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Caterpillar Inc.

100 N. E. Adams Street
Peoria, Illinois 61629

November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008

Ladies and Gentlemen:

Caterpillar Inc. commends the Public Company Accounting Oversight Board ("the Board") and its staff for the thorough and expeditious manner in which you have discharged your responsibilities. Caterpillar would like to thank you for the opportunity to comment on your proposed auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("the proposed standard").

For more than 75 years, Caterpillar Inc. has been building the world's infrastructure, and in partnership with Caterpillar dealers, is driving positive and sustainable change on every continent. A Fortune 100 company, Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines and industrial gas turbines. The company is a technology leader in construction, transportation, mining, forestry, energy, logistics, electronics, financing and electric power generation.

Over the years, Caterpillar has built a solid reputation as a highly ethical company. We recognize and take seriously our role in restoring public confidence in Corporate America, including our responsibility to maintain an effective system of internal controls. We also acknowledge that the external auditor's independent oversight role is critically important to this restoration. Accordingly, we support, in principle, the Board's goal of enhancing the effectiveness of internal control over financial reporting. However, we believe the proposed standard exceeds the intended requirements of Section 404 of the Sarbanes-Oxley Act ("the Act") and is insensitive to the cost of compliance for U.S. companies and audit firms. We believe the proposed standard, as written, sets forth requirements that create a cost disadvantage and operational disruptions for U.S. companies versus foreign competitors. In our opinion, the disadvantages to implementing the proposed standard will far outweigh the benefits to investors in public companies.

Please accept our comments to the Board's specific questions in Attachment I in the constructive manner in which they are intended. The following summarizes our key observations and concerns:

- ***Adverse consequences and costs of implementation and on-going compliance with the proposed standard***

  We believe the following provisions of the standard will impose significant, unintended consequences and costs to implement and comply on a continuing basis:

  Restricting the auditor's reliance on the work of management and others -- In our opinion, paragraphs 103-110 represent the most onerous provisions of the standard and will cause significant and unnecessary duplication of effort by the external auditor, internal auditors, and management. **We strongly object to the limitations placed on the external auditor in relying on the work of others.** We agree that the work of others cannot replace the work of the external auditor. However, we believe the auditor should be allowed to rely on competent, objective internal auditors, and to a large extent management, similar to the reliance permitted under Statement of Auditing Standards No. 65 (SAS 65), *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. This reliance should not be limited to the internal auditor's tests of routine transactions and processes.

  We understand the importance of auditor independence from management. **However, the collaborative relationship that often exists between the external and internal auditors is extremely effective and cost-efficient in providing the broadest audit coverage and greatest level of assurance to investors.** This collaborative assurance is greatly reduced under the proposed standard.

  Furthermore, we believe the scope of the auditor's work under the proposed standard exceeds the scope intended in Section 404 of the Act. In our opinion, the scope of the auditor's work was intended to be an attestation of management's assertion of the process used to evaluate the effectiveness of internal controls; not an audit of internal controls. Requiring the same level of assurance from both management and the auditor will unnecessarily require significant and duplicative work.

  Prescriptive audit procedures -- We do not believe the proposed standard sufficiently permits the external auditor to use professional judgment in designing and executing audit strategies and procedures. For the same reasons the Board concluded internal control is not "one-size-fits-all," audit procedures should not be "one-size-fits-all." It is our belief the auditor should be allowed the latitude to apply audit strategies and procedures based on the auditor's trained and professional judgment, the size and complexity of the organization, and the competence and objectivity of management.

We agree that walkthroughs of significant processes, limited rotation of audit procedures, and year-to-year unpredictability of testing can all be effective audit procedures and strategies. However, we believe the application of these strategies and procedures should be the discretion of the auditor based on the numerous and varied factors affecting management's assertion regarding the effectiveness of its internal controls.

Appropriate consideration of well-controlled companies -- We agree with the Board that an effectively designed internal control framework, must have the five components of internal control. However, we believe the proposed standard focuses too narrowly on the auditor's responsibilities with respect to only two of those components -- *Control Activities* and *Monitoring.* We do not believe the proposed standard's restricted use of others' work and the prescriptive nature of the audit procedures enable the auditor to consider the *Control Environment, Risk Assessment, and Information and Communication* components of the framework in determining the nature, timing and extent of his/her work.

A strong internal control framework, including proper interaction of the five components, should enable the auditor to rely on the work of others, rotate audit focus, and design audit strategies and procedures that are commensurate with the internal control risk environment.

- ***Evaluating the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting***

We agree that an effective audit committee is an important monitoring control and is essential in maintaining an effective control environment. Accordingly, effective audit committee oversight is yet another control expected in the overall internal control framework. Therefore, in our opinion, the specific requirement that the external auditor evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is unnecessary. Furthermore, because the audit committee is charged with oversight of the auditor, including their appointment, compensation, and dismissal, this relationship could preclude the auditor from making an unbiased evaluation.

