

RELEASE

adequate internal control, the Act's requirement for management assessments and auditor attestations has prompted a new focus in the way companies maintain their internal controls.

Under Section 404 of the Act, for the first time, the investing public will receive audited financial statements coupled with reports from management and the auditor explaining the soundness of the control system used to produce the financial statements. This integrated approach provides investors with a more complete story of a company's financial reporting.

For many companies, Section 404 reporting is the culmination of an intensive process of re-examining the adequacy of internal checks and balances, changing existing or implementing new controls where weaknesses existed, and assessing, overall, whether the control systems are effective. Accompanying these efforts is a similarly rigorous process performed by the companies' independent auditors – undertaken for the purpose of expressing an opinion about management's report – to evaluate the adequacy of management's process and obtain evidence about the effectiveness of the companies' internal control.

As companies adapt to this new regime, some will report that internal control over financial reporting is not effective. Investors will benefit from disclosure about material weaknesses, including the company's plans to remediate them.^{1/} Until the company eliminates the material weakness, however, investors may be left uncertain about the reliability of the company's financial statements.

Both managements and report users have recognized the importance of a mechanism for telling investors the rest of the company's story when a material weakness in internal control over financial reporting has been disclosed.^{2/} The federal

^{1/} See Prepared Testimony of William H. Donaldson, Chairman, U.S. Securities & Exchange Commission ("SEC" or the "Commission"), before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, March 9, 2005.

^{2/} The Board's Standing Advisory Group ("SAG") discussed possible auditor involvement with the elimination of a material weakness at its November 18, 2004 public meeting. See the related briefing paper on this topic, "Reporting on the Correction of a Material Weakness," on the PCAOB's Web site at www.pcaobus.org/Standards/Standard_Advisory_Group/Meetings/2004-11-17-18/Material_Weakness.pdf

RELEASE

securities laws provide part of that mechanism. The company is required to disclose to investors any changes in internal controls that occurred during the company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.^{3/} Therefore, investors will learn of significant improvements, such as the elimination of a material weakness, on a timely basis through quarterly disclosures.^{4/}

When a company eliminates a material weakness, it may determine that disclosure is sufficient. Investors and companies, however, have called for the ability to bolster confidence in management's assertions about those internal control improvements with the added assurance of the company's independent auditor. The Board, therefore, is proposing a standard for auditors to provide this assurance when, in the company's judgment, such assurance would be appropriate. Such assurance is not required by the Act or other securities laws. Nevertheless, it is appropriate to provide a mechanism to facilitate such assurance.

In anticipation of the demand for auditor reporting on the elimination of a material weakness, the Board reviewed its existing auditing and attestation standards to determine whether adequate standards governing such an engagement already existed. The Board's interim attestation standards already provide requirements for general attest engagements; however, these standards lack sufficient specificity for this purpose.^{5/} The proposed standard would be tailored more narrowly to an engagement

^{3/} See Item 308(c) of Regulation S-K, 17 C.F.R. § 229.308(c).

^{4/} In addition, even if internal control over financial reporting is effective as of the end of a company's fiscal year, investors also could potentially learn if it deteriorates significantly during the year through these quarterly disclosures.

^{5/} See AT sec. 101, "Attest Engagement" of the Board's interim standards. Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, five temporary interim standards rules (PCAOB Rules 3200T, 3300T, 3400T, 3500T, and 3600T) that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"). These rules were approved by the SEC on April 25, 2003. See SEC Release No. 33-8222. On December 17, 2003, the Board approved technical amendments to the interim standards rules indicating that, "when the Board adopts a new auditing and related professional practice standard that addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standards will be superseded or effectively amended. Accordingly, the Board approved adding the phrase 'to the extent

RELEASE

to report on the elimination of a material weakness, given the relationship between such an engagement and PCAOB Auditing Standard No. 2.

II. Overview of an Engagement to Report on the Elimination of a Material Weakness

The proposed standard would establish a stand-alone engagement that is entirely voluntary, performed only at the request of the company. Providing a specific standard governing such auditor reporting will facilitate implementation of the requirements of Section 404 of the Act and provide for additional assurance regarding the reliability of public company financial reporting.

The objective of an auditor's engagement to report on the elimination of a material weakness in internal control would be to express an opinion on whether the company has eliminated a previously reported material weakness. The proposed standard, therefore, draws from many of the concepts applicable to the auditor's annual report on the effectiveness of internal control over financial reporting, as expressed in PCAOB Auditing Standard No. 2, although in a more narrowly focused and limited manner. As appropriate, relevant concepts from the Board's interim attestation standards also have been used in the proposed standard. For these reasons, most of the requirements in the proposed standard should be familiar to auditors.

The proposed standard would provide that, for an auditor to provide an opinion on the elimination of a material weakness, the material weakness in question must have been identified in an auditor's previous report on internal control over financial reporting as of year-end. In other words, the reporting is limited to the elimination of the material weaknesses identified in the annual assessment process. For example, if a company identifies a material weakness in the second quarter of the year, discloses that material weakness to the market in connection with its quarterly reports, and eliminates the weakness in the third quarter of that same year, the proposed standard would not permit the auditor to separately report on the elimination of that material weakness in the third quarter.

not superseded or amended by the Board' to each of the interim standards rules." *Technical Amendments to Interim Standards Rules*, PCAOB Release No. 2003-26 (Dec. 17, 2003); Exchange Act Release No. 49624 (Apr. 28, 2004) (SEC Approval). The Statements on Standards for Attestation Engagements are codified into the AICPA Professional Standards, vol. 1, as AT sections 101 through 701, and are available on the Board's Web site at <http://www.pcaobus.org>.

RELEASE

Similar to any other attestation service, under the proposed standard an auditor's report on the elimination of a material weakness would be based on management's assertion that the material weakness has been eliminated. Fundamentally, the auditor's assurance is that the material weakness has, in the auditor's opinion, in fact been corrected. In this instance, the auditor would determine whether the material weakness had been eliminated by evaluating management's assertion and performing audit procedures necessary to determine that the controls specified in management's assertion were designed and operated effectively to eliminate the material weakness. Management's written statement, therefore, should identify the previously reported material weakness, refer to the specific controls that eliminate the material weakness, and identify the control objectives that are met by the identified controls.

Although the auditor's evaluation of the design and operating effectiveness of controls generally would follow the requirements of PCAOB Auditing Standard No. 2, this proposed type of engagement would be significantly narrower in scope because the auditor's testing would be limited to the controls specifically identified by management as eliminating the material weakness. Both management and the auditor would use the company's stated control objectives (discussed in the next section) as the target for determining whether the specified controls eliminate the material weakness.

In several ways, the proposed standard also would allow for significant flexibility in the performance of an engagement to report on the elimination of a material weakness. First, the engagement could be undertaken at any time during the year (limited only by the nature of the material weakness) and would not have to be performed in conjunction with an audit or review of financial statements. The proposed standard also would allow an auditor to report on the elimination of one or more material weaknesses as part of a single engagement. In other words, if a company identified more than one material weakness in its Section 404 reporting, this proposed standard would permit the auditor to report on any of those material weaknesses as soon as management asserted that they had been eliminated and the auditor could test their elimination sufficiently. The proposed standard also would allow the auditor to use the work of others, consistent with the framework for using the work of others that PCAOB Auditing Standard No. 2 established.

