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April 3, 2006

Ms. Nancy M. Morris
Federal Advisory Committee Management Officer
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-9303

Re: Advisory Committee on Smaller Public Companies Request for Public Comment; File No. 265–23, 71 Fed. Reg. 11090 (March 3, 2006).

Dear Ms. Morris:

The American Bankers Association[1] ("ABA") appreciates the opportunity to comment on the recommendations of the Securities and Exchange Commission's Advisory Committee on Smaller Public Companies ("Committee"). The Securities and Exchange Commission ("Commission") chartered the Committee to assess the effect of securities laws and regulations, in particular the Sarbanes-Oxley Act of 2002 (hereinafter referred to as "Sarbanes-Oxley" or "the Act"), on smaller public companies. In the Exposure Draft of its Final Report, the Committee makes a number of recommendations to lower regulatory barriers to capital formation.

While the ABA supports the regulatory burden relief provided by many of the Committee's recommendations, we are limiting our comments to the following Committee recommendations:

- To provide for scaled securities regulation based, in part, on equity capitalization and annual revenue;

- To revise the current shareholder measurement threshold that requires issuers of securities traded over-the-counter to be subject to the periodic reporting requirements of the Securities Exchange Act of 1934;

[1] The ABA, on behalf of the more than two 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.

- To create a task force to assess and propose ways to reduce redundancies in the regulatory requirements of various government agencies;

- To clarify the reach of the personal loan prohibition of Section 402 of the Sarbanes-Oxley Act;

- To reduce certain burdens relating to accounting standards and Section 404 processes.

<u>Scaling Securities Regulation for Smaller Companies (Recommendations II.P.1, III.P.1 and III.P.2)</u>

The ABA supports the primary recommendation of the Committee regarding scaled or proportional regulation of smaller public companies, and we support the criteria proposed by the Committee for establishing such a framework. The Committee 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 Committee proposes exempting from Section 404 all microcap companies with less than $125 million in annual revenues[2] that have certain corporate governance controls in place. These controls include an adherence to audit committee standards (Rule 10A-3 of the Exchange Act), the adoption of a code of ethics (Item 406 of Reg. S-K), and the design and maintenance of effective internal controls over financial reporting.

The Committee also recommends exempting all smallcap companies with less than $250 million in annual revenue[3] from the external audit requirements of

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[2] The Committee's proposal would also permit certain smallcap companies with limited annual revenue to take advantage of this exemption.

[3] Certain microcap companies with significant annual revenues would only be exempt from the external audit requirements of Section 404.

Section 404, so long as the companies have the above-specified corporate governance controls in place. Additionally, these firms would continue to be required to: (1) maintain a system of internal controls that provides reasonable assurances as to the accuracy, as required by Exchange Act Section 13(b)(2)(B) enacted under the FCPA; (2) complete and report on management's assessment of internal control under Section 404; (3) provide chief executive officer and chief financial officer certifications under Section 302; (4) receive external financial audits; (5) comply with the controls and procedures disclosures required by Forms 10-K and 10-Q, and (6) disclose, consistent with current Section 404 rules, all material weaknesses known to management, including those uncovered by the external auditor and reported to the audit committee.

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. This section, more than any other section of Sarbanes-Oxley, 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. Furthermore, the recommendation makes clear that several securities laws would remain in full effect for these exempt companies. For example, the external audit, CEO/CFO certification, and material weakness disclosure requirements would remain applicable to smallcap companies exempted from Section 404's external audit requirements.[4]

<u>Alternative External Audit Standard (Recommendation III.P.3)</u>

The Committee recommends, in the absence of the smallcap exemption from external audit noted above, that the Commission direct the Public Company Accounting Oversight Board ("PCAOB") to change the requirement for implementing the external audit requirement of Section 404 to a cost-effective standard or "ASX," which would provide for an external audit of the design and implementation of the internal controls.

[4] Despite recently publicized arguments that the Commission does not have the proper authority to exempt firms from Section 404, we are assured by Chairman Oxley and Sub-Committee Chairman Baker's recent letter to Chairman Cox that the Commission indeed has the proper authority. <u>See</u> Letter of March 2, 2006, from Chairman Michael G. Oxley and Sub-Committee Chairman Richard H. Baker to Christopher Cox, Chairman of the Securities and Exchange Commission.

