American Federation of Labor and Congress of Industrial Organizations

815 Sixteenth Street, N.W.
Washington, D.C. 20006
(202) 637-5000
www.aflcio.org

February 26, 2007

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 021

Dear Sir or Madam:

On behalf of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), I appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements And Other Related Proposals* ("Proposal"). We believe that the auditors' report on management's assessment of internal controls over financial reporting is an integral part of the shareholder protections provided by Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") and that, in general, the PCAOB has provided appropriate guidance to auditors and managed the issues surrounding Section 404 and its application to smaller companies in a thoughtful and balanced manner.

We support the PCAOB's adherence to the statutory language of Section 404 by proposing standards that:

- apply a single standard to all companies regardless of size;
- require companies to test all material controls annually;
- recognize that a company's complexity is not simply a function of revenue or market capitalization; and
- require the outside auditor to perform a genuine test of controls.

We urge the Commission in the strongest possible terms to maintain these requirements in the final rule.

Union members participate in benefit plans with over $5 trillion in assets. Union-sponsored pension plans hold approximately $400 billion in assets, and union members also participate in the capital markets as individual shareholders. In particular, union members' pension funds are broadly invested in a variety of small-cap index funds and are sizable shareholders in many smaller public companies.

The AFL-CIO recognizes that small businesses are an engine of job creation and economic growth. However, we continue to believe that our members and their pension funds should not assume unmanageable risks when investing in smaller public companies. More than 18 percent of smaller public companies, defined by the Advisory Committee on Smaller Public Companies as those with a market capitalization less than $787.1 million,[1] reported material weaknesses in their first year of reporting on internal controls.[2] Smaller public companies have also historically accounted for the vast majority of SEC accounting fraud cases.[3] Recent studies reveal that the number of restatements by large public companies, who implemented Section 404 in 2004, fell by nearly 20 percent in 2006.[4] We look forward to similar decreases in smaller companies' level of restatements after the Proposal's implementation.

We appreciate the opportunity to comment on the Proposal and would like to call your attention to several areas where we believe modifications will enhance audit quality and better serve the interests of the investing public.

We are concerned that the Proposal's focus on efficiency will be misinterpreted by some issuers and auditors as a license to perform inadequate assessments of internal controls. The Proposal recommends a "top-down" approach that "directs the auditor's attention to accounts, disclosures, and assertions that present a *reasonable* possibility of material misstatement to the financial statements and related disclosures," allows auditors to rely solely on internal controls to address the risk of material misstatements in smaller companies' financial reports, and allows control testing at a single central location when multiple locations are in operation. [5] While we support efforts to enhance efficiency, we continue to believe that the primary role of the PCAOB is to prescribe a minimum level of effectiveness. In view of these concerns, we would respectfully request that the final rule emphasize that the top-down, risk-based approach does not permit less rigorous evaluation methods and procedures.

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[1] *Final Report of the Advisory Committee on Smaller Public Companies*, S.E.C. (April 23, 2006) (available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf) (accessed February 26, 2007).
[2] Remarks of Charles D. Niemeier on the Proposed Auditing Standard on an Audit of Internal Control Over Financial Reporting. PCAOB Open Meeting (December 19, 2006); Audit Analytics.
[3] *SOX and Small Business*, Letter to the Editor, Wall St. J., August 19, 2005
[4] David Reilly, *Restatements Still Bedevil Firms*, Wall St. J. February 12, 2007, at C7.
[5] *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements And Other Related Proposals*. PCAOB Release 2006-007 (December 19, 2006).

While we recognize the financial burden smaller companies face in implementing Section 404 and the desire to avoid duplicative efforts by management and external auditors, we are concerned that allowing auditors to rely excessively on issuers' internal reports may not fulfill the requirements of Section 404. A 2005 report released by the American Institute of Certified Public Accountants stated that "because management is primarily responsible for the design, implementation, and maintenance of internal controls, the entity is always exposed to the danger of management override of controls."[6] Increased reliance on internal audits creates a substantial risk that, in situations where management is not both competent and honest, external auditors will not detect misconduct that would affect the financial statements. We continue to believe that allowing the independent auditor to rely excessively, without testing, on representations of the issuer's internal audit staff undermines the critical concept that independent audits are conducted by independent auditors, not the employees of the preparer.[7]

