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May 1, 2006

J. Gordon Seymour
Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington, DC 20006-2803

Re: Internal Control Roundtable – May 10, 2006

Dear Mr. Seymour:

The American Bankers Association (ABA) appreciates the willingness of the Securities and Exchange Commission (the Commission) and the Public Company Accounting Oversight Board (PCAOB) to hold a roundtable discussion on second-year experience with 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 May 10 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 continue to be very concerned about the huge time and cost burdens experienced in complying with the Act, as well as business opportunity costs. The purpose of this letter is to share our remaining 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 is well equipped to implement Section 404. Because of our industry's prior experience with management reporting, 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 you to focus on the most important recommendations, which relate to the costs of implementation for all companies and the impact of Section 404 on small companies.

Costs of Implementation for All Banking Institutions

According to many of our members, 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, bankers agree 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 spent on unnecessary testing rather than on providing products and services to customers.

For the banking industry, which has been reporting on internal controls under FDICIA, the benefits generally do not outweigh the incremental costs. The costs appear to be truly excessive, particularly when one considers the similarities between the requirements of the Act (and the Commission's regulations relating to Section 404) and FDICIA.

We were astonished by the Big Four accounting firms' recent study regarding Section 404 audit fees and other audit fees.[1] This is the exact opposite feedback that we are receiving from the banking industry. In fact, the feedback that we are receiving is that, generally, the costs are either the same *or higher*. According to our members, the auditing firms are claiming that last year's fees were insufficient to cover their costs and this year's fees remain high in order to better cover this year's costs. Thus, we reject the notion that the accounting firms' sample is representative of the experience of the banking industry.[2] We have also been informed that there has been a peripheral impact on banks that are not subject to 404 as firms are beginning to apply stricter 404-like testing and review to financial statement audits.

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[1] CRA International. Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update. Washington, DC. 17 Apr 2006.

[2] The survey purports to estimate issuers' costs of complying with Section 404. However, this estimate does not come from the issuers, but from the accounting firms. Without input from the issuers, these estimates may not reflect all of the costs.

Impact on Community Banks

Community banks are simply being buried in unnecessary paperwork and procedures required by the auditors and the PCAOB for Section 404 compliance. 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.[3] This is because their boards believe the costs of being a 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.

As we mentioned to the Government Accountability Office (GAO) during its study of the impact of the Act on small businesses, many small banks are being forced to change accounting firms for their annual audits because of the dramatic increase in fees. Some community banks prefer using a particular firm because of its banking expertise, 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. The delays in the effective date for smaller public companies have been helpful, but these same banks that have benefited from the delayed effective have still had to deal with rising audit costs and anticipate significant increases upon being subject to the requirements of Section 404.

The following comment 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."

Commission and PCAOB Efforts to Improve the Process

The ABA would like to thank the Commission and PCAOB for their efforts over the past year or so in attempting to reduce the burdens of the Act. These actions have brought about meaningful changes:

- Last year's Commission and PCAOB Roundtable on Section 404 provided all parties with the opportunity to provide input in an organized, public, and productive manner. This was a critical first step. The most notable results of last year's Roundtable were the nearly immediate PCAOB guidance, issued

[3] According to research in the Commission's EDGAR database, since January 2003, over seventy banks and savings associations have de-registered with the Commission.

May 16, 2005, and the establishment of the Commission's Advisory Committee on Smaller Public Companies (ACSPC).

- The PCAOB's May 16 guidance was extremely important, because it provided much-needed clarifications on issues and processes about which the accounting firms and companies were not seeing eye-to-eye. This provided a foundation for attempting to streamline some of the costs relating to Section 404.

- The Commission's ACSPC, which was tasked with developing recommendations to improve the environment created by the Act and ease some of the compliance and cost burdens that companies were experiencing in their first year of reporting subject to the Act, has focused on the appropriate issues. Recently, the ACSPC finalized its recommendations, all of which we support except for the recommendation to change the interpretation of "held of record" in Sections 12(g) and 15(d) of the Securities Exchange Act to mean "beneficial holder" rather than "holder of record".

