

# American Federation of Labor and Congress of Industrial Organizations



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

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February 26, 2007

**VIA FACSIMILE (202) 772-9324**

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

**Re: File Number S7-24-06**

Dear Ms. Morris:

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

## **I. Background**

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

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

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

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

## **II. Specific Comments**

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

### *A. Reliance on Internal Reports*

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

### *B. Focus on Efficiency*

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

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<sup>1</sup> *Management Override of Internal Controls: The Achilles Heel of Fraud Prevention*. American Institute of Certified Public Accountants, The Audit Committee and Oversight of Financial Reporting. (2005).

<sup>2</sup> Damon A. Silvers. Speech. *Statement of the American Federation of Laborers and Congress of Industrial Organizations*, S.E.C. Roundtable on Internal Controls (April 13, 2005) (Copy of transcript on file with the Securities and Exchange Commission).

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

### *C. Further Extensions*

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

### **III. Limitation on Auditor Liability**

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

### **IV. Conclusion**

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

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<sup>3</sup> *Management’s Report on Internal Control Over Financial Reporting*. Release Nos. 33-8762; 34-54976; File No. S7-24-06 at 24. (December 20, 2006).

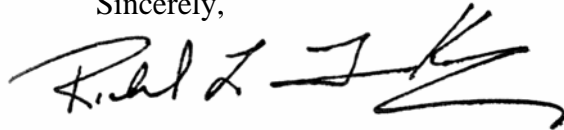
<sup>4</sup> *Id* at 25, 40.

<sup>5</sup> 5 U.S.C § 553.

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

Sincerely,

A handwritten signature in black ink, appearing to read "Richard L. Trumka", with a stylized flourish at the end.

Richard L. Trumka

RLT/me  
opeiu #2, afl-cio

cc: Chairman Christopher Cox  
Commissioner Paul S. Atkins  
Commissioner Roel Campos  
Commissioner Annette L. Nazareth  
Chairman Kathleen L. Casey  
Chairman Mark. W. Olson  
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