



Michael Elias Baroody
Executive Vice President

May 17, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: File No. PCAOB-2004-03

Dear Mr. Katz:

On behalf of the National Association of Manufacturers ("NAM"), I would like to submit the following comments to the Securities and Exchange Commission (SEC) on the Public Company Accounting Oversight Board (PCAOB) Release No. 2004-03, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" (the proposed rules). The PCAOB release, dated March 9, 2004, impacts the implementation of the requirements under Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33-8138 and 34-46701 by companies and auditors.

The NAM is the nation's largest industrial trade association. Our 14,000 members include 10,000 small and mid-sized companies and 350 member associations serving manufacturers and employees in every industrial sector and all 50 states. Headquartered in Washington, D.C., the NAM has 10 additional offices across the country. The NAM's mission is to enhance the competitiveness of manufacturers and to improve American living standards by shaping a legislative and regulatory environment conducive to U.S. economic growth, and to increase understanding among policymakers, the media and the public about the importance of manufacturing to America's economic strength.

Overview

The NAM endorsed the Sarbanes-Oxley Act of 2002 as a way to safeguard investors and help restore confidence in our financial markets. At the same time, we believe that although the abuses that gave rise to the Sarbanes-Oxley Act and the proposed rules were indeed egregious, they were not pervasive in the business community. While the NAM supports the efforts of the PCAOB and the SEC to implement the new legislation, we are concerned about the promulgation of unworkable rules that would restrict the ability of executives to effectively run their businesses and compete in the global marketplace.

The NAM applauds current efforts to require effective internal control systems at the foundation of financial reporting; however, we have serious concerns about PCAOB's proposed rules. In particular, we are concerned that the proposed rules, as drafted, would place an undue and costly compliance burden on companies and could lead to unnecessary litigation. In addition, the proposed rules could have a negative impact on U.S. public markets as a source of capital and discourage quality financial professionals with strong values from remaining in the profession. Finally, the problems with the proposed rules are exacerbated by the lack of interpretative guidance.

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Specific Concerns

The NAM is concerned that the proposed rules are unnecessarily onerous and vague in many areas. Even where specific, the rules are overridden by the principle of aggregation that is referred to throughout the PCAOB's release. The current documentation effort for many companies, based on the COSO¹ framework, requires reviewing many hundreds of potentially significant internal controls for each operating location. The proposed PCAOB rules require that risk analyses focus on critical controls designed to protect against material errors in financial statements. The result should be to center the review effort on vital areas. However, by also requiring review of individually insignificant controls that could be significant in the aggregate, the proposed rules became vague and subject to interpretation in the absence of interpretive guidelines. In this regard, the concept of aggregation is so vague that, absent further guidance, implementation would be extremely onerous, if not impossible.

The proposed rules also provide that accounts or business units, which are not otherwise material by themselves, may be material when aggregated with others. The rules further provide that whether a control issue is merely a control weakness or significant deficiency depends on whether it could be material when aggregated with other issues not only in terms of actual impacts, but also potential impacts.

Finally, the rules lack clarity in defining a significant deficiency versus a material weakness. Again, aggregation plays a role. The definitions include terms such as "remote", "inconsequential" and "material." All of these terms are subject to interpretation and, without adequate guidance, could increase the number of issues that might require aggregation. Evaluation is further complicated by the requirement that individual weaknesses be considered in combination with others, leaving open the possibility of numerous potential "combinations."

The NAM is very concerned that the vagueness of the rules, coupled with the absence of interpretive guidance, will lead to unnecessary litigation. Issuing final rules – without a trial period – could indeed lead to legal activity that would be both significant and unfounded. The targets of these suits would include both companies and well-intentioned executives whose only error may be misinterpreting the rules.

Furthermore, the lack of specificity in the rules could put both companies and individuals at significant risk, making financial careers and the use of public markets to access capital less attractive. We do not believe that either the PCAOB or the Commission want this to happen.

Recommendations

In order to allow significant time to adequately review and address these important issues, we recommend that the SEC:

- Specify a one-year pilot implementation plan during which both companies and their auditors are required to perform reviews and communicate the results of these activities to each company's audit committee;
- Follow the pilot implementation phase with a formal comment period with input from industry, auditors and regulators to provide the basis for formal interpretative guidance; and
- Require external reporting under the final rules in 2005.

¹ Committee of Sponsoring Organizations of the Treadway Commission

Conclusion

As noted above, we both applaud and support the efforts of the PCAOB and the SEC to implement the Sarbanes-Oxley Act. At the same time, we would like to underscore the fact that, while the abuses that gave rise to the Sarbanes-Oxley Act and the proposed rules were indeed egregious, this type of behavior does not pervade the business community. Moreover, NAM members are concerned about diverting time, effort and resources from activities that create value to unnecessary compliance activities. Consequently, we urge you to delay finalizing the PCAOB rules until you have the opportunity to review and address the issues outlined above. Thank you in advance for considering our request.

Sincerely,

/s/

Michael E. Barody
Executive Vice President
National Association of Manufacturers