The Board recognizes that some material weaknesses will lend themselves to auditor assurance regarding their elimination as of an interim date more easily than others. For example, a company might have a material weakness in internal control at year-end because it was not reconciling its cash accounts to its bank statements. If, in the interim period following the company's year-end, the company began performing

RELEASE

this reconciliation, an auditor might be able to perform procedures sufficient to conclude that the material weakness had been eliminated as of a subsequent interim date.

On the other hand, a company might have ineffective internal control over financial reporting at year-end because of pervasive weaknesses in its control environment. Because the control environment can have significant effects on other components of internal control over financial reporting, it might not be possible for management or the auditor to conclude on the effectiveness of the control environment without evaluating, and testing, the effects of the corrective action on the other internal control components. Therefore, a narrow, interim engagement may not be suitable for auditor reporting on the elimination of this type of material weakness. The same may be true for a situation in which the company had pervasive weaknesses in automated application controls requiring significant information technology modifications that the company would undertake over the course of the next 18 months. It, therefore, follows that managements and auditors may reasonably conclude that the engagement provided for in the proposed standard is not appropriate in some circumstances, in which case the auditor's assurance will await the company's year-end integrated audit of the financial statements and the company's overall internal control over financial reporting as of year-end.

III. Focus on Stated Control Objectives to Determine Whether a Material Weakness Has Been Eliminated

A *control objective* states the objective that a control, or group of controls, must be designed to achieve for the control to be effective. In other words, a control objective provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant financial statement assertion, such as whether certain recorded transactions are genuine, and provides a basis for evaluating the effect of a company's controls on that assertion.^{6/}

Management establishes control objectives that are tailored to the individual company. The process of tailoring control objectives to the individual company allows the control criteria (i.e., the evaluation framework) used for management's annual assessment (for example, the Committee of Sponsoring Organizations of the Treadway

^{6/} See paragraphs 68 to 70 of PCAOB Auditing Standard No. 2 for additional information on relevant assertions.

RELEASE

Commission's *Internal Control – Integrated Framework* ("COSO") to be applied to the facts and circumstances in a reasonable and appropriate manner.

Management's ability to translate the overarching provisions of the control criteria, such as COSO, into specific control objectives is part of the risk assessment component of internal control over financial reporting. The company should be able to assess risks to the reliability of its financial reporting. In other words, the company would ask, "What could go wrong?" to enable it to design and implement controls that are effective in addressing those risks.

Control objectives can be thought of as the converse of what could go wrong with a company's published financial statements. For example, sales initiated on the company's Web site probably are processed differently, in some respects, from sales initiated in-person inside the company's stores. Sales initiated on the company's Web site may present unique risks that fictitious transactions will be recorded. In this circumstance, one of the company's control objectives might be that "recorded sales of product X initiated on the company's Web site are real."

In an audit of internal control over financial reporting, the auditor already has a responsibility to identify the company's control objectives in each area and to identify the controls that satisfy each control objective.^{7/} Therefore, this concept in an engagement to report on the elimination of a material weakness already should be familiar to both management and the auditor.

If a material weakness has been disclosed previously, a necessary control objective at the company has not been achieved. A *stated control objective* in the context of an engagement to report on the elimination of a material weakness is the specific control objective identified by management that, if achieved, would result in the material weakness being eliminated. The stated control objective provides management and the auditor with a specific target against which to evaluate whether the material weakness has been eliminated. For this reason, management and the auditor must be satisfied that, if the stated control objective were achieved, the elimination of the material weakness would result.

When a material weakness has a pervasive effect on the company's internal control over financial reporting, identifying the control objectives that are not being met is difficult because of the large number of control objectives that would be affected by a

^{7/} See paragraph 88 of Auditing Standard No. 2.

RELEASE

pervasive material weakness. A material weakness related to an ineffective control environment would be an example of this. If management and the auditor have difficulty in identifying *all* of the stated control objectives affected by a material weakness, the material weakness is probably not suitable for this type of narrow, interim reporting and should be addressed instead through the auditor's annual audit of internal control over financial reporting.

IV. Engagement Acceptance by the Auditor

The auditor must have sufficient knowledge of both the company and its internal control over financial reporting to perform an engagement to report on the elimination of a material weakness. The significance of this requirement, in both the amount of time required and the in-depth exposure to the financial reporting process necessary to gain this sort of understanding, led the Board to propose that only the company's auditor, of both the company's financial statements and internal control over financial reporting, should perform this work. The auditor engaged to report on the elimination of a material weakness, therefore, usually will be the auditor who performed the audit of the company's financial statements and internal control over financial reporting in the previous year, when the material weakness was reported initially. In cases in which the company has engaged a new auditor to perform the audit of the financial statements and internal control over financial reporting for the current year, the new auditor may report on the elimination of a material weakness as his or her initial engagement. In this circumstance, the proposed standard would require the new auditor to obtain a sufficient understanding of both the company and its internal control over financial reporting. The auditor will need to obtain this understanding, in any case, to complete his or her audit of internal control over financial reporting as of year-end.

V. Using the Work of Others in an Engagement to Report on a Material Weakness

The proposed standard would require the auditor to evaluate management's assertion that the material weakness has been eliminated. Additionally, the proposed standard would require the auditor to obtain sufficient evidence that the material weakness has been eliminated. Similar to PCAOB Auditing Standard No. 2, the proposed standard would permit the auditor to use the work of others to alter the nature, timing, and extent of the auditor's performance of this work.

Specifically, the proposed standard would apply the framework for using the work of others described in PCAOB Auditing Standard No. 2. This framework requires the auditor to obtain the principal evidence supporting his or her opinion and to evaluate the nature of the controls being tested, together with the competence and objectivity of the

RELEASE

persons performing the work. Under both PCAOB Auditing Standard No. 2 and the proposed standard, the framework measures principal evidence in relation to the overall assurance provided by the auditor. Accordingly, whereas in PCAOB Auditing Standard No. 2, the "principal evidence" supporting the auditor's opinion should be evaluated in relation to the auditor's opinion on internal control over financial reporting overall, the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion on the elimination of a material weakness would need to be applied at the control objective level.

An engagement to report on the elimination of a material weakness could include an opinion by the auditor that each material weakness identified in management's assertion has been eliminated because each stated control objective is now being met. If, for example, management's and the auditor's reports identify three separate material weaknesses that have been eliminated, the auditor would, in effect (if not in form), be rendering three separate opinions. In that case, those opinions would indicate that each of the three individual material weaknesses has (or has not) been eliminated. Therefore, the proposed standard would require the auditor to obtain the principal evidence that *each* of the three identified material weaknesses has been eliminated. To the extent that certain evidence supports determinations that more than one stated control objective has been addressed, however, an auditor may realize efficiencies.

VI. Auditor's Report on the Elimination of a Material Weakness

To render an unqualified opinion, the auditor must have obtained evidence about the design and operation of the relevant controls, determined that the material weakness has been eliminated, and determined that no scope limitations were placed on the auditor's work. Because of the narrow focus of this engagement, qualified opinions would not be permitted under the proposed standard. Any limitations on the scope of the auditor's work would preclude the auditor from rendering an opinion. Therefore, the reporting options permitted by the proposed standard are for an unqualified opinion or an adverse opinion (stating that the material weakness has not been eliminated). Additionally, the auditor would be permitted to disclaim an opinion or withdraw from the engagement.

