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By E-mail (comments@pcaobus.org) and Federal Express

Mr. William J. McDonough
Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008,
Release No. 2003-017, October 7, 2003

Dear Mr. Chairman and Members
and Staff of the Board:

**PROPOSED PCAOB ATTESTATION ENGAGEMENT STANDARD:
An Audit of Internal Control Over Financial Reporting Performed
in Conjunction With an Audit of Financial Statements**

Introduction

Manufacturers Alliance/MAPI Inc. (Alliance or MAPI) is pleased to have this opportunity to comment to the Public Company Accounting Oversight Board (PCAOB or Board) on PCAOB's proposed attestation engagement standard, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements." If adopted, the proposal would result in the standard on attestation engagements governing external auditor attest to management's assessment of internal control over financial reporting, as required by Sections 404(b) and 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 (SOA or Act).

The Alliance is a nonprofit business league, established 1933, in service to the business community under Internal Revenue Code Section 501(c)(6) for the purposes of engaging in economic and policy research and executive continuing professional education. Most Alliance members are public companies affected directly by SOA and subject to external audit by public company accountants (alternatively referred to herein as external auditors) registered with the Board. Consequently, the Alliance has a direct and immediate interest in the proposed standard to which this statement is directed.

To summarize, PCAOB's proposal is comprehensive, but also seems unnecessarily prescriptive and potentially quite costly for audited entities. In the broadest sense, the message we hope to convey to PCAOB in this brief commentary is one of "moderation" to the extent that the Board has discretion in carrying out this project while conforming fully to the spirit and intent of SOA Section 404. More specifically, we believe that the final standard should be more flexible, including some rebalancing with respect to the orientation to, manner of, and obligations for auditor testing of the control(s) subject to management assessment.

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Having requested the first extension of the regulatory deadline for implementation of this provision and being familiar with the logistics of financial statement audit with this new appendage, the Alliance has no wish to delay this project. We understand the significance of Section 404, and are aware that the Securities and Exchange Commission (SEC or Commission) must review the final submission after PCAOB is finished with it. Meanwhile, the absence of implementation rules creates uncertainty for all parties and inconvenience—possibly including unnecessary cost—for companies, notably those in the early waves of affected parties having fiscal years beginning on or after June 15, 2004.

Background

SOA was enacted in circumstances of a “crisis of confidence” caused by accounting and audit failures at several public companies, which, in combination with economic conditions of recession, resulted in devastating equity market losses. In capsule summary, the Act was emergency legislation characterized by new rules of corporate governance and accountability and commensurately increased penalties for noncompliance.

As the most sweeping overhaul of the federal securities laws since the 1930s, SOA was intended to fill oversight and financial reporting gaps, address accounting and audit rule-making inadequacies, explore areas of suspected abuse, and sensitize all financial capital market participants to their responsibilities. At the same time, the outcome was intended to restore confidence in institutions and entities without prejudice to basic concepts of self-regulation and without detriment to the fundamental dynamism of private enterprises competing in open markets.

Since enactment of SOA, Section 404 has demanded considerable attention and resources of affected public companies to identify, map, and document all processes involving and internal control over financial reporting. The foregoing has been undertaken in anticipation of determining integrity of process that will support the required management assessment and independent attest thereto.

Although regard for internal control over financial reporting hardly is new in well-managed companies, the statutorily required management assessment subject to independent attestation adds a new dimension to the topic. Moreover, SOA significantly raised management’s financial reporting obligations overall and increased appreciably the potential liability of directors, managers, and public companies’ external auditors for failure to prevent or detect and deal with financial reporting control deficiencies.

The Alliance does not suggest that SOA Section 404 has been all cost and no benefit. To the contrary, the exercise in process mapping and documentation has led serendipitously to some discoveries of reengineering opportunities. Also, the necessary introspection has uncovered some areas of financial reporting processes that frankly needed reinforcement. Like the certification procedures of SOA Sections 302 and 906, the responsibility to assess publicly—albeit not entirely welcomed—has imparted some increment of sensitivity and commensurate flow-down of duties to persons who should be held accountable.

