AEROSPACE INDUSTRIES ASSOCIATION

John W. Douglass
President

March 31, 2005

Mr. William H. Donaldson, Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File No. 4-497

Dear Mr. Donaldson:

The Aerospace Industries Association represents the nation's leading manufacturers and suppliers of civil, military, and business aircraft, helicopters, UAVs, space systems, aircraft engines, missiles, materiel, and related components, equipment, services, and information technology. Together, our member companies represent every facet of the aerospace industry.

The Aerospace Industries Association endorses the goals of the Sarbanes-Oxley Act of 2002 (the Act): proper governance of our companies, financial stewardship at all organizational levels, and rigorous internal control systems. The Act strengthens the responsibility of the Boards of Directors and increases their involvement in sound financial governance. The Act promotes the value of ethical behavior, which we fully support -- and we endorse the requirement for establishment of a Code of Conduct. We strive to foster strong internal control environments to meet the Act's requirements and the requirements of our industry's largest customer, the United States government.

While we continue to implement the requirements of the Act, we welcome the opportunity to provide you with our comments regarding the implementation of Section 404 pertaining to internal control over financial reporting and the related Standard developed by the Public Company Accounting Oversight Board (PCAOB). Opportunities for industry dialogue on this matter have been few. Although we understand there have been sessions between the PCAOB and the audit firms without the participation of industry. We urge more industry participation in joint determination of standards and procedures, and applaud the SEC for hosting the open session on April 13, 2005. We hope that the April 13th session will initiate more open sessions in the future.

It has been reported that a survey by the Financial Executives International has found that it costs an average of $4.36 million per company to comply with Section 404. Therefore, we would like to address some of the highest cost driving aspects of Section 404 and the PCAOB Standard Number 2 (the Standard). Reasonable modifications to the existing rules and/or clarification of interpretation of the rules would assist industry in addressing many of these cost drivers, resulting in greater efficiency and reduced cost while still ensuring effective systems of control and accurate financial reporting as envisioned by the drafters of Section 404. The following recommendations cover areas of interpretation, degree of detail, assessment scope, and practical implementation, rather than accounting rules, principles or changes in legislation.

The following are modifications that we would like you to consider:

1) We recommend that external auditors focus on the system of internal controls as a whole by examining entity controls and key processes and controls, and devoting less time to inconsequential issues and detailed remediation of those issues.

The auditors should conduct an assessment of entity controls and the overall system of internal controls before doing detailed control activity testing. Based on the assessment, they should determine the level of detailed auditing required.

If the auditors first focus on the effectiveness of the control environment as a whole, the ultimate goal of obtaining accurate and reliable financial statements will be achieved without testing an excessive number of controls, obtaining hard copy signatures on numerous pieces of paper, and requiring auditors to attend meetings just to prove they happened. In our experience, the focus of audits often involves detailed examination of a significant number of control activities because they are the easiest areas to evaluate even though they have the least impact on producing accurate and reliable financial statements.

Some of our members have been told by their external auditors that "risk assessment" is not relevant in determining the proper controls to have in place for an "in scope process" at an "in scope location." They have also been informed that audits should assess what could go wrong, irrespective of risks. This mindset causes a significant number of additional controls to be considered key, and therefore subject to testing by both management and the external auditor. If auditors don't change their practices in this area, unnecessary testing will continue to increase the costs of complying with the Act and implementing standards.

The SEC and PCAOB may feel the Standard already addresses our concerns by suggesting that auditors review the adequacy of internal controls by reference to five interrelated components contained in the Committee of Sponsoring Organizations framework. That is, Control Environment, Risk Assessment, Control Activities, Information and Communication Technology, and Monitoring. However, our experience has been that external auditors do not audit to the components of the framework as a whole or in the preferred sequence. Instead, they spend a disproportionate amount of time on two of those components: Control Activities and Information and Communication Technology. If the auditors start with an assessment of the Control Environment (i.e., entity controls and risk assessment) they would avoid spending countless, unproductive hours on the review of Control Activities and Information and Communication Technology components. A review of the auditors' Section 404 workpapers and hours would likely support the observation that this is where they spend the majority of their effort.

2) We recommend the adoption of a more risk-based, rotational approach to audit coverage and testing.