Unlike an audit of internal control over financial reporting, where the assessment is required to be as of the date of the financial statements, an auditor's report on the elimination of a material weakness does not have to be as of a specific date. The company selects an "as of" date for its assertion, which represents the day the company believes the material weakness has been eliminated and management has adequately assessed its effectiveness. In the event that the auditor begins testing the elimination of

RELEASE

the material weakness and concludes that additional remediation action is required, the company has the opportunity to re-address its remediation efforts, reset the assertion date and ask the auditor again to opine on the elimination of the material weakness. In such a circumstance, the proposed standard does not require the auditor to issue an adverse opinion as of the original assertion date.

If, however, the auditor determines that a material weakness has not been eliminated, and the auditor does not issue an adverse report, the proposed standard would require the auditor to communicate to the company's audit committee, in writing, his or her conclusion that the material weakness has not been eliminated. As the company's auditor, the auditor also has other responsibilities if, in light of this knowledge, the auditor believes that the company's quarterly reports are materially misleading (because, for example, the company disclosed in its quarterly reports that the material weakness *had* been corrected).^{8/}

Paragraph 52 of the proposed standard addresses the circumstance in which the auditor reports on fewer than all of the previously reported material weaknesses. In this circumstance, the proposed standard would require the auditor to include language in his or her report stating that management's annual assessment of the company's internal control over financial reporting identified additional material weaknesses, that the auditor is not reporting on whether those other material weaknesses have been eliminated, and that the auditor, accordingly, is expressing no opinion on whether those material weaknesses exist after the company's year-end. The proposed standard would not require the auditor to specifically identify the other material weaknesses in his or her report.

To describe the narrow focus of the engagement clearly, the proposed standard would require the auditor's report to identify the material weakness, stated control objectives, and specified controls that are the subject of the engagement and also to include language to emphasize to readers that the auditor has not performed procedures sufficient to reach conclusions about the effectiveness of any other controls or provided an opinion regarding the effectiveness of internal control over financial reporting overall.^{9/} The auditor's emphasis on the narrow scope of the engagement

^{8/} See PCAOB Auditing Standard No. 2, paragraphs 200-206; see also Section 10A of the Securities Exchange Act, 15 U.S.C. 78j-1; AU sec. 317.

^{9/} The Standing Advisory Group's November 18, 2004 discussion of this type of auditor reporting included discussion about the importance of such a report clearly communicating to report users the scope of the engagement. Several SAG members

RELEASE

would help report users understand that the scope of the auditor's opinion is limited and does not provide auditor assurance on internal control over financial reporting overall.

VII. Effective Date of the Proposed Standard

The standard would be effective as of the date of SEC approval.

VIII. Conforming Amendments

If the Board adopts, and the SEC approves, this proposed auditing standard, the Board's interim standards^{10/} would effectively be amended. Appendix 2 describes the nature and extent of the conforming amendments to the Board's interim standards that would result. Specifically, paragraph .04 of AT sec. 101, *Attest Engagements*, describes certain services that are not covered by the Board's interim attestation standards. AT sec. 101 would be amended to specify that an auditor's engagement to report on the elimination of a material weakness may *not* be conducted under the more general AT sec. 101 but, rather, must be conducted pursuant to the Board's Proposed Auditing Standard, *Reporting on the Elimination of a Material Weakness*.

The Board has determined that, in keeping with the intent of Section 404 of the Act, positive assurance as to both the design and operating effectiveness of the controls implemented is the most appropriate form of communication by an auditor regarding the elimination of a material weakness. In other words, an auditor's opinion regarding whether the material weakness has been eliminated can only be rendered when the auditor is satisfied that the identified controls are both designed and operating effectively. This opinion will provide the most meaningful information to investors and avoid confusion on the part of report users. Therefore, if the Board adopts, and the SEC approves, the proposed standard, the auditor would be precluded from performing an agreed-upon procedures or review engagement (using AT sec. 101) when the subject matter of the engagement is the elimination of a material weakness.

emphasized the potential for report users to believe, mistakenly, that the auditor, as a result of this limited engagement to report on the elimination of a material weakness, had rendered a current opinion regarding the effectiveness of internal control over financial reporting overall. The webcast of the November 18, 2004 Standing Advisory Group discussion is available on the Board's Web site (www.pcaobus.org).

^{10/} See footnote 5.

RELEASE

IX. Opportunity for Public Comment

The Board invites comment on any aspect of the proposed standard, and encourages the commenter to consider certain issues in particular. First, does the sample auditor's report, which is included in the proposed standard, clearly describe the results of the engagement? If not, how might it communicate more clearly to report users?

Second, 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? Would such a requirement provide helpful information to report 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)? 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?

Third, 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 (in other words, identified and eliminated without ever being addressed in the company's Section 404 reporting)?

The Board will seek comment on the proposed standard for a 45-day period. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 018 in the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on May 16, 2005.

The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to adopt a final standard, with or without amendments. Any final standard adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are deemed to be rules under the Act.

RELEASE

* * *

On the 31st day of March, in the year 2005, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Acting Secretary

March 31, 2005

APPENDICES –

1. Proposed Auditing Standard – *Reporting on the Elimination of a Material Weakness*
- 2: Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Proposed Auditing Standard – *Reporting on the Elimination of a Material Weakness*

RELEASE

Appendix 1 – Proposed Standard

Proposed Auditing Standard –

***REPORTING ON THE ELIMINATION OF A MATERIAL
WEAKNESS***

RELEASE

Table of Contents

	Paragraph
APPLICABILITY OF STANDARD	1-3
AUDITOR'S OBJECTIVE IN AN ENGAGEMENT TO REPORT ON THE ELIMINATION OF A MATERIAL WEAKNESS	4-6
CONDITIONS FOR ENGAGEMENT PERFORMANCE	7-8
FRAMEWORK AND DEFINITIONS FOR EVALUATION	9-14
PERFORMING AN ENGAGEMENT TO REPORT ON THE ELIMINATION OF A MATERIAL WEAKNESS	15-39
Applying the Standards of the PCAOB	16-20
Planning the Engagement.....	21
Obtaining an Understanding of Internal Control Over Financial Reporting	22-24
Testing and Evaluating the Elimination of a Material Weakness.....	25-32
Using the Work of Others.....	33-37
<i>Opinions based, in part, on the report of another auditor</i>	37
Forming an Opinion on the Elimination of a Material Weakness.....	38-39
REQUIREMENT FOR WRITTEN REPRESENTATIONS	40-42
DOCUMENTATION REQUIREMENTS	43
REPORTING ON THE ELIMINATION OF A MATERIAL WEAKNESS	44-58
Management's Report.....	44
Auditor's Evaluation of Management's Report	45-46
Auditor's Report	47-58
<i>Report Modifications</i>	50-51
<i>Other material weaknesses reported previously by the company as part of the company's annual assessment of internal control are not addressed by the auditor's opinion</i>	52
<i>Material weakness not eliminated</i>	53-54
<i>Subsequent events</i>	55-56
<i>Management's report containing additional information</i>	57-58
EFFECTIVE DATE	59