PCAOB is an integral part of the Section 404 dialogue because the Board must issue the attestation engagement standard for registered public company accountants to follow in evaluating and opining on the assessments of controls made by management. SOA Title I established PCAOB in part to replace the Auditing Standards Board (ASB) in its prior work of issuing generally accepted auditing standards (GAAS). Although PCAOB was authorized by SOA on an interim basis to adopt preexisting standards and the Board did so, the Board elected to issue its own Section 404 standard in lieu of existing alternatives not considered efficacious.

As indicated earlier, the effective date of SOA Section 404 already has been moved once, and little time remains for orderly completion of PCAOB’s project and application of the resulting rules to companies with fiscal years beginning on or after June 15, 2004.

General Observations

PCAOB’s authority in this matter derives from the SOA sections mentioned earlier, the clearest manifestations of congressional intent being reflected in the statute itself supplemented by related congressional reports and SEC’s interpretations to date. In our opinion, certain aspects of the Act and surrounding circumstances are especially instructive as to congressional intent for implementation by the Board.

Principles-oriented approach. In enacting SOA Section 404, Congress clearly sought more visible management accountability to the public with respect to internal control over financial reporting, including an independent party to attest to the reliability (or lack thereof) of management's assessment of the condition of such control. However, Congress was sensitive to the consequences of regulatory burden, took a principles-oriented approach to the law itself, and left the implementing agencies with considerable discretion.

Regulatory burden. Congress had no option in the circumstances of SOA but to enact fairly sweeping revisions, even though many well-managed entities would be treated the same as the small number of poorly governed organizations that precipitated the "crisis of confidence" and related reforms. In addition, Congress knew that private companies, public companies not registered with SEC, and issuers of asset-backed securities would not be affected by the new mandates applicable to many registered public companies. Surely, the regulatory burdens of the latter would be a competitive advantage to the former.

No separate engagement. For reasons just noted, among others, Congress did not intend to encumber processes and relationships unduly. Nor did Congress intend to cause affected parties, including owners and other constituents of public companies, to think that the outcomes of the Section 404-prescribed routines would be failsafe. Although Congress obviously intended to have a management assessment of control over financial reporting and some measure of independent testing leading to public attestation, the latter explicitly was not to have the status of a separate engagement.

Avoiding prescriptive remedies. Purposefully avoiding prescriptive remedies, Congress chose not to stipulate the type or extent of control over financial reporting required by SOA Section 404 or the precise amount or output of attest activity. The object of Section 404 was to induce better accountability for and oversight of financial reporting as part of the SOA mission to reinforce public confidence, but to do so with as little intrusiveness as circumstances would warrant. In section after section of SOA where "command and control" regulation could have been used, Congress simply stated goals or commissioned studies.

One size fits all. We concur in PCAOB's assertion that internal control over financial reporting is not "one size fits all." However, as the Board surely is aware, the final PCAOB pronouncement will, in fact, be a "one size fits all" directive for affected companies. In so stating, the Alliance does not argue in favor of differential treatment for regulated parties. Such variance would only skew further the unanticipated and unintended consequences of the measure as between similarly situated parties, some of whom are affected by the standard whereas others are not. Rather, we recommend leaving much more room for judgment and mutual agreement on how best to address particular facts and circumstances.

Self-governance works. Further on the latter theme, we urge that PCAOB review its proposed standard with care and eliminate unnecessary stipulation of procedures in favor of reciting objectives and principles. Also, we recommend the exercise of professional skepticism about presumed beneficial effects of more rather than less detail. Just as the Board is a self-regulatory body premised on the idea that self-governance can work more efficiently than government edicts, so too might its output reflect such a conviction by establishing goals and allowing incentives, disincentives, and innovation to operate with minimal constraint.

Interpret with reserve. To repeat, SOA occurred in emergency circumstances, and a reasonable bipartisan solution was needed quickly. The circumstances did not admit of surgical remedies so blanket coverage became the order of the day. Congress delegated authority liberally among existing regulators (e.g., SEC, the Financial Accounting Standards Board (FASB), and national securities exchanges), and new standard setters (e.g., PCAOB). Quite clearly, however, Congress also intended that policy interpretation be performed with restraint.

Our recommendations that constitute the remainder of this letter are concerned with regulatory excess, and we strongly urge the PCAOB to abide by a "rule of reason" approach. SOA Section 404 may be the single most demanding provision of the Act, and we believe that the Board's proposal has disruptive potential.

