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James W. Owens
Chairman and Chief Executive Officer

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OFFICE OF THE SECRETARY

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

Re: File No. 4-497, Feedback on Implementation of Sarbanes-Oxley Internal Control Provisions

Dear Chairman Donaldson:

Caterpillar Inc. would like to thank the Securities and Exchange Commission for the opportunity to comment on our experiences in implementing the provisions of Section 404 ("Section 404") of the Sarbanes-Oxley Act of 2002 ("the Act").

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.

Executive Summary

Over the years, Caterpillar has proudly built a solid reputation as a highly ethical company. We recognize and take seriously our role in restoring and maintaining public confidence in Corporate America, including our responsibility to maintain an effective system of internal controls. Accordingly, we continue to support, in principle, the Commission's goal of enhancing the effectiveness of internal control over financial reporting.

However, David Hirschmann, Senior Vice President of the U.S. Chamber of Commerce effectively captured Caterpillar's position regarding Section 404 in a recent Reuters article. He said, "There is no opposition to strengthening internal controls, but there is a more cost effective approach. The Act sets forth sound, cost efficient, and effective corporate governance practices.

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However, Section 404 of the Act represents the most burdensome, least effective, bureaucratic requirements of the legislation."[1]

While we do not believe ethical and responsible corporate behavior can be legislated, we concur that the Act was necessary to reform corporate governance and to restore investor confidence in the wake of recent highly publicized corporate accounting scandals. In fact, in conjunction with our continuous efforts to review and improve our system of internal controls, Caterpillar had implemented most provisions of the Act years prior to its enactment. We have long believed that independent board members, whistle-blower procedures and protection, audit committee financial expertise, an objective and competent internal audit function, etc. are all necessary and cost efficient elements of sound corporate governance.

The Section 404 certification process, however, is long and arduous. We believe the provisions dictating Section 404 implementation were unnecessarily burdensome to issuers and were not anticipated nor intended by the Act resulting in:

- Excessive costs of implementation and on-going compliance
- Disproportionate focus on process/transaction level controls, which has undermined the objective of preventing and detecting fraud
- A compliance process, which threatens the competitiveness of U.S.-based issuers
- The creation of an audit market oligopoly for large public companies

Recommended Improvements

Caterpillar believes the following recommendations preserve the spirit of Section 404 of the Act and will improve its effectiveness while reducing the burden on issuers:

1. Reduce the cost burden of Section 404 as well as the market power of the Big Four audit firms by modifying the Public Company Accounting Oversight Board Audit Standard No. 2 to:
    a. Require the external auditor to perform only an attestation of the process used by management to support its assertion on the effectiveness of internal controls, not an audit of internal controls.
    b. Enable the auditor to place greater reliance on work performed by management, particularly when an objective, competent audit department performs an effective oversight function of management's assertion.

c. Permit management and the auditor to use a risk-based approach to evaluating internal controls placing greater focus on fraud prevention and detection controls in areas having the greatest financial statement risk and susceptibility to fraud.

2. Improve competitiveness of U.S. companies by requiring foreign issuers to meet the same requirements and deadlines of Section 404 as U.S.-based issuers. In addition, permit issuers a one-year grace period to evaluate the effectiveness of internal controls over financial reporting of acquisitions without opinion qualification or explanation.

Conclusion

The Sarbanes-Oxley Act of 2002 was a necessary corporate governance reform. We support and have previously implemented and adhered to those elements that lead to good corporate governance, including tone at the top, independence of the Board and whistleblower protection. However, Section 404 of the Act has placed a significant cost burden on U.S. companies to achieve compliance. We are hopeful the Commission will re-evaluate interpretations of Section 404, in particular the PCAOB's Audit Standard No. 2, and strongly consider future relief for issuers by eliminating bureaucratic requirements and permitting external audit firms to rely more on management's assessments of internal controls.

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 or Mr. Mike Carr at (309) 675-4291.

Sincerely,

Jim Owens

James W. Owens
Chairman and CEO
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Attachment

Specific Observations

Our key observations regarding the unintended consequences of Section 404 implementation follow. Please accept our comments in the constructive manner in which they are intended.