Appendix A – Illustrative Report on the Elimination of a Material Weakness

RELEASE

**AUDITING AND RELATED PROFESSIONAL PRACTICE
STANDARDS**

**Proposed Auditing Standard – *Reporting on the Elimination
of a Material Weakness***

Applicability of Standard

1. This standard establishes requirements and provides direction that applies when an auditor is engaged to report on the elimination of a material weakness in internal control over financial reporting (herein after referred to as a material weakness).
2. An auditor may conduct an engagement to report on the elimination of a material weakness if (1) the auditor has audited the company's financial statements and internal control over financial reporting in accordance with Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, within the past year, or (2) the auditor has been engaged to perform an audit of the financial statements and internal control over financial reporting in accordance with Auditing Standard No. 2 in the current year and has a sufficient basis for performing this engagement. (See paragraph 23 for additional requirements that apply specifically to a successor auditor's application of this standard.) The auditor also may report on the elimination of more than one material weakness as part of a single engagement.
3. The engagement described by this standard is voluntary. The standards of the PCAOB do not require an auditor to undertake an engagement to report on the elimination of a material weakness when a material weakness was previously reported. The auditor may audit the company's internal control over financial reporting in accordance with Auditing Standard No. 2 without ever performing an engagement in accordance with this standard.

Note: In this context, *previously reported material weakness* means a material weakness that was previously described in an auditor's report issued pursuant to Auditing Standard No. 2.

RELEASE

Auditor's Objective in an Engagement to Report on the Elimination of a Material Weakness

4. The auditor's objective in an engagement to report on the elimination of a material weakness is to express an opinion on whether the company has eliminated a previously reported material weakness. The auditor's opinion relates to the elimination of a specifically identified material weakness as of a specified date and does not relate to the effectiveness of the company's internal control over financial reporting overall.

5. To form a basis for expressing an opinion on the elimination of a material weakness, the auditor must plan and perform the engagement to obtain reasonable assurance about whether the company has eliminated the material weakness as of the date specified by management.

6. To obtain reasonable assurance, the auditor should obtain and evaluate evidence about whether specified controls were designed and operated effectively as of the date specified by management and whether those controls satisfy the company's stated control objective.

Note: Obtaining and evaluating evidence about whether the specified controls are designed effectively without also obtaining evidence about whether those controls operated effectively would not result in the auditor obtaining reasonable assurance for the purpose of expressing an opinion on whether the company has eliminated a material weakness.

Conditions for Engagement Performance

7. The auditor may report on a company's elimination of a material weakness only if each of the following conditions is met:

- a. Management accepts responsibility for the effectiveness of internal control over financial reporting;
- b. Management evaluates the effectiveness of the specific control(s) that it believes eliminates the material weakness using the same control criteria that management used for its most recent annual assessment of internal control over financial reporting and its stated control objective(s);
- c. Management asserts that the specific control(s) identified is effective in achieving the stated control objective;

RELEASE

- d. Management supports its assertion with sufficient evidence; and
 - e. Management presents a written report that will accompany the auditor's report that contains all the elements described in paragraph 44.
8. If the conditions in paragraph 7 are not met, the auditor may not complete the engagement to report on the elimination of a material weakness.

Framework and Definitions for Evaluation

9. The terms *internal control over financial reporting*, *control deficiency*, *significant deficiency*, and *material weakness* have the same meanings as the definitions of those terms in paragraphs 7 through 10, respectively, of Auditing Standard No. 2.
10. Paragraph 13 of Auditing Standard No. 2 states that management is required to base its annual assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as *control criteria*) and describes the characteristics that make a framework suitable for this purpose. For purposes of an engagement to report on the elimination of a material weakness, both management and the auditor must use (1) the same control criteria used for the company's most recent annual assessment of internal control over financial reporting and (2) the company's stated control objective(s) to evaluate whether a material weakness has been eliminated.

Note: The performance and reporting requirements in Auditing Standard No. 2 and in this standard are based on the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission's publication, *Internal Control – Integrated Framework*. Known as the COSO report, it provides a suitable and available framework for purposes of management's annual assessment of internal control over financial reporting. (More information about the COSO framework is included in paragraphs 14 and 15 of Auditing Standard No. 2, the COSO report, and AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.^{1/})

^{1/} The Board adopted the generally accepted auditing standards, as described in the AICPA Auditing Standards Board's ("ASB") Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, on an initial, transitional basis. The Statements on Auditing Standards promulgated by the ASB have been codified into the AICPA *Professional Standards*,

RELEASE

11. A *control objective* provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant financial statement assertion and provides a basis for evaluating the effect of a company's controls on that assertion.^{2/} Management establishes control objectives that are tailored to the individual company. The process of tailoring control objectives to the individual company allows the control criteria used for management's annual assessment to be applied to the facts and circumstances in a reasonable and appropriate manner. Although control objectives are used most frequently to evaluate the effectiveness of control activities, the other components of internal control over financial reporting (i.e., control environment, risk assessment, information and communication, and monitoring) also can be expressed in terms of control objectives.

12. In an audit of internal control over financial reporting, the auditor should identify the company's control objectives in each area and identify the controls that satisfy each control objective.^{3/}

Volume 1, as AU sections 100 through 900. References in this standard to AU sections refer to those generally accepted auditing standards, as adopted on an interim basis in PCAOB Rule 3200T and amended by the Board.

^{2/} See paragraphs 68 to 70 of Auditing Standard No. 2 for additional information on relevant assertions.

^{3/} See paragraph 88 of Auditing Standard No. 2.

RELEASE

13. Table 1 includes examples of control objectives and their related assertions:

Table 1
Examples of Control Objectives and Related Assertions

Control Objectives	Assertions
Recorded sales of product X initiated on the company's Web site are real	Existence or occurrence
Product X warranty losses that are probable and can be reasonably estimated are recorded as of the company's quarterly financial statement period ends	Completeness
Interest rate swaps are recorded at fair value	Valuation or allocation
The company has legal title to recorded product X inventory in the company's Dallas, TX warehouse	Rights and obligations
Pending litigation that is reasonably possible to result in a material loss is disclosed in the quarterly and annual financial statements	Presentation and disclosure

14. If a material weakness has previously been reported, a necessary control objective (or objectives) has not been achieved. A *stated control objective* in the context of an engagement to report on the elimination of a material weakness is the specific control objective identified by management that, if achieved, would result in the material weakness being eliminated. The stated control objective provides management and the auditor with a specific target against which to evaluate whether

RELEASE

the material weakness has been eliminated. For this reason, management and the auditor must be satisfied that if the stated control objective were achieved, the elimination of the material weakness would result.

Performing an Engagement to Report on the Elimination of a Material Weakness

15. In an engagement to report on the elimination of a material weakness, the auditor must obtain sufficient competent evidence about the design and operating effectiveness of specified controls that provide reasonable assurance that the company's stated control objective is achieved in the context of the control criteria (e.g., COSO).

Note: An individual material weakness may be associated with a single stated control objective or with more than one stated control objective, depending on the nature of the material weakness and the manner in which the company tailors its stated control objectives to its business.

