first year of Section 404 reporting, the SEC provided some relief to accelerated filers by freezing the existing 75-day deadline rather than requiring the new 60-day deadline. The 60-day deadline is too short, and companies should be given the full 75-day time frame to help ensure quality reporting.
  - 10-Q reporting: The SEC also provided some relief for quarterly reporting by requiring reporting within 40 days rather than the accelerated 30-day filing date. Although the requirements for Section 404 at quarter-end are not as in-depth as year-end (unless there are changes in controls), companies and their auditors must go through similar processes at quarter-end and year-end. The 30-day time frame will be too short for some companies, and we suggest that the SEC continue to use the 40-day window at this time.
- Consider a 90-day window (prior to a company's fiscal year-end) during which a company could establish its "as of" assessment date. Closing procedures are generally the same for third quarter and fourth quarter, and this could ease some of the overload for staffing by the accounting firms and for year-end work by banks. We recognize that the law specifies the "as of" date; however, additional rollforward procedures relating to significant changes could be required in order to continue to ensure compliance with the law. This could be extremely useful to companies, which are extremely busy at year-end, and to audit firms, which seem to be thinly staffed at year-end.

PCAOB

For the purpose of reporting on internal controls by management and the related attestations by auditors, the requirements of FDICIA and the Sarbanes-Oxley Act are virtually identical. Similarly, the regulations that implement those laws (FDIC 12 CFR Part 363 and SEC Release No. 33-2838) are also virtually identical (the most significant differences are: the definition of the reporting entity, the requirements relating to material weaknesses, and certain quarterly procedures). These similarities were not included in these laws and regulations by mistake. As noted in the SEC's final regulations, the SEC and banking regulators coordinated "to eliminate, to the extent possible, any unnecessary duplication…"

The similarities between FDICIA implementation and Section 404 implementation (aside from the definition of the reporting entity) diverge under the rules issued by the PCAOB. When the PCAOB developed its new auditing standard, Auditing Standard No. 2 - "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements" (AS 2), for use by auditors in providing the attestations required by Section 404, it expanded certain requirements.

ABA's suggestions for the PCAOB are as follows:

- PCAOB should focus on how to reduce unnecessary duplication.
  - Attestations should be required rather than attestations plus audits of internal controls. Section 404 requires an attestation by external auditors on management's assessment of internal controls, but AS 2 requires an additional stand-alone opinion by auditors on internal controls. The PCAOB appears to have based its decision to require audits (AS 2, paragraphs E15-E16) on Section 103(a) of the Act, which is a section that describes rules to be established by the PCAOB. However, we do not believe that Section 103(a) requires audits; instead, Section 404 clearly states that attestations—not audits of internal controls—are required in the reporting process. We agree with the definition of an attestation in the introduction to the proposed version of AS 2, which states that: "An attestation, in a general sense, is an expert's communication of a conclusion about the reliability of someone else's assertion." This is what we believe is required by the Act and FDICIA, and we believe that the PCAOB should require attestations rather than attestations and audits. The requirement for attestations plus audits of internal controls results in auditors' re-testing management's testing of internal controls (for the attestations) and then performing new tests of those same areas (for the audits of internal controls). This results in unnecessary duplication of effort and cost with little corresponding benefit.
  - The ABA recommends that the PCAOB leverage, to the greatest extent appropriate, the work of internal auditors and others in order to reduce duplicate testing. The ABA would like to work with the PCAOB to consider how to best make use of the work of internal auditors by external

auditors under the existing rules. We believe that increased communication between the PCAOB and the accounting firms, possibly through further use of authoritative questions and answers, could resolve some of the problems. It appears that at least two areas need attention: (1) clarifying the appropriate degree of reliance on the work of internal auditors; and, (2) clearer guidance as to what is meant by the requirement that auditors use principal evidence.

  - Reliance on internal auditors. Much of the work done by internal audit is routine, based on routine transactions, and the current interpretation of AS 2 is resulting in unnecessary duplication. One result of the Act is the enhancement of the quality, independence, and reporting relationship of the internal audit function. If the quality of the internal audit function within a company is deemed to be reliable, there is little reason why the external auditor must duplicate so much work.
  - Principal evidence. The use of the term "principal evidence" (AS 2, paragraphs 108-111 and 116) may be the source of a significant amount of the unnecessary duplication that is being done. Paragraph 108 states that: "the auditor must perform enough of the work himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion." Even though AS 2 describes this within the section of the rule that permits a certain degree of reliance on the work of internal auditors, it is being translated by some auditors as requiring that nearly the entire amount of work be original work performed by the auditor. This is effectively requiring a higher level of audit certainty than financial statement audits, and is not what is intended by the Act. It is a primary contributing factor to the escalation of costs. Within a context of adequate verification, there can be more reliance on management's assessment and internal audit work.

