Center for Public Company Audit Firms
AICPA
Committed to Audit Quality

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May 16, 2005

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. 018: Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness

Members and Staff of the Public Company Accounting Oversight Board:

The Center for Public Company Audit Firms (the "Center") respectfully submits the following written comments on the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") Proposed Auditing Standard on Reporting on the Elimination of a Material Weakness (the proposed standard). The Center was established by the American Institute of Certified Public Accountants (AICPA) to, among other things, provide a focal point of commitment to the quality of public company audits and provide the PCAOB and the Securities and Exchange Commission, when appropriate, with comments on their proposals on behalf of Center member firms. There are approximately 900 Center member firms that collectively audit 97% of all SEC registrants. All of the Center's member firms are U.S. domiciled accounting firms. The AICPA is the largest professional association of certified public accountants in the United States, with more than 340,000 members in business, industry, public practice, government and education.

The Center recognizes the enormous effort made by the PCAOB's members and staff to implement the provisions of the Sarbanes-Oxley Act of 2002 (the Act). As part of that effort, a significant responsibility of the PCAOB is to help restore public confidence in audited financial statements of public companies. The establishment and maintenance of high quality auditing and other professional standards is critical to that goal. The Center is committed to working cooperatively with the PCAOB in the continuous improvement of high quality audit standards.

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Overall, we support the Board's proposed standard. We also applaud the Board for listening and responding to the concerns expressed by our member firms as well as the users of the audited financial statements regarding this topic. However, we have identified a number of issues that we believe require further consideration or clarification by the Board.

Our comments have been drafted primarily in response to the questions posed by the PCAOB. However, we have also included additional comments under the section, Other Comments.

<u>Question 1</u>

(a) Does the sample auditor's report included in the proposed standard clearly describe the results of the engagement?

(b) If not, how might it communicate more clearly to report users?

In certain respects, we do not believe that the sample auditor's report in the proposed standard clearly reflects the purpose and results of the engagement. The following are our concerns and recommendations on how to more clearly communicate to report users.

<u>Wording of Report - "Elimination" of a Material Weakness</u>

The title of the proposed standard, the wording in the auditor's opinion and the stated objective of such audit engagement "to express an opinion on whether the company has eliminated a previously reported material weakness" may be misleading. The wording "elimination of a material weakness(es)" while technically correct, does not take into consideration the fact that while the deficiency may have been reduced, it may not have been fully eliminated. We are concerned that this wording may mislead investors to believe that the deficiency, which has been classified as a material weakness, has been eliminated entirely which may not always be the case.

We strongly recommend that the proposed standard be revised such that it is clear in the standard and the illustrative auditor's report that the purpose of the engagement is to express an opinion on whether the company has achieved the control objective(s) related to a previously reported material weakness(es).

<u>Notion of Materiality in Audit Report</u>

The auditor's report does not take into consideration or reflect the notion of materiality or "presents fairly." The opinion paragraph has an exactness to it that is not consistent with Auditing Standard No. 2, thereby misrepresenting the precision of the auditor's assessment and neglecting the notion of reasonable assurance. The opinion paragraph in the sample auditor's report states:

> In our opinion, XYZ Company has eliminated the material weakness described above as of [*date of management's assertion*] because the stated control objective is met as of [*date of management's assertion*].

It is unclear to us as to why the concept of "material misstatement" is raised in paragraph 45(d) of the proposed standard but it is not reflected in the auditor's report. We strongly recommend that language be added to reflect the concepts of reasonable assurance and materiality in the auditor's report.

Clarification of the Auditor's Responsibility in Auditor's Report

Our members are concerned that the proposed standard may confuse the investing public as to what the auditor's responsibilities are with respect to management's quarterly disclosures related to changes in internal control. We suggest that the PCAOB clarify in the proposed standard the auditor's responsibilities related to management's quarterly reports when there are specific material weakness(es) in internal control during a quarterly review as compared to their responsibilities on the engagement in the proposed standard.

We further recommend that an element be added to paragraph 47 to clarify in the auditor's report that the engagement in the proposed standard is voluntary and performed only at the request of management.

Reporting When Management and the Auditor Disagree Regarding Elimination of Material Weakness

With respect to how to handle a situation where management asserts that the material weakness has been eliminated and the auditor disagrees, there appears to be an inconsistency in the proposed standard. Paragraph 45(d) seems to require compliance as a type of precondition to the performance of the engagement, whereas paragraph 53 directs the auditor to issue an adverse report or disclaim an opinion. These two directives seem to conflict.

Notwithstanding the apparent conflict between paragraph 45 d and paragraph 53, the proposed standard states in paragraph 53 that in cases where the auditor determines that the material weakness has not been eliminated as asserted by management, the auditor is not required to issue a report, but rather is required only to communicate, in writing, his or her conclusion to the audit committee. Some members believe that it is important that the auditor formally document his or her conclusions through the issuance of an adverse report. While the adverse report would serve an important purpose to formally document and clarify the auditors' conclusions, it does not need to be made publicly available.

Reference to a Predecessor's Auditor's Report Where a Material Weakness is Identified

The proposed standard does not require the successor auditor to reference a predecessor's auditor's report on management's most recent annual assessment of the effectiveness of internal control over financial reporting where a material weakness was identified. Rather paragraph 47(b) states that in this case, the auditor's report should refer to the predecessor's auditor's report only if necessary. To prevent misleading the public in thinking that the successor auditor performed the audit of the company's internal controls and identified the material weakness(es) as of year-end, we recommend that the successor auditor's report on the elimination of a material weakness directly refer to the predecessor auditor's report unless the material weakness was identified as of an interim date.