Applying the Standards of the PCAOB

16. The auditor must adhere to the standards of the PCAOB in performing an engagement to report on the elimination of a material weakness. Adherence to the standards involves:

- a. planning the engagement,
- b. obtaining an understanding of internal control over financial reporting,
- c. testing and evaluating the elimination of a material weakness, including using the work of others, and
- d. forming an opinion on the elimination of a material weakness.

17. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing the elimination of a material weakness involves a process of gathering, updating, and analyzing information. Accordingly, the auditor may perform some of the procedures and evaluations described in this section on "Performing an Engagement To Report on the Elimination of a Material Weakness" concurrently.

RELEASE

18. The engagement to report on the elimination of a material weakness must be performed by a person or persons having adequate technical training and proficiency as an auditor. In all matters related to the assignment, an independence in mental attitude must be maintained. Due professional care must be exercised in the performance of the engagement and the preparation of the report. Paragraphs 30 through 36 of Auditing Standard No. 2 describe the application of these standards in the context of an internal control-related service.

19. This standard establishes the fieldwork and reporting standards applicable to an engagement to report on the elimination of a material weakness.

20. The concept of materiality, as discussed in paragraphs 22 and 23 of Auditing Standard No. 2, underlies the application of the general and fieldwork standards in an engagement to report on the elimination of a material weakness. Therefore, the auditor uses materiality at the financial-statement level, rather than at the individual account-balance level, in evaluating whether a material weakness exists.

Planning the Engagement

21. The auditor should properly plan the engagement to report on the elimination of a material weakness and should properly supervise any assistants. When planning the engagement to report on the elimination of a material weakness, the auditor should evaluate how the matters described in paragraph 39 of Auditing Standard No. 2 will affect the auditor's procedures.

Obtaining an Understanding of Internal Control over Financial Reporting

22. To perform an engagement to report on the elimination of a material weakness, the auditor must have a sufficient knowledge of the company and its internal control over financial reporting. An auditor who has audited the company's internal control over financial reporting within the past year in accordance with Auditing Standard No. 2 would be expected to have obtained a sufficient knowledge of the company and its internal control over financial reporting to perform an engagement to report on the elimination of a material weakness.

Note: The second sentence of paragraph 22 contemplates that the auditor's previous engagement under Auditing Standard No. 2 resulted in rendering an opinion. If an auditor previously engaged to perform an audit of internal control over financial reporting in accordance with Auditing Standard No. 2 has not yet rendered an opinion on the effectiveness of the company's internal control over

RELEASE

financial reporting, then that auditor should follow the requirements for a successor auditor in paragraphs 23 and 24, except paragraph 23c. Additionally, if an auditor has previously performed an audit of internal control over financial reporting at the company and is now a successor auditor (because another auditor has subsequently performed an audit of internal control over financial reporting at the company in intervening years), the auditor should follow the requirements in paragraphs 23 and 24 for a successor auditor.

23. When a successor auditor^{4/} performs an engagement to report on the elimination of a material weakness as his or her initial engagement, that auditor must perform procedures that will enable him or her to obtain sufficient knowledge of the company's business and its internal control over financial reporting to address the objective of the engagement, as described in paragraph 4. A successor auditor who has not yet completed an audit of internal control over financial reporting at the company must perform the following procedures as part of obtaining sufficient knowledge of the company's business and its internal control over financial reporting:

- a. Comply with paragraphs 47 through 51 of Auditing Standard No. 2 regarding obtaining an understanding of internal control over financial reporting. The extent of understanding of internal control over financial reporting needed to satisfy these requirements in the context of an engagement to report on the elimination of a material weakness depends on the nature of the material weakness on which the auditor is reporting. The more pervasive the effects of the material weakness, the more extensive the understanding of internal control over financial reporting should be under these requirements. For example, if the material weakness affects company-level controls, a more extensive understanding of internal control over financial reporting will be necessary than if the effects of the material weakness are isolated at the transaction level.
- b. Perform a walkthrough as described in paragraphs 79 through 82 of Auditing Standard No. 2 for all major classes of transactions that are directly affected by controls specifically identified by management as eliminating the material weakness.

^{4/} The term *successor auditor* has the same meaning as the definition of that term in paragraph .02 of AU sec. 315, *Communications Between Predecessor and Successor Auditors*.

RELEASE

Note: Some controls have only an indirect effect on a major class of transactions, such as certain controls in the control environment or risk assessment components of internal control over financial reporting.

- c. In addition to the communication requirements described in AU sec. 315, *Communications Between Predecessor and Successor Auditors*, the successor auditor should make specific inquiries of the predecessor auditor. These inquiries should address the basis for the predecessor auditor's determination that a material weakness existed in the company's internal control over financial reporting and the predecessor auditor's awareness of any information bearing on the company's ability to successfully eliminate that material weakness.

24. A successor auditor may determine that he or she needs to perform procedures in addition to those specified in paragraph 23 to obtain a sufficient knowledge of the company's business and its internal control over financial reporting. Depending on the nature of the company's business, its organization, its internal control over financial reporting, and the specific material weakness that is the subject of this engagement, a successor auditor may determine that he or she is not able to obtain a sufficient basis for reporting on the elimination of a material weakness without performing a complete audit of internal control over financial reporting in accordance with Auditing Standard No. 2.

Testing and Evaluating the Elimination of a Material Weakness

25. The auditor must obtain an understanding of and evaluate management's evidence supporting its assertion that the specified controls related to the material weakness are designed and operated effectively, that these controls achieve the company's stated control objective(s) consistent with the control criteria, and that the identified material weakness has been eliminated. If the auditor determines that management has not supported its assertion with sufficient evidence, the auditor cannot complete the engagement to report on the elimination of a material weakness, because one of the conditions for engagement completion described in paragraph 7 would not be met.

Note: Paragraphs 40 through 46 of Auditing Standard No. 2 apply to the auditor's evaluation of management's annual assessment of internal control over financial reporting and management's related documentation. The auditor may apply the relevant concepts described in that section to the evaluation of

RELEASE

management's evidence supporting management's assertion regarding the elimination of a material weakness.

26. As a part of evaluating management's evidence supporting its assertion, the auditor should determine whether management has selected an appropriate date for its assertion. In making this determination, the auditor should take into consideration the following:

- a. Management's assertion that a material weakness has been eliminated may be made as of any specified date that permits management to obtain sufficient evidence supporting its assertion.

Note: The auditor also should determine whether the specified date of management's assertion permits the auditor to obtain sufficient evidence supporting his or her opinion.

- b. Depending on the nature of the material weakness, the stated control objective, and the specified controls, the specified date of management's assertion may need to be after the completion of one or more period-end financial reporting processes.
- c. Controls that operate daily and on a continuous, or nearly continuous, basis generally permit the auditor to obtain sufficient evidence as to their operating effectiveness as of almost any date management might choose to specify in its report.
- d. Controls that operate over the company's period-end financial reporting process typically can be tested only in connection with a period-end.

27. The auditor should obtain evidence about the effectiveness of all controls specifically identified in management's assertion. The nature, timing, and extent of the testing that enables the auditor to obtain sufficient evidence supporting his or her opinion on the elimination of a material weakness will necessarily depend on both the nature of the controls specifically identified by management as meeting the company's stated control objectives and the date of management's assertion.