Specific Recommendations

The comments to follow relate to certain paragraphs of the proposed PCAOB attestation standard, and, to the extent not previously addressed, to some of the Board's questions raised in prefatory material accompanying the proposal.

Reasonable judgment (briefing paper p. 3, proposal appendix E). We urge clarification for companies of *all* sizes, rather than "small" companies alone by some definition, that the external auditor is to exercise "reasonable judgment" in determining the extent of the audit of internal control over financial reporting and the extent of testing needed to ascertain the effectiveness of that control. Regulatory burden may be somewhat less tolerable for small companies, but certainly affects all entities reached by the standard and is not a function of size alone.

We note further that some of the characteristics cited in appendix E for small- and medium-sized companies often are encountered in entities of all sizes. The PCAOB's generalization about entity affluence and bountiful staff resources as being a factor of size could be misleading.

Inherent limitations (proposal paragraph 15). PCAOB should emphasize that inherent limitations apply in internal control attestation because control is dependent on human diligence and strict compliance. Emphasize further that persons inclined to misbehavior, whether they are acting individually or in conspiracy, may be able to circumvent such control. By underscoring this fact, PCAOB can relieve external auditors of some of the potential litigation risk that otherwise may result in excessive (even duplicative), costly testing.

Auditor competence (proposal paragraph 31, preamble query 5). We recommend that PCAOB *not* specify external auditor competence as a factor to be applied in the attestation standard. Avoid any such micromanaging in policy instruments. The proposal is overly complex as it stands. Furthermore, the most competent auditor cannot be expected to identify every actual or potential control deficiency. Auditors already have standards of professional conduct and reputations to uphold, and can be expected to assign competent personnel to the work.

Assessment Process (proposal paragraphs 153 – 182). The Board should direct the external auditor's focus to the adequacy of management's process to determine control effectiveness, with the expectation that the auditor will test to some extent in arriving at a determination as to the integrity of the process and, by extension, the reliability of findings based thereon. Congress ordered (i.e., in SOA Section 404(b)) an attestation to and a report on management's assessment. Whether the auditor focuses on the assessment process or the controls themselves, testing will be part of the routine.

Work sharing (proposal paragraphs 5, 103 - 110). We recommend that PCAOB give flexibility to the section on the external auditor's use of the work of persons acting under the direction of management. Notably, we recommend eliminating the various categories of work and findings that are restricted to the external auditor. Auditor and client need much more leeway to arrive by mutual agreement at a division of labor in conduct of the attest activity. On such a basis, the matter of the auditor's confidence in persons acting at the direction of management is a "given" and need not be addressed in the standard.

Furthermore, since SOA enactment, many companies have conferred on their internal auditors significant independence by means of functional reporting to their audit committees. Internal auditors uniquely are able to perform significant amounts of the testing, and nothing in the standard should prevent auditor and client from reaching a mutually acceptable accommodation.

Walkthroughs (proposal paragraphs 79 - 83). We are not in favor of the requirement of "walkthroughs" of "all significant processes." Certainly the external auditor wants to be satisfied that the control subject to assessment works. However, the auditor logically would use sampling where cost-efficient, and should be expected to rely some on credible work done by others. Again, the latter should be an item for negotiation and mutual agreement, understanding that such agreement will reflect in some measure the external auditor's confidence in client personnel, other client agents, and the control environment generally.

Design/operating effectiveness (proposal paragraphs 84 – 112). PCAOB should reengineer the proposal as it relates to evaluating design effectiveness and the testing of operating effectiveness. We understand the differences between "design" and "operation," but also recognize that effective design bodes well for operating effectiveness. By contrast, the proposal treats these matters as if they were separate and unrelated types of work to be performed, which leaves little to professional judgment and adds needless complexity to the standard.

Sampling and risk assessment (proposal paragraphs 60 – 78, preamble query 16). We think it would be extravagant to require the external auditor *annually* to obtain evidence of the effectiveness of control for *all* relevant assertions for *all* significant accounts and disclosures. In such a mandate, PCAOB would leave little or no room for the external auditor working in conjunction with internal audit to agree on sensible sampling procedures, risk assessment, or the tailoring of test cycles to suit individual facts and circumstances. The auditors, rather than a standard, should determine the propriety of sampling, risk assessment, and cycles.

