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Ms. Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. PCAOB-2007-02

Dear Ms. Morris:

Thank you for the opportunity to submit our views concerning the PCAOB Proposed Rule on Auditing Standard No. 5 (AS5). We are a family of small businesses categorized as an “accelerated filer” by reference to our total market capitalization. The Alamo Group has fully complied with the provisions of Sarbanes-Oxley Section 404 (SOX 404) for the past three years, carefully considered the provisions of the newly released AS5 as well as the proposed management guidance provided by the SEC, and considered the projected effects of these new standards on our future work and expenses. We believe our experience has been and will continue to be representative of that which the SEC intends to impose on all smaller “non-accelerated filers” beginning in 2007.

Concerns about management trust and reliability underlie the corporate scandals that gave rise to the Sarbanes-Oxley Act, the intent of Congress in developing that Act, and current unease expressed by groups that represent consumers and institutional investors. Nevertheless, for the past several years attempts to address these concerns have focused almost entirely on auditing, with virtually no emphasis on management’s role, responsibilities and reporting requirements. No amount of internal control auditing can compensate for an unreliable management team who, in addition to those decisions relating to establishing and reporting on internal control, make literally thousands of other decisions relating to products, markets, distribution channels, locations and personnel. In our view, the continuing focus on auditing instead of management accountability is seriously misplaced.

AS5 reflects refinements rather than substantive changes in the approach to satisfying SOX 404 requirements. That approach continues to center on the PCAOB requirement for an annual full-blown external ‘audit of internal control’, which in our experience has been the single largest contributor to the extraordinarily high expense associated with SOX 404 compliance. The external ‘audit of internal control’ perpetuated by AS5 is *clearly not required by SOX 404* and represents an approach to protecting the interests of investors that has been specifically considered *and rejected* in the UK, Canada, Japan and perhaps other international jurisdictions.

In AS5 the PCAOB indicates its requirement for an annual full-blown external ‘audit of internal control’ is warranted by Section 103 of the Sarbanes-Oxley Act. Section 103 goes to the standards and rules the PCAOB must establish; Section 404(a) specifically emphasizes and requires a management assessment of internal control, and Section 404(b) specifically requires an external auditor’s report on management’s assessment. In AS5, the PCAOB chooses to address SOX Section 103 by requiring a very expensive service that Congress did not specifically mandate while at the same time largely eliminating the much more focused and potentially far more cost effective service that Congress specifically required in SOX Section 404(b). In our view, the election to address SOX

Section 103 while largely disregarding SOX Section 404(b) vastly increases the cost of SOX 404 compliance for all registrants, provides little if any incremental value to investors, and is inconsistent with the intent of Congress as well as the requirements of the Act.

Additionally we are aware of no evidence of compliance with the Regulatory Flexibility Act, which we understand to require in part an analysis of:

- 1) the impact of the proposed AS5 on small entities, and
- 2) significant alternatives that would accomplish the objectives of the Sarbanes-Oxley Act while minimizing the economic impact on small entities.

With respect point 1) above, we see at least three reasons why AS5 will **NOT** have any significant impact on the high level of expense that has been associated with SOX 404 compliance:

- a) The elimination of the external auditor's report on management's assessment has been described by some as the most significant change in AS5. For the past three years, the external audit fees associated with that report have been minimal relative to the fees associated with the full-blown external "audit of internal control." We therefore expect this "most significant change" to have a minimal affect on future expense.
- b) AS5's emphasis on a "top-down, risk based" approach that focuses on "the most important matters" has been described as a major contributor to future efficiency and cost reduction. As noted by the PCAOB however, that "approach follows the same principles that apply to the financial statement audit." The approach described in AS5 also follows the same principles that we and many other accelerated filers used to comply with SOX 404 for the past three years. There is literally nothing new here.
- c) The core requirements of AS5 are largely identical to those of AS2, in that the external auditor is expected to identify any and all "little problems" (control deficiencies) that might combine to become "big problems" (material weaknesses). In order to do so effectively in a highly litigious environment, experience suggests external auditors will continue to feel compelled to identify and evaluate most if not all of the "little problems" in control. It is simply not prudent to conclude about unknown "little problems" in the absence of a comprehensive analysis.

Accordingly, we believe the cost of compliance with AS5 will continue to be unacceptably high for all registrants and disproportionately burdensome to small companies.

With respect to point 2) above, one obvious significant alternative to accomplishing the objectives of the Sarbanes-Oxley Act would be a requirement to comply with its Section 404(b) instead of the continuing emphasis on Section 103. Under this alternative the external auditor would focus and report on management's assessment in lieu of performing the much broader, full-blown external 'audit of internal control'. If the SEC would provide objectively verifiable standards and benchmarks for performance of management's assessment and the PCAOB were to provide reasonable expectations for an external auditor's review of that assessment, we believe this alternative could potentially offer a much more cost effective approach to compliance with SOX 404 while investors would benefit from the same level of protection or more than is provided in other international jurisdictions.