Excessive Implementation and On-Going Compliance Costs

The Commission's original cost estimate for implementing Section 404 was around $91 thousand per company[2] or about 400 staff hours. Caterpillar incurred approximately $30 million and 450,000 staff, consultant and external auditor hours to implement Section 404 of the Act. This includes a 63% increase in 2004 external audit fees and approximately $3 million paid to another Big 4 firm to provide consultation and supplemental assistance for controls validation. However, this $30 million figure **excludes** significant Caterpillar senior management and audit committee time devoted to review our controls and monitor our compliance progress. The Commission's original estimated aggregate cost to issuers of implementing Section 404 was $1.24 billion.[2] Current aggregate estimates range from $5.5 billion[1] to $35 billion.[3]

Although Caterpillar is developing a more cost efficient and sustainable Section 404 compliance process for 2005 and beyond, we believe the on-going compliance costs under a more mature process could approximate 50% to 75% of the initial $30 million implementation costs. A survey conducted by the Corporate Executive Board and preliminary 2005 fee estimates from our external auditors suggest that audit fees are not expected to decrease significantly in 2005.[4] Therefore, avoidance of implementation inefficiencies and one-time-only activities provides only moderate cost relief to our on-going compliance efforts.

In our opinion, the excessive cost of compliance is due to overly conservative interpretations of applicable regulations, external auditor restrictions on the use of others' work, the absence of timely and practical guidance to issuers, and the creation of an audit market oligopoly for large public companies.

Overly Conservative Interpretations of Regulation –

Along with many other companies, Caterpillar strongly objected to the Public Company Accounting Oversight Board's (PCAOB) interpretation of Section 404 in its Audit Standard No. 2 requiring external auditors to opine on both the issuer's process to evaluate internal controls as well as the effectiveness of the issuer's controls. We continue to believe the scope of the external auditor's work was intended to be an attestation of management's process used to support its assertion on the effectiveness of internal controls; not an audit of internal controls. Requiring the same level of assurance from both management and the auditor unnecessarily resulted in extensive, duplicate work without an equivalent benefit.

Issuers also objected to the prescriptive nature of audit procedures required by the PCAOB. We believe the audit requirements do not enable management and the external auditor sufficient use of judgment in determining the nature, timing and extent of audit procedures and coverage. We continue to believe that based on acceptable prior year testing results of lower risk processes and controls, and confirmation that control design or operation which remain unchanged should be considered when determining the nature, timing and extent of subsequent year audit procedures. For example, rotation of procedures and reduced transaction level testing of lower risk processes and control could be introduced to help alleviate compliance costs without reducing assurance or increasing risk.

Broad use of the Treadway Commission's Committee of Sponsoring Organizations (COSO) internal control framework and the conservative positions taken by audit firms and issuers also caused issuers to include more controls in their assertion scope than necessary. In some cases, this drove documentation of controls and audit procedures that were unrelated to financial statement disclosure and reporting. The following are a few examples related to Caterpillar:

- Auditor attendance and observation of planning and operations control meetings to ensure they actually occurred
- Seven-year retention of all computer system change tickets
- Examination of signed employee performance evaluations and other documentation not directly related to accounting systems or financial reporting

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

External Auditor Restrictions on Use of Others' Work –

In our opinion, the restrictions placed on external auditors, either regulatory or self-imposed, represent the most onerous and bureaucratic consequences of the regulation. While we agree that the work of others cannot replace the work of the external auditor, the external auditor should be permitted greater reliance on competent, objective internal auditors, and to a larger extent on management. To put this in perspective:

> Caterpillar's assertion process required documentation and validation of approximately 19,000 separate control points throughout our global enterprise. Management teams, including the full-time equivalent of approximately 150 staff, initially documented and validated these controls. In order to satisfy the external auditor requirements set forth in the PCAOB's Audit Standard No. 2, management teams duplicated the tests to obtain evidence controls remained effective through the "as of" date of our internal control report.

In addition, our team of internal auditors repeated this process selectively re-performing management's work and independently validating control effectiveness of approximately one-half management's scope. Upon completion, management and internal audit jointly validated controls covering approximately 85% of our consolidated assets and sales, nearly four times.