Disclosure of Controls Related to Eliminated Material Weakness

The proposed standard seems to require that only the specific controls implemented to eliminate a material weakness be identified in the auditor's report. However, there is no mention of existing controls that contributed to the remediation of the material weakness when aggregated with the newly implemented controls. Accordingly, we suggest that the PCAOB consider adding language to the auditor's report that indicates that there may have been certain pre-existing controls that contributed to the remediation of the material weakness and specifically list all the controls, not just those newly implemented, that were relevant in achieving the stated control objective(s). In addition, we recommend that the proposed standard state that the auditor's responsibility includes tests of all controls necessary to achieve the control objective(s) related to a previously reported material weakness(es) or a material weakness(es) identified and remediated in an interim period, not just the newly implemented controls.

Question 2

(a) If the auditor does not express an opinion on all of the material weaknesses that were identified during the company's most recent audit of internal control over financial reporting, should the proposed standard require the auditor's report to specifically identify the additional material weaknesses?

(b) Would such a requirement provide helpful information to users or would it detract from an otherwise clear communication by implying that the auditor believes that those material weaknesses do still exist or that only those material weaknesses exist (i.e., no other controls have materially deteriorated since the date of the annual assessment of internal control over financial reporting)?

(c) Might specific identification of other material weaknesses not addressed by the auditor's report deter companies from engaging the auditor to perform this work unless the company believed that all previously reported material weaknesses had been eliminated?

We believe that, in order to limit confusion, it is necessary to add a paragraph to the auditor's report regarding the remaining material weaknesses similar to the sample language included in paragraph 52. Further, we believe that making a brief mention of the nature of the other material weaknesses previously reported on with a clear statement that the auditor was not engaged to audit those areas would further clarify the report and lessen the users' confusion. By briefly identifying the other weaknesses in the report, the users would be more easily able to reconcile the interim auditor's report on the elimination of a material weakness to the year-end auditor's report on the effectiveness of internal control over financial reporting.

To address the question as to whether or not identifying the other material weaknesses deters companies from engaging their auditor to perform this work, would depend on the nature of the remaining material weaknesses coupled with the company's reasoning behind the request for the engagement. For example, if a particular material weakness primarily impacts year-end, the company would not be as concerned of its mention in the report as an unresolved material weakness. However, if a material weakness has a significant impact throughout the year or on other systems, identifying it as unresolved in the report might be more of a deterrent. In addition, if a specific third party transaction is driving the need for reporting on the elimination of a particular material weakness, mentioning the other unresolved material weaknesses may not be a concern to the company.

Question 3

> ***Should this standard allow an auditor to report on the elimination of a material weakness in the circumstance in which the material weakness was identified and eliminated by management as of an interim date?***

Generally, our members do not agree with allowing the auditor to report on the elimination of a material weakness that was not previously reported as of year-end. However, if the proposed standard allows an auditor to report on the elimination of a material weakness that was identified and eliminated by management as of an interim date, we recommend that additional guidance and sample wording for the auditor's report be provided. The additional guidance should clarify that if during the assessment of the remediation of the material weakness identified as of an interim date, the auditor determined that he or she is not able to obtain a sufficient basis for reporting on the elimination of the material weakness without performing a complete audit of internal control, the auditor should either issue an adverse opinion or disclaim an opinion.

OTHER COMMENTS

Date of Management's Assertion

The proposed standard allows management to specify any date to make its assertion that the control objective(s) were achieved related to a previously reported material weakness(es). Although paragraph 26 sets some parameters regarding the appropriateness of the date selected by management, we believe that assessing the control objectives related to the material weaknesses would be best achieved as of a quarterly reporting period. In most cases, this would provide the best assurance that the control objectives are functioning properly in all respects, particularly since the material weaknesses were identified during a year-end reporting period. Accordingly, we recommend that the proposed standard require that management's assertion and the audit regarding the elimination of material weakness be conducted as of a quarterly period.

Use of Substantive Procedures

The proposed standard states in paragraph 31 that "the auditor also may determine that performing substantive procedures to support recorded financial statement amounts or disclosures affected by the specifically identified controls is necessary to obtain sufficient evidence regarding the operating effectiveness of those controls." Given the fact that a material weakness previously existed and was most likely identified by performing substantive procedures as part of the year-end audit, it seems that, in most cases, some substantive procedures would be necessary as part of the engagement proposed by this standard. Some members believe that because of the discretionary wording regarding this matter (i.e., "may determine") and the lack of parameters and guidance in the proposed standard, they fear that the strong likelihood that some amount of substantive procedures would be necessary may be overlooked. Accordingly, some members recommend that the wording be made less discretionary and perhaps more parameters and/or guidelines be incorporated in the proposed standard with respect to the use of substantive procedures to support recorded financial statement amounts or disclosures affected by the specifically identified controls.

Performance of Walkthroughs

There is an inconsistency in the Using the Work of Others section of the proposed standard regarding the use of walkthroughs. While paragraph 35 states that "the auditor should perform any walkthroughs himself or herself because of the degree of judgment required in performing this work," paragraph 36 provides an example which states that "The auditor might perform a walkthrough …" The wording of the example in paragraph 36 should be reworded to say "should" to be consistent with the guidance in paragraph 35.

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We appreciate the opportunity to comment on the Board's proposed standard. We are firmly committed to working with the PCAOB and would welcome the opportunity to meet with you to clarify any of our recommendations.

Sincerely,

Robert J. Kueppers
Chair
Center for Public Company Audit Firms

cc: Mr. William J. McDonough, Chairman, PCAOB
Ms. Kayla J. Gillan, Member, PCAOB
Mr. Daniel L. Goelzer, Member, PCAOB
Mr. Willis D. Gradison, Member, PCAOB
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