Unless and until the impact on small entities is assessed and significant alternatives to the present approach are explored, we believe it is inappropriate to apply the requirements of AS5 to "non-accelerated filers". Further, we believe AS5 offers little relief to "accelerated filers" since it largely perpetuates an unnecessarily expensive approach to complying with SOX Section 404.

Given the apparent conflict between the requirements of Sections 103 and 404 of the Act, it would seem appropriate to focus on resolution of that conflict in favor of the approach that permits the most cost effective way of accomplishing the objectives of the Sarbanes-Oxley Act for *ALL* registrants and their investors. In the pages that follow we describe a six point action plan toward that resolution and further substantive change. Key elements of that plan are as follows:

- 1) Delete the existing Section 103(a)(2)(A)(iii) of the Act and replace it with new wording
- 2) Clarify Section 404(b) of the Act
- 3) Revise the SEC's proposed management guidance to include clear investor protection principles similar to those suggested by the Consumer Federation of America,
- 4) Further revise the SEC's proposed management guidance to include a description of the minimum level of verifiable documentation that *ALL* registrants must provide to support their annual management assessment of internal control,
- 5) Withdraw AS5 in its entirety and replace it with an audit standard directed at providing investors with reasonable, independent assurances with respect to management's annual assessment,
- 6) Delay application of SOX 404 reporting requirements to all "non-accelerated filers".

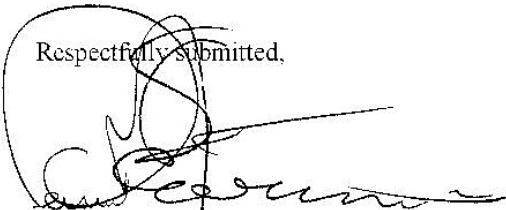
Should the changes we suggest be made, we believe external auditors will be able to report on management's assessment in much the same way, and investors should benefit from the same level of protection or more, than is provided in other international jurisdictions. Costly and unnecessary redundancy in the internal control assessment process would be removed for all registrants, accelerated filers would enjoy a substantial reduction in audit fees, and non-accelerated filers would have a much more practical approach to satisfying the requirements of SOX 404.

During the comment period ending in February, 2007 organizations representing thousands of registrants and experienced managers wrote to support the view that the proposed AS5 eliminates "the wrong opinion"; that it is in fact the external auditor's report on management's assessment that should be retained instead of the external "audit of internal control." Many of their comments are reproduced on the following pages.

In the Proposed Rule on AS5, the PCAOB suggests it is constrained by the provisions of SOX Section 103 from acting on such comments. Accordingly, we suggest the SEC work with Congress toward amending the Sarbanes-Oxley Act so as to change Section 103 to be consistent with the requirements of Section 404, thereby reinforcing the notion that maintaining, assessing and reporting on internal controls is primarily a management responsibility that management must satisfy as management considers necessary and appropriate to protect and enhance shareholder value.

Thank you for your consideration.

Respectfully submitted,



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Background

The Alamo Group is a family of small businesses categorized as an “accelerated filer” by reference to total market capitalization. As such the provisions of the Sarbanes-Oxley Act (SOX) and Auditing Standard 2 (AS2) have been fully applied to the Alamo Group for the past several years. We believe our experience has been and will continue to be representative of that which the SEC intends to impose on all smaller “non-accelerated filers” beginning in 2007.

During each fiscal year the Alamo Group as well as all other accelerated filers have six internal control related projects performed:

- 1) management’s quarterly review and update of control procedures as required by SOX Section 302,
- 2) management’s annual assessment, inspection and test of internal control as required by SOX Section 404(a), and
- 3) the annual full-blown external ‘audit of internal control’ as required by AS2.

Our SOX related expenses have been substantial. These expenses include management and staff time, charges for outside assistance, and external audit fees. External audit fees are the single largest expense associated with our SOX compliance efforts and represent about 40% of our total costs. The majority of those fees relate to the full-blown external ‘audit of internal control’ required by AS2.

Benefits

There have been benefits. Through an array of comment letters and roundtable discussions sponsored by the SEC and PCAOB, many report a focus on corporate governance that had not existed in the past and improvements in the quality and efficiency of important corporate processes and controls. Corporate board members note an improvement in audit committee oversight, while investors suggest public company financial reporting is of higher quality and transparency. At the Alamo Group there is clearly more of a focus on corporate governance and an elevated “control consciousness”. Audit committee oversight has been expanded and improved, we enhanced certain control procedures and we increased our transparency to potential investors through timely reports of control problems.