Then, of course, our external auditor independently tested internal controls over approximately 65% to 75% of consolidated assets and sales and revenues. Their audit procedures also included re-testing of controls through their opinion. Our external auditors place between 30% and 70% reliance on internal audit.

By the "as of" date of our internal control report, management, internal audit and the outside auditors reviewed and tested most controls over 65% to 75% of Caterpillar's consolidated assets and sales and revenues a combined total of six times during 2004.

Absence of Practical Guidance to Issuers –

The logistics of Caterpillar's Section 404 implementation, similar to other large issuers, was extremely challenging to ensure consistent control documentation and validation and deficiency evaluation across approximately 370 "auditable" locations in 28 countries. The chronology of Caterpillar's Section 404 assertion process was as follows:

Caterpillar launched 6 Sigma project to address Section 404 requirements	March 2003
Securities and Exchange Commission implemented Section 404	June 2003
Caterpillar deployed instructions and tools to "auditable" locations to begin controls assessment	August 2003
PCAOB issued proposed audit standard over internal controls	October 2003
PCAOB issued final Audit Standard No. 2	March 2004
Audit firms received internal Section 404 training	May 2004
Accounting firm task force published final framework for evaluation of control deficiencies	December 2004
Caterpillar filed 2004 Form 10-K	February 2005

Our process to scope, design and deploy instructions and tools to our "auditable" locations began several months prior to issuance of the PCAOB's proposed standard over internal controls. Absent specific guidance to practically apply Section 404, Caterpillar participated in consortia of other issuers, engaged another Big 4 audit firm, and later relied on the PCAOB's proposed audit standard to interpret requirements and formulate the scope and approach of our controls assessment.

Throughout the process, external auditors were reluctant to provide definitive guidance due to independence considerations. Similar to other issuers, Caterpillar engaged another Big 4 audit firm; however, due to unfamiliarity with our business and operations, their assistance was limited to professional interpretive guidance and additional capacity to help complete the controls validation process.

Considerable confusion arose about the nature, timing and extent of controls validation necessary to support management's assertion. Furthermore, advice from the Big 4 often varied until all firms delivered extensive Section 404 training to their engagement teams around mid-2004, nine months after our assertion process began. This new external audit insight resulted in changes to our approach and caused rework to satisfy external auditor requirements.

In research conducted by the Corporate Executive Board, companies indicate management's assertion covers a range between 67% and 100% of assets, revenues and / or net income with an average of about 86%.[5] This wide disparity of management coverage further evidences the varying interpretations of requirements and the absence of specific guidance.

Creation of an Audit Market Oligopoly for Large Public Companies –

The consolidation of audit firms and the collapse of Arthur Andersen have caused the market for audit services to become an oligopoly for large public companies. Though the General Accounting Office found no evidence of impaired competition in a July 2003 study, the Big 4 audit firms have potentially significant anti-competitive market power.[6] The profitability pressures on the Big 4 as the result of divesting consulting practices, the limited ability of smaller firms to serve large multi-national companies, greater risk aversion arising from the current regulation and litigation environment, and the barriers for engaging new auditors have created the opportunity for audit firms to increase fees without competitive pressure. This market power, combined with the overly conservative interpretation of the Act, resulted in an unmanageable increase in audit costs to issuers.

Recent press publications indicate that external audit firms, particularly the Big 4, have been resigning from some of their clients due to lack of resources arising from increased workloads demanded by the Section 404 attestation process. One must therefore question how such actions help restore investor confidence.

Disproportionate Focus on Internal Controls at the Transaction / Process Level

The recent highly publicized corporate fraud and accounting abuses were, in our opinion, the result of indiscretions perpetrated by senior officials of those companies. These frauds were often the result of collusion with senior subordinates, peers or with directors -- not by the failure of an accounting supervisor to initial a journal entry. These officials not only engineered the frauds but also had significant and direct influence over financial reporting. These are not abuses that are readily detected by internal controls at the transaction or process level. Rather, these abuses are most efficiently and effectively prevented or detected by sound corporate governance such as independent boards of directors, whistleblower policies, internal audit function, etc.