The ABA supports this alternative recommendation of a streamlined, cost-reduced approach to assessing the design and implementation, in the absence of the preferred full exemption. The cost of the full, invasive external audit of internal controls is still the largest hurdle to realizing a net benefit for investors in internal control soundness, so to the extent an external audit is a requirement, it is most beneficial that it be restricted to a more cost-effective form.

<u>Securities Exchange Act Recommendation (Recommendation IV.S.1)</u>

The Committee has recommended that the Commission amend current Rule 12g5-1 to interpret "held of record" as that term is used under Sections 12(g) and 15(d) of the Securities Exchange Act of 1934 ("Exchange Act") to mean held by actual beneficial owners.[5] As we have previously stated,[6] the ABA is quite concerned about the Committee's recommendation to interpret "held of record" under Section 12(g) of the Exchange Act to mean beneficial holders.

The ABA first suggested in March 2005 that the current 500 shareholder threshold should be raised to some number between 1,500 and 3,000.[7] We made this suggestion because the shareholder number has not been updated in over 40 years, while the securities markets have grown exponentially.

In making this recommendation, the ABA specifically did not recommend that the current interpretation of "held of record" in Sections 12(g) and 15(d) be revised to mean "beneficial holder" rather than "record holder." Indeed, in communications with the Committee, we expressed our opposition to any such movement as it could in practice increase regulatory burden—the very purpose of the Committee and its work—forcing into the periodic reporting system many banks that currently are not in the system.

Recent discussions with our member banks have confirmed that many banks that currently are exempt from Exchange Act periodic reporting requirements because they have less than 500 record holders could be, were such a change of measurement to "beneficial holders" adopted, newly subject to these reporting requirements. In order for these banking organizations that are not publicly traded under current Commission rules to maintain their <u>current status</u> should the Committee's recommendation be adopted by the Commission, the beneficial shareholder number would have to be significantly increased, even beyond our earlier recommendation..

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[5] We understand that the Committee has used the term "beneficial owner" to mean equitable owners and not those persons who are deemed "beneficial owners," under Rules 13d-3 and 14b-2, by virtue of having voting or investment authority over the securities.

[6] <u>See</u> Letter of Dec. 13, 2005, from Sarah A. Miller, American Bankers Association, to Gerald LaPorte, Securities and Exchange Commission.

[7] <u>See</u> Letter of Mar. 2005, from Wayne A. Abernathy, American Bankers Association, to William Donaldson, Securities and Exchange Commission.

If the number is not raised significantly, then an even greater pressure will be exerted on banking organizations and other affected companies to reduce the number of shareholders in order either to avoid registration requirements or to de-register. As Daniel Blanton, President and CEO of Georgia Bank Financial Corporation, testified before the Advisory Committee:

> We are reluctant to [de-register] because the Bank was founded on the belief that the Augusta [Georgia] area needed a locally owned and operated, relationship-based bank. Most of our shareholders live within our market and all but a few do some business with the bank. This localized ownership is quite common at community banks across the U.S. Often times, investing in the local bank is the only remaining investment members of a community can still make.

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.

Should the Commission determine to embrace the Committee's recommendation to scale securities regulation for smaller public companies and its interim recommendations to exempt microcap companies from Section 404 and smallcap companies from the external audit requirements of Section 404, our opposition to interpreting "held of record" to mean "beneficial owner" would remain. While it is true that many of the regulatory burdens associated with being a publicly traded company would be reduced, this reduction in regulatory burden would be of little comfort to those banking organizations that had never before been subject to the regulatory burdens associated with the periodic reporting system, as well as Exchange Act proxy and insider transaction reporting requirements.

Equally significant is the fact that the Committee's recommendation fails to address the serious practical problems with measuring "held of record" according to the number of "beneficial holders." In general, it is not an easy matter for issuers to know, at any one time, the precise number of equitable or beneficial holders of company stock. Banks and broker-dealers are reluctant to share customer information with issuers. Moreover, any information issuers receive from third parties under the Commission's shareholder communications rules[8] is frequently confusing and incomplete. Under these rules, issuers use third parties to inquire of banks and broker-dealers that hold the issuer's securities in nominee name regarding the number of sets of proxy materials each bank and broker-dealer will need to forward on to beneficial owners. "Beneficial ownership" under these rules means holders with voting authority, not equitable ownership of the underlying securities. From the beneficial ownership number compiled, issuers can make reasonable estimates on how many sets of proxy

[8] See e.g., Rules 14a-13, 14b-1, 14b-2 and 14c-7.

materials are needed to send on to persons that have voting authority with respect to the company's securities.

