November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008
Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements

Dear Sir or Madam:

America's Community Bankers ("ACB")[1] is pleased to comment on the proposed auditing standard for attestation engagements required by Section 404(b) and Section 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") issued by the Public Company Accounting Oversight Board "PCAOB".[2]

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.

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[1] America's Community Bankers 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] Pub. L. 107-204 (2002).

ACB Position

The PCAOB's proposed auditing standard would add burdensome, conflicting, and overlapping requirements on community banks. ACB believes that section 404 was meant to mirror the similar requirements imposed on financial institutions by the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA").[3] FDICIA, which has been in place for 12

years, requires management of depository institutions with $500 million or more in assets to assess the effectiveness of the institution's internal control structure.[4] The institution's independent public accountant must examine, attest to, and report separately on, management's assessment. The federal banking regulators have never interpreted this legislative language to require an independent audit of the effectiveness of the internal control structure, as is being proposed by the PCAOB. Congress was aware of the process used to comply with FDICIA, but still adopted almost identical language in section 404(b) of Sarbanes-Oxley to describe the responsibility of the public auditor.

We believe that the PCAOB should conform the standard to the requirement mandated by Congress by requiring an attestation only of management's assessment of the internal control structure to avoid duplication of work and unnecessary expense. If the PCAOB adopts the proposal to require an audit of internal control over financial reporting, the PCAOB should exempt from that requirement insured depository institutions that are regularly examined and subject to continuing supervision by federal banking regulators. The PCAOB should recognize the significant and substantial protections afforded to depositors and investors by the banking laws and establish a standard for depository institutions that mirrors the standard in FDICIA that only requires an attestation of management's evaluation of internal control over financial reporting.

ACB also has concerns with the following provisions of the proposal:

- The requirement that the auditor conduct evaluations of the internal control structure over financial reporting be conducted on a *quarterly* basis.
- The requirement that the external auditor evaluate the effectiveness of the audit committee's oversight of the company's financial reporting and internal control structure.
- The requirement that the external auditor limit the use of testing performed by management and others in a number of areas.
- The lack of adequate guidance regarding attestation procedures for small and medium-size businesses.

Attestation of Management's Assessment of Internal Control

In its proposed auditing standard, the PCAOB proposes to adopt an unnecessary and significantly expanded interpretation of the Sarbanes-Oxley requirements. Two sections of Sarbanes-Oxley

[3] Pub. L. 102-242 (1991).
[4] 12 U.S.C. § 1831m and 12 C.F.R. Part 363.

address the attestation of management's assessment of the internal control structure. Section 103(a)(2)(A) stipulates that the PCAOB develop an auditing standard that would require the external auditor to "*describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b)*…." Following this wording, Section 404(b) of Sarbanes-Oxley directs public company auditors to "*attest to, and report on, the assessment made by management*." However, the PCAOB is proposing that the auditor perform a detailed integrated audit of internal control and financial statements and opine directly on the effectiveness of internal controls.

An attestation traditionally refers to a process in which the auditor provides a conclusion about the reliability of management's written assertion, while an audit traditionally involves examination of the financial statements. There is a very distinct difference between the two that was recognized by Congress. Requiring an independent audit of internal control over financial reporting will be duplicative of work performed by a company's internal audit function and senior management and will ultimately be very costly and burdensome. Public company auditors will interpret their responsibilities under the standard quite broadly and, in an effort to avoid future liability, will err on the side of doing too much, rather than not doing enough. This would be understandable in light of recent corporate scandals and the collapse of Arthur Andersen. However, the public auditors will be adequately compensated for this work at a significant cost to public companies and their shareholders.

We urge the PCAOB to reconsider whether a separate audit of internal controls is really necessary and scale back these standards to a reasonable level of inquiry that allows an auditor to opine on the conclusions reached by management. There are other requirements recently put in place that will protect the investing public and that make a more burdensome standard inappropriate. For instance, the chief executive officer and chief financial officer must certify each quarter as to the accuracy of the company's financial statements and their responsibility for establishing and maintaining internal controls.[5] They also must certify that the internal controls have been designed to provide reasonable assurance about the reliability of the financial statements and that they have evaluated the effectiveness of the internal controls. The certifications with regard to the compliance of the periodic filing with the Securities Exchange Act of 1934 are made under the threat of criminal liability if the officer knowingly makes a false certification.

ACB believes that the standard adopted by the banking regulators under FDICIA of requiring an attestation of management's assessment of internal controls, as provided for in section 36 of the Federal Deposit Insurance Act and implemented by Part 363 of the Federal Deposit Insurance Corporation,[6] should be adopted as the standard under the plain language of section 404(b) of Sarbanes-Oxley. If the PCAOB does not believe that this standard is appropriate for all public companies, it should at least acknowledge the comprehensive scheme of regulation and examination that governs depository institutions and their holding companies and exempt these institutions and holding companies from the more burdensome requirement of an independent internal control audit. Insured depository institutions are required to have internal controls,

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[5] Sections 302 and 906 of Sarbanes-Oxley; Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 57276 (Sept. 9, 2003).
[6] 12 U.S.C. § 1831m and 12 C.F.R. Part 363.

information systems and an internal audit function adequate and appropriate for the institution's size and the nature and scope of its activities.[7] An institution's compliance with these safety and soundness requirements is subject to regular examinations by the federal bank regulators.[8]

Quarterly Reviews

The proposed standard outlines some responsibilities that the auditor would have for evaluating management's section 302 disclosures about internal control over financial reporting. ACB opposes the requirement that the auditor perform limited procedures on a quarterly basis to confirm that management's disclosures are complete. Quarterly evaluations are not mandated by Sarbanes-Oxley. Section 404 of Sarbanes-Oxley requires that annual reports include an internal control report and that the independent auditor attest to, and report on, this annual assessment. ACB believes that quarterly evaluations would be impractical, time-consuming, and costly. The experience of the banking industry under FDICIA has shown that an annual auditor review of management's evaluation of internal controls is quite adequate.