Additionally, we do not believe it is appropriate for the auditor to evaluate aspects of the audit committee where there is no measurable criteria (e.g., amount of time the audit committee devotes to control issues), or require the auditor to evaluate aspects of the audit committee for which the board of directors has already performed (e.g., independence of audit committee members from management, committee's compliance with listing standards, whether the committee includes a financial expert).

We believe the audit committee is best evaluated by the board of directors.

- ***Definitions and reporting of significant deficiency and material weakness in internal control over financial reporting***

  Under the proposed standard, a significant deficiency or material weakness can exist as either a single deficiency or a combination of deficiencies. In our opinion, the definitions as worded, could guide the auditor to evaluate a single internal control deficiency as a significant deficiency or material weakness without regard to the entire internal control framework or other mitigating controls. We urge the Board to recognize that an effective internal control framework consists of numerous, interrelated control activities and processes and that a single control is seldom effective on a standalone basis. Rather, the effectiveness of controls depends on all five components of the control framework.

  Furthermore, we believe the terms *"more than inconsequential"* and *"more than remote"* unreasonably lower the bar, vis-à-vis FAS No. 5, in evaluating whether control deficiencies represent reportable conditions. In our opinion, terms used in the definitions in paragraphs 7 through 9 of the standard should be more closely aligned with FAS No. 5.

* * * * *

We welcome the opportunity to discuss these issues at your convenience. If you have questions regarding this letter, please contact Mr. Ali Bahaj at (309) 675-4212.

Sincerely,

Ali M. Bahaj
Vice President
Auditing & Compliance Division
Caterpillar Inc.

Attachment I
Responses to Specific Questions

<u>Questions regarding an integrated audit of the financial statements and internal control over financial reporting</u>:

1. *Is it appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting as the audit of internal control over financial reporting?*

    No, we believe that if Congress intended for the external auditor to perform an "audit" of internal controls, Section 404(b) of the Sarbanes-Oxley Act ("the Act") would have been so written. In our opinion, the scope of the auditor's work was intended to be an attestation of management's assertion of the process used to evaluate the effectiveness of internal controls; not an audit of internal controls. Requiring the same level of assurance from both management and the auditor will unnecessarily require significant and duplicative work.

    In its report (Report 107-205) of major provisions of the Act, The Committee on Banking, Housing and Urban Affairs states that, "In requiring the registered public accounting firm preparing the audit report to attest to and report on management's assessment of internal controls, the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees." Prior to the Board's issuance of the proposed audit standard, Financial Executives International reported that, "In this new regulatory environment, companies will have to add financial staff and pay significantly higher auditing fees - projected at 20 percent to 200 percent over pre-Enron/Andersen fees."

2. *Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?*

    We believe the auditor should perform both an attestation of management's assertions regarding internal control and perform the audit of the financial statements.

3. *Rather than requiring the auditor to also complete an audit of the financial statements, would an appropriate alternative be to require the auditor to perform work with regard to the financial statements comparable to that required to complete the financial statement audit?*

    As stated in the response to question two above, we believe the same auditor should perform both an attestation of management's assertions regarding internal control and perform an audit of the financial statements.

<u>Question regarding the costs and benefits of internal control</u>:

4. *Does the Board's proposed standard give appropriate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at, small and medium-sized issuers?*

   We appreciate that the Board acknowledges internal control is not "one-size-fits-all," and, to a great extent, depends on the size and complexity of the company. However, as evidenced by proposed restrictions placed on the external auditor's reliance on management, we do not believe the standard gives appropriate consideration or importance to a strong control environment ("tone-at-the-top") and sophistication and competence of management, including internal audit, which may be present in larger companies.

<u>Question regarding the audit of internal control over financial reporting</u>:

5. *Should the Board, generally or in this proposed standard, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively? For example, it would be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.*

   No, we believe that existing attestation and audit standards provide sufficient guidance in the supervision of audit personnel. We believe that penalties to audit firms provide sufficient incentive to ensure their personnel possess the necessary professional competencies and training to conduct attestation engagements.

<u>Questions regarding evaluation of management's assessment</u>:

6. *Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?*

   No. Please refer to our response to question 1. We do not believe that the auditor should provide the same level of assurance as management. We believe the collaborative effort of the external auditor, internal auditor and management provides investor the broadest, most cost-efficient assurance regarding a company's system of internal accounting controls.

7. *Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?*

   We believe the Board has provided an appropriate level of criteria to enable the auditor to exercise judgment in evaluating the adequacy of management's documentation.