Clearly, the right to vote a security cannot be equated with equitable ownership of the underlying security. For example, a sole equitable owner of a security may serve as a co-trustee, along with two other trustees, of the trust that holds the securities and all three share voting authority. In this situation, the number communicated to the issuer would be three holders of voting authority, when, in truth, there was only one equitable owner of the security.[9] In addition, the number provided frequently does not represent the number of downstream correspondent banks that hold securities in nominee name on behalf of their clients. It is not uncommon in the banking industry for many banks to hold client securities at the Depository Trust Company ("DTC") through an upstream correspondent bank. The upstream correspondent bank, not the many downstream banks, would be listed as the nominee on DTC's records.

It is interesting to note that during the pendency of this comment process, the ABA endeavored to gather data on the number of beneficial owners of company stock existing for each responding community bank. The responses we received from our members indicated that it was not easy to gather this information with any degree of certainty and confidence.

Further, while estimates of the number of holders with voting authority do not present material problems for providing proxy materials, relying on such estimates to determine compliance with Exchange Act periodic reporting is another problem altogether. Without a precise measurement of beneficial ownership, relying upon a vague standard of measurement for Exchange Act reporting requirements is unworkable and inappropriate, introducing a new source of regulatory risk for banks and others that they cannot easily resolve.

The Committee has made some excellent recommendations which we sincerely hope the Commission will consider. We fear, however, that changing the standard of measurement from record holder to beneficial holder would not only undermine such progressive efforts at regulatory relief, but also introduce significant new regulatory burden. Many community banks will find themselves in a worse position if the Committee's recommendation is adopted. We are, therefore, opposed to changing the measure of a publicly traded company from record to beneficial ownership.

Nor do the public policy reasons offered in support of this recommendation justify the impact it will have on the banking industry. The banking industry does not seek to "go dark," no longer providing investors with disclosures. Significant financial and other information regarding every bank and savings association can be publicly viewed on the website maintained by the

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[9] In this connection, we assume that the Committee's proposal would view a trust as the equitable or beneficial owner and not the underlying trust beneficiaries. If we are incorrect and the Committee intends that trust beneficiaries should be included in the measure, then the ABA's opposition to this proposal would be significantly increased.

Federal Deposit Insurance Corporation ("FDIC"). All banks are required to make annual reports available to both their customers and investors. Most provide financial and other information to investors through their company websites. Indeed, many community banks that elected to de-register under the current regulatory requirements pledged to make public disclosures on their website of information previously required to be filed with the Commission. The Commission should take note of the banking industry's extensive public disclosure record and not penalize one industry for the bad acts of a few.

Inter-agency Task Force (Recommendation IV.S.3)

The Committee has recommended the formation of a task force, consisting of officials from the Commission and the appropriate federal bank regulatory agencies, to discuss ways to reduce inefficiencies associated with Commission ad other governmental filings. Specifically, the Committee has suggested that the task force study the feasibility of synchronized filing requirements involving substantially similar information, such as financial statements, and extending incorporation by reference privileges to publicly available governmental filings, other than those filed with the Commission. In addition, many banks have informed the Committee of the overlap and duplication of internal control reporting required under both the banking and securities laws.

We believe this to be an excellent suggestion and one that can and should be implemented quickly, so long as there is no expansion of bank regulatory disclosures requirements. We agree with the Committee that the Commission's pilot program to use, for financial statement filings, interactive data in XBRL format, a format that is currently required for banking regulatory filings, may facilitate many of the Committee's suggestion for avoiding regulatory duplication and overlap.

Section 402 Recommendation (Recommendation IV.S.10)

Section 13(k) was added to the Exchange Act by Section 402 of the Sarbanes-Oxley Act. That section generally prohibits publicly-held companies from extending credit or arranging for an extension of credit in the form of a personal loan to any director or executive officer of the company. This prohibition does not apply, however, to loans made by an insured depository institution, if the loan is subject to the insider lending restrictions of Regulation O.

The Committee has recommended that Commission staff provide clarifying guidance as to the types of transactions that fall outside the prohibition. The ABA strongly supports the Committee's recommendation.