In light of the significant potential for weaknesses in smaller companies' internal controls, we respectfully request that the final rule emphasize that the opportunity to scale the audit of a smaller, less complex company does not permit less rigorous evaluation methods and procedures. Auditors should be on notice that they may need to increase their analysis of a company's particular circumstances including its corporate governance structure, incentives and opportunities for members of senior management to commit misconduct, or the competence of personnel when more traditional, concrete evidence is unavailable. For example, the final standard should enunciate that in situations where auditors are forced to test controls through inquiry and observation or rely on monitoring performed by senior management the auditors should consider opportunities and incentives for misconduct faced by top management.

We generally support the Proposal's provisions that allow auditors to incorporate prior years' assessments of the risks of material misstatements and the competency and objectivity of management and employees in subsequent audits. Auditors, in the exercise of their professional judgment, should be permitted to use their knowledge of a company's internal controls and procedures to determine what testing is necessary to identify material weaknesses in management's internal controls over financial reporting. We believe that the Proposal strikes the proper balance between effectiveness and efficiency without violating the annual testing requirement of Section 404 and we would

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[6] *Management Override of Internal Controls: The Achilles Heel of Fraud Prevention.* American Institute of Certified Public Accountants, The Audit Committee and Oversight of Financial Reporting. (2005).
[7] Damon A. Silvers. Speech. *Statement of the American Federation of Laborers and Congress of Industrial Organizations*, S.E.C. Roundtable on Internal Controls (April 13, 2005) (Copy of transcript on file with the Securities and Exchange Commission).

strongly oppose any amendments that allow key controls to be tested on a rotational basis as both unwise and contrary to the statute.

We also support the Proposal's application of the same definition of materiality for auditors reviewing both annual financial statements and management's internal control over financial reporting. We believe that the Proposal's qualitative approach to determinations of materiality are supported by the SEC, the Financial Standards Board, and the US Supreme Court and would oppose any revisions to the Proposal that would establish a rules-based, numerical formula to calculate materiality. [8]

We commend the PCAOB for formulating an auditing standard that fulfills the statutory requirements of Section 404 and specifically addresses the concerns smaller companies face in implementing Section 404. We believe that implementation of the Proposal will go a long way toward restoring investor confidence in the quality and reliability of audited financial statements. We thank you for this opportunity to comment on this Proposal, and hope that the PCAOB will consider our comments in formulating its final rule.

If you have any questions regarding our comments, please feel free to contact Damon A. Silvers at (202) 637-3953.

Sincerely,

Richard L. Trumka

RLT/me
opeiu #2, afl-cio

cc: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel Campos
Commissioner Annette L. Nazareth
Chairman Kathleen L. Casey
Chairman Mark. W. Olson
Board Member Kayla J. Gillan
Board Member Daniel L. Goelzer
Board Member Bill Gradison
Board Member Charles D. Niemeier

[8] *See, e.g.,* SEC Staff Accounting Bulletin: No. 99 – Materiality, 17 C.F.R. § 211 (Aug. 12, 1999).

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February 26, 2007

VIA FACSIMILE (202) 772-9324

Ms. Nancy M. Morris
Committee Management Officer
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9309

Re: File Number S7-24-06

Dear Ms. Morris:

On behalf of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), I appreciate the opportunity to comment on the Securities and Exchange Commission's ("SEC") proposed interpretive guidance, Management's Report on Internal Control Over Financial Reporting ("Proposal"). We believe that the effective internal controls ensured by Section 404 are the backbone of high-quality financial statements, and that, in general, the Commission has managed the issues surrounding Section 404 in a thoughtful and balanced manner.

I. Background

Union members participate in benefit plans with over $5 trillion in assets. Union-sponsored pension plans hold approximately $400 billion in assets, and union members also participate in the capital markets as individual shareholders. In particular, union members' pension funds are broadly invested in a variety of small-cap index funds and are sizable shareholders in many smaller public companies.

We support the Commission's adherence to the statutory language of Section 404 by proposing guidance that:

- applies a single standard to all companies regardless of size;
- requires companies to test all material controls annually;
- recognizes that a company's complexity is not simply a function of revenue or market capitalization; and
- requires the outside auditor to perform a genuine test of controls.

