PCAOB
Public Company Accounting Oversight Board

1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202)862-8430
www.pcaobus.org

# STANDING ADVISORY GROUP MEETING

## REPORTING ON A CORRECTION OF A MATERIAL WEAKNESS

**NOVEMBER 17-18, 2004**

### Introduction

The Standing Advisory Group ("SAG") will discuss issues relating to whether there is a need for an auditor to separately report at an interim date on a company's correction of a material weakness in internal control over financial reporting. Separate reporting might be relevant if a material weakness existed as of year end and, resulting in an adverse opinion on the effectiveness of internal control over financial reporting as of year end, and if the company believes it corrected the material weakness as of a subsequent interim date. If there is a need for this kind of auditor reporting, the PCAOB would need to develop a new auditing standard governing this service because the PCAOB's existing interim standards do not address such an engagement.

### Background

When companies begin complying later this year with the internal control reporting provisions of Section 404 of the Sarbanes-Oxley Act of 2002 (the Act), investors and other report users will receive information about public companies that has never before been available on a widespread basis. Consideration of management's assessment and report on the effectiveness of the company's internal control over financial reporting and an auditor's report on management's assessment and the effectiveness of the company's internal control over financial reporting will lead to investors and other report users needing and wanting to know how to best make use of this new information.

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In the past, the annual report included, among other things, the company's financial statements and the auditor's report on those statements. SEC rules prohibit a public company from filing an annual report that contains an auditor's adverse report on the company's financial statements (that is, an auditor's opinion that the company's financial statements are not fairly stated). One reason for this requirement is that management can correct the company's misstated financial statements by making the necessary adjustments. Thus, the company ultimately should be able to obtain an unqualified auditor's opinion on its financial statements if it makes corrections.

Reporting on internal control over financial reporting is different. Section 404 of the Act requires management to assess, and the auditor to opine on, the effectiveness of internal control over financial reporting as of the company's year end. If a material weakness in internal control over financial reporting is determined to exist as of year end, that circumstance can be corrected only as of a future date. Accordingly, a company's annual report will contain an adverse auditor report on internal control over financial reporting by stating that internal control over financial reporting is not effective because a material weakness exists.

When management expresses an adverse conclusion on the effectiveness of the company's internal control over financial reporting because of the existence of a material weakness, and the auditor issues an adverse opinion on the effectiveness of internal control for the same reason, report users will need to understand more than the fact that the auditor's opinion was other-than-unqualified. Reports including adverse opinions will have important disclosures explaining the nature of any material weakness and its actual and potential effect on the company's financial statements. It will be important for report users to evaluate, for each material weakness disclosed, how it resulted, what it will take to correct it, and what its potential effect on the company's financial statements could be in the meantime.

Section 302 of the Act requires a company's management, with the participation of the principal executive and financial officers (the certifying officers) to make quarterly and annual certifications with respect to the company's internal control over financial reporting. The required certifications include disclosing any changes in the company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting. When the reason for a change in internal control over financial reporting is the correction of a material weakness, management has a responsibility to determine whether the reason

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for the change and the circumstances surrounding the change are material information necessary to make the disclosure about the change not misleading. Accordingly, management's Section 302 certifications should provide investors and others with timely information about whether a material weakness that existed at year end has subsequently been corrected.

PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,* establishes certain limited evaluation responsibilities for the auditor as they relate to management's quarterly certifications on internal control over financial reporting. The standard describes limited procedures the auditor should perform quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to comply with the requirements of Section 302 of the Act. Based on the limited nature of these responsibilities, however, PCAOB Auditing Standard No. 2 does not provide for auditor reporting as of an interim date regarding management's Section 302 certifications because the limited nature of the auditor's procedures would not be sufficient to enable the auditor to render an opinion on management's Section 302 certifications.

When management plans to disclose in a quarterly Section 302 certification that the company has made a material change to internal control over financial reporting because a material weakness has been corrected, management may request the auditor to provide it with "comfort" that the auditor also believes that the material weakness has been corrected. This might be analogous to the "comfort" that companies often request the auditor to provide in connection with a company's earnings release (see June 22, 2004 SAG meeting materials for *Discussion of the Auditor's Responsibility for Communications to Investors Containing Financial Information* for further information about the auditor's involvement in earning's releases as well as the SAG's previous discussion of this topic).

Currently, management, the audit committee, investors, and other interested parties, will receive formal auditor assurance regarding the company's correction of a material weakness at the time of the company's next annual report. This assurance will be provided in connection with the company's compliance with Section 404 of the Act for the following year and the auditor's next normal engagement under PCAOB Auditing Standard No. 2. Although the auditor could perform an integrated audit of the financial statements and internal control over financial reporting under PCAOB Auditing Standard No. 2 as of an interim date, normally, such an engagement would be impractical.

The PCAOB's existing interim standards do not address the auditor's engagement to report only on the correction of a material weakness as of an interim date. If such an engagement were addressed in the PCAOB's standards, the report would, of course, need to clearly communicate the nature of the assurance being provided. For example, an auditor's adverse report on internal control over financial reporting issued under Auditing Standard No. 2 for a material weakness existing as of year end could not be combined with an auditor's report on the correction of that material weakness as of an interim date. Such a combination would lead to the presumption that auditor assurance had been rendered as of an interim date on the effectiveness of internal control over financial reporting overall. An auditor's report providing only assurance on the correction of a material weakness would provide no assurance about whether any new material weaknesses had arisen elsewhere in the company's internal control over financial reporting during the intervening period.

Some material weaknesses would lend themselves to auditor assurance as to their correction as of an interim date more easily than others. For example, consider a company with a material weakness existing at year end because it was not performing any reconciliations of its cash accounts with independently generated records from its banking institutions. If, in the interim period following the company's year end, the company subsequently prepared all such reconciliations, an auditor could reasonably be expected to be able to perform procedures sufficient to enable the auditor to provide assurance about whether that material weakness had been corrected as of an interim date. If a material weakness existed, however, because of a deficiency in the company's annual financial reporting process that, ostensibly, only operates once a year or because of pervasive weaknesses in automated application controls that require significant IT modifications that the company would undertake over the course of the next 18 months, the nature of the material weakness and its requirements for correction wouldn't lend themselves to auditor assurance that the weakness had been corrected as of an interim date following the company's initial compliance with Section 404 of the Act. Nor, perhaps, would this situation even lend itself to management being able to certify as of an interim date that it had made a material change to correct the material weakness. The unique nature of a particular material weakness affects how easily it could be addressed by an auditor's report as of an interim date.

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**Discussion Question –**

1. Will there be a demand for the auditor to separately opine on a company's correction of a material weakness as of an interim date? If so, what type of assurance will be demanded?

    - What kind of assurance can reasonably be expected from an auditor regarding the isolated correction of a material weakness at an interim date?

    - Would report users understand the assurance that would be provided from such a report?

    - In understanding the assurance that would be provided from such a report, would report users find that type of assurance valuable?

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.