Evaluation of the Audit Committee

The proposed standard would require the independent auditor to evaluate the effectiveness of the audit committee's oversight of the company's financial reporting and internal control over financial reporting. This would create serious conflict of interest issues for the auditor and the audit committee. Among the most important goals of Sarbanes-Oxley was to strengthen the role of the audit committee in overseeing the auditor. The audit committee is now specifically responsible for hiring and compensating the external auditor. The proposed requirement will, in effect, dilute the power of the audit committee and may lead to inadequate oversight in an effort to ensure a satisfactory evaluation. The auditor, on the other hand, may be reluctant to issue a harsh evaluation of the committee that is responsible for his or her hiring and compensation. Furthermore, there are no objective criteria or adequate guidelines for the auditor to use to evaluate the audit committee. The evaluation would be completely subjective and based on each auditor's opinions and beliefs on how an audit committee should function. We believe that the review of the effectiveness of the audit committee, at least for regulated financial institutions, is more properly left to the federal banking agencies.

Reliance on the Work of Others

The proposed standard addresses the auditor's use of testing performed by management and others and limits this use in a number of areas, including controls over the period-end financial reporting process and certain information technology general controls. The inability to use the testing performed by management to the fullest extent possible, together with requiring the auditor to conduct walkthroughs of the company's significant processes, would result in unnecessary cost and burden. The external auditor's responsibility should be to obtain a thorough understanding of the processes in place and evaluate if, and to what extent, he or she

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[7] 12 U.S.C. § 1831p-1; 12 C.F.R. Parts 30, 364, and 570, and Appendix D-1 to Part 208.
[8] *See*, for example, section 355 of the Office of Thrift Supervision's *Thrift Activities Handbook*, available at www.ots.treas.gov

can rely on the work performed by management and others by considering the factors discussed in paragraph 103 of the standard. The company's professional and independent audit staff, especially in the highly technical areas like IT controls, may be better suited than the external auditor to understand the internal accounting controls and how they perform. The external auditor's task should be to determine whether he or she can rely on the work performed by the company's professional staff.

If a walkthrough has been sufficiently performed and documented by the company's internal auditors, there is no reason for duplicating their work. This is particularly true in the case of financial institutions, which are required by banking law and regulation to have an internal audit function and that function is evaluated during safety and soundness examinations. The PCAOB itself acknowledges the importance of internal audit by indicating in paragraph 108 of the standard that the auditor may be able to use the results of procedures conducted by internal auditors to a greater extent than the results of procedures performed by others.

Guidance for Small and Medium-Size Companies

ACB is particularly concerned about the effect of the proposed auditing standard on small and medium-sized community banks. The PCAOB states that it is sensitive to the possible effects of the auditing standard on small and medium-size businesses. However, the PCAOB does not offer any specific examples that might serve as guidelines for reviewing internal controls for these companies. The external auditor is left to decide what constitutes an acceptable review and will most likely take a conservative approach. The PCAOB also does not indicate what constitutes a small or medium-size company.

The PCAOB should provide more specific guidance to auditors in evaluating internal controls at small and medium-size companies. As a preliminary matter, the PCAOB should define these companies. An approach would be to define these companies as those that are not considered "accelerated filers" under the rules of the Securities and Exchange Commission ("SEC"). The SEC defines an accelerated filer as a company that (i) has a common equity public float of at least $75 million; (ii) has been subject to the reporting requirements of the Securities Exchange Act for a period of at least 12 months; and (iii) has filed at least one annual report as a public company.[9]

Small and medium-sized businesses will find the extensive walkthroughs, quarterly evaluations, and other requirements in the proposed standard to be prohibitively burdensome and costly. This is especially true for small community banks, which, in addition to the lack of resources that larger banks possess, might not have ready access to auditors experienced in attestation procedures. The requirements would only add to already increasing costs and would likely decrease the competitiveness of these institutions. The PCAOB should provide specific examples of how the external auditor should address the issues particular to small and medium-size businesses and how the attestation process for those companies would differ from that used for larger companies. For example, the requirements for the walkthroughs could be scaled back and the auditor could be given more leeway to rely on the testing performed by management.

[9] 17 C.F.R. § 240.12b-2.

Also, the PCAOB could provide guidance on the review that is expected when there cannot be complete segregation of duties because of the limited staff resources at many smaller companies. While we appreciate the PCAOB's efforts to recognize the special circumstances of small and medium-size companies, more specific guidance in this area is needed to limit the cost and burden of the attestation for community banks.

Conclusion

ACB believes that many aspects of the proposed standard would be unnecessarily costly and burdensome. The standard goes beyond what is required by Sarbanes-Oxley by requiring an integrated audit of internal control and financial statements. Quarterly evaluations and limits on the use of testing performed by others will multiply the cost of the audit and the requirement to evaluate the audit committee will create conflicts of interest. If the PCAOB adopts the standard as proposed, exceptions should be made for depository institutions in light of the existing substantial oversight of those institutions by federal banking agencies.

ACB appreciates the invitation to comment on this issue. If you have any questions about our comments, please do not hesitate to contact me. You can also contact ACB's Senior Regulatory Counsel, Diane Koonjy, at (202) 857-3144 or via e-mail at dkoonjy@acbankers.org, and Accounting and Financial Management Specialist, Dusan Jovanovic at (202) 857-3158, or via e-mail at djovanovic@acbankers.org.

Sincerely,

Charlotte M. Bahin

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Senior Vice President, Regulatory Affairs