In our experience these benefits spring from a number of sources. Congress provided an Act that clearly focused on improving corporate governance and delineating management, Board and external auditor responsibility. In response our management team reassessed and improved our corporate governance procedures and developed systems to identify and continuously monitor over 1,000 control procedures that mitigate over 100 risks spread over some 40 processes executed in over ten locations in five countries. Our external auditors helped frame our management assessment, provided valuable insight, and ultimately were in a position to advise the investment community as to the value of our work. Our Board very closely monitored and guided all of this through timely reporting.

In contrast however the PCAOB suggests in its newly released Auditing Standard 5 (AS5) that it is solely the annual full-blown external ‘audit of internal control’ prescribed by AS2 and perpetuated by AS5 that is responsible for these benefits¹. In our experience, the annual full-blown external ‘audit of internal control’ has largely duplicated our management assessment, provides little incremental value to either management or shareholders, vastly increases our external auditor’s potential liability, and in each of the past three years has been our *single largest expense associated with our SOX compliance efforts*.

To the best of our knowledge and belief, there is no proof or evidence of any kind to support the PCAOB's contention that it is the annual full-blown external 'audit of internal control' that is responsible for these benefits. While we believe our external auditors counsel as well as their review and test of our assessment adds value for management, our Board and our shareholders, we see little value and unacceptable cost in the continuing requirement for external auditors to perform an annual full-blown external 'audit of internal control'.

Justification

An external 'audit of internal control' was **NOT** required by Congress through SOX 404; it is solely an invention of the PCAOB. For the past several years, it has not been clear *why* the PCAOB chose to impose this service on the American business community. On the last page of the last Appendix to AS5 however the PCAOB indicates this choice was and is justified in part by the Sarbanes-Oxley Act itself and in part by somewhat arbitrary decisions. The justification cited by the Act itself is as follows:

Section 103 of the Act requires the Board's standard on auditing internal control to include "testing of the internal control structure and procedures of the issuer" Under Section 103, the Board's standard also must require the auditor to present in the audit report, among other things, "an evaluation of whether such internal control structure and procedures ... provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles" ²

Other decisions are described as follows:

The Board continues to believe that the overall scope of the audit that was described by Auditing Standard No. 2 and the proposed standard is correct; that is, to attest to and report on management's assessment, as required by Section 404(b) of the Act, the auditor . . . audits management's assessment – the statement in management's annual report about whether internal control is effective – by auditing whether that statement is correct – that is, whether internal control is, in fact, effective.³

Alternatives

The requirements of Section 404(b) of the Act could have been satisfied much more cost effectively had alternative decisions been made. The SEC could have elected to provide standards and benchmarks for management's annual assessment. The PCAOB could have elected to prescribe what external auditors should do to ensure those standards and benchmarks had been met. In contrast to the approach suggested by the PCAOB above, the auditor could have audited management's assessment by determining whether that assessment met standards provided and publicly described by the SEC. External auditors could have provided investors with assurance that management performed its assessment conscientiously and reasonably supported the conclusions expressed in management's report.

Instead, for more than three years, no standards or benchmarks whatsoever were provided for management's assessment and the PCAOB elected to provide for an external "audit of internal control" that resulted in two, major, very expensive, largely identical but independent internal control assessment projects performed at every qualified registrant every year.

Cost

The resulting cost has been well documented. AMR Research estimated a total \$6 billion expenditure for complying with SOX requirements in 2006, on par with the \$6.1 billion spent in 2005.⁴ The Committee on Capital Markets Regulation recently estimated the average first-year cost for companies to comply at \$4.36 million,⁵ while venture capitalists suggest the average compliance cost for smaller portfolio companies is in the area of \$1 million to \$3 million.⁶

As was done in all previous related guidance, AS5 attempts to address these widely expressed concerns about excessive cost by providing redefinition and redirection on *how auditor's should perform* an external 'audit of internal control' without ever addressing *the need for and value of the service itself*. The most significant change promulgated by AS5 is often described as elimination of a requirement for the external auditor to report on management's assessment as prescribed by Section 404(b) of the Act. While there may be some question as to whether the PCAOB has the requisite authority to override a Congressional Act, in our experience only a small portion of our external audit fees relate specifically to this requirement. Accordingly we expect this "most significant change" to have little or no effect on our future expenses.

AS5 further encourages auditors to use a "top-down, risk based" approach that focuses on "the most important matters." Key elements of this approach to the annual full-blown external 'audit of internal control' are described as follows:

. . . the auditor must plan and perform the audit . . . to obtain reasonable assurance about whether material weaknesses exist . . .⁷

Multiple control deficiencies . . . may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies . . . collectively result in a material weakness.⁸

In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.⁹

Let's reconsider these key elements in plain words. Clearly the external auditor must plan and perform the audit so as to identify any existing "big problems" in control (material weaknesses). However, the auditor must be aware that a number of "little problems" (control deficiencies), when combined, can become "big problems". While the auditor is not required to search for "little problems", he or she does have an obligation to identify situations where a number of "little problems" combine to become "big problems".