28. As part of testing and evaluating the design effectiveness of the specified controls, the auditor should determine whether the specified controls would meet the stated control objectives if they operated as designed. In making this evaluation, the auditor should apply paragraphs 88 through 91 of Auditing Standard No. 2.

RELEASE

29. Consistent with the direction in paragraph 92 of Auditing Standard No. 2, the auditor should evaluate the operating effectiveness of a specified control by determining whether the specified control operated as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. In determining the nature, timing, and extent of tests of controls, the auditor should apply paragraphs 93 through 102 and 105 through 107 of Auditing Standard No. 2.

30. The auditor should apply paragraph 98 of Auditing Standard No. 2 regarding an adequate period of time to determine the operating effectiveness of a control in the context of an engagement to report on the elimination of a material weakness. Paragraph 98 of Auditing Standard No. 2 states (in part):

The auditor must perform tests of controls over a period of time that is adequate to determine whether, as of the date specified in management's report, the controls necessary for achieving the objectives of the control criteria are operating effectively. The period of time over which the auditor performs tests of controls varies with the nature of the controls being tested and with the frequency with which specific controls operate and specific policies are applied.

For example, a transaction-based daily reconciliation generally would permit the auditor to obtain sufficient evidence as to its operating effectiveness in a shorter period of time than a pervasive, company-level control, such as any of those described in paragraphs 52 and 53 of Auditing Standard No. 2.

31. Depending on the nature of the material weakness, 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.

32. When the specified controls, stated control objectives, and material weakness affect multiple locations or business units of the company, the auditor may apply the relevant concepts in paragraphs B1 through B13 of Appendix B of Auditing Standard No. 2 to determine the locations or business units at which to perform procedures.

RELEASE

Using the Work of Others

33. The auditor should evaluate whether to use the work performed by others in an engagement to report on the elimination of a material weakness. To determine the extent to which the auditor may use the work of others to alter the nature, timing, or extent of the work the auditor would otherwise have performed, the auditor should apply paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2.

34. The auditor's opinion relates to the company's elimination of a material weakness because the stated control objectives are met. Therefore, if the auditor has been engaged to report on more than one material weakness or on more than one stated control objective, the auditor must evaluate whether he or she has obtained the principal evidence for the opinion on each material weakness and stated control objective identified in management's assertion. The auditor may, however, use the work of others to alter the nature, timing, or extent of the work he or she otherwise would have performed. For these purposes, the work of others includes relevant work performed by internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides information about the effectiveness of internal control over financial reporting.

35. Paragraph 122 of Auditing Standard No. 2 should be applied in the context of the engagement to report on the elimination of a material weakness. Paragraph 122 states, in part, "As the significance of the factors listed in paragraph 112 increases, the ability of the auditor to use the work of others decreases at the same time that the necessary level of competence and objectivity of those who perform the work increases." Because the scope of an engagement to report on the elimination of a material weakness is more narrowly focused than an audit of the effectiveness of internal control over financial reporting overall, each of the controls identified in an engagement to report on the elimination of a material weakness is significant to the engagement. Additionally, the auditor should perform any walkthroughs himself or herself because of the degree of judgment required in performing this work.

36. The following example illustrates how to apply this section on using the work of others to an engagement to report on the elimination of a material weakness.

In this example, the company's previously reported material weakness relates to the company's failure to perform bank reconciliations at its 50 subsidiaries. The specified controls identified by the company are the timely preparation of complete and accurate reconciliations between the company's recorded cash balances and the company's cash balances as reported by its financial institution.

RELEASE

Although certain of the controls over bank reconciliations are centralized, the performance of the bank reconciliations themselves is not centralized because they occur at each individual operating unit. Further, each operating unit has, on average, three separate cash accounts. The cash accounts affected are not material individually but are material in the aggregate. Most of the controls over the preparation of bank reconciliations involve a low degree of judgment in evaluating their operating effectiveness, can be subjected to objective testing, and have a low potential for management override.

If these conditions describe the specified controls over the preparation of bank reconciliations, the auditor could determine that, based on the nature of the controls as described above, he or she could use the work of others to a moderate extent, provided that the degree of competence and objectivity of the individuals performing the tests is high. The auditor might perform a walkthrough of the reconciliation process himself or herself; perform testing at a limited number of locations himself or herself; test the work of others performed at a limited number of other locations; review the results of the work of others at all other locations tested; and determine that, qualitatively and quantitatively, principal evidence had been obtained.

On the other hand, if the company's previously reported material weakness related to the company's failure to perform a reconciliation of its only cash account, few controls and few operations of those controls would underlie management's assertion that the material weakness had been eliminated. In this circumstance, it is unlikely that the auditor would be able to use a significant amount of the work of others because of the limited scope of the total amount of work needed to test management's assertion and the requirement that the auditor obtain the principal evidence himself or herself.

Note: The examples provided in paragraph 126 of Auditing Standard No. 2 illustrate how to apply the requirements in Auditing Standard No. 2 regarding using the work of others in an audit of internal control over financial reporting. Because of the differences between the auditor obtaining the principal evidence supporting an opinion on the effectiveness of internal control over financial reporting overall and obtaining the principal evidence supporting an opinion on the much narrower subject of the elimination of a specified material weakness in internal control over financial reporting, the examples in Auditing Standard No. 2 may not illustrate the appropriate application of using the work of

RELEASE

others in an engagement to report on the elimination of a material weakness. For example, the examples in paragraph 126 of Auditing Standard No. 2 suggest that, for certain controls, the auditor could potentially use the work of others in its entirety. Although this frequently could be appropriate in the context of gathering evidence regarding the effectiveness of internal control over financial reporting overall, in most cases, the auditor could not use the work of others in its entirety for any given control specified in management's assertion regarding the elimination of a material weakness and, at the same time, obtain the principal evidence supporting his or her opinion. As another example, Auditing Standard No. 2 describes an example of appropriately alternating tests of controls. Alternating tests of controls applies in the context of a recurring engagement, which is not the context for the auditor's reporting on the elimination of a material weakness.

37. *Opinions, based in part, on the report of another auditor.* The auditor may apply the relevant concepts in AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, in an engagement to report on the elimination of a material weakness, with the following exception. If the auditor decides to serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion, the principal auditor must not divide responsibility for the engagement with the other auditor. Therefore, the principal auditor must not make reference to the other auditor in his or her report.

Forming an Opinion on the Elimination of a Material Weakness

38. When forming an opinion on the elimination of a material weakness, the auditor should evaluate all evidence obtained from all sources. This process should include an evaluation of the sufficiency of the evidence obtained by management and the results of the auditor's evaluation of the design and operating effectiveness of the specified controls.

39. The auditor may issue an unqualified opinion only when he or she concludes that the identified material weakness has been eliminated and when there have been no restrictions on the scope of the auditor's work. Because of the scope of an engagement to report on the elimination of a material weakness, any limitations on the scope of the auditor's work require the auditor either to disclaim an opinion or to withdraw from the engagement (see paragraph 51).