The ABA has long been on record that guidance with respect to Section 402 is needed. While loans made in accordance with Regulation O are exempt from the prohibition, much confusion exists within the corporate and legal communities as to what constitutes "a personal loan," as well as what activities constitute "arranging" for an extension of credit.

The Committee's recommendation suggests that the staff address whether cashless exercises of stock options, indemnity advances, relocation accommodations, and split dollar life insurance polices are prohibited. Unlike large public companies, smaller companies, including banks, often do not have the extensive legal resources necessary to interpret all the ambiguous and regulatory language that affects them. Commission staff guidance along the lines suggested by the Committee would be most welcome and might alleviate some of the legal expenses of smaller institutions.

Accounting and Section 404 Recommendations

Safe-Harbor for Legal and Regulatory Action (Recommendation V.P.1)

The Committee has recommended that the Commission 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. The ABA supports this recommendation with some reservations.

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.

A good example is Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133). In order to properly mitigate risks in the current business environment, some smaller businesses are beginning to utilize derivatives to hedge various risks. The most recently published edition[10] of the implementation aid for FAS 133 is 880 pages, the length of which is largely due to technical clarifications, amendments, and guidance that was issued after FAS 133 was issued. It is nearly impossible for large companies to comply perfectly with every single facet of the accounting standard, let alone for a smaller company to absorb these rules. Small businesses do not and cannot be expected to have the depth of accounting expertise nor the budget to hire outside expertise that larger companies have. They can be expected to make good faith efforts and determinations that are reasonable and reflect the economic substance of transactions. (While we acknowledge that most smaller businesses are not involved in the more complex derivatives that would require an in-depth understanding, some might argue that they should fully understand the rules relating to derivatives. Additionally, FAS 133 is simply used here as an example.)

[10] FASB Derivatives Codification – Third Edition – *Accounting for Derivatives Instruments and Hedging Activities [DC133-3],* March 2004, 880 pages.

Another problem that is discussed in the Committee 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 Committee 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."

For the reasons above, the safe-harbor concept is appealing in order to temper the penalties for certain missteps in GAAP application. Our only reservation about a safe-harbor exception is that it must be developed carefully so as to not allow for careless accounting under the guise of a good faith effort.

<u>Extended Effective Dates for Microcaps (Recommendation V.P.2)</u>

The Committee recommends that the Financial Accounting Standards Board ("FASB") permit microcap companies to apply the same extended effective dates that are allowed for private companies.[11]

The ABA agrees that extended effective dates should be permitted for microcap companies when FASB allows such extensions for private companies. In the banking industry, smallcap companies also include community banks, which should also be permitted these extensions. It is often not the market capitalization that determines the resource constraints, but the size of the institution itself. Thus, microcap and smallcap companies have the same resource constraints that the private companies have when dealing with new guidance and should be allowed a commensurate extension.

The proposal notes that "the FASB does not require new standards to be effective immediately upon issuance". While this is generally true with regard to new accounting standards, FASB does issue other accounting rules (in the form of Staff Positions and EITF consensuses) that sometimes take effect immediately upon issuance or shortly thereafter. In the event that these rules are either too complex or too time consuming to implement, extensions may be appropriate so that smaller companies can comply.

Another benefit of the extended effective date for microcap and smallcap companies is that problems encountered by the large companies can be resolved

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[11] The proposal also states that the Committee has determined that "different accounting standards should not be created for smaller and larger public companies." We believe that there may be areas of accounting that could apply only to larger companies. For example, the fair value footnote disclosures required by Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments,* is generally an unnecessary disclosure for community banks. However, before establishing different rules for larger vs. smaller companies, an evaluation should be made about whether current or future users of financial statements need the information.

before the microcap and smallcap companies are required to comply. The auditors and external resources used by microcap and smallcap companies would also have the benefit of the experiences they garnered working with the larger companies, which hopefully would translate to saving both time and money in implementation for the microcap and smallcap companies. This would also help justify the costs vs. benefits of new rules for smaller public companies.

Additionally, this extension would help in situations where the rules are final and being implemented by larger companies, but the need for changes to those rules have been identified and are being made by the rulemakers. In such situations, the smaller companies would simply follow the updated set of rules.

Materiality Guidance for Previously Issued Financials (Recommendation V.P.3)

The Committee recommends that the Commission consider additional guidance for all public companies with respect to materiality related to previously-issued financial statements.