In a recent interview, Joseph T. Wells, founder and Chairman of the Board of the Association of Certified Fraud Examiners (ACFE) said, "[Sarbanes-Oxley Section 404] falls into the 'if you have enough control you're not going to have fraud' trap."[7] In their 2004 Report to the Nation on Occupational Fraud and Abuse, the ACFE reported that approximately 85% of occupational frauds were detected either by tips, internal audit or by accident. Only 18% of all fraudulent activities were detected by a company's system of internal accounting control.[8] We acknowledge the importance of controls and believe they are most important in preventing errors. But controls - by themselves - will not eliminate fraud.

Investors also recognize that not all control deficiencies are equally severe. Rating agencies, such as Moody's and Fitch Ratings, have both reported publicly that the character of internal control failures will determine future rating actions. They consider weaknesses in overall control environment such as poor tone-at-the-top, financial reporting transparency and audit committee effectiveness as serious control weaknesses. We agree with Moody's and Fitch Ratings that weaknesses in internal controls at the transaction or process level can be "audited around" by the external auditor to gain assurance as to the fair presentation of financial statements.

Threat to U.S. Economy and Competitiveness of U.S.-Based Companies

We believe the Commission's recent deferral of the compliance date for another year for foreign issuers is unconscionable. The entire Caterpillar team, particularly our accounting and finance staff, experienced extremely challenging demands during our Section 404 implementation. Our team managed the following demands without the regulatory relief enjoyed by foreign issuers:

- Unprecedented demand for products and services with sales and revenues rising 33% over 2003
- Extensive training of office personnel to operate U.S. factories and serve our customers in the event of a labor walkout
- Implementation of a new accounting and reporting system to better align internal decision support information with our external reporting. This alignment alone improved control and transparency and reduced financial reporting risk.

While we understand the demands foreign issuers face in implementing International Accounting Standards, the demands on U.S. companies and concerns expressed to the PCAOB regarding Audit Standard No. 2 were largely ignored. Even under the original compliance date, foreign issuers already enjoyed the advantage of knowing the pitfalls and false starts the accelerated filers, such as Caterpillar, endured.

In our opinion, Section 404 also discourages wealth creation. Caterpillar agrees with the perspectives outlined by Treasury Secretary John Snow in a recent BusinessWeek interview in that some investments that should be made to create wealth for society, investors and shareholders, and to spur economic growth will not be made because Section 404 has raised investment hurdle rates and cost of doing business. The bureaucratic requirements of Section 404 have increased costs, diverted management attention from operations, and will negatively impact the level of investment in new products, certain planned acquisitions, emerging market expansion and other activities.[9]

Given the Commission's recent decision to extend the compliance date for another year for the foreign issuers' to comply with the provisions of Section 404, we urge the Commission to reduce the regulatory burden for U.S. companies by considering the recommendations contained in earlier sections of this letter.

References

1. Reuters, New York, February 11, 2005, by Arindam Nag

2. *SEC Final Rule: Management's Reports on Internal Control Over Finanical Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, 17 CFR PARTS 210, 228, 229, 240, 249, 270, and 274. The estimate excludes costs associated with the auditor's attestation report, and the SEC acknowledged that it received comments suggesting this amount could be substantial.

3. *Sarbanes-Oxley Section 404: The 'Section' of Unintended Consequences and its Impact on Small Business*, February 2005, American Electronics Association (AeA), by Alex Davern, Chief Financial Officer, National Instruments and Chairman of AeA's Sarbanes-Oxley Section 404 Committee

4. *2005 Section 404 Attestation Fees (Forward-Looking Survey),* February 2005, Corporate Executive Board

5. *State of Section 404 Compliance*, February 2005, Corporate Executive Board

6. *Public Accounting Firms, Mandated Study on Consolidation and Competition*, July 2003, United States General Accounting Office

7. *Sound Skepticism*, Internal Auditor, February 2005, by Ed Zwirn

8. *2004 Report to the Nation on Occupational Fraud and Abuse*, pg. 18, Association of Certified Fraud Examiners

9. *Sarbanes-Oxley: A Sense of "Siege"*, BusinessWeek online, January 2005, by Rich Miller