No reasonable external auditor can determine if the "little problems" combine to become "big problems" without first identifying and evaluating most if not all of the "little problems" in control. It is simply not prudent for the auditor to conclude about what he or she does not know without first studying control procedures very thoroughly. This simple truth should be considered in light of what a former "Big 4" senior partner and corporate governance practice leader recently observed: "The reality is that a particular audit partner is likely to suffer greatly if he or she is deemed to have done too little work . . .".¹⁰

There is no evidence to suggest that AS5 will have any significant impact on the level of scrutiny which has heretofore been associated with the annual full-blown external 'audit of internal control'. There is no evidence supporting the contention that the provisions of AS5 will significantly reduce cost for accelerated filers, and there is no evidence supporting the contention that the cost of

compliance will not be disproportionately burdensome to small companies. As Mark G. Heesen, President of the National Venture Capital Association, said in his February 23, 2007 comment letter to the SEC/PCAOB:

The PCAOB has issued extensive guidance under AS-2 aimed at improving the cost-benefit balance. With all this effort, the costs still outweigh the benefits. . . . AS-5 is a continuation of the “better implementation” approach to improving the SOX 404 situation. It is a triumph of hope over experience.

Over the next few months, public accounting firms can reasonably be expected to digest AS5, develop related firm standard audit procedures, develop training materials pertaining to those procedures, and train staff. During much of the same period, we understand the SEC intends to require smaller “non-accelerated filers” to perform their first management assessment. In 2008 and all subsequent years, “non-accelerated filers” would hope to build on the management assessment performed in 2007, while their external auditors will be required to perform a full-blown external ‘audit of internal control’ as mandated by AS5.

With their first management assessment scheduled in 2007 smaller companies are likely to perform most if not all of the related work before their external auditor has had a chance to digest AS5, develop their firm’s standards and train their staff. Therefore a smaller company’s first management assessment may not be closely aligned with the approach their external auditor eventually develops. This may well result in substantially increased expenses in 2008. As Jeanette Y. Bennion, Vice President Financial Compliance, Washington Group International, reports in her February 26, 2007 comment letter to the PCAOB:

. . . I recently attended a seminar presented by a Big 4 accounting firm on the proposed PCAOB regulatory changes and SEC guidance. In that presentation, the audit partner stated, under the PCAOB's proposals, the cost of the 404 audit might actually increase if management's approach to 404 (differs significantly from) the independent accountants. In that situation, it may actually cause the independent accountant to do more work . . .

Based upon our reading of the recently released AS5, our reading of related management guidance proposed by the SEC, and discussions with our external auditors, we anticipate only minor if any change in our SOX related costs. This view is shared by others:

A. Stephen Meadows, Chief Accounting Officer of the Rock-Tenn Company, a ‘large accelerated filer’ engaged in paper and paper products manufacturing, in comments to the SEC/PCAOB dated February 26, 2007:

Absent more substantial change, we believe the new proposals will do very little to materially reduce the cost of Sarbox compliance. Based on their initial review of the new proposal, our auditors have indicated that they do not expect a dramatic reduction in external annual Sarbox compliance costs to result from the new proposal. . . . While we understand that the proposed new standard incorporates a more “top down,” approach to (internal control) testing, we doubt that the proposed changes will translate into a significant reduction of both internal resource effort and external auditor effort . . .

David Jordan, Director of Compliance, NIKE, Inc., a “large accelerated filer” involved in sports, fitness, and related attire, in comments to the SEC/PCAOB dated February 26, 2007:

. . . we believe that removing the requirement for an evaluation of management’s process will not eliminate a meaningful amount unnecessary audit work. Under current standards, the external

auditor already spends the overwhelming majority of effort conducting a redundant assessment of controls in parallel with management's assessment. We believe, conversely, that true efficiencies can only be realized by strengthening the evaluation of management's process and by eliminating the external auditor's own opinion over internal controls.

With implementation of AS5, we fully expect the annual \$6 billion expenditure cited by AMR Research will continue for "accelerated filers" with little change. To that will be added the cost of compliance experienced by smaller, "non-accelerated filers" that have previously been exempt. If the experience of others is similar to our own, some 40% of this annual expenditure, to date roughly \$2.4 billion per year, can be attributed to the PCAOB requirement for a full-blown external 'audit of internal control'. The following PCAOB notice is useful in assessing the incremental benefit of this high cost:

. . . an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) may not detect a material weakness in internal control over financial reporting . . . ¹¹