The ABA agrees with this recommendation, which suggests the Commission put forth materiality guidance for all public companies related to circumstances in which a prior period change could be accounted for through a cumulative adjustment and disclosures rather than full prior period restatements.

This recommendation highlights the fact that the impact of errors causing restatements may not be meaningful to a reasonable investor. The determination of materiality, as indicated in the recommendation, can be a highly subjective exercise. In the past, restatements were less common; however, there seems to be a trend to restate more readily in recent years (as indicated in footnote 204 of the proposal). There is also a concern that this subjectivity may be approached too conservatively by auditors in the current environment, forcing restatements that do not necessarily result in information that is any more useful to a third party user. Prior period restatements that are required as a result of accounting rule changes should always be subject to a cost/benefit analysis, and at the point that the cost/benefit becomes unfavorable, there should be significant reluctance to require restatement.

The solution provided in the recommendation of thorough disclosure to fully explain and present the impact of the changes offers a reduced cost method for conveying accounting changes to the users who may want to delve into prior periods as part of their financial statement analysis.

CPA Firm Competition/Alternative Promotion (Recommendation V.S.1)

The Committee recommends that the Commission, PCAOB, and the FASB promote competition and reduce limited auditor choice perceptions by including non-Big Four firms in various groups and meetings that would increase awareness of these firms.

While the ABA agrees with the end result of this recommendation, we do not agree with the wording of it. We believe it is not the responsibility of the Commission, PCAOB, or the FASB to promote competition among audit firms. However, we believe that it is important for these rulemakers to include a higher percentage of the smaller firms in various groups and meetings.

The ABA recognizes that the Commission, PCAOB, and FASB currently make efforts to include non-Big Four firms in discussions and groups. We feel that this effort can still be taken further so that the smaller firms become more active, and, thus, more knowledgeable, about current issues. Generally, all the Big Four are included, but only a few of the smaller firms are included. Being a direct participant, with access to staff, board members, and documents, can be extremely valuable to these firms. It is the knowledge and the participation that we believe are important for the Commission, PCAOB, and FASB to promote, rather than competition. That said, we believe that the end result will be to promote competition, which has become even more important with the demise of Arthur Andersen and the increased accounting firm work generated by the passage of Sarbanes-Oxley.

Additionally, this recommendation acknowledges the risk that some of the other recommendations may have the effect of increasing the concentration of smaller public companies with revenues over $250 million who are audited by the Big Four. Smaller banks have voiced concerns over service issues and priority relegation based on size and revenue potential when all banks are trying to get the same services from the same firms. Additional resources for external accounting expertise would help to mitigate these concerns.

Encourage Objectives-Based Accounting Standards (Recommendation V.S.2)

The Committee recommends the Commission formally encourage the FASB to pursue objectives-based accounting standards with a focus on simplicity and ease of application.[12]

[12] The report states that certain accounting standards create complexity because, in part, "the standards have different measurement attributes (such as historical cost versus fair value) and treatment alternatives." We want to make it clear that the ABA, since as early as 1990, has continuously objected to piecemeal fair value accounting with the Commission, FASB, and AICPA. However, the FASB has chosen this path over our objections, resulting in the need to continuously repair the model with more and more fair value. The FASB has more recently stated its intent to move to a full fair value accounting model for financial instruments. This is a movement which the ABA has repeatedly asked the FASB to fully research and provide evidence for its claims of usefulness. The ABA has done its own work on this issue, including meeting with actual users of bank financial statements. We found that, while some users said they would appreciate fair value as an additional metric, it is not a desirable replacement for the current accounting model when the current model more accurately reflects the business model. We would again take this opportunity to suggest that a study should be done before moving to full fair value for financial instruments. Additionally, the report states that "There should be fewer (or no) exceptions for special interests." While this is theoretically true, we also believe that the accounting standards should reflect the company's business model.

The ABA appreciates the direction and intent of the recommendation and understands the perceived benefit to smaller and microcap companies. While we agree in concept with objectives-based accounting standards, the reality is that the FASB, Commission, auditors, and many preparers are not ready for it. We believe that the smaller companies are the very ones asking for more guidance and additional clarifications due to their own lack of resources and in-house expertise to address all the changes sufficiently.