- The Commission provided a delay of the effective date for Section 404 for certain smaller public companies. The delay extended the compliance date until the first fiscal year ending on or after July 15, 2007 for non-accelerated filers (defined as filers with below $75 million of public float).

- The SEC Commissioners, PCAOB Board members, and the staffs of the SEC and PCAOB have been very accessible, so that trade associations and their members have been able to provide feedback on progress or lack of progress.

- We appreciate the straightforward process that the Commission and PCAOB have used, which has been to request input from all parties, to use a public forum for providing further guidance, and to avoid providing guidance through speeches at conferences.

We appreciate the efforts of the Commission and PCAOB to provide these important changes and clarifications and for recognizing that providing useful information to shareholders could be done in a more efficient manner. However, more needs to be done to reel in the exorbitant compliance costs.

ABA Suggested Solutions

The following suggested solutions were provided to you in our April 3, 2005, letter, and they continue to represent the areas that are most in need of repair:

- Improving the rules – The ABA would like to work with the Commission and the Public Company Accounting Oversight Board 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 Commission, PCAOB, and accounting firms to achieve a

more meaningful and targeted approach in the interpretation and application of the PCAOB's rules relating to Section 404.

Improving the Rules

Securities and Exchange Commission
The ABA recommends that the Commission:

- 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.

- Seriously consider some of the recent recommendations of the ACSPC for differentiating the rules for small businesses by making the rules less burdensome. Without substantial change, we are concerned that many community banks may opt to go private. For those community banks that cannot reasonably go private due to a large shareholder base, many could be forced to merge with a larger partner in order to spread out the cost of compliance. Such regulatory-induced mergers cannot be wise public policy.

    - Accept the primary recommendation of the ACSPC regarding scaled or proportional regulation of smaller public companies and the criteria proposed by the ACSPC for establishing such a framework. The ACSPC envisions that this new system would replace the Commission's current filing system for "small business issuers" eligible to use Regulation S-B, as well as the current scaling system based on "non-accelerated filer" status. In its place, companies would be eligible for scaled regulation based on their size relative to larger companies. Specifically, microcap companies, defined generally as companies with the lowest 1% of total US equity market capitalization (below approximately $128 million), would be entitled to the accommodations afforded to small business issuers and non-accelerated filers under the Commission's current rules. Smallcap companies, defined generally as companies with between 1% and 5% of total US equity market capitalization (approximately between $128 million and $787 million), would be entitled to some accommodations based on their size but not to the same degree given to microcap companies. Until the Commission develops a framework for assessing internal control over financial reporting that recognizes and addresses the specific characteristics and needs of these smaller companies, the ACSPC proposes exempting from Section 404 all microcap companies with less than $125 million in annual revenues that have certain corporate governance controls in place. The ABA strongly supports these recommendations because the regulation imposes excessive costs and questionable benefits to the investing public. The costs associated with Section 404 consist of external costs in the form of increased auditor fees and consultant fees, hiring additional staff to assist with compliance, and lost productivity.

Section 404, more than any other section of the Act, has significantly burdened smaller public companies, through extraordinarily high audit fees. Section 404 has also imposed significant opportunity cost by dampening the growth of business and diverting staff from their regular responsibilities. A number of our member banks, wishing to expand their businesses by opening new branches, have determined that they cannot afford the regulatory costs that would follow the initial public offering needed to raise the requisite capital for expansion. Still other banks have had to sacrifice developing and providing new products for their customers to channel resources toward compliance with the Act. The suggested alternatives permit the Commission to require Section 404 compliance in a more cost-effective manner.

- Accept the ACSPC recommendation to develop a "safe harbor" protocol for accounting for transactions that would protect well-intentioned preparers from regulatory or legal action when the process is appropriately followed. As accounting standards have increased in complexity, sources, frequency of change, and volume, it has become extremely onerous for both large and small businesses to ensure perfect compliance with generally accepted accounting principles (GAAP) in its various forms. Smaller businesses, which have limited resources, make a good faith effort to comply, but often find compliance especially difficult. Another problem that is discussed in the ACSPC proposal is a situation that we find troubling for both large and small companies. Often, the accounting rulemakers, the Commission, or the accounting firms set forth new views about the application of old accounting rules. In these instances, companies have believed for many years that they were following GAAP. We strongly agree with the comment in the ACSPC proposal that: "The result is that companies frequently end up adopting an approach dictated by their auditors, which the companies believe is caused by their auditors' concerns about regulators questioning their judgments, or for other reasons."