The audit requirements should be made less prescriptive. Companies should be allowed to design a system of internal controls that is appropriate to the circumstances. There should be greater use of risk-based testing to increase efficiency without reducing effectiveness. To achieve this change in focus, it would be most helpful if the following modifications were considered.

- Test only changes in Information Technology (IT) controls in conjunction with a monitoring process to identify such changes,
- Require external auditor walkthroughs for only those processes that have changed,
- Do not require that all evidence to support a current year's assessment be based on current year's testing and samples -- instead, allow reliance on cumulative or prior year testing, especially when there have been few if any changes and there is evidence of strong entity level controls,
- Consider rotational reviews, including rotational testing (For example, conduct a robust review once every three to five years with a high-level review focusing on change control, walk-through, and reliance on company-level controls in between or test the individually significant locations each year and rotate testing at other less significant locations.),
- Consider rotational auditing based on the complexity of the process. From an audit perspective, processes with non-routine transactions that rely heavily on the use of estimates generally involve higher risk than those with routine transactions that do not involve estimates. Processes with routine transactions also have more automated controls. Therefore, they should only have to be audited on a rotating basis; especially if their IT controls have not changed or the changes are under the control of effective general IT controls.

3) We recommend that external auditors be allowed to place greater reliance on internal audits and management testing.

More reliance should be placed on management and internal audit testing by allowing the external auditor to sample verification testing and not engage in duplicative re-testing. This could be accomplished by reducing the prescribed areas that the external auditor must test for their own primary evidence and allowing use of risk-based and sample verification testing in those areas. Also, requiring management to take responsibility for its system of controls would result in a positive and commensurate increase in the amount of management self-assessment, independent testing and internal audit testing. While the Standard's paragraphs 108 through 126 allow the auditor flexibility to use the work of others, in our members' experience, auditors vary in their level of reliance and interpretation of the Standard. In some of our member companies, auditors relied on management's testing to a reasonable degree. Yet in other companies, the auditors frequently duplicated management's testing. It is recommended that auditors be reminded of the above-referenced paragraphs that promote flexibility and the need to rely on management's independent and competent testing to the greatest extent possible. We understand that a number of audit firms have had good experience with this approach.

4) We recommend that controls related to Information Technology (IT) be better defined and limited to those controls truly pertaining to financial reporting.

There has been little to no guidance issued surrounding the implementation of the Standard's references to IT controls by the SEC or PCAOB. Control Objectives for Information and related Technology ("COBIT"), issued by the IT Governance Institute and now in its third edition, is increasingly accepted internationally as generally sound practices for control over information, IT and related risks. However, the framework for COBIT, which was largely recommended and imposed by consulting and auditing firms, extends beyond the scope of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission framework for financial reporting. This has resulted in an expansion of the scope of general IT controls into IT operational areas and details probably not envisioned by the Sarbanes-Oxley Act. The twelve control areas specified in COBIT go well beyond those directly related to financial reporting. Some increase our members' costs without the associated benefit related to facilities, operations, service levels, and technology infrastructure. It is recognized that these areas are required for proper IT operations, but they do not need to be subjected to the extensive rigor of the PCAOB auditing standards for testing, documentation, and issue management. In the COSO framework, the Act specifically limits the scope to that of financial reporting, and excludes operations. We recommend that a commensurate scope be adopted for the review/assessment of general IT controls.

5) We recommend that guidance allow a level of flexibility that will accommodate rather than inhibit IT system change and upgrade initiatives.

There were many unintended consequences of the first year implementation of Section 404. One was the delay of IT systems implementations and upgrades, which would have enhanced the effectiveness and efficiencies of operations. Many firms put a moratorium on changes for many months of last year because there were questions as to what really is a material change in controls pertaining to an IT system. Guidance changes should emphasize flexibility in assessing the magnitude of IT changes because such changes occur regularly in the maintenance and updating of financial systems and controls.

6) We recommend that external auditors treat the potential for error and misstatement as they would an actual error or misstatement in determining what is a significant deficiency.