Comments

In our experience, the annual full-blown external 'audit of internal control' required by the PCAOB has largely duplicated our management assessment, provides little incremental value to either management or our shareholders, vastly increases our external auditor's potential liability, and *in each of the past three years has been the single largest expense associated with our SOX compliance efforts*. We believe the PCAOB requirement for a full-blown external 'audit of internal control' should be eliminated in its entirety. In its place should be a requirement that external auditors review, test and report on management's annual assessment of internal control, all as specifically required in Section 404(b) of the Act itself. This view is shared by many:

Mark G. Heesen, President, National Venture Capital Association (NVCA), representing more than 450 venture capital and private equity firms who provide start-up and development funding for innovative entrepreneurial businesses, in comments to the SEC/PCAOB dated February 23, 2007:

For the types of small, high-growth technology companies that are the focus of many venture funds, investment dollars must be devoted to key business goals if those companies are to survive and hopefully grow. Money spent on unproductive regulatory compliance can quickly undermine the ability of small start-ups to disrupt the market share of entrenched incumbents or break through skepticism to create entirely new industries. This is especially true in the ever-growing number of technologies and products where the competition is truly global. . . .

(AS5) will not reduce auditor work to the point where SOX 404 is cost effective. SOX 404 cost excesses are driven primarily by the requirement that the auditor attest to the effectiveness of (internal controls). Regulations, not the language of the Act, are the basis for this expansive auditor role in the SOX 404 scheme. Sound policy arguments support the total elimination of the audit of (internal control) effectiveness. . . . The primary value of SOX 404 is the requirement that management report on the effectiveness of internal controls. . . . The outside audit of (internal control) effectiveness provides some additional assurance, but the benefit is only incremental and the cost is unacceptable.

Victoria D. Hadfield, President, Semiconductor Equipment and Materials International North America (SEMI), and Jodi Shelton, Executive Director, Fabless Semiconductor Association (FSA). SEMI is an international industry association representing more than 2,200 companies globally, while FSA is an international industry association which serves as the voice of members in more than 21 countries across the globe, in comments to the SEC/PCAOB dated February 26, 2007:

SEMI and FSA used surveys, email dialogues and conference calls to obtain direct feedback on the experience to date with SOX 404 as well as operational level evaluation of the SEC and PCAOB proposals from member companies. . . . none of our members -- from the largest to the smallest -- believe that the full annual audit of (internal control) as required by current rules can be justified on a cost-benefit basis. Furthermore, they are very doubtful whether the full external audit, under any rules, can be done cost-effectively.

SEMI and FSA strongly support the elimination of one of the two external auditor reports on (internal control) that have been required under current SEC and PCAOB rules. . . . However, our evaluation of the proposals, based on the responses of seasoned and knowledgeable member company executives, leads us to conclude that the Commission's proposal eliminates the wrong auditor attestation. . . . Therefore, we believe that the most significant change -- perhaps the only change -- that can correct the SOX 404 cost-benefit imbalance will be to eliminate the external auditor's obligation to attest to the effectiveness of (internal control).

Carl Guardino President & CEO, Silicon Valley Leadership Group, representing more than 200 of the Silicon Valley's most respected employers, in comments to the SEC dated February 26, 2007:

we note that an alternate approach to relieve the duplicative, burdensome and costly impact of 404 (b) compliance requirements would be to remove the requirement for auditor attestation of the financial controls themselves and instead require solely an attestation of management's assessment of such controls. . . . We believe this approach is worthy of serious consideration on the parts of both the SEC and the PCAOB because it would appear to have a more far-reaching and salutary impact on the issues of complexity and excessive costs. Furthermore, it may be the best way in a regulatory context to emphasize the primacy of management's responsibility over internal controls over financial reporting.

John G. Gaine, President, Managed Funds Association, representing over 1,300 professionals who manage a significant portion of an estimated \$1.5 trillion invested globally, in comments to the SEC/PCAOB dated February 26, 2007:

We share the view expressed by other public issuers that SOX 404(b) does not require outside auditors to perform an audit of internal control. From our experience, the external audit of internal control promulgated by the PCAOB in AS2, greatly increased compliance costs, is duplicative of, if not overshadowing of, management's role in assessing internal controls, and is not cost-efficient.

Edward J. Resch, Executive Vice President and Chief Financial Officer, State Street, the world's leading provider of financial services to institutional investors, in comments to the SEC/PCAOB dated February 26, 2007:

(we) believe that the independent attestation of internal control is the primary factor that results in excessive work and implementation challenges by registrants. . . . We propose that the PCAOB rules conform to the Sarbanes Oxley Act of 2002 (and) eliminate the requirement of a stand alone opinion of internal control . . . we believe that management should continue to be accountable for assessing the design and operation of internal control over financial reporting.

