United Technologies Corporation
United Technologies Building
Hartford, CT 06101

Jay L. Haberland
Vice President, Business Controls

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

November 19, 2003

Dear Sir or Madam:

Re.: PCAOB Rulemaking Docket Matter No. 008

We appreciate this opportunity to comment on the proposed auditing standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements. We applaud the Board's effort to strike an appropriate balance that considers the varied interests of the parties involved in the financial reporting process. We also appreciate the Board's willingness to seek comments to improve the proposed Standard.

The proposed Standard requires an audit of internal control over financial reporting, and the Release implicitly concedes that an audit of internal control over financial reporting is different from an audit of management's assessment of the effectiveness of internal controls over financial reporting. To preclude confusion, if the final Standard preserves the requirement for a scope that is more fairly characterized as an audit of internal control over financial reporting, we believe it would be better to expressly acknowledge the difference and set forth the reasons why the PCAOB believes that an audit of internal control over financial reporting is necessary to fulfill the requirements of the Act, Rules and sound policy.

In the proposed Standard, the PCAOB attempts to strike a balance between the exercise of judgment on the part of the auditor and prescription of specific audit rules. We strongly encourage the Board to focus on the exercise of judgment by the auditor in the final Standard. Several of the questions posed by the Board ask whether the final Standard should provide more specific direction to the auditor and, therefore, reduce the amount of judgment that the auditor can employ in certain situations. As we have seen with the promulgation of accounting principles, standards that are too prescriptive lend themselves to potential abuse through a strict interpretation of the "letter" vs. the "spirit" of the standard. This is particularly true in situations that deviate from the norm or those situations envisioned when the rules were developed. It is difficult to envision prescriptive rules that would apply equally well to a large, diversified, multinational, corporation and a small single segment business.

Our specific responses to the thirty-one questions posed by the Board are included as Attachment 1 to this letter. In general, we ask the Board to keep in mind that the process of maintaining a sound system of internal control is a dynamic one. As such, the requirements for these controls must: satisfy multiple constituencies by being useful for those employing the controls; allow for the application of the controls to ever changing situations; and, facilitate the on-going maintenance of the control system. Similarly, the evaluation of the internal control system by management must be meaningful and sustainable. Requirements which are inflexible or impose an unnecessary burden will be much more difficult to sustain and will diminish in their usefulness.

We would be pleased to discuss our comments with you in greater detail. Please feel free to contact the undersigned at (860) 728-7604.

Yours very truly,

Jay L. Haberland
Vice President, Business Controls

Attachment 1

PCAOB Questions for Comment

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?

The proposed Standard requires an audit of internal control over financial reporting, and the Release implicitly concedes that an audit of internal control over financial reporting is different from an audit of management's assessment of the effectiveness of internal controls over financial reporting. Accordingly, it is not appropriate to imply that they are the same. To preclude confusion, if the final Standard preserves the requirement for a scope that is more fairly characterized as an audit of internal control over financial reporting, we believe it would be better to expressly acknowledge the difference and set forth the reasons why the PCAOB believes that an audit of internal control over financial reporting is necessary to fulfill the requirements of the Act, Rules and sound policy.

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?

This seems to us unnecessary as a practical matter. Section 404 of the Act and Rules require that the proposed audit of internal control over financial reporting be conducted by the issuer's independent auditor and not as an engagement separate from the annual audit of the financial statements. We believe that these Act-driven requirements are sound, because it will be far more cost efficient to have the same auditor perform both the audit of internal control over financial reporting and the audit of the financial statements. In particular, we believe that the scope of the audit of the financial statements can be appropriately adjusted to reflect the audit evidence gained from thoroughly evaluating the internal control over financial reporting.

Therefore, the question would only have practical consequence if an issuer had some reason to require another separate audit of its internal controls over financial reporting. We are unable to imagine one, but if such a case exists, it is clear in theory that an audit of internal control over financial reporting is not identical to an audit of financial statements. The PCAOB's Release acknowledges that human behavior and compliance are an absolute limitation on the effectiveness of even well-designed and operated internal controls. For purposes, if any, that are distinct from satisfying the requirements of the Act and Rules, issuers should be free to procure audits of their internal controls over financial reporting without the necessity that such an audit scope include the financial statements themselves.