We urge the Commission in the strongest possible terms to maintain these requirements in the final rule.

II. Specific Comments

While we believe that the Commission's proposed guidance generally responds to investor and small business concerns in a thoughtful and substantive manner, we would like to offer the following comments.

A. Reliance on Internal Reports

While we recognize the financial burden smaller companies face in implementing Section 404 and the desire to avoid duplicative efforts by management and external auditors, we are concerned that allowing auditors to rely excessively on issuers' internal reports may not fulfill the requirements of Section 404. A 2005 report released by the American Institute of Certified Public Accountants stated that, "because management is primarily responsible for the design, implementation, and maintenance of internal controls, the entity is always exposed to the danger of management override of controls."[1] Increased reliance on internal audits creates a substantial risk that, in situations where management is not both competent and honest, external auditors will not detect misconduct that would affect the financial statements. We continue to believe that allowing the independent auditor to rely excessively, without testing, on representations of the issuer's internal audit staff undermines the critical concept that independent audits are conducted by independent auditors, not the employees of the preparer.[2]

B. Focus on Efficiency

We are concerned that the Commission's focus on efficiency will be misinterpreted by some issuers and auditors as a license to perform inadequate assessments of internal controls. The proposed guidance recommends a "top-down, risk-

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[1] *Management Override of Internal Controls: The Achilles Heel of Fraud Prevention.* American Institute of Certified Public Accountants, The Audit Committee and Oversight of Financial Reporting. (2005).
[2] Damon A. Silvers. Speech. *Statement of the American Federation of Laborers and Congress of Industrial Organizations*, S.E.C. Roundtable on Internal Controls (April 13, 2005) (Copy of transcript on file with the Securities and Exchange Commission).

based evaluation" that allows auditors to rely solely on company-level controls to identify financial reporting risks.[3] It also states that in selecting which controls to test "management may consider the efficiency with which evidence of the operation of a control can be evaluated," and allows control testing at a single central location when multiple locations are in operation.[4] While we support efforts to enhance efficiency, we continue to believe that the primary role of the Commission is to prescribe a minimum level of effectiveness. In view of these concerns, we would respectfully request that the final rule emphasize that the top-down, risk-based approach does not permit less rigorous evaluation methods and procedures.

C. *Further Extensions*

We appreciate the efforts of both the Commission and the PCAOB to clarify their expectations for management and auditors, and have supported the need to allow a modest extension to non-accelerated filers to allow them to implement policies and procedures in compliance with the new guidance. The AFL-CIO is keenly aware of the particular hardships that smaller public companies face in implementing Section 404, however, public companies have been required to establish and maintain internal controls over financial reporting since Congress passed the Foreign Corrupt Practices Act in 1977. In light of these considerations, we do not support any further extensions of the compliance deadline for any part of Section 404 beyond this modest proposed extension.

III. Limitation on Auditor Liability

In a recent speech at *The SEC Speaks in 2007*, SEC Chief Accountant Conrad Hewitt raised the possibility that either the SEC or the PCAOB would seek to limit auditors' liability through this rulemaking. In light of the fact that neither the Proposal, the PCAOB's AS-5, nor any prior proposed rules introduced this concept, any change to the standard of auditor liability is impermissible absent compliance with the notice and comment requirements of the Administrative Procedures Act. We are unable to comment on this matter absent further information about "either the terms or substance of the proposed rule or a description of the subjects and issues involved."[5]

IV. Conclusion

We commend the Commission for formulating comprehensive guidance to instruct issuers struggling with the implementation of Section 404. We believe that

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[3] *Management's Report on Internal Control Over Financial Reporting.* Release Nos. 33-8762; 34-54976; File No. S7-24-06 at 24**.** (December 20, 2006).
[4] *Id* at 25, 40.
[5] 5 U.S.C § 553.

implementation of the proposed guidance and rapid implementation of Section 404 for all publicly traded companies will go a long way toward restoring investor confidence in the quality and reliability of audited financial statements. We thank you for the opportunity to comment on this proposal, and hope that the Commission will consider our comments in formulating its final rule. If you have any questions regarding our comments, please feel free to contact Damon A. Silvers at (202) 637-3953.

Sincerely,

Richard L. Trumka

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