RELEASE

Requirement for Written Representations

40. In an engagement to report on the elimination of a material weakness, the auditor should obtain written representations from management:

- a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;
- b. Stating that management has evaluated the effectiveness of the specified controls using the specified control criteria and its stated control objective(s);
- c. Stating management's assertion that the specified controls are effective in achieving the stated control objective(s) as of a specified date;
- d. Stating management's assertion that the identified material weakness has been eliminated as of the same specified date;
- e. Stating that management believes that its assertions are supported by sufficient evidence;
- f. Describing any material fraud and any other fraud that, although not material, involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting; and
- g. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect the stated control objective(s) or the identified controls.

41. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the engagement. As discussed further in paragraph 51, if there is a limitation on the scope of an engagement to report on the elimination of a material weakness, the auditor must either disclaim an opinion or withdraw from the engagement. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations of management, including, if applicable, representations obtained in an audit of the company's financial statements.

RELEASE

42. AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updating letter.

Documentation Requirements

43. The documentation requirements in Auditing Standard No. 3 are modified in the following respect as they apply to this engagement. Paragraph 14 of Auditing Standard No. 3 defines the *report release date* as the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements. As described in paragraph 26 of this standard, management's assertion that a material weakness has been eliminated may be made as of a date other than a period-end financial reporting date. Therefore, the auditor's release of a report on the elimination of a material weakness may not necessarily be associated with the issuance of financial statements of the company. Accordingly, in an engagement to report on the elimination of a material weakness, the report release date for purposes of applying Auditing Standard No. 3 is the date the auditor grants permission to use the auditor's report on the elimination of a material weakness.

Reporting on the Elimination of a Material Weakness

Management's Report

44. As a condition for the auditor's performance of this voluntary engagement, management is required to present a written report that will accompany the auditor's report, as described in paragraph 7e. To satisfy this condition for the auditor's performance of this engagement, management's report should include:

- a. A statement of management's responsibility for establishing and maintaining effective internal control over financial reporting for the company;
- b. A statement identifying the control criteria used by management to conduct the required annual assessment of the effectiveness of the company's internal control over financial reporting;
- c. An identification of the material weakness that was identified as part of management's annual assessment;

RELEASE

Note: This report element should be modified in the case in which management's annual assessment did not identify the material weakness, but, rather, only the auditor's report on management's annual assessment identified the material weakness.

- d. An identification of the control objective(s) addressed by the implementation or modification of specified controls and a statement that the specified controls achieve the stated control objective(s) as of a specified date; and
- e. A statement that the identified material weakness has been eliminated by the implementation of the specified controls as of the same specified date.

Auditor's Evaluation of Management's Report

45. With respect to management's report, the auditor should evaluate the following matters:

- a. Whether management has properly stated its responsibility for establishing and maintaining effective internal control over financial reporting;
- b. Whether the control criteria used by management to conduct the evaluation is suitable;
- c. Whether the material weakness, stated control objectives, and specified controls have been properly described; and
- d. Whether management's assertions, as of the date specified in management's report, are free of material misstatement.

46. If, based on the results of this evaluation, the auditor determines that management's report does not include the elements described in paragraph 44, the conditions for engagement performance have not been met.

Auditor's Report

47. The auditor's report on the elimination of a material weakness must include the following elements:

- a. A title that includes the word *independent*;

RELEASE

- b. A statement that the auditor has previously audited and reported on management's annual assessment of internal control over financial reporting as of a specified date based on the control criteria, as well as a statement that the auditor's report identified a material weakness;

Note: This report element should be modified in cases in which a successor auditor's performance of this engagement is his or her initial engagement. In this circumstance, the auditor's report should refer to management's annual assessment and management's identification of the material weakness or, if necessary, to the predecessor auditor's report on management's annual assessment and the predecessor auditor's identification of the material weakness if it was not identified in management's annual assessment.

- c. A description of the material weakness;
- d. An identification of management's assertion that it has eliminated the identified material weakness in internal control over financial reporting;
- e. An identification of the title of the management report that includes management's assertion;
- f. A statement that management is responsible for its assertion;
- g. An identification of the specific controls that management asserts eliminate the material weakness;
- h. An identification of the company's stated control objective that is achieved by these controls;
- i. A statement that the auditor's responsibility is to express an opinion on the elimination of the material weakness based on his or her auditing procedures;
- j. A statement that the engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

RELEASE

- k. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the engagement to obtain reasonable assurance about whether the company has eliminated a previously reported material weakness;
- l. A statement that the engagement includes obtaining an understanding of internal control over financial reporting, examining evidence supporting management's assertion, and performing such other procedures as the auditor considered necessary in the circumstances;
- m. A statement that the auditor believes the auditing procedures provide a reasonable basis for his or her opinion;
- n. The auditor's opinion on whether the identified material weakness has been eliminated as of the date of management's assertion because the stated control objective is met as of the date of management's assertion;
- o. A paragraph that includes the following statements:
 - That the auditor was not engaged to and did not conduct an audit of internal control over financial reporting as of the date of management's assertion, the objective of which would be the expression of an opinion on the effectiveness of internal control over financial reporting, and that the auditor does not express such an opinion, and
 - That the auditor has not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company as of any date after the date of management's annual assessment of the company's internal control over financial reporting, other than the controls specifically identified in the auditor's report, and that the auditor does not express an opinion that any other controls operated effectively after the date of management's annual assessment of the company's internal control over financial reporting.

Note: This report element statement should be modified in the case in which a successor auditor's performance of this engagement is his or her initial engagement to read as follows: That the auditor has not, in this engagement,

RELEASE

applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company other than the controls specifically identified in the auditor's report and that the auditor does not express an opinion that any other controls operated effectively.

- p. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;
- q. The manual or printed signature of the auditor's firm;
- r. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and
- s. The date of the auditor's report.

48. Example A-1 in Appendix A is an illustrative auditor's report for an unqualified opinion on the elimination of a material weakness.

49. As stated in paragraph 2, the auditor may report on the elimination of more than one material weakness as part of the same engagement. In this circumstance, the auditor should modify the report elements described in paragraph 47 accordingly.

50. *Report Modifications.* The auditor should modify the standard report if any of the following conditions exist.

- a. Other material weaknesses that were reported previously by the company as part of the company's annual assessment of internal control are not addressed by the auditor's opinion. (See paragraph 52.)
- b. The specified material weakness has not been eliminated. (See paragraphs 53 and 54.)
- c. A significant subsequent event has occurred since the date being reported on. (See paragraphs 55 and 56.)

RELEASE

- d. There is additional information contained in management's report on the elimination of a material weakness. (See paragraphs 57 and 58.)

51. As described further in the following sections, the form of the auditor's opinion resulting from an engagement to report on the elimination of a material weakness may be unqualified or adverse, or it may be in the form of a disclaimer of opinion. A qualified opinion is not permitted. As discussed in paragraph 39, any limitations on the scope of the auditor's work preclude the expression of an opinion. In addition to these reporting alternatives, an auditor may elect not to report on the elimination of a material weakness and, instead, withdraw from the engagement.