8. *Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?*

   We believe the auditor should be permitted to evaluate whether the absence of documentation represents an internal control deficiency. The absence of internal control procedural documentation does not alone represent a deficiency that would lead to misstated financial statements. However, the absence of management's evidential documentation that controls are operating effectively, could call into question the validity of management's assertion. In our opinion, neither the absence of procedural documentation nor the absence of evidential documentation represent de facto evidence those internal controls are non-existent or ineffective.

   We believe the absence of documentation represents a <u>potential</u> internal control deficiency that the auditor should evaluate to determine whether the severity warrants elevation to significant deficiency or material weakness.

<u>Questions regarding obtaining an understanding of internal control over financial reporting</u>:

9. *Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?*

   We agree that walkthroughs are an extremely effective and necessary procedure in identifying and understanding the operation of internal controls in complex transaction systems. However, we believe the auditor should be permitted to exercise professional judgment in selecting and designing audit procedures and testing strategies.

10. *Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors or others?*

    We do not believe the external auditor should be precluded from relying on the results of walkthrough procedures conducted by others, such as a competent internal audit function or even management. In addition, paragraph 101 of the standard appears to preclude the year-to-year rotation of audit procedures. We do not agree that full, detailed walkthrough procedures be conducted annually, if the auditor is satisfied, through inquiry and validation, that process change controls and IT general controls over processes and systems are operating effectively.

Question regarding testing operating effectiveness:

11. *Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?*

    Again, we believe the auditor should be permitted to exercise professional judgment in determining the nature, timing and extent of audit procedures. One factor used by the auditor is the cumulative knowledge and evidence obtained in previous years.

    In addition, we believe an effective internal control framework should include process change controls. Therefore, we believe evidence of the effectiveness of controls can be efficiently obtained every year if the auditor is satisfied, through inquiry and validation testing, that process change controls and IT general controls over processes and systems are operating effectively.

Questions regarding using the work of management and others:

12. *To what extent should the auditor be permitted or required to use the work of management and others?*

    We are sensitive to the need for the external auditor to maintain an "arms-length" relationship with management. However, we believe the Auditor Independence provisions of Title II of the Act will achieve the desired relationship. We believe restrictions placed on the external auditor in paragraphs 103–110 are not sensitive to the public company representative's concerns voiced at the Board's July 29 roundtable discussions. In our opinion, paragraphs 103-110 represent the most onerous provisions of the standard and will cause a significant and unnecessary duplication of effort.

    We understand the work of others should not replace the work of the external auditor, in whole or in part. Rather, we believe that the external auditor should be able to attest to management's assertion on the effectiveness of internal controls by understanding management's evaluation process through auditor testing on a sample basis and through re-performing work conducted by management and internal auditors on a sample basis.

    Furthermore, internal auditors performing their work in accordance with the Institute of Internal Auditors' Standards for the Professional Practice of Internal Auditing should be relied upon, by the external auditor, to conduct their work with competence and objectivity. Of course, we recognize the external auditor will be required to re-perform certain work of internal audit to develop a basis on which to judge the internal auditors' competence and objectivity.

13. *Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?*

    We believe the three categories outlined by the Board are appropriate. However, as stated in our cover letter and in our response to question 12 above, we believe paragraphs 104-106 of the Standard unnecessarily restrict the external auditor's use of others' work.

    We believe the external auditor, subject to his/her professional judgment and direction, should be able to use the results of controls testing performed by internal auditors, and to a large extent, by management. For example, we believe internal audit can competently and objectively carry out audit tests of those areas specifically restricted by the standard including: fraud controls, controls over period-end financial reporting, IT general controls, walkthroughs, significant non-routine and non-systematic transactions, and controls over significant accounts where the external auditor has assessed the risk of failure as high.

14. *Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?*

    As stated in our cover letter and in responses to questions 12 and 13 above, we do not believe the standard permits enough reliance on the work performed by internal auditors and creates unnecessary duplication of work between the internal and external auditors.

    Furthermore, the monitoring component of an effective internal framework should include an internal audit function. If, through adequate re-performance of a sample of their work, the external auditor has judged the internal auditors to be competent and objective, then the external auditor should be permitted to use the work of internal auditors.

15. *Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (for example, reperform tests of all significant accounts or reperform every test performed by others that the auditor intends to use)?*

    We agree the auditor should have the flexibility in determining the extent of reperformance of the work of others. However, consistent with our responses to questions 10-14, we believe the Standard does not permit the auditor enough latitude in applying professional judgment to the design and execution of audit procedures. We believe Congress did not intend for compliance with the Act to increase audit fees. Therefore, we believe the Standard should allow for more flexibility in reperformance.

16. *Is the requirement for the auditor to obtain the principle evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor?*

    Again, the auditor should be permitted to exercise professional judgment in determining the evidence necessary to attest to management's assertion on the effectiveness of internal controls. It is the auditor's responsibility to evaluate the credibility of the evidence obtained. If this concept remains in the final standard, "principle evidence" should be better defined.