Brian G. O'Malley, Senior Vice President, Internal Audit, The Nasdaq Stock Market, Inc. (NASDAQ), the largest screen-based equity securities market in the United States, in comments to the SEC/PCAOB dated February 26, 2007:

The focus of the independent auditor's opinion should be on evaluating the effectiveness of management's program rather than the effectiveness of individual internal controls. Management should continue to be held accountable for the accuracy of their financial statements and the effectiveness of their associated internal controls. The current proposal, however, removes the need for an independent auditor opinion on the execution of management's program rather than removing the opinion on internal controls. This provides minimal relief, as we believe the primary driver of auditor fees is the opinion on internal controls. The auditor needs to be refocused toward seeing the forest (management's program effectiveness) rather than the trees (individual controls).

Paul A. Sharman, President and CEO and Jeffrey C. Thomson, Vice President of Research & Applications Development, the Institute of Management Accountants, representing over 70,000 members around the world, in comments to the SEC/PCAOB dated February 13, 2007:

We do not believe that it was the intent of Congress to require that a company's auditor provide their own subjective view on whether control is or is not "effective". . . . the process is costly and inefficient, it de-emphasizes management's accountability, and further increases the enormous litigation exposure of auditors (passed on to management in the form of higher fees). . . . we fully support what we believe is the true intent of 404(b) – an independent report on whether management is taking the responsibility assigned in section 404(a) seriously and conscientiously.

John A. Ingleman, Senior Vice President and Chief Financial Officer, and David P. Radloff, Vice President of Corporate Finance, Hutchinson Technology Inc., a "large accelerated filer" involved in design and manufacturing, in comments to the SEC/PCAOB dated February 23, 2007:

. . . the PCAOB through AS2 has required an external audit opinion on the effectiveness of (internal control). Our experience is that our audit costs have more than doubled due to this requirement. This requirement entails significantly more work than would be required under a more precise interpretation of SOX 404(b) and is redundant with management's own assessment and it is management's job to make sure the controls are in place and effective. . . . The requirement that external auditors express an opinion on the effectiveness of (internal control) is not required by the SOX 404 legislation, is the source of most of the increased audit costs associated with SOX 404 compliance and does little if anything to mitigate the root issues that precipitated the SOX 404 legislation. . . . We strongly urge the PCAOB to . . . eliminate the requirement for external auditors to express an opinion on the effectiveness of (internal control).

International

Like many smaller "non-accelerated filers", the Alamo family of small businesses competes globally. The international business community does *not* universally see value in the full-blown external 'audit of internal control' required by the PCAOB. Such services have been considered by regulatory authorities in Canada, the UK, Japan and perhaps other international jurisdictions. *None* mandated them.

Chris Hodge, Corporate Governance Unit, Financial Reporting Council, the independent regulator responsible for promoting confidence in corporate reporting and governance in the United Kingdom, in comments to the SEC/PCAOB dated April 28, 2006:

In the UK . . . there is no requirement on the auditor to express a view publicly on the effectiveness of the company's internal control system.

There was virtually no demand from investors or companies for an increased role for external auditors. The existing powers and remit of the external auditors were considered sufficient; in particular, there was no support for the external auditor being required to attest as to the effectiveness of the company's internal controls.

Robert Hodgkinson, Executive Director, Technical, The Institute of Chartered Accountants in England and Wales (ICAEW), representing over 128,000 members in more than 140 countries, in comments to the SEC/PCAOB dated February 26, 2007:

Section 404(b) of the Sarbanes-Oxley Act states, in respect of the internal control assessment required of management under section 404(a), that the auditor "...shall attest to, and report on, the assessment made by the management of the issuer." In AS 2 and AS 5, the PCAOB has interpreted section 404(b) as mandating an audit opinion which expresses the auditor's own assessment of the issuer's internal control over financial reporting. . . . we believe that the SEC and PCAOB should have eliminated the opinion on the issuer's internal control over financial reporting, not the opinion on management's assessment of internal control over financial reporting. They have also failed to provide a proper basis for their action. The subject of the auditors' work specified by the Act is 'the assessment made by the management' not 'the company's internal control over financial reporting' as specified by AS 5. We do not see how these two terms can be equivalent.

Paul Moxey, Head of Corporate Governance and Risk Management, Association of Chartered Certified Accountants, with 115,000 members in 170 countries, in comments to the SEC/PCAOB dated February 26, 2007:

The PCAOB decision to remove the requirement to evaluate management's evaluation process yet retain a requirement to audit internal control seems perverse. In our view the wrong opinion has been dropped. It makes sense for the auditors to base their work on what management is doing. The separate auditor opinion on internal control is likely to mean duplication of effort and may lead to management performing more work than otherwise necessary to satisfy audit requirements. It also means two quite separate costly and time consuming processes will be required to achieve what is essentially the same purpose.

Philip Broadley, Chairman, The Hundred Group of Finance Directors, representing the finance directors of Britain's largest companies (almost 40 of which are SEC registrants), in comments to the SEC dated February 26, 2007:

We believe, however, that requiring auditors to opine only on management's own evaluation process . . . would result in the most cost effective outcome in complying with the Act . . . We also consider that an assessment of management's own evaluation process and the conclusions from that work by the auditor would provide sufficient comfort to registrants and investors with regard to the effectiveness of ICFR. . . .