- Accept the ACSPC recommendation that the Commission provide, and request that COSO and PCAOB provide, additional guidance for smaller companies to help facilitate the assessment and design of internal controls and make processes related to internal controls more cost-effective. During the first year of Section 404, some companies documented more controls than were necessary, and auditors audited them. Thus, too much work was done. This should help ensure that the level of detail relating to the internal controls framework is appropriate for smaller companies.

<u>PCAOB</u>

For the purpose of reporting on internal controls by management and the related attestations by auditors, the requirements of FDICIA and the 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). It is not

accidental that these similarities were included in these laws and regulations. As noted in the Commission's final regulations, the Commission 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 AS2 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:

- Focus on how to reduce unnecessary duplication.

- Accept the ACSPC recommendation regarding the PCAOB's Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements" (AS2), to assess if and when it would be advisable to reevaluate and consider amending it.

- Require attestations, rather than attestations plus audit opinions, on 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.

- Leverage, to the greatest extent appropriate, the work of internal auditors and others in order to reduce duplicate testing. Although the PCAOB was clear in its May 16 clarifying guidance, in practice, additional encouragement is needed. As was mentioned last year, 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 (AS2, paragraphs 108-111).

- Re-examine other restrictions on information that independent accountants can use to assess the internal control structure.

  - The detail level of testing is still extensive and redundant. PCAOB should evaluate and provide public guidance on how much testing the external auditors must perform. This situation has improved since Year 1, but even more reliance can be placed on internal testing.

  - 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.

  - 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.

  - 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. The reverse should also be true: if a signature does not exist, this does not necessarily mean the control is not in place. This issue was addressed specifically in PCAOB Staff Q&A No. 53, where it was explained that "the absence of documentation evidencing the operation of an individual control is not determinative that the control is not operating effectively." While this was a helpful issuance, the level of documentation being required needs to be reduced.

- Reconsider the SAS 70 report "as of" dates. 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.

- 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. Banks have indicated that some audit firms are even asking for coverage a high as 100 percent. One banker also indicated that his auditor scoped in some balance sheet items of $25 million despite an asset total of $45 billion. We would ask that the PCAOB put forth some guidance establishing reasonableness standards for scoping.

Improving the Accounting Firms' Interpretations of the Rules

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 new role of the PCAOB as inspector and regulator of the accounting firms has resulted in uncertainty and is paralyzing the firms' willingness to exercise an appropriate level of flexibility. For example, in situations where the PCAOB's rules appropriately provide a certain level of flexibility, 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 a dated article with strong language, but it reflects the perception in the marketplace and represents a

major component of the costs. It would be useful for the firms to reconsider their approaches and to develop a more reasoned application of the rules.

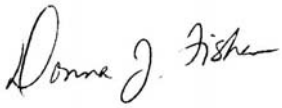
- The role of external auditors needs to be returned to a trusted – albeit arms-length – advisor role. Although the Act clearly increases the tension between an auditor's role as both an advisor and independent examiner, it appears that the role of external auditors may have shifted too far with respect to independence from management. 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. We recognize that the PCAOB has attempted to address some of these concerns, and we are seeing some progress toward re-establishing advisory relationships between auditors and their clients. However, the natural friction that has resulted from the new reporting relationship means that management may be less comfortable sharing and solving problems with their audit firms.

- Certain decisions need to be made at the local level. We understand the accounting firms' desire to have consistency in their decisions relating to accounting, auditing and internal controls. However, we are also seeing a disturbing trend of the accounting firms elevating even the most routine decisions either to their national office or to a higher review by the FASB or the Commission. This appears to be based on an effort to centralize decision making, or, possibly, in order to isolate them from being second-guessed. In some cases, this appears to result in new interpretations of old rules. This only serves to add time and cost for companies without a recognizable benefit.

- 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. There have been improvements in this area, but more needs to be done.

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,



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