- PCAOB should re-examine other restrictions on information that independent accountants can use to assess the internal control structure.
  - The detail level of testing is extensive and redundant. PCAOB should evaluate and provide public guidance on how much testing the external auditors must perform.
  - Auditors should be able to consider other compensating controls that are not included in the internal controls flowcharts, including risk management practices. The PCAOB rules are being implemented on an excessively detailed level, described as: check the checker to check the checker to check the checker to make sure financial statements are being typed correctly. A very prescriptive approach is being used, focusing, for example, on the mechanical process of locating a signature or a set of initials (indicating a manager's review of a control) and ignoring some of the broader and more important company practices. Risk management practices, many hours of internal audit testing, many dollars spent on banking regulatory examinations, etc., are not being considered. Auditors should be able to consider business processes in place that control risks that are beyond the flowcharts. Further, we request that the PCAOB state that

there is no presumption that a control does not exist simply because it is not documented.
    - Auditors should be able to rely on analytics as opposed to relying only on a demonstration of a control. For example, if delinquency levels and loan charge-offs are acceptable, the auditor could reduce or eliminate detail testing of collection histories, etc. In many cases, analytical reviews provide more information about how risk is controlled than does sample testing.

- Materiality needs to be defined better, possibly as an amount that would result in the need to restate earnings. We recognize that this is a difficult task; however, more consistency is needed.
  - Accounting firms are using ranges that may or may not be material. In some cases, the percentage appears to be low for reporting to the audit committee, especially if it relates to a small line item.
  - Materiality with respect to deficiencies generally appears to be within a 3-5% range (3-5% percent of pre-tax earnings for income statement purposes; 3-5% of total assets for balance sheet purposes). However, this range is not being consistently applied. The definition may need to include other issues, such as whether the amount in question places the company in an inappropriate capital position, whether it would have an impact on debt covenants, etc.
  - PCAOB should reconsider how or whether the SEC's Staff Accounting Bulleting No. 99 applies with respect to materiality (AS 2, paragraphs 22-23 state that "the same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting…"). It is our understanding that an internal control deficiency that results in as little as a one to two cent change in the earnings per share for a large company (with a high per share value) is being considered as a significant deficiency.
- The definitions of control deficiencies (significant deficiencies and material weaknesses) need to be revised. For example, evaluating the significance of a deficiency is initially evaluated by determining: "The likelihood that a deficiency, or a combination of deficiencies, *could* result in a misstatement of an account balance or disclosure…" (AS 2, paragraph 131; emphasis added). The definitions lack meaning because "could" is very broad, and too much energy is expended on deficiencies that do not have a true financial impact on investors.
- The extent of documentary evidence should be reviewed and revised. Relying solely on signatures/signoffs as the only evidence that a control is in place (the notion that if the control is not documented, it is not in place) is inadequate. Oversight or failure to document a signature on a report to support management's review happens and does not directly correlate to invalid financials. The signoff focus also leads to expending too much energy on form over substantive control work. It should be noted that AS 2 (paragraph 97) describes the reverse situation: when a signature exists, the auditor still may need to check perform additional procedures. We believe that the reverse should also be true: if a signature does not exist, this does not necessarily mean the control is not in place.

- SAS 70 report "as of" dates should be reconsidered. External auditors require financial institutions to obtain SAS 70 reports from their service providers that extend to December 31 of the current year. Obviously, the service providers cannot provide these reports until after year-end, as their own external auditors cannot produce them until February or later. It would be preferable for external auditors to require that service provider controls be monitored annually without mandating the December 31 date. This issue is even more onerous for a company whose fiscal year-end is prior to December 31, because the SAS 70 reports were not available until December and auditors would not release their signed opinion and consents until after the SAS 70 reports were received and reviewed by them. It should be noted that AS 2 (paragraphs B25-B28 and PCAOB Staff Q&A No. 25) describe the procedures required if a significant period of time has elapsed between the "as of" date in the SAS 70 report and a company's year-end. However, this may not be operating effectively in practice.
- There should be an assessment of whether current body of talent in the audit firms can keep pace with the new workload. Due to the focus on controls as of year-end, along with the financial statement audit staffing required at year-end, the work force availability has been reduced.
- The PCAOB should consider establishing a reasonable scope of financial statement and disclosure coverage. Some accounting firms expect coverage in excess of 80 percent of the balance sheet and income statement and financial disclosures, which seems excessive.

Improving the Accounting Firms' Interpretations of the Rules

We believe that a major component of the costs relating to Section 404 is the accounting firms' interpretations of the rules.

