



INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

TERRY J. JORDE
Chairman
JAMES P. GHIGLIERI, JR.
Chairman-Elect
CYNTHIA BLANKENSHIP
Vice Chairman
KEN PARSONS, SR.
Treasurer
ROBERT C. FRICKE
Secretary
DAVID E. HAYES
Immediate Past Chairman

CAMDEN R. FINE
President and CEO

July 12, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File Number PCAOB-2007-02

Dear Ms. Morris:

The Independent Community Bankers of America (ICBA)¹ appreciates the opportunity to offer comments in connection with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*, hereinafter referred to as "AS5." This new auditing standard will supersede Auditing Standard No. 2 and will provide guidance to auditors when performing an internal control audit pursuant to Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX 404).

ICBA Supports Delaying SOX 404 for Small Filers

As we stated in our previous letter to the SEC when AS5 was first proposed and in our recent statement to the House Committee on Small Business², while AS5 may curtail excessive testing of controls and reduce some of the unnecessary documentation required by SOX 404 audits, ICBA still has doubts that it will reduce SOX 404 audit costs, particularly for smaller public companies. Since AS5 has not been field tested, there is no evidence to suggest, 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.

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 See ICBA's letter dated February 26, 2007 to the SEC and the PCAOB and ICBA's Statement to the United States House of Representatives Committee on Small Business dated June 5, 2007, which is attached.

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 effectiveness of their efforts to reduce unnecessary SOX 404 costs 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 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 are serious about reducing the overall costs of SOX 404 and are committed to achieving that goal.

With respect to quantitative benchmarks, we note that the SEC still has not responded to the request by the House Committee on Small Business for additional information on the cost impact of Section 404 on non-accelerated filers. We agree with the Committee that the SEC should collect SOX 404 compliance cost data next year from the accelerated filers to see if AS5 has reduced the costs of a 404 audit. **As mentioned above, ICBA believes that the SEC should reassess AS5 and the implementation schedule for non-accelerated filers if the compliance cost data indicates that AS5 has not had a significant effect (e.g., 20% or greater reduction) on overall audit costs.**

With respect to our specific comments about AS5, we have attached a copy of our Statement to the House Small Business Committee on AS5.

Conclusion

While we commend the SEC and the PCAOB for their efforts to create a scalable, top-down approach for SOX 404 audits, we still have doubts that AS5 will reduce 404 audit costs, particularly for smaller public companies. 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. We agree with the House Small Business Committee that the SEC should collect SOX 404 compliance cost data next year

from the accelerated filers to see if AS5 has reduced the costs of a 404 audit and reassess AS5 and the non-accelerated filer implementation schedule if costs are not significantly reduced.

ICBA appreciates the opportunity to offer comments in connection with AS5. 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,

A handwritten signature in black ink that reads "Christopher Cole". The signature is written in a cursive, slightly slanted style.

Christopher Cole
Regulatory Counsel



**Statement on behalf of the
Independent Community Bankers of America
Washington, DC**

**Sarbanes-Oxley Section 404: Will the SEC's and
PCAOB's New Standards Lower Compliance Costs for
Small Companies?**

**United States House of Representatives
Committee on Small Business**

June 5, 2007

The Independent Community Bankers of America (ICBA)¹ appreciates the opportunity to offer this statement before the House Small Business Committee concerning the impact that the new guidance and standard under Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) will have on small business. Section 404 requires publicly held companies to include an assessment by management of the effectiveness of a company's financial controls and procedures in their annual reports and to have the company's auditor attest to the effectiveness of the company's internal controls and procedures.

Approximately two weeks ago, the Securities and Exchange Commission (SEC) approved new guidance for management under SOX Section 404(a) (the "SEC Guidance"). At the same time, the Public Company Accounting Oversight Board (PCAOB) approved a new internal control auditing standard under SOX Section 404(b), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (referred to hereafter as Auditing Standard No. 5 or "AS5"), that would supersede Auditing Standard Number 2. The purpose of both the SEC Guidance and AS5 is to (1) clarify the requirements of SOX Section 404(a) for management and (2) simplify and scale the internal control audit required by Section 404(b) so that outside auditors would focus on those matters most important to internal control.

Summary of ICBA's Position

- While the SEC Guidance and AS5 may curtail excessive testing of controls and reduce some of the unnecessary documentation required by SOX 404 audits, ICBA still has doubts that it will reduce 404 audit costs, particularly for smaller public companies.
- ICBA is disappointed that the SEC did not adopt our recommendation to delay by one year the Section 404 due dates for non-accelerated filers so that they would 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 have given the SEC and the PCAOB an opportunity to evaluate the impact and the cost effectiveness of their proposed guidance on accelerated filers and would also have given 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.