Questions regarding evaluating results:

17. *Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?*

    We believe that definitions are necessary. However, we believe the terms "more than remote likelihood" and "more than inconsequential in amount" significantly lower the bar for determining when and internal control deficiency is considered significant vis-à-vis existing authoritative literature – FAS 5. We see no reason for the proposed standard definitions to differ from FAS 5. Again, we believe the auditor should use professional judgment in determining whether an internal control deficiency is a reportable condition.

18. *Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commenters could suggest that would provide further interpretive help?*

    We agree the examples in Appendix D are helpful in applying the definitions of material weakness and significant deficiency. However, the examples do not demonstrate how other components of the internal control framework could help to mitigate weaknesses in control activities or minimize the likelihood of significant deficiencies or material weaknesses.

19. *Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?*

    Yes, it is essential the auditor evaluate the severity of all identified internal control deficiencies. However, deficiencies should not be evaluated as a standalone control but rather in the context of all five components of the control framework and in relation to company-level controls and mitigating controls.

20. *Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?*

Currently, our external auditor reports internal control weaknesses noted while conducting the financial statement audit. We believe it is appropriate for the auditor to report internal control deficiencies that warrant the attention of management. However, we believe it is unnecessary for the auditor to report internal control deficiencies that management is already aware of or is addressing via remedial actions.

21. *Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such?*

We agree that most of the matters identified by the Board represent strong indicators, but not represent de facto evidence, that a potential material weakness in internal control may exist.

22. *Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?*

We agree that an effective audit committee is an important monitoring control and is essential in maintaining an effective control environment. Accordingly, effective audit committee oversight is yet another control expected in the overall internal control framework. Therefore, in our opinion, the <u>specific requirement</u> that the external auditor evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is unnecessary.

In addition, we believe this provision could be construed a conflict of interest for the auditor. Because the audit committee is charged with oversight of the auditor, including appointment, dismissal and compensation, this conflicting interest could bias the external auditor's evaluation of the audit committee.

In addition, we believe the criteria, outlined in paragraph 57 of the standard, against which the external auditor is expected to evaluate the audit committee, are either immeasurable or already performed by the board of directors.

We believe the audit committee is best evaluated by the board of directors.

23. *Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?*

No. Please refer to our response to question 22. In addition, audit committee members' expertise and background is varied and broad generally well exceeding that of the auditor. Accordingly, the auditor would only be able to evaluate the audit committee on an incomplete set of criteria.

24. *If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the audit engagement?*

No. Please refer to our response to question 23. We do not believe the auditor is in a position to objectively evaluate the audit committee.

If the requirement of the auditor to evaluate the effectiveness of the audit committee survives the final standard, we believe the decision whether to withdrawal from the engagement should be at the auditor's discretion. Furthermore, we believe it is inappropriate to presuppose the severity of ineffective audit committee oversight as warranting withdrawal from an engagement vis-à-vis other material weaknesses.

Questions regarding forming an opinion and reporting:

25. *Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?*

Yes, we believe it is appropriate for the auditor to express an adverse opinion on the effectiveness of the company's internal controls if a material weakness exists. However, this conclusion is only appropriate if the auditor is not satisfied that other controls within the five components of the control framework have not effectively mitigated the weakness. In addition, an adverse opinion is inappropriate if management remedies the weakness before the date of management's assertion.

26. *Are there circumstances where a qualified "except for" conclusion would be appropriate?*

Yes. For example, we believe that outsourcing a significant service or a material acquisition, particularly a non-U.S. company, in the fourth quarter would not allow sufficient time for management to assess, and the auditor to attest, as to the internal controls of the acquired company. In these examples, a qualified opinion would be appropriate.

27. *Do you agree with the position that when the auditor issues a non-standard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated?*

If the auditor concurs with management, we believe the auditor's report should refer to whether management's assessment is fairly stated. If however, the auditor does not concur with management, then the auditor's opinion should speak directly to the effectiveness of internal control over financial reporting.

Questions regarding auditor independence:

28. *Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard?*

Yes, additional guidance may be helpful.

29. *Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?*

We believe the external auditor should be prohibited from designing and implementing internal controls that have a significant impact over financial reporting.

Questions regarding auditor's responsibilities with regard to management's certifications:

30. *Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?*

Yes, we believe the limited scope the auditor's responsibility related to management's quarterly certifications are appropriate. However, we believe the scope of the auditor's work should be limited to inquiry of management and review of internal audit reports. We do not believe it is practicable for the auditor to observe whether significant changes in internal control have occurred over significant accounts each quarter.

31. *Is the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting appropriate?*

Please refer to our response to question 30 above. We believe the scope of the auditor's quarterly procedures should be limited to inquiry.