ABA's suggestions are as follows:

- The accounting firms' terror of the PCAOB must be replaced. Aside from the duplication of work as described in an earlier section of this letter, this appears to be the most significant cost relating to the application of Section 404. Although a high level of respect is healthy, the ABA believes the pendulum has swung too far and may well be counterproductive. While it is clear the PCAOB needed to establish tough, yet reasonable, standards for accounting firms to follow, ABA is concerned that the PCAOB may have underestimated the reaction by the accounting firms. This must be addressed in order to bring reasonableness back to the process.
- In situations where the PCAOB's rules provide a certain level of flexibility, which we believe is appropriate, the accounting firms appear to be ignoring the flexible nature of the rules and applying only the most stringent interpretations. Many companies believe that these decisions are being made by the risk managers within the firms rather than audit practice staff, and those risk managers are aiming for absolute assurance rather than reasonable assurance (reasonable assurance that is required under AS 2). In a November 24, 2004 Wall Street Journal article, Holman W. Jenkins Jr. wrote: "…each

of the Big Four is free pretty much to interpret Section 404 by its own whimsical lights, acting as judge and jury, with the accountants' dominant incentive being to protect their own posteriors with paperwork lest they be targeted in a shareholder lawsuit next time one of their clients goes bust." This is obviously strong language, but we believe that it reflects the perception in the marketplace and represents a major component of the costs. We believe it would be useful for the firms to reconsider their approaches and to develop a more reasoned application of the rules.

- The accounting firms appear to be testing for attestation purposes and then re-testing the same work for the audit of internal controls. We believe that this is not necessary, according to the PCAOB's release relating to AS 2 (PCAOB Release No. 2004-001, March 9, 2004, page 11):

  > "The natural starting place for the audit of a company's internal control over financial reporting is management's assessment. By evaluating management's assessment, an auditor can have confidence that management has a basis for expressing its conclusion on the effectiveness of internal control. Such an evaluation also provides information that will help the auditor understand the company's internal control, helps the auditor plan the work necessary to complete the audit, and provides some of the evidence the auditor will use to support his or her opinion.
  >
  > The work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work the independent auditor will need to perform. Auditing Standard No. 2 allows the auditor to use, to a reasonable degree, the work performed by others. The more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.
  >
  > Also, the more clearly management documents its internal control over financial reporting, the process used to assess the effectiveness of the internal control, and the results of that process, the easier it will be for the auditor to understand the internal control, confirm that understanding, evaluate management's assessment, and plan and perform the audit of internal control over financial reporting. This too should translate into reduced professional fees for the audit of internal control over financial reporting."

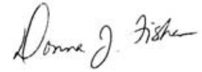
- The role of external auditors needs to be returned to a trusted – albeit arms-length – advisor role. Although the Act clearly increases the tension between an auditor's role as both an advisor and independent examiner, it appears that the role of external auditors may have shifted too far with respect to independence from management. We believe there are at least two reasons for this: (1) the new reporting relationship between the auditor and the audit committee, and (2) the rules relating to auditor independence. In the past, auditors have been a good source of recommendations for improvements to management. However, in the current environment, this appears to have shifted heavily toward enforcement, with the almost complete loss of the auditor as a valued advisor to management. Further, some audit firms

continue to believe that: (1) if the company asks the external auditors a question about the accounting for a particular transaction, it may be viewed as a significant deficiency and a strong indicator of a material weakness (even though this does not seem to be required under PCAOB Staff Q&A No. Q.7.); and, (2) draft financial statements should not be shared with external auditors, because if early drafting errors are identified by the auditors (even if purely mechanical), such errors can be cited as control deficiencies. We recognize that the PCAOB has attempted to address some of these concerns; however, it does not seem to be clear to some auditors.

- External auditors should re-evaluate the frequency of contact with audit committees, and should consider whether the issues being presented to the audit committees are significant enough to require their attention. For example, it is our understanding that: (1) minor disagreements between audit firm and company are being reported to the audit committee, (2) insignificant errors are being reported, (3) payments of relatively small fees are being required to be pre-approved, and (4) minor issues are being discussed with audit committees. This is not a wise use of the audit committee's time and distracts the committee from more important issues. It also slows the business processes for the company, due to preparation and explanation of the issues with the audit committee.
- The information technology (IT) emphasis has been interpreted too broadly by external auditors. Specifically, it appears that auditors are struggling to clearly define for their clients the appropriate level of IT controls documentation to achieve the intended scope and focus of Section 404 (i.e., financial reporting and disclosure). A company's IT approach should, for Section 404 purposes, remain focused on significant applications truly critical to the accurate reporting and presentation of financial data. The accounting firms also appear to have a significant staffing shortage in this area.
- SAS 70 Reports. Some auditors believe that a company cannot rely on a SAS 70 report if that report is prepared by the company's audit firm. However, SEC's Q&A Question 14 permits reliance.
- Accounting firms need further staffing and education on the Section 404 process, with particular emphasis on IT. In some cases, a significant amount of time was wasted during the Section 404 process due to disjointed approaches by the audit firm, poor timing, lack of knowledge, and having to check with their national offices before making even minor decisions. (It should be noted that the NASDAQ survey, March 2, 2005, found that 70% of respondents said the accounting industry does not have sufficient adequately trained audit staff to work on Sarbanes-Oxley.) We recommend that the accounting firms evaluate whether this is simply a problem relating to the initial implementation of Section 404 or whether it will be a problem next year as well.

Thank you for your consideration of our views. If you would like to discuss this letter in more detail, please contact me at 202-663-5318.

Sincerely,



Donna J. Fisher

cc: Mr. William McDonough, Chairman, PCAOB