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?**

   It is not clear to us what the advantage would be (from either a cost or efficiency standpoint) of requiring the auditor to perform a level of work comparable to that required to complete an audit of the financial statements but not also be responsible for the audit of those financial statements.

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?**

   The evaluation of internal control requires judgment. It also requires an understanding that inherent in the establishment of a system of internal control is the evaluation and assumption of risk. These factors should be considered both in the formulation of an appropriate system of internal control and in the evaluation of that system. For example, a small issuer might not be able to effectively implement the desired level of preventative controls but might be more able than a larger business to effectively implement and carry out "after the fact detective controls." The auditor must consider these differences in his or her evaluation of control and be astute enough to evaluate a particular control in a given circumstance. Appendix E should expressly address this possibility, so that auditors will be more comfortable making such judgments.

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 audit 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.**

   The example provided is sufficiently clear that it seems unlikely to occur. Beyond such an easy case, we do not believe that a level of specificity greater than that contained in paragraph 31 regarding qualifications of the auditor is necessary or advisable. The original generally accepted auditing standards required that audit work be performed by "persons having adequate technical training and proficiency as an auditor." It would also not be realistic (if even possible) to specify the level of competence and training necessary for all the situations that might be encountered.

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?**

   As a normal outgrowth of expressing an opinion on management's assessment, we would expect the auditor to directly obtain a certain amount of evidentiary matter. However, because a major emphasis of the auditor's work should be directed toward opining on management's assertion, we would expect the auditor to focus heavily on the work performed by management and others. We would expect the auditor to perform enough work to determine the veracity of the work performed by management and others to support their assessment of the internal control over financial reporting.

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

   We are concerned that the criteria set forth in paragraph 43 could be too narrowly interpreted by the external auditor as being required for each element of documentation. The Board's guidance regarding documentation contained in paragraph 44 is appropriate. Above all, documentation should be useful for the users and sustainable over the long term. Documentation requirements that are too prescriptive run the risk of reducing the usefulness of the documentation and increasing the likelihood that it will not be properly maintained.

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 a significant deficiency or material weakness in internal control?**

   The determination that documentation is inadequate implies that, the lack of proper documentation has caused the internal control over financial reporting to function in a less than adequate fashion. The auditor should consider the outcome from the lack of proper documentation. The lack of proper documentation, in and of itself, may or may not rise to the level of a significant deficiency or a material weakness. As with any other deficiency, the auditor should evaluate the significance of the weakness in light of the overall system of internal control

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

   Walkthroughs should be treated as any other audit test. The auditor should be permitted to use judgment in determining when walkthroughs are appropriate and whether they need to personally perform the walkthrough or can rely on a walkthrough performed by management or others.

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?

As indicated in our response to question 9, the decision regarding whether the auditor needs to personally perform the walkthrough or can rely on a walkthrough performed by management or others should be left to the judgment of the auditor. This decision needs to be performed on a case-by-case basis and should consider the significance of the area being reviewed and the expertise of the party performing the walkthrough. The proposed auditing standards should not preclude the auditor from using walkthrough procedures performed by third parties, especially internal auditors or other audit professionals hired by management to perform reviews of internal controls.

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?

The auditor, in conjunction with management, should be required to determine if significant changes in internal control over financial reporting have occurred from year to year. If no significant changes have occurred, the auditor should be able to limit his or her work to determining that the internal controls still function as intended. This would limit the need to obtain evidence for all assertions or significant accounts each year.

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

The auditor should be permitted to exercise professional judgment to use the work of management and others. The auditor should only be required to perform enough work on their own to determine that the work of management and others is credible. The final auditing standards should not establish detailed prescriptive measures of when the work of management or others cannot be used. This would be consistent with the concept embodied in the Act and Rules that the auditor is opining on management's assertion regarding the effectiveness of internal control over financial reporting.

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 that the three categories of control and the degree to which the auditor may rely on the work of others are too narrowly defined in the sense that they appear to severely limit the amount of reliance that the auditor can place on the work of others. We believe that the auditor should be permitted to exercise judgment in determining where they may place reliance on the work of others. Preliminary discussions with our external audit firm would indicate that they believe the amount of reliance that they may place on the work of others, including internal audit, would be very limited under the proposed Standard.

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?