52. *Other material weaknesses reported previously by the company as part of the company's annual assessment of internal control are not addressed by the auditor's opinion.* In the circumstance in which the company previously has reported more than one material weakness, the auditor may be engaged to report on the elimination of any or all of the material weaknesses. If the auditor reports on fewer than all of the previously reported material weaknesses, the auditor should include the following or similar language in the paragraph that states that the auditor was not engaged to perform an audit of internal control over financial reporting:

Our report on management's annual assessment of XYZ Company's internal control over financial reporting, dated [*date of report*], identified additional material weaknesses other than the one identified in this report. We are not reporting on whether those other material weaknesses have been eliminated and, accordingly, express no opinion regarding whether those material weaknesses exist after [*date of management's annual assessment, e.g., December 31, 200X*]. [*Revise this wording appropriately for use in a successor auditor's report.*]

53. *Material weakness not eliminated.* If the auditor determines that the material weakness has not been eliminated and the auditor reports on the results of the engagement to report on the elimination of a material weakness, he or she must express an adverse opinion on the company's elimination of the material weakness. In the circumstance in which the auditor determines that the material weakness has not been eliminated, the auditor is not required to issue a report. If the auditor does not issue a report in this circumstance, the auditor must communicate, in writing, his or her conclusion that the material weakness has not been eliminated to the audit committee. Additionally, the auditor must consider that conclusion as part of his or her evaluation of

RELEASE

management's quarterly disclosures about internal control over financial reporting, as described in paragraphs 204 and 205 of Auditing Standard No. 2.

54. For example, if the auditor were engaged to report on the elimination of two separate material weaknesses and concluded that one had been eliminated and one had not, the auditor's report could comprise either of the following: (1) a report that contained one unqualified opinion on the elimination of the material weakness that the auditor concluded had been eliminated and one adverse opinion on the elimination of the weakness that the auditor concluded had not been eliminated or (2) a report that contained only a single unqualified opinion on the elimination of the material weakness that the auditor concluded had been eliminated if the company modified its assertion to address only the material weakness that the auditor concluded had been eliminated. In this second circumstance, the auditor must communicate, in writing, his or her conclusion that a material weakness has not been eliminated to the audit committee and also should apply paragraph 52 regarding other material weaknesses disclosed previously that are not addressed by the auditor's opinion. Additionally, the auditor must consider that conclusion as part of his or her evaluation of management's quarterly disclosures about internal control over financial reporting, as described in paragraphs 204 and 205 of Auditing Standard No. 2.

55. *Subsequent events.* A change in internal control over financial reporting or other factors that might significantly affect the effectiveness of the identified controls or the achievement of the company's stated control objective might occur subsequent to the date of management's assertion but before the date of the auditor's report. Therefore, the auditor should inquire of management whether there was any such change or factors. As described in paragraph 40, the auditor should obtain written representations from management regarding such matters. Additionally, to obtain information about whether such a change has occurred that might affect the effectiveness of the identified controls or the achievement of the company's stated control objective and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following:

- Internal audit reports (or similar functions, such as loan review in a financial institution) relevant to the stated control objective or identified controls issued during the subsequent period;
- Independent auditor reports (if other than the auditor's) of significant deficiencies or material weaknesses;

RELEASE

- Regulatory agency reports on the company's internal control over financial reporting; and
- Information about the effectiveness of the company's internal control over financial reporting obtained as a result of other engagements.

56. If the auditor obtains knowledge about subsequent events that he or she believes adversely affect the effectiveness of the identified controls or the achievement of the stated control objective as of the date specified in management's assertion, the auditor should follow the requirements in paragraph 53 regarding a material weakness that has not been eliminated. If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the identified controls or the achievement of the stated control objective, the auditor should disclaim an opinion.

57. *Management's report containing additional information.* If management's report includes information in addition to the matters described in paragraph 44, the auditor should disclaim an opinion on the additional information. For example, the auditor should use the following or similar language as the last paragraph of the report to disclaim an opinion on management's plans to implement new controls:

We do not express an opinion or any other form of assurance on management's statement referring to its plans to implement new controls by the end of the year.

58. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information.

Note: If management makes the types of disclosures described in paragraph 57 outside its report on the elimination of a material weakness and includes them elsewhere within a document that contains management's and the auditor's reports on the elimination of a material weakness, the auditor would not need to disclaim an opinion, as described in paragraph 57. However, in that situation, the auditor's responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

RELEASE

Effective Date

59. This standard is effective [insert date of SEC approval].

RELEASE

Appendix A – Illustrative Report on the Elimination of a Material Weakness

Paragraphs 47 through 58 of this standard provide direction on the auditor's report on the elimination of a material weakness. The following example illustrates how to apply those paragraphs.

Example A-1—Illustrative Auditor's Report Expressing an Unqualified Opinion on the Elimination of a Material Weakness

Report of Independent Registered Public Accounting Firm

We have previously audited and reported on management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X based on *[Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."]*. Our report, dated *[date of report]*, identified the following material weakness in the Company's internal control over financial reporting:

[Describe material weakness]

We have applied auditing procedures to management's assertion, included in the accompanying *[title of management's report]*, that management has eliminated the material weakness in internal control over financial reporting identified above by implementing the following control(s):

[Describe control(s) implemented]

Management has asserted that the control(s) identified above eliminates the material weakness in internal control over financial reporting identified above because the control(s) achieves the following stated control objective, which is consistent with the criteria established in *[identify control criteria used for management's annual assessment of internal control over financial reporting]*: *[state control objective addressed]*. Management also has asserted that it has tested the control(s) identified above and concluded that the control(s) was designed and operated effectively as of *[date of management's assertion]*. XYZ Company's management is responsible for its assertion. Our responsibility is to express an opinion on the elimination of the material weakness based on our auditing procedures.

RELEASE

Our engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the engagement to obtain reasonable assurance about whether the company has eliminated a previously reported material weakness. Our engagement included obtaining an understanding of internal control over financial reporting, examining evidence supporting management's assertion, and performing such other procedures as we considered necessary in the circumstances. We believe that our auditing procedures provide a reasonable basis for our opinion.

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]*.

We were not engaged to and did not conduct an audit of internal control over financial reporting as of *[date of management's assertion]*, the objective of which would be the expression of an opinion on the effectiveness of internal control over financial reporting. Accordingly, we do not express such an opinion. This means that we have not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company as of any date after December 31, 200X, other than the control(s) specifically identified in this report. Accordingly, we do not express an opinion that any other controls operated effectively after December 31, 200X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

[Signature]
[City and State or Country]
[Date]

RELEASE

APPENDIX 2

Conforming Amendments to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Proposed Auditing Standard – Reporting on the Elimination of a Material Weakness

Attestation Standards

The Board's interim attestation standards include the Statements on Standards for Attestation Engagements promulgated by the ASB, as in existence on April 16, 2003.^{15/} The proposed conforming amendment to the Board's interim attestation standards is as follows:

– *AT sec. 101, Attest Engagements*

AT sec. 101 would be amended by adding as letter f. to paragraph .04, the following:

Engagements in which the practitioner is engaged to report on the elimination of a material weakness. Such engagements must be conducted pursuant to PCAOB Auditing Standard No. xx, *Reporting on the Elimination of a Material Weakness*.

^{15/} The Statements on Standards for Attestation Engagements are codified into the AICPA *Professional Standards*, vol. 1, as AT sections 101 through 701, and are available on the Board's Web site at <http://www.pcaobus.org>.