Arguments

There is nevertheless a wide range of opinion as to the need for and value of a full-blown external 'audit of internal control'. One extreme might be represented by the CFO of a \$76 million company: "This has turned into a check-the-box process. The work is being done by individuals – often only 22 to 26 years old – with very little business knowledge. They just don't know where to begin."¹² Here the feeling is that the external 'audit of internal control' as performed for the past three years provides

little value to shareholders and has little to do with the problems inherent in the corporate accounting scandals that gave rise to Sarbanes-Oxley.

On the other hand, groups that represent consumers and institutional investors see any attempt to water down the SOX provisions as shortsighted. They generally view management reports on internal control and possibly management teams themselves as unreliable. These groups might argue that a full-blown external ‘audit of internal control’ is critical to restoring and maintaining investor confidence. Without it, management is free to use what the proxy research firm Glass, Lewis & Co., characterized as “a rubber stamp to certify the effectiveness of internal controls”.¹³

No amount of internal control auditing can compensate for an unreliable management team who, in addition to those decisions relating to establishing and reporting on internal control, make literally thousands of other decisions relating to products, markets, distribution channels, locations and personnel. Yet virtually all previous efforts to define SOX 404 compliance roles and responsibilities have focused on auditing, with virtually no emphasis on management’s role, responsibilities and reporting requirements. In the interim much has been learned, and an entire industry appears to have developed around SOX 404 and the provision of assistance when needed. Any management team that finds it necessary to get assistance in performing their management assessment will surely find that assistance readily available.

While there may be wide-ranging arguments about *how* to satisfy the requirements of SOX 404, there is no argument about the importance of restoring and maintaining investor confidence. To date, efforts to restore and maintain investor confidence have proven unduly expensive and inefficient. In AS5, the PCAOB proposes to maintain the fundamental approach inherent in those efforts. Bold action is needed to develop a better way of providing management with the ability to assess and report on internal controls while also providing investors with reasonable assurance that results have substance and are not in fact a “rubber stamp”.

A Six Point Action Plan Toward Substantive Change

As previously indicated, the PCAOB justifies the need for a full-blown external ‘audit of internal control’ in part by reference to Section 103 of the Sarbanes-Oxley Act, which goes to the standards and rules the PCAOB must establish. Section 404(a) of the Act however specifically emphasizes and requires a management assessment of internal controls, while Section 404(b) specifically requires an external auditor’s report on management’s assessment.

AS5 reflects refinements rather than substantive changes in the approach to satisfying SOX 404 requirements. It now appears substantive changes cannot be made without first redefining the PCAOB’s standard-setting responsibilities as described in Section 103 of the Act. Accordingly, it is clear that in order to provide the opportunity for development of a more rational and reasonable approach to satisfying the requirements of SOX 404, **we need assistance from Congress, revisions to the Sarbanes-Oxley Act itself, and substantive changes to requirements promulgated by both the SEC and the PCAOB. Specifically:**

1) the existing Section 103(a)(2)(A)(iii) of the Act should be deleted in its entirety and replaced with new wording similar to the following:

(iii) provide in each audit report their conclusion as to whether management’s assessment of internal control for financial reporting performed as required under Section 404(a) meets standards established by the Securities and Exchange Commission.

2) Section 404(b) of the Act could be clarified to read as follows:

With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall report on the assessment made by the management of the issuer. Any such report shall not be the subject of a separate engagement.

3) The SEC should revise its management guidance to include clear investor protection principles that must be observed by ALL registrants. In their comment letter to the SEC dated February 27, 2007, the Consumer Federation of America, Consumer Action, and the U.S. Public Interest Research Group suggest principles similar to these:

- a) Management is responsible for maintaining a system of internal controls that is reasonably likely to prevent a material misstatement of annual and interim financial statements.
- b) Management's annual assessment of internal control plays a central role in that effort. Through this process, management is responsible for carefully scrutinizing internal controls at the company to determine whether they are functioning at a level that provides reasonable assurance they will detect and prevent a material misstatement and identifying weaknesses that may prevent them from doing so.
- c) In assessing internal controls, managers are responsible for obtaining sufficient evidence to support their conclusion about the adequacy of internal controls.
- d) Managers must maintain sufficient documentation to allow a third party to review the work performed and determine whether the conclusion reached by management is reasonable.
- e) When the assessment uncovers material weaknesses in internal control, management is responsible not only for reporting on those weaknesses in a timely fashion, but also for acting promptly to rectify those weaknesses.