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.

- To indicate that it is serious about reducing costs, ICBA believes that the SEC should have set a quantitative benchmark or goal for the new standard that would be tied to a reduction in overall SOX 404 audit costs.
- While a risk-based and scalable AS2 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.

Comments Concerning AS5 and the SEC Guidance

We commend the SEC and the PCAOB for their efforts to create a scalable, top-down approach for SOX 404 audits. As noted in the release for the proposed 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.

We also commend the PCAOB for aligning AS5 more closely with the SEC guidance and making the new standard more scalable for smaller public companies. By using the same definitions of “material weakness” and “significant deficiencies” in AS5 that the SEC uses in its final management guidance, the PCAOB has gone a long way in making the new standard more in sync with the SEC guidance. Eliminating the “principal evidence” provision and changing walkthroughs from a mandatory requirement to a recommended step will help make AS5 more flexible for smaller public companies.

However, 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 there is no evidence to suggest that, despite the proposed standard’s focus on scalability and risk-based testing, auditors will significantly change their audit procedures or reduce the time they take to perform a 404 audit.

ICBA is disappointed that the SEC did not adopt our recommendation to delay by one year the Section 404 due dates for non-accelerated filers so that calendar year filers would have until the due date for their 2008 annual report rather than the due date of their 2007 annual report to file their management internal control reports. The one-year delay would have accomplished several things. First, it would have given 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 would have had little impact on SOX 404 audit costs for the 2007 and 2008 accelerated filers, then the SEC and the PCAOB would have time to revise the guidance and the new standard before it is fully implemented by non-accelerated filers. Second, a one-year delay would also have given 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. As it stands, non-accelerated filers will have a very limited time—

approximately six months—to prepare the management assessment of controls in accordance with the new guidance.

ICBA also believes that the SEC and the PCAOB should have established 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 and the PCAOB should have stated that the goal of AS5 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 would be revised further. It is too ambiguous for the SEC or the PCAOB to state that their goal is to increase the “cost effectiveness of the 404 audit” or “to eliminate unnecessary audit procedures” particularly when there has been no field testing of the new standard and therefore no assurance that it will reduce costs. A specific benchmark or goal would have conveyed 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.

Defined Terms Need to be Clearer

While we agree that the SEC and the PCAOB have made some progress in clarifying some of the defined terms used in AS2, we believe there is more room for improvement. Specifically, there will still be 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 AS5 and SEC Guidance, the SEC and the PCAOB use the same definition but substitute “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 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 over financial reporting and encourages them to be very conservative with their testing and documentation.

ICBA believes a more precise definition of “material deficiency” that is tied to the impact on a company’s earnings would have been very helpful. Last year, ICBA supported the COMPETE Act,² 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 greater clarity as to how companies both large and small can achieve that goal would have been beneficial. The guidance should also have indicated at what point a combination of control deficiencies give rise to a material weakness. Illustrations of

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

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 should have been 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 entirely too vague. At a minimum, the SEC should have provided 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.

The SEC Guidance Should Provide a Clear Safe-Harbor for Management

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 recommended 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 realize that it has 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 Endorses a Small Company 404 Exemption

ICBA commends the SEC and the PCAOB for their endorsement of a scalable approach to SOX 404 audits. AS5, for instance, does incorporate a discussion of scaling concepts, similar to what was proposed, throughout the final standard. Specifically, notes to relevant paragraphs in the new standard describe how to tailor the audit to the particular circumstances of a smaller, less complex company. We understand that 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 AS2 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 avoid unnecessary costs and 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 unduly 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 404.³ These costs far outweigh the benefits for these small companies.

Conclusion

ICBA is disappointed that the SEC did not grant another one year delay in the Section 404 due dates for non-accelerated filers so that they would 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 have given the SEC and the PCAOB an opportunity to evaluate the impact and the cost effectiveness of their proposed guidance on accelerated filers and would also have given 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.

³ 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.

To indicate that it is serious about reducing costs, ICBA also believes that the SEC should have set 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 AS2 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 avoid unnecessary costs and to be competitive with larger companies and foreign competition.

ICBA appreciates the opportunity to offer this statement before the House Small Business Committee concerning the impact that AS5 and the SEC guidance under Section 404 of the Sarbanes-Oxley Act will have on small business.