One problem that companies face, particularly financial companies, is that the frequency and speed with which the new guidance is released. Many new accounting rules focus on financial instruments, resulting in many new changes for the banking industry. Smaller companies have had a difficult time keeping up with the changes that the FASB has been abundantly and quickly promulgating. Sometimes this speed, along with the broad nature of the rules, results in rules for which the application is not well understood by any of the parties. An example of this is the FASB's FIN 46, *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*. After FIN 46 was issued, it was determined by one of the Big Four firms that "trust preferred securities" were covered by FIN 46, even though there had been no discussion about it during the development of FIN 46. This took many banking institutions and their accounting firms by surprise, as we believed that FIN 46 did not even remotely apply to trust preferred securities. This is an example of an attempt to provide an objectives-based rule within a very short time frame, resulting in insufficient due process and revised standard-setting based on rules rather than principles. (FIN 46 was revised shortly thereafter to indicate the inclusion of trust preferred securities.) We feel that a better effort to anticipate the effects of standards prior to release could help reduce this problem. Too many times, accounting standards are written with a particular instrument or entity in mind and the effect of the standard is not fully explored before the standard is issued.

Another roadblock to objectives-based accounting is the current environment in which auditors are also asking for more detailed guidance in anticipation of being second-guessed by the Commission or the PCAOB. Fear of repudiation is enough to send previously accepted treatments to the FASB for clarification and reconsideration. This concern has been brought to our attention repeatedly by our members – rulemaking in the absence of FASB guidance. When the principles do not lend themselves to strict interpretation, the role of interpreter is not left to the preparer, but is usurped by the auditor in most cases due to the threat of legal or regulatory action. It is the responsibility of the FASB and not auditors to promulgate GAAP. Our concern is that with objectives-based standards, this problem will be exacerbated and due process will effectively be eliminated for preparers.

The ABA believes that a balance of well-paced principles and rules will ultimately benefit the financial reporting system the most by allowing companies sufficient time to adapt and providing the specific guidance sometimes needed to implement the changes. Objectives-based accounting standards should only be used if due process can be adequately followed and the Commission, auditors, PCAOB, and FASB are prepared to accept such standards.

Monitor and Improve Client/Auditor Interactions (Recommendation V.S.4)

The Committee recommends that the Commission and other bodies monitor the state of interactions between auditors and their clients in evaluating internal controls over financial reporting and take further action to improve the situation if warranted.

The ABA agrees with this recommendation. Our letter to the Commission (April 1, 2005) in preparation for its roundtable on Section 404, included the following:

- 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 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.

The first two bullet points continue to be very problematic; however, the PCAOB's guidance issued subsequent to the Commission/PCAOB roundtable has resulted in significant improvement in the issues discussed in the third bullet point.

<u>Provide Further Guidance on Internal Controls and Consider Amending AS2 (Recommendation III.S.1)</u>

The Committee proposes, as a secondary recommendation, that the Commission provide, and request that COSO and PCAOB provide, additional guidance to help facilitate the assessment and design of internal controls and make processes related to internal controls more cost-effective; also, assess if and when it would be advisable to reevaluate and consider amending AS2.

The ABA supports the notion of developing a more reasonable internal controls framework for smaller public companies. This should help ensure that the level of detail relating to the internal controls framework is appropriate for smaller companies. 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.

With respect to AS2, we continue to believe, as we stated in our letter to the Commission dated April 1, 2005, that neither the law itself nor the

Commission's regulations require an audit opinion relating to Section 404. Instead, only an attestation is required. However, the PCAOB requires both an attestation and a separate audit opinion. We believe that eliminating the opinion would help reduce costs.

Evaluate COSO Structure (Recommendation III.P.2)

The Committee proposes, as a secondary recommendation, that the Commission determine the necessary structure for COSO to strengthen it in light of its role in the standard-setting process in internal control reporting.

We agree with the thrust of this recommendation. When COSO was first established, its framework was not required. Over time, it has become a de facto standard setting body. It may be that no change is needed; however, this should be examined.

Conclusion

In conclusion, the ABA appreciates the opportunity to comment on the effect of the Sarbanes-Oxley Act of 2002 on small banks and savings associations. Corporate governance and the regulatory framework, in general, have become an increasingly important issue for our member banks, both large and small. However, given their more limited resources, smaller public companies, such as community banks, have proportionally experienced the heaviest burden from the requirements. We hope that our comments will assist the Committee preparing its final recommendations for the Commission. Please do not hesitate to contact the undersigned should you wish to discuss these matters further.

Sincerely yours,

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