4) The SEC should further revise its management guidance to expand on principle d) above by describing the minimum level of verifiable documentation that ALL registrants must provide to support their annual management assessment of internal control. This evidential matter might include:

- a) A written plan that is submitted to and approved by the registrant's Board of Directors or its Audit Committee at least annually, describing in reasonable detail:
 - 1) the risks to reliable financial reporting that management has identified,
 - 2) the degree to which those risks are affected by multiple locations of the registrant, if any,
 - 3) management's evaluation as to whether the design of the controls that address each of those risks is reasonably adequate;
 - 4) the methods and procedures management plans to utilize to gather and evaluate evidence as to the effectiveness of those controls as well as any entity-wide or other pervasive elements of internal control that management considers applicable in the circumstances.
- b) Reports provided by management to the registrant's Board of Directors or its Audit Committee, on a schedule that is acceptable to the Board of Directors or its Audit Committee, describing in reasonable detail progress against managements plans to gather and evaluate evidence as described above.
- c) A written description and evaluation, provided to the registrant's Board of Directors or its Audit Committee in a timely manner, of any control failings or weaknesses that:

- 1) management considers significant, including the impact those failings had or may have had on any information reported or to be reported by the registrant in compliance with any known requirement or request of the Securities and Exchange Commission,
 - 2) management considers to be material, including their root cause, the impact those failings had or may have had on any information reported or to be reported by the registrant in compliance with any known requirement or request of the Securities and Exchange Commission, as well as management's plans to rectify and report upon each such control failing or weakness.
- 5) The PCAOB should withdraw AS5 in its entirety. In its place the PCAOB should provide an audit standard directed at providing reasonable, independent assurance that management's annual assessment of internal control met SEC standards as described in **3) and 4)** above. Additionally the external auditor might provide assurance as to:
- a) Whether the risks to reliable financial reporting that management identified appeared reasonably comprehensive based on the external auditor's experience with other registrants in the same or similar industries;
 - b) Any significant disagreements the external auditor might have with respect to management's evaluation of the design of controls put in place to mitigate those risks;
 - c) Whether the evidence supplied by management in support of their annual assessment appeared reasonably adequate to support the conclusions expressed in management's related reports.
- 6) The SEC should delay application of SOX 404 reporting requirements to all "non-accelerated filers" until the year following that in which the Congress, the SEC and the PCAOB complete the work described above.

Should these changes be made, public accounting firms should be able to report on management's assessment in much the same way, and investors should benefit from the same level of protection or more, than is provided in other international jurisdictions. Redundancy in the internal control assessment process would be removed for all registrant's, accelerated filers would enjoy a substantial reduction in audit fees, and non-accelerated filers would have a much more practical and cost effective approach to satisfying the requirements of SOX 404. We believe that with assistance from Congress, management teams, Boards of Directors and public accounting firms can and will work together much more efficiently to design, implement, assess and report on internal control systems as needed to protect the interests of shareholders and investors.

We strongly urge the SEC to work with Congress on this six point plan toward substantive change in the approach to complying with SOX 404, thereby reinforcing the notion that maintaining, assessing and reporting on internal controls is primarily a management responsibility that management must satisfy as management considers necessary and appropriate to protect and enhance shareholder value.

¹ PCAOB Release 2007-005, May 24, 2007, page 2, “. . . the audit of internal control over financial reporting has produced significant benefits, including an enhanced focus on corporate governance and controls and higher quality financial reporting.”

² PCAOB Release 2007-005, May 24, 2007, Page A4-16, *Additional Discussion of Comments*

³ Ibid

⁴ Kevin Reilly, “AMR Research Estimates Sarbanes-Oxley Spending Will Exceed \$6 Billion in 2006,” *AMR Research Press*, November 29, 2005

⁵ *Interim Report of the Committee on Capital Markets Regulation*, November 30, 2006, page 5

⁶ Sean Wolfe, “SEC Shifts SOX Strategy—Can SOX really be scalable?,” *Red Herring The Business of Technology*, December 14, 2006

⁷ PCAOB Release 2007-005, May 24, 2007, Page A1-4, *Standard*, paragraph 3

⁸ PCAOB Release 2007-005, May 24, 2007, Page A1-27, *Standard*, paragraph 65

⁹ PCAOB Release 2007-005, May 24, 2007, Page A1-26, *Standard*, paragraph 62

¹⁰ Richard M. Steinberg, “What The New Guidance Will Mean To You,” *Compliance Week*, May 22, 2007

¹¹ PCAOB Release 2007-005, May 24, 2007, Page A3-2, *Conforming Amendments to AU sec. 230, "Due Professional Care in the Performance of Work"*, paragraph a.

¹² American Electronics Association, *Sarbanes-Oxley Section 404: The Section of Unintended Consequences and its Impact on Small Business*, February 2005, page 5

¹³ Melissa Klein Aguilar, “SOX 404 Deficiencies Preceded By "Effective" 302 Reports”, *Compliance Week*, July 26, 2005