The Standard conveys that "if a control is not documented, it does not exist." This approach causes anxiety in our members when they are determining the degree and type of documentation that is sufficient. For example, if a management review or authorization has taken place but is not documented in a manner acceptable to the auditor, it effectively is reported as a management review or authorization that did not occur. It is much more important that a control (e.g., management review) actually occur, than be fully and explicitly documented in a manner acceptable to the auditor. Moreover, the related concept (Standard paragraphs 131 and 132) that the potential for an error is equal to the actual existence of an error produces a distorted impression of actual risk. For instance, in the area of IT general controls, one company was cited for a significant deficiency because programmers both developed and placed into production software code. Even though this is acceptable practice in engineering, and there were compensating controls in place to restrict any damage, the auditor continued to classify this dual role as a lack of separation of duties, necessitating a significant deficiency citation. In another member's example, an immaterial issue was determined to be a significant deficiency based on the auditor's judgments of the potential for a much higher level of materiality while totally ignoring the actual occurrence or level of damage. The concept referenced in the above-mentioned paragraphs tends to drive costly discussion, follow-up, remediation and reporting.

7) We recommend that refinements related to the reliance that may be placed on SAS 70 reports from third party providers be considered.

For the Statement of Auditing Standards (SAS) 70 to be useful, it needs to be a more transparent and reliable indicator of the effectiveness of the third party provider's controls. The reliance on SAS 70s for third party providers of services produced mixed results and many surprises the first year. Schedules were unknown, there was no interim reporting to determine if issues would appear in the final report, and results were reported too late in the year for remediation. Also, it was not known in advance which key controls would be included in the testing. This necessitated obtaining a greater understanding of the internal controls of the provider and their relevance to management's assessment, as well as the imposition of specific contractual terms to ensure direct control verification and/or audits. These two actions have significantly increased our members' costs.

8) We recommend external auditors be permitted more latitude in their role as business advisors during the resolution of complex accounting issues.

More emphasis on the current Standard's recognition of the need for judgment and more encouragement to the audit firms to provide reasoned dialogue in the resolution of issues would help prevent deterioration in auditor-client relationships brought about by the Standard's lack of specificity in these areas. An understandable degree of independence must be required in professional auditing, and in the Standard's pronouncements as to what constitutes "reasonable assurance." In practice, however, it is evident that many factors have strained the relationship between the auditor and the client: the absence of a peer-to-peer relationship with external auditors, the lack of specificity in the Standard, the prospect of inspections, unknown expectations of auditing firms engaged by companies, and changing requirements during the first year of implementation. This has resulted, in varying degrees, in a reluctance to engage in intellectual debate over issues, strained relationships, and most important, increased costs.

Under the current guidance, when companies are faced with a complex accounting problem and are forced to seek counsel of someone other than their external auditor, the result is increased cost, differences of opinion, and reduced reliability and accuracy of the financial statements. The Q&A number 7 issued by the PCAOB on June 23, 2004, may have exacerbated the external auditors' negative interpretation of paragraph 140 of the Standard. The Q&A offers guidance about sharing "draft" financial statements. The once important, free-flowing dialogue that existed between the external auditor and management can no longer take place under current guidance. Management must now represent the "state of completion" of the financial statements and hope that the external auditor does not disagree with the accounting position taken by management and issue a "Significant Deficiency," or worse, a "Material Weakness." Prior to issuance of the Standard, discussion by the auditors and management related to complex accounting issues strengthened and improved the accuracy and reliability of the financial statements.

9) We recommend the use of lay terms when referring to key concepts.

It would be extremely helpful if terms used in the Standard were stated in language plainly understood by our members, their external auditor, and consulting firms providing compliance counseling to our members. Between auditors and clients, much time is spent in debating and trying to understand what is meant by many of the key terms in the Standard. This also contributes to different interpretations between audit firms. Some key terms, which cause confusion and varying interpretations, are "significant deficiency," "more-than-inconsequential," and "less-than-remote." For shareholders, terms such as "unqualified" or "qualified" opinion have also created confusion.

In conclusion, we appreciate this opportunity to provide recommendations for change and supporting examples of existing problems for your consideration with the goal of reasonable refinement of the guidance documents that implement the provisions of the Act, particularly Section 404. We understand that some of our recommendations will likely generate the need for further dialogue between industry, the accounting firms, the SEC, and the PCAOB. We believe that this further underscores the need for greater involvement of industry in the initial development of standards related to Section 404 and the practical interpretation and implementation of such standards. However, this should not be taken as criticism of external audit firms, the SEC or the PCAOB. We recognize that this has been a mutually challenging first phase of a renewed and evolving emphasis on good corporate governance and the maintenance of sound, rigorous systems of internal control over financial reporting.

Sincerely,

John W. Douglass
President and CEO

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