Re-testing at yearend (proposal paragraphs 94 – 100). SOA Section 404 presents affected entities with a formidable logistical challenge. PCAOB is well advised, in our opinion, to leave to auditor and management collaboration and mutual agreement how much, if any, of control testing during a fiscal year needs to be repeated at yearend for the sake of having an up-to-date evaluation. We urge the abandonment of wasteful requirements for the re-testing for work already performed during the fiscal year. External auditors that have reason to re-test a process for the sake of assurance of integrity can be expected to insist on doing so.

Existing practices (proposal paragraphs 131 – 144). We suggest that PCAOB simplify the “evaluation of test results” and the “forming of an opinion” by leaving room for professional judgment and incorporating wherever possible existing practices applicable in the financial statement audit and such other contexts as are compatible with Section 404 attestation. This SOA Section 404 project may be the Board’s first foray into standard setting for audit, but the novelty of the occasion is not a reason to treat the subject matter as if evaluating test results and forming opinions were unprecedented activities for auditors.

Required communications (proposal paragraphs 190 – 193). We candidly have mixed reactions to these provisions. We certainly favor communication of significant findings, and the escalation provisions as to reporting to management or the audit committee seem logical. Also, issues of fraud clearly should be handled in a manner consistent with AU sec. 316. As for timely communication, the matters of “relative significance” and “urgency of corrective follow-up action” are best left to professional judgment. The proposal seems to us less than transparent for that purpose, so we suggest that PCAOB revisit the issue.

Tone at the top (proposal paragraphs 19 – 20, 41 – 47, 56 – 59). To the extent possible, SEC and PCAOB might better orient their SOA Section 404 activity to processes followed at higher levels in affected companies. The ill-governed organizations that precipitated the Act almost universally were corrupt, inept, and/or ineffective at levels in the organization that had oversight responsibility. The Board’s proposal, if it had been adopted and blessed with complete compliance at some earlier date, would not necessarily have curbed the malfeasance that resulted in the Act.

Some of the paragraphs cited for this comment seem to envision audit of the audit committee role in control over financial reporting. As PCAOB may be aware, a number of audit committees have adopted use of their own control self-assessment (CSA) routines, and the movement appears to be spreading. We think that the standard should take this into consideration with a view to economizing on audit committee time commitment for SOA Section 404 control testing purposes.

Attest or audit (preamble query 1). PCAOB asks, in essence, whether the process it is standardizing should be characterized as “audit” or “attest.” To some parties, the question might seem to be an exercise in semantics. However, an audit is a task with very specific meaning in the profession, as the Board is aware, and is an activity of more consequence than “reviews” or lesser activities by external auditors. Rather than complicate an area where potential liability already is in question, PCAOB might be well advised to regard the task as attest only. We have used the words interchangeably in this letter because the Board has done so in its release.

In conjunction with financial statement audit (preamble queries 2 - 3). The question, to summarize, is whether Section 404 attest always should be done in the context of financial statement audit. We would like to think otherwise if the added flexibility would translate into operational economies, less intrusiveness, and lower fees. The issue is with the wording of the statute. If PCAOB has a way to lessen the burden of Section 404 by re-characterization or otherwise without offense to the legislation, we suggest that the idea at least be explored.

Scope of the audit (preamble query 6). Basically, PCAOB inquires whether it is appropriate for the Board to be requiring auditors to evaluate management's assessment while also requiring that the auditor perform various procedures directly. As noted earlier, PCAOB should take every opportunity to reduce the unwieldy transaction cost of this standard. To restate our earlier remark, the Board is putting the external auditor in a position of auditing work that may already have been performed (or could have been done) by internal audit or other management-directed parties on whom the external auditor could rely, assuming sufficient confidence. We recommend leaving more discretion to the parties.

Inadequate documentation (preamble query 8). We do not think that inadequate documentation necessarily is a control deficiency. The suitability of documentation will vary with individual circumstances. One size truly does not fit all, as PCAOB has contended. Appendix E appropriately so indicates although, as noted, the generalization about businesses of certain sizes could be misleading.

The Alliance again thanks PCAOB for this opportunity to comment on Rulemaking Docket Matter No. 008. Should you have questions about any of the foregoing, please do not hesitate to call me at (703) 841-9000.

Respectfully submitted,



Francis W. Holman, Jr.
Vice President and Secretary