The auditor should have the ability to exercise judgment in deciding when to use the work of internal auditors just as they do when deciding when it is appropriate to rely on the work of others. They need to assess the quality, competence and credibility of any third party (management or others) upon which they may choose to rely. They then need to evaluate the situation in which they intend to rely on the work of others on a case-by-case basis. Once again, the final auditing standards should not establish detailed prescriptive measures of when the work of management or others cannot be used.

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)?

The auditor must be permitted to exercise judgment in determining to what extent they need to reperform the work of others. The greater the level of work performed by others upon which the auditor intends to rely, the greater the level of comfort they would need in the quality and credibility of that work. We strongly urge the Board to not further curtail the auditor's ability to exercise judgment. In our opinion, to do so would substantially increase the costs of the audits of internal control over financial reporting and preclude the exercise of appropriate professional judgment in such examinations. As management is required to exercise judgment in making their assertion, so should the auditor be in assessing management's assertion and the effectiveness of the internal control over financial reporting. Once again, the final auditing standards should not establish detailed prescriptive measures of when the work of management or others cannot be used.

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?

The auditor's conclusion regarding the effectiveness of internal control over financial reporting should be based on all of the evidence obtained by the auditor. The specific source of the evidence should be left to the professional judgment of the auditor but the auditor should be required to evaluate credibility of the source from which the evidence was obtained.

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 do not believe that the new definitions of significant deficiency and material weakness will significantly alter the consistency in evaluation of weaknesses. Given that the determination of a significant deficiency or material weakness involves judgment, we would not recommend that the Board attempt to provide additional clarification. However, it would be helpful for the Board to reconcile the auditor's responsibility for reporting significant deficiencies and material weaknesses under the proposed standard with their existing responsibilities with respect to audits of financial statements. Presumably, the auditor should have previously reported these deficiencies and weaknesses to the registrant.

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 the commenters could suggest that would provide further interpretive help?

We believe the Board should exercise caution in determining when and whether to provide examples of significant deficiencies and material weaknesses. The determination of these conditions requires the exercise of considerable judgment on the part of management and the auditor and must be evaluated in light of a number of factors. We are concerned that the auditor could too narrowly construe the examples and restrict the exercise of judgment in their evaluation.

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

The auditor must always evaluate the severity of an identified control weakness to determine what, if any, action is to be taken. The auditor must also always evaluate the severity of identified weaknesses in the aggregate, as well as individually. It is quite possible that for minor deficiencies the evaluation will be relatively informal.

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?

Yes. This is no different from the past when auditors would communicate the internal control deficiencies through a management letter.

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

Yes, however, the auditor must still use judgment to evaluate these indicators before reaching the conclusion that a significant deficiency or material weakness exists.

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?

One could argue that there is a potential conflict of interest in asking the auditor formally to evaluate the committee charged with selecting, engaging and supervising the auditor. Indeed, this principle is normally considered essential to the effectiveness of significant internal controls (e.g. approval of expense reports) and forms the basis of significant personnel policies in most companies. We believe that, rather than "evaluate" the committee's performance, the auditor should identify and recommend policies and processes to the audit committee, where appropriate, to ensure that the committee receives all material information required to fulfill its responsibilities to oversee the issuer's external financial reporting.

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

See answer to question 22.

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?

See answer to question 22. If the final Standard preserves the concept that the independent auditor should evaluate the effectiveness of the audit committee, we think that the decision on whether to issue an adverse opinion or withdraw from the audit engagement should be left up to the auditor.

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?

While the distinction is probably not particularly meaningful, the sample opinions in Appendix A are inconsistent. The "unqualified" opinion expresses an opinion on management's assessment while the "adverse" opinion expresses an opinion on the system of internal control over financial reporting and not on management's assessment as required by paragraph 153 (l) of the proposed standard. It seems to us that the auditor should be held to the same reporting standard in terms of what is reported on (i.e. management's assessment or the system of internal control) regardless of their opinion.

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

No.

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 internal control over financial reporting rather than to whether management's assessment is fairly stated?

This gets to the question of whether the auditor is opining on management's assertion or on the internal control over financial reporting. If the auditor is opining on management's assertion, the auditor's opinion should state whether management's statement is correct.

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

We do not believe than any guidance beyond that already mandated is necessary.

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

The auditor should be prohibited from performing all internal-control related non-audit services for their audit clients.

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

We believe that the differing levels of responsibility are appropriate.

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

We believe that the scope of the auditor's responsibility